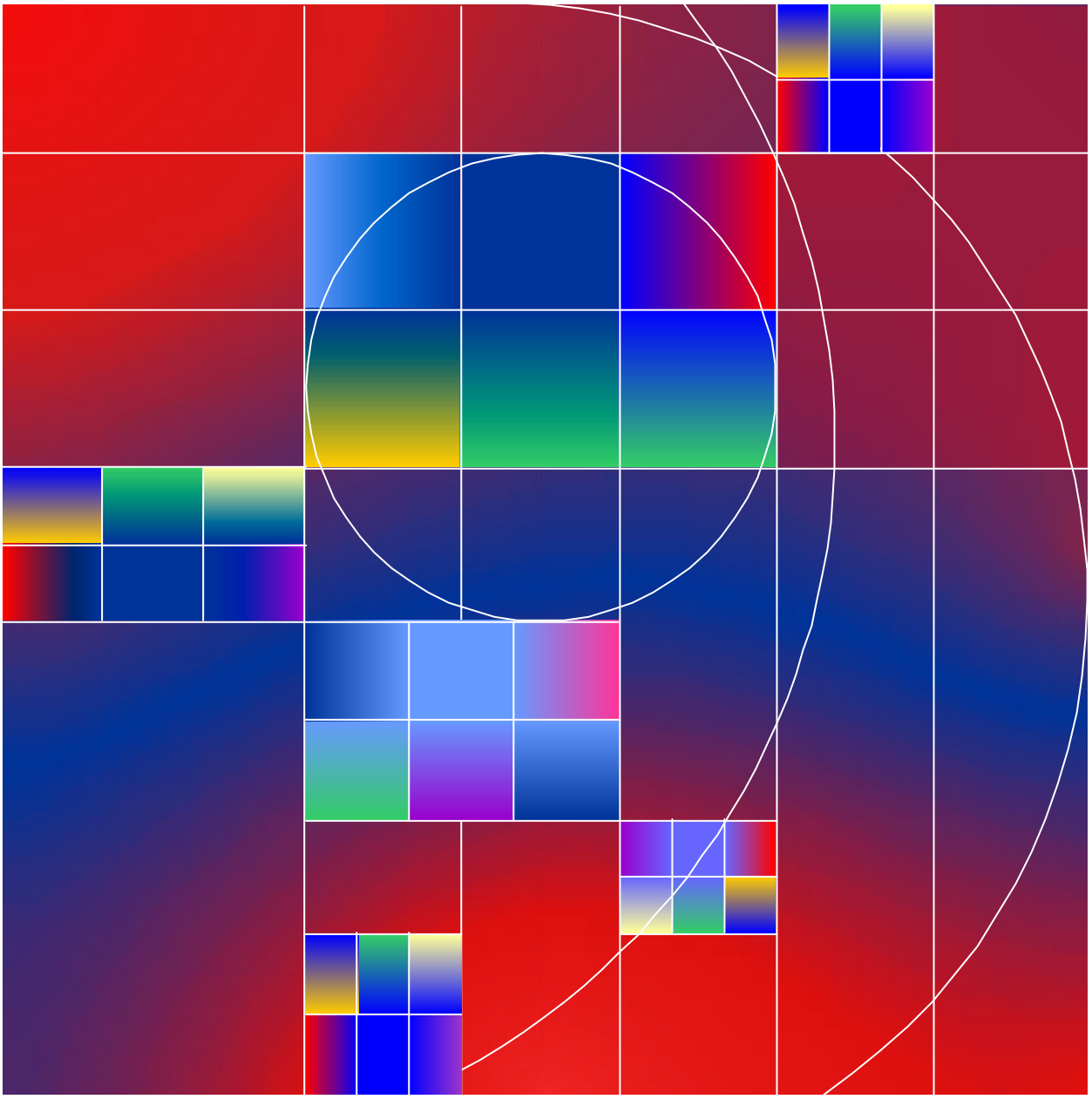
UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

TRADE AND DEVELOPMENT REPORT, 1998

FinancialInstability

Growth in Africa

UNITED NATIONS



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FOREWORD

The 1998 *Trade and Development Report* examines current performance and prospects in the world economy with special reference to the financial turmoil which has challenged policymakers everywhere over the past year. In accordance with the request made to me in General Assembly resolution 52/180 of 4 December 1997, concerning the analysis of current trends in global financial flows and ways and means of addressing their volatility, the *Report* assesses the causes of the current crisis and its consequences, particularly for developing countries, and puts forward recommendations on how future crises might be prevented.

East Asia now confronts problems of rising poverty and unemployment which decades of policy efforts and rapid economic growth had seemingly solved. Africa has been struggling with problems of underdevelopment and poverty for more than two decades. Despite some recent encouraging trends, the continued economic marginalization of Africa remains one of the most pressing concerns of the international community. This *Report* calls for a rethinking of policies at both the international and the national level aimed at bringing about a faster pace of investment and growth in Africa. It takes a fresh look at the question of debt relief, draws particular attention to underinvestment in agriculture, and explores possible ways of diversifying production and exports.

The United Nations system is pursuing a new dialogue with African policymakers, and individual governments are adopting new initiatives. It is hoped that the analysis offered in this *Report* will advance that dialogue in ways which can bring new hope to the continent.

Kofi A. Annan
Secretary-General of the United Nations

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Explanatory notes

Classification by country or commodity group

The classification of countries in this Report generally follows that of the UNCTAD *Handbook of International Trade and Development Statistics 1995*.[1] It has been adopted solely for the purposes of statistical or analytical convenience and does not necessarily imply any judgement concerning the stage of development of a particular country or area. As noted in the Foreword to the *Handbook*, the classification differs from that used previously, in particular as regards regional and total aggregates for developing countries.

The term "country" refers, as appropriate, also to territories or areas.

References to "Latin America" in the text or tables include the Caribbean countries unless otherwise indicated.

Unless otherwise stated, the classification by commodity group used in this Report follows generally that employed in the *Handbook of International Trade and Development Statistics 1995*.

Other notes

References in the text to *TDR* are to the *Trade and Development Report* (of a particular year). For example, *TDR 1997* refers to *Trade and Development Report, 1997* (United Nations publication, Sales No. E.97.II.D.8).

The term "dollar" ($) refers to United States dollars, unless otherwise stated.

The term "billion" signifies 1,000 million.

The term "tons" refers to metric tons.

Annual rates of growth and change refer to compound rates.

Exports are valued f.o.b. and imports c.i.f., unless otherwise specified.

Use of a hyphen (-) between dates representing years, e.g. 1988-1990, signifies the full period involved, including the initial and final years.

An oblique stroke (/) between two years, e.g. 1990/91, signifies a fiscal or crop year.

Two dots (..) indicate that the data are not available, or are not separately reported.

A dash (-) or a zero (0) indicates that the amount is nil or negligible.

A dot (.) indicates that the item is not applicable.

A plus sign (+) before a figure indicates an increase; a minus sign (-) before a figure indicates a decrease.

Details and percentages do not necessarily add to totals because of rounding.

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[1] United Nations publication, Sales No.E/F.97.II.D.7.

Abbreviations

ACP	African, Caribbean and Pacific (group of States)
ACU	Asian Currency Unit
ASEAN	Association of South-East Asian Nations
BIBF	Bangkok International Banking Facility
BIS	Bank for International Settlements
CEPAL	Economic Commission for Latin America and the Caribbean (Comisión Económica para América Latina y el Caribe)
CEPR	Centre for Economic Policy Research (London)
CFA	Communauté financière africaine (franc zone)
CIS	Commonwealth of Independent States
c.i.f.	cost, insurance and freight
DAC	Development Assistance Committee (of OECD)
EC	European Community (or Communities)
ECA	Economic Commission for Africa
ECAs	export credit agencies
ECE	Economic Commission for Europe
ECLAC	Economic Commission for Latin America and the Caribbean
ECU	European currency unit
EEC	European Economic Community
EMS	European Monetary System
EMU	Economic and Monetary Union
ERM	Exchange Rate Mechanism of EMS
ESAF	Enhanced Structural Adjustment Facility (of IMF)
ESCAP	Economic and Social Commission for Asia and the Pacific
EU	European Union
FAO	Food and Agriculture Organization of the United Nations
FDI	foreign direct investment
f.o.b.	free on board
FY	fiscal year
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
GNP	gross national product
GSP	generalized system of preferences
HIPCs	heavily indebted poor countries
IBF	international banking facilities
IBRA	Indonesian Bank Restructuring Agency
IBRD	International Bank for Reconstruction and Development (World Bank)
ICIC	International Credit Insurance Corporation
ICP	International Comparison Project
IDA	International Development Association
IDB	Inter-American Development Bank
IFAD	International Fund for Agricultural Development
IFC	International Finance Corporation
IFI	international financial institution
ILO	International Labour Organisation
IMF	International Monetary Fund

IOSCO	International Organization of Securities Commissions
ISI	import-substitution industrialization
LDC	least developed country
LIBOR	London Interbank Offered Rate
MBs	marketing boards
MERCOSUR	Southern Cone Common Market
MFA	Multi-Fibre Arrangement
MFN	most favoured nation
MIGA	Multilateral Investment Guarantee Agency
MTAs	Multilateral Trade Agreements
MVA	manufacturing value added
NAFTA	North American Free Trade Agreement (Canada-United States-Mexico)
NBER	National Bureau of Economic Research (United States)
NGO	non-governmental organization
NIEs	newly industrializing economies
NIESR	National Institute of Economic and Social Research (London)
NPC	nominal protection coefficient
NRI	Nomura Research Institute (Tokyo)
NTMs	non-tariff measures
ODA	official development assistance
OECD	Organisation for Economic Cooperation and Development
OPEC	Organization of the Petroleum Exporting Countries
PORIM	Palm Oil Research Institute of Malaysia
PPP	purchasing power parity
R&D	research and development
S&Ls	savings and loan associations
SACU	South African Customs Union
SADC	Southern African Development Community
SAF	Structural Adjustment Facility
SAP	Structural Adjustment Programme
SDDS	Special Data Dissemination Standard
SDR	special drawing right
SELA	Sistema Económica Latino-Americana
SITC	Standard International Trade Classification
SSA	sub-Saharan Africa
STFF	short-term financing facility
TNCs	transnational corporations
TRIMs	trade-related investment measures
TRIPs	trade-related intellectual property rights
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNIDO	United Nations Industrial Development Organization
UNU	United Nations University
VAT	value-added tax
WIDER	World Institute for Development Economics Research
WIPO	World Intellectual Property Organization
WTO	World Trade Organization

OVERVIEW

"The ascendancy of finance over industry together with the globalization of finance have become underlying sources of instability and unpredictability in the world economy. Financial markets have for some time had an independent capacity to destabilize developing countries; there are now increasing indications of the vulnerability of all countries to financial crisis. The evidence indicates that the costs of financial liberalization and deregulation can be quite high ... Overall, there appears to be a need for more collective control and guidance over international finance."

"Disruptions and disorder in such markets have so far been contained in that they have not led to crises with serious and widespread damage for the real economy. However, the crisis management has been costly. ... More important, so long as the international monetary and financial system remains structurally vulnerable, the potential for an extremely costly crisis will remain."

These passages were written in TDR 1990. Warnings fell on deaf ears. Since then the world economy has witnessed further bouts of financial instability at roughly two-yearly intervals. First, there was debt deflation in the United States, followed by the EMS crisis in Europe in 1992-1993; that crisis was followed by the Mexican crisis of 1994-1995, and most recently by the East Asian crisis of 1997-1998. Each time, the prevailing approaches have been based on the notion of the infallibility of markets and on an explanation of the crisis in terms of misguided domestic policies. Turning a blind eye to the systemic nature of financial instability is neither responsible nor acceptable.

As financial markets expand and integration deepens, each episode of crisis comes with greater force, inflicting greater damage on the real economy. The cost of the crisis in East Asia is about 1 per cent of global output this year alone, or some $260 billion, equivalent to the annual income of sub-Saharan Africa. Prospects for the years ahead are extremely uncertain, but the risks are on the downside. Further policy errors might well drive the world economy into a deep recession.

International financial instability and the world economy

For some time the UNCTAD secretariat has maintained that the world economy needs to grow by at least 3 per cent, year in, year out, if a dent is to be made in unemployment in industrialized countries and poverty in developing countries. Most countries in the South need to grow at twice this rate if they are to overcome their social and technological handicaps and close the income gap with the small club of rich industrial economies. During the 1990s this 3 per cent target has been reached only in 1996-1997, thanks to recovery in Latin America and Africa and continued strong growth in East Asia and the United States.

Last year's *Trade and Development Report* argued that international financial instability constituted the single most important impediment to attaining steady and rapid growth. Modern financial markets are organized less to create wealth and employment than to extract rent by buying and selling second-hand assets, and the "discipline" these markets exert on policymakers reinforces the advantages of existing wealth holders. The *Report* came out once more against "big-bang" financial liberalization in developing countries, pointing out that successful examples of modern industrialization and development distinguished themselves by the ways they managed integration into the global economy.

The dramatic turnaround in the economic fortunes of the East Asian economies leaves this conclusion unshaken. Contrary to the tenets of financial orthodoxy, the problems of those countries do not stem from resistance to a globalizing world and the discipline of global market forces. Rather, the crisis occurred because governments failed to manage integration into global capital markets with the same prudence and skill they had earlier shown in managing trade liberalization. Throwing caution to the wind, the voices of orthodoxy ordained even larger doses of financial liberalization.

The speed at which some of the most successful developing countries in East Asia have been derailed by volatile financial flows has taken the international community by surprise. During the annual meetings of the Bretton Woods institutions in Hong Kong, China, in September 1997, it was generally held that the ongoing disturbances were no more than a blip and would cause only a temporary slowdown of growth in the region. The IMF indicated that it expected growth to accelerate in 1998 in Thailand, and to remain broadly unchanged in other countries of the region. Even in its *Interim Assessment* of December 1997, the Republic of Korea and the countries of ASEAN, with the exception of Thailand, were expected to register positive growth in 1998. Since then, estimates have been constantly lowered, both for the region and for the world economy as a whole, as the promises of the policies adopted in response to the crisis failed to be fulfilled.

Countries that year after year enjoyed growth rates of 8-10 per cent per annum, maintained full employment and went a long way towards eradicating poverty are now suffering a severe economic contraction. Output is projected to decline for 1998 as a whole by at least 12 per cent in Indonesia and by 6-8 per cent in the Republic of Korea and Thailand. With the exception of China and its Taiwan Province, no country in the region can expect to register satisfactory growth this year. Expectations of a quick recovery have had to be pushed back several years into the future.

Clearly, and although there are no simple remedies, the international community has yet to learn how to manage such turmoil, let alone prevent it. Indeed, the international policy response has contributed to the severity of the crisis by failing to appreciate the full gravity of the situation, and by placing too much faith in conventional policy prescriptions. While the rash of bank closures under-

mined confidence throughout East Asia, the hike in interest rates failed to restore it. Rather, while unsuccessful in stopping the downward spiral in exchange rates, high interest rates added to the woes of debtors, forcing them to cut down on their activity and liquidate assets, while economies were driven into deep recession. Nor was confidence helped by official pronouncements on the alleged structural weaknesses of the economies in crisis. External financing was used not to support the domestic currency and stop the exchange rate losses of unhedged debtors, but to maintain convertibility and free capital flows. The credit crunch has bitten so deep that, despite favourable exchange rates, exports have stagnated or fallen as access to trade credit was drastically curtailed.

A strategy of introducing a standstill and bringing borrowers and lenders together with a view to rescheduling debt before committing external funds did not find favour, apparently for fear that the crisis would spread. But the course chosen did not prevent contagion. Rather, it precipitated the translation of what was initially a liquidity crisis into a solvency crisis, leaving behind a large stock of debt, part of which now appears to be unpayable.

A few lessons are now evident. First, the worst time to "reform" a financial system is in the middle of a crisis. Second, when currency turmoil is associated with financial difficulties, raising interest rates over an extended period may simply worsen the situation by bringing about widespread corporate and bank insolvencies. Finally, currencies should not be left to sink while funds are used to bail out the international creditors.

The events of the past year should serve to underline the warning in last year's *Trade and Development Report* of a potential backlash against the contradictions of a globalizing world. When a colossal global market failure and measures taken to bail out creditors are paid for at the expense of the living standards of ordinary people, and of stability and development in the debtor developing countries concerned, who is to say that justice has been served?

In East Asia the trend of decades of rising incomes has been reversed, and unemployment, underemployment and poverty are reaching alarming levels. Many of the lost jobs have been in sectors that had helped to reduce poverty by absorbing low-skilled workers from the countryside. Rising food prices and falling social expenditures have further aggravated social conditions and contributed to growing poverty. Even on conservative estimates, the proportion of the Indonesian population living on incomes below the poverty line in 1998 is expected to be at least 50 per cent greater than in 1996. Similarly, poverty in Thailand can be expected to increase by at least one third.

As the crisis drags on, it will be increasingly difficult for the new poor to recover from deprivation and return to their previous occupations and living standards. Moreover, the social harm could persist long after economic recovery is achieved. Judging from the mounting evidence of growing child malnutrition and declining primary school enrolments, the impact of the crisis on human resources will spill over into future generations.

Safety net measures can act as palliatives to cushion the impact of the crisis on poor and vulnerable groups, but they are in no way a lasting solution. Only the resumption of rapid and sustained growth can bring unemployment and poverty levels back down to pre-crisis levels. Policy should turn from deflation to reflation, supporting the unemployed by lowering interest rates, expanding liquidity and raising public expenditure, thus breaking out of a vicious circle that could do incalculable harm.

Global ramifications

The consequences of the East Asian crisis for global growth and development will depend on the course taken by international trade and capital flows. A precise assessment is difficult, not only because of the complexities of global interdependence, but also because of the fickle nature of financial market sentiments, and uncertainties regarding policy response in other countries. However, the deflationary impact of the crisis is proving deeper than initially expected. Current projections for

1998 suggest a drop of at least one percentage point (at market exchange rates) in world output growth from the rate reached in 1997.

The revisions to estimated GDP growth have been more substantial for developing than for developed countries. Growth in developing countries in 1998 is expected to be half that of 1997, falling to less than 2.5 per cent. In view of the bleak prospects for recovery in East Asia, the tendency noted in *TDR 1997* for the income gap between North and South to widen can be expected to continue. For the first time for many years, growth in the developing world, excluding China, will fall below that of the developed world. Even in China it is unlikely to exceed 6 per cent, which would be only about one half of the average rate achieved since the beginning of the decade.

Developing countries are trapped in a corner. To lessen the risk of contagion, many emerging markets have introduced pre-emptive monetary and fiscal restrictions in an attempt to maintain market confidence and to reduce their vulnerability to a reversal of capital flows. In so doing they have choked domestic demand and lowered growth prospects still further.

According to current projections by some financial institutions no significant declines are expected in capital flows to emerging markets in Latin America and Eastern Europe. Nevertheless, it is notable that the spreads on bonds of such emerging markets that went up sharply last autumn have not come down significantly. Many emerging-market currencies are now trading at all-time lows against the dollar, despite hikes in domestic interest rates. The fruits of the hard work of the developing world, both assets and goods, are now going for a song. But they may decline even further in value before the appetite for risk of global investors returns. Flight to safety appears to underline much of the recent boom in bond prices and the continued stock market rally in the United States.

Since East Asia accounts for a quarter of world trade, much of the global impact of the crisis will be transmitted through changes in trade flows. The impact will depend primarily on what happens to exports to the region, shifts in relative competitive positions in third markets and, more importantly, the effect of the crisis on commodity prices.

By the spring of 1998, the East Asian countries most directly affected by the crisis had undergone an import compression in the order of 30-40 per cent, while their exports had stagnated or fallen. Other Asian developing countries have exhibited similar trends, though to a lesser extent. In consequence, world trade, which grew in volume by 9.5 per cent in 1997, the second highest rate in two decades, can be expected to grow much more slowly in the current year.

There is considerable variation among developing countries in their dependence on Asian markets for exports. Those markets absorb, on average, about 10 per cent of Latin America's total merchandise exports; the proportion is as high as 25 per cent for Peru and over 38 per cent for Chile. Also, almost 60 per cent of total Latin American exports to OECD countries are potentially vulnerable to Asian competition. While competition in third markets is less important for African countries, a number of them depend directly on East Asia for 25-35 per cent of their total export earnings.

East Asian economies provide important markets for metals, agricultural raw materials and energy products, both for domestic consumption and as inputs into their export industries. Thus, reduced or sluggish exports and cut-backs in domestic absorption are expected to exert a major influence on the prices of such commodities. By contrast, increases in East Asian exports of a small number of commodities may have only a limited impact on world commodity markets.

While other influences have certainly been at work, the crisis in East Asia is the single most important factor in the recent downturn in commodity prices. Non-oil prices, which had begun to decline in 1996 after two years of sustained increase, started to level off in 1997. However, with the outbreak of the crisis, further downward pressures were evident. Between June 1997 and April 1998, non-oil commodity prices declined by some 10 per cent. At one point in late spring 1998, the price of oil was down by over 40 per cent from its peak in 1997.

From Chile, Jamaica, Paraguay and Peru in Latin America to Gabon, Sudan, United Republic of Tanzania and Zambia in Africa, and to Kazakhstan, Mongolia and Myanmar in Asia, developing countries in all regions are dependent, to varying degrees, on metals and agricultural raw materials for much of their export earnings. The loss of export earnings may be as much as one quarter for some of these countries, corresponding to as much as 12 per cent of GDP in some cases. For oil exporters, expected shortfalls are equally or even more dramatic.

Declines in export earnings are already forcing cuts in government spending in countries where they are an important source of fiscal revenue, such as Chile and Mexico. They are also hurting major developed-country commodity exporters such as Australia, Canada and New Zealand, exerting pressure on their currencies. By contrast, in major industrial countries, particularly in the United States and Western Europe, the benefits of declining commodity prices and improving terms of trade appear, so far, to have outweighed the loss of earnings due to lower exports to East Asia. However, the longer-term impact of adjustment of the external balances of the Asian economies is expected to be quite different.

Latin America is perhaps the region most susceptible to adverse influences from East Asia. Growth is expected to slow to around 3 per cent on average, following the highest rate attained for a quarter of a century in 1997. Even so, current account deficits are expected to continue to rise. Latin America thus remains particularly vulnerable to an interruption of capital inflows.

In Africa, growth had already slowed down in 1997 due to declining commodity prices and adverse weather conditions. The impact of the crisis can be expected to vary considerably among countries: oil and food importers will benefit from lower prices, while exporters of metals and oil and other fuels are particularly vulnerable. For sub-Saharan Africa growth in 1998 is not expected to be much higher than in 1997, and even this forecast may be over-optimistic.

The impact of the crisis on transition economies will occur in large part through declines in prices of energy products. However, in view of the structural weaknesses in its financial system and of fiscal imbalances, the Russian Federation is particularly vulnerable to shifts in market sentiment, and its currency and stock markets have already suffered large declines. Many Central and Eastern European economies are not directly affected by the crisis because of weak trade linkages, and the region as a whole is expected to register a positive, though moderate, growth rate for the second successive year since the beginning of the transition, although there is considerable uncertainty surrounding prospects for the Federation.

Coming on top of a possible cyclical slowdown, the impact of the East Asian crisis on the United States economy may be quite important. The economy continued to grow vigorously in 1997, driven by private spending in excess of incomes. Inflation continued to fall even though growth exceeded by a wide margin the rate officially considered to be compatible with stable inflation. The process of adjustment in East Asia, the appreciation of the dollar, and lower commodity prices all contribute to lower inflation, but by the same token they lower incomes and purchasing power in United States export markets, with the result that there is likely to be a substantial increase in the United States trade deficit. Private spending cannot be expected to continue at the recent pace, while the fiscal surplus will be a drag on economic activity. All in all, it is probable that growth of the economy will slow down significantly in the second half of the year.

This prognosis of a benign slowing of the United States economy could be upset by financial factors. Since the extended period of recovery has been associated with an expansion of bank lending, the slowing down of growth may create repayment difficulties for many borrowers. Furthermore, declining company earnings and margins may lead to a reassessment of the level of equity prices. Difficulty in servicing bank loans or a sharp correction in stock prices would reinforce the existing deflationary impulses and lead to a rougher landing than currently foreseen.

Should domestic demand slow down sharply, the contribution of the United States to the growth of global demand would fall even as the trade deficit widened. There would consequently be an

enlargement of the global demand gap brought about by the crisis in East Asia and the sharp swing in trade balances of the region. Any such gap is unlikely to be filled by strong demand in Europe or Japan. In the European Union, with the exception of the United Kingdom, growth has so far depended on exports, and the Asian crisis is expected to reduce both output and export growth by over 0.5 percentage points. The situation in the United Kingdom is similar to that of the United States, although inflation is faster. In the other major European Union countries exports to Asia have started to decline rapidly. Thus, any recovery in domestic demand would only replace the decline in net exports without creating any additional stimulus. Moreover, the uniform monetary policy of the newly operative European Central Bank cannot be expected to provide any stimulus to demand in the earlier stages of monetary union, but to err on the side of deflation rather than inflation.

Recovery of the Japanese economy will be crucial to recovery in the rest of Asia. The current recession in Japan has prevented it from playing the same role as that of the United States during the Mexican recovery. Despite the recently introduced package of public expenditures and tax cuts, growth is expected to remain negative for the year. A policy of relying on yen devaluation to boost external demand would create a risk of further currency instability in the region, and in international financial markets more generally. Without a strong recovery in domestic demand Japan will not be able to provide an expanding export market for other Asian economies.

However, there is no reason why Japan could not provide considerable external financing to those countries in the form of long-term lending. The impact of such lending would most likely be greater on growth in Japan itself, as well as in the newly industrializing economies (NIEs), than a domestic fiscal package of an equal magnitude, since the money would largely be recycled to Japan in the form of increased imports. Indeed, a regional approach could prove a more effective way of dealing with the crisis than has so far been the case under standard multilateral initiatives.

Because of the nature of the crisis, recovery in East Asia is likely to be much slower than it was in Mexico after 1995. A crisis of over-investment and financial fragility is more difficult to resolve than one of over-consumption. Restructuring balance sheets and adjusting the stock of debt and assets takes much longer than a realignment of consumer spending.

Perhaps the worst possible outcome of the crisis is further bouts of financial instability in emerging markets, a large correction of equity prices in the major industrial countries, together with a sharp slowdown in the United States economy, prolonged recession in East Asian NIEs and Japan, and increased trade imbalances in the major industrial countries. Any such outcome would put increased pressure on banking systems in the developed world. The result might not only be a world economy in deep recession, but also a re-emergence of trade conflicts that could wreak havoc. If that is to be avoided, countries in surplus, namely Japan and the members of the European Union, must increase their contribution to world demand, and deflationary policies in East Asia must be reversed.

The management and prevention of financial crises

The anatomy of financial crises

The East Asian crisis is only the latest in a string of financial crises which have disrupted the global economy since the breakdown of the Bretton Woods system. Such crises have been occurring with increasing frequency in both industrial and developing countries. In industrial countries the episodes of financial instability have involved either banking or currency crises; but in developing countries they have typically been a combination of the two, and have been accompanied by difficul-

ties over external debt service. These differences reflect divergences in net external indebtedness as well as the increasing dollarization of the economies of developing countries.

A greater understanding of the causes and nature of financial crises is essential for their better management as well as for designing policies to reduce their likelihood. While each episode of financial instability has had its own special characteristics, a number of common features stand out:

- They have typically been preceded by financial deregulation and – where there was currency instability – by liberalization of capital transactions;

- Banking crises have been associated with excessive lending on certain categories of assets such as property and stocks, and with speculative bubbles, frequently following a large movement by banks into certain types of financing for the first time. Such lending has often, but not always, taken place in the context of weak financial regulation and supervision;

- Currency crises have typically been preceded by periods of sharply increased capital inflows attracted by a combination of an interest rate differential and relatively stable exchange rates. These act as an incentive to borrow abroad, but at the same time they increase exposure to currency risk;

- There is no known case in any country, developed or developing, of a large increase in liquidity in the banking sector resulting from capital inflows that did not lead to an over-extension of lending, a decline in the quality of assets and increased laxity in risk assessment;

- The inflows generate tendencies to currency appreciation and deterioration of the balance on current account. When there are excessive capital inflows, the worsening of external balances and the weakening of the financial sector are often two sides of the same coin;

- Much of the impetus for the increased capital flows is related to the crisis of commercial banking in the major industrial countries. Because it has exerted pressure on banks to find alternative sources of business to increase returns, greater competition in the financial sector brought about by deregulation has been an important cause of increased international financial instability;

- Reversals of capital flows are often associated with a deterioration of macroeconomic conditions resulting from the effects of the inflows, rather than with shifts in policies. But almost all major episodes of capital outflows and debt crisis in developing countries have been associated with rising international interest rates. The consequent currency depreciation leads to capital losses among those with unhedged exposures, and may become a force transforming the depreciation into a free fall owing to the rush for foreign exchange.

Other features of currency crises have varied. They have occurred under rather diverse conditions with respect to types of financial flows, borrowers and lenders. For example, they have been preceded by borrowing by the private and public sectors in different proportions. Likewise, the most important form of capital flows in many recent crises (including that in East Asia) was international bank lending, but in the Mexican crisis a large share consisted of portfolio investment in equities and in the paper of the Mexican Government.

Management of financial crises

The East Asian experience has laid bare certain weaknesses in the international approach to the management of crises involving sudden withdrawal of foreign capital and massive and sustained attacks on the currency. As a result of this approach, what appeared to be a liquidity crisis has been

translated into a solvency crisis, through a collapse of currencies and asset prices. This process hurts not only those with external liabilities but also the economy as a whole, owing to its effects on output and employment.

There are four possible lines of defence against an attack on the currency:

- Domestic policies, primarily monetary policy;
- Maintaining a sufficiently high level of precautionary foreign reserves and credit lines;
- Recourse to an international lender of last resort; and
- Imposition of a debt standstill and exchange restrictions, accompanied by initiation of negotiations for a rapid debt workout.

Under normal conditions, interest rate differentials are important determinants of international capital movements, and monetary policy can alter the incentives for capital flows. However, as events in East Asia have shown, under conditions of panic, the effects of monetary tightening can be quite different, since interest rate hikes may simply point to declining creditworthiness and greater default risk. Intensified difficulties among debtors can eventually lead to exchange-rate stabilization owing to the resulting squeeze on sales of domestic currency, but at the expense of depressing the economy rather than through bringing back foreign capital.

Maintenance of precautionary reserves or credit lines in amounts adequate to meet outflows during a currency attack poses problems of cost and feasibility. One way of accumulating reserves for this purpose would be to sterilize some of the capital inflow, i.e. to purchase it with the proceeds of domestically issued debt. But such a strategy is likely to entail two sorts of costs: firstly, there is a cost to the economy as a whole, since the rate of interest on foreign loans usually exceeds the return on foreign reserves; and, secondly, there is a cost to the public sector, since the real interest on government debt typically also exceeds the return on reserves.

Alternative approaches might be to cover the short-term external liabilities of the private sector by long-term public borrowing matched by short-term investment abroad, or to arrange a private lender of last resort. But the borrowing or credit lines could be very large, especially if allowance is made also for withdrawals by non-residents from stocks and bonds. Moreover, a country may not have access to such borrowing or credit lines, and there is no assurance that monies under credit lines would be available as needed. Besides, net costs in both cases could be substantial.

Financial assistance coordinated by the IMF in recent years has usually come only after the collapse of the currency, and has taken the form of bailouts designed to meet the demands of creditors and to prevent defaults. Such operations have a number of drawbacks: they protect creditors from bearing the costs of their decisions, thus shifting the entire burden to debtors and creating moral hazard for creditors; and by securing *ex-post* public guarantees for private debt they reduce perceived default risks. More importantly, the sums required have been increasing and are reaching the limits of political acceptability in countries providing them. This is also one of the main impediments to the establishment of a genuine lender-of-resort facility which would stabilize currency markets and thus avoid the transformation of currency attacks into solvency crises.

In the absence of timely provision of adequate liquidity to counter attacks on a currency, a liquidity crisis will eventually lead to widespread defaults and bankruptcies. The most effective way to prevent such an outcome would be through extension and application of insolvency principles such as those in chapter 11 of the United States Bankruptcy Code. Based on the premise that the value of a firm as a going concern exceeds that of its assets in the event of liquidation, those principles are designed to address financial restructuring rather than liquidation. The procedures allow for a standstill on debt servicing in order to provide the debtor (who is left in possession) with a breathing space from its creditors, and so prevent a "grab race" for assets that is likely to be detrimental not only to the debtor but also to unprotected creditors. The debtor thus has an opportunity to formulate a debt

reorganization plan, and equal treatment for creditors is also guaranteed. During the reorganization the debtor is provided with access to the working capital needed for its operations, by granting a seniority status to the new debt contracted. Reorganization is followed by resolution, and insolvency procedures may accelerate the process by discouraging holding-out by particular classes of creditors.

The application of such principles to international debtors was raised in *TDR 1986* during the sovereign debt crisis. It was there noted that under such conditions, the debtors "experience the financial and economic stigma of being judged *de facto* bankrupt, with all the consequences that this entails as regards creditworthiness and future access to credits. At the same time, they are largely without the benefits of receiving the financial relief and financial reorganization that would accompany a *de jure* bankruptcy handled in a manner similar to chapter 11 of the United States Bankruptcy Code".

The increasingly private character of external debt in developing countries has not only increased the likelihood of harmful debt runs and asset-grab races by creditors and investors, but also has given greater pertinence to these bankruptcy principles in the management and resolution of international debt crises. However, a full fledged international chapter 11 is neither practical nor necessary. Article VIII of the Articles of Agreement of IMF may provide a statutory basis for the application of debt standstills through the imposition of exchange controls if a currency comes under attack, and it can be combined with the existing practices for restructuring debt through negotiations.

While standstills could be sanctioned by IMF, a conflict of interest might arise since countries affected by its decisions are also its shareholders and the Fund itself is often a creditor. It may be desirable to place standstill authority with an independent panel whose rulings would have legal force in national courts. A standstill could be decided unilaterally by the debtor country facing an attack on its currency, once its reserves or currency fall below a certain threshold, and then be submitted for approval to the panel within a specified period. Such a procedure would help to avoid a panic, and be similar to GATT safeguard provisions allowing countries to take emergency actions. During the standstill and the subsequent negotiation of a debt reorganization debtor-in-possession financing could be provided by IMF "lending into arrears", which would require much smaller sums than bailout operations.

Procedures of this kind would meet the need once again evident in the East Asian crisis to safeguard debtor countries from the over-reaction of financial markets. In the words of the New York Court of Appeals, which had once ruled in favour of a debtor government that had imposed a unilateral standstill, this would be "in entire harmony with the spirit of bankruptcy laws, the binding force of which ... is recognized by all civilized nations."

Prevention of financial crises

The crisis in East Asia has once again focused the attention of the international community on ways and means of preventing such crises. A number of proposals have been made for measures to be taken at global, national and regional levels. However, global initiatives regarding the international financial system have not gone to the root cause of the problem. On the contrary, some such initiatives could reduce the autonomy and flexibility of national policymakers in introducing measures needed to protect their economies from volatile and speculative capital flows.

With greater integration of financial markets and increased scope for contagion, the international surveillance of national policies has gained added importance in ensuring the stability of the international monetary and financial system. However, it has so far been unsuccessful in preventing international financial crises and currency turmoil; nor is it clear that recently proposed improvements will lead to more effective implementation:

- Major financial crises are typically connected to large shifts in macroeconomic conditions external to countries where the crisis originated. External factors are as important as domestic ones in

triggering both capital inflows and capital outflows. However, existing modalities do not address the problems of policy surveillance due to unidirectional impulses from changes in the monetary policies of the United States and a few other OECD countries which exert a strong influence on capital movements and exchange rates. There are no mechanisms under the existing system of global economic governance for dispute settlement or redress regarding these impulses;

- The focus of attention of the proposed improvements in surveillance continues to be the role of domestic policies in generating financial fragility and crisis. However, even in this more limited area, the record has been mixed, in large part because of the tendency to ignore that markets can go wrong;

- While improvements in the timeliness and quality of information concerning key macroeconomic and financial variables is essential for effective surveillance, emphasis on the inadequacy of information as the major reason for the failure to forecast the East Asian crisis appears misplaced or exaggerated. Although the crisis has pointed to certain weaknesses in available information, these did not play an essential role. Rather, there was inadequate evaluation of the implications of the available data, including those in the periodic reports of BIS, for countries' ability to continue to obtain funding from international financial markets.

Similarly, the contribution to the East Asian crisis of weaknesses in domestic financial regulation and supervision has led to increased attention to reform in this area. However, while such reform can reduce the likelihood of financial crises, experience indicates that, owing to the vulnerability of the financial sector to changes in economic conditions and to unavoidable imperfections in the regulatory process itself, even a state-of-the-art system of financial regulation does not provide fail-safe crisis prevention.

There are serious weaknesses in the regulatory framework for cross-border lending and investment at the source of such flows. They have been an important cause of the shifting of a disproportionate share of the cost of resulting crises onto debtors. A number of proposals have been made for new rules and institutions directed at exerting tighter control over international lenders and investors. While some could be adopted without major changes in existing institutions and policy regimes, others would require, to varying degrees, new and far-reaching international agreements, which might be difficult to achieve owing to uncertainties with regard to their effectiveness or to the concentration of power which they would entail.

Collaboration and consultation at the regional level are capable of contributing to the prevention of financial crises. Their potential role is particularly important with respect to the prevention of currency disorders and contagion effects. Initiatives in this area, which may involve monitoring mechanisms or more ambitious arrangements linked to the provision of mutual external financial support, can benefit from the long and wide-ranging experience of the European Union.

However, none of these proposals for crisis prevention is capable of eliminating the need for active national policies in respect of the balance of payments and external liabilities. In this respect exchange rate policies and controls over capital movements merit particular attention.

There is no reason to condemn managed-exchange-rate regimes and sacrifice currency stability in the interest of free capital mobility. The alternative of freely floating rates, combined with capital mobility, would undermine currency stability with attendant consequences for trade, investment and growth. A currency board system can eliminate problems for debt management due to currency mismatches, and has proved a useful vehicle in certain countries for halting hyperinflation. But such systems do not insulate economies from instability of external origin, since the effects of capital inflows and outflows are transmitted to levels of economic activity and to goods and assets prices, and may include threats to banking stability.

However, managed-exchange-rate regimes are vulnerable to large accumulations of short-term external debt and to other potentially volatile capital inflows. Even if used flexibly, such regimes are

likely to be sustainable only if accompanied by active management of external liabilities, which may often entail recourse to capital controls.

Capital controls are a tried technique for dealing with unstable capital movements. The measures traditionally focused mainly on cross-border transactions of residents and non-residents. However, owing to deregulation and recent developments in banking technique, accounts and transactions denominated in foreign currencies are now often available to residents. Since they can affect macroeconomic variables such as the exchange rate in much the same way as cross-border transactions, they are also a legitimate target for controls. Postwar experience has been marked by frequent use of such controls in industrial countries, and they have also played an important role in policies adopted by several developing countries during recent years in response to large capital inflows.

The extent of successful recourse to capital controls suggests that current initiatives aiming to restrict national freedom of action in this area are inappropriate. The probability of financial crises can be reduced by better macroeconomic fundamentals, effective prudential regulation and supervision of the financial system, and improved corporate governance. But these entail structural reforms with an unavoidably long time-scale: in industrial countries decades were typically required to complete such reforms and to build the institutions needed. Moreover, such actions at national level will not provide fail-safe insulation against currency attacks, which also respond to conditions in international financial markets and in the countries of international lenders and investors. The harm inflicted by currency attacks could be contained by new arrangements for crisis management such as a proper international lender of last resort or a framework for debt standstills and work-outs, but these too are powerless to prevent them from starting and causing damage. Thus, in the absence of global mechanisms for stabilizing capital flows, controls will remain an indispensable part of developing countries' armoury of measures for the purpose of protection against international financial instability, so that for the foreseeable future flexibility regarding governments' options rather the imposition of new constraints is required.

African development in a comparative perspective

After two decades of almost continuous economic decline, Africa is now enjoying a recovery. In 1995, for the first time in many years, the region as a whole experienced an increase in per capita income, a performance that was repeated in 1996 and again, although to a lesser extent, in 1997. The recovery was underpinned by a strong growth in export earnings and owed much to better weather conditions as well as to diminished civil strife in a number of countries.

However, even if the growth of the past three years in sub-Saharan Africa (SSA) could be sustained in the coming decade, that would not reverse the marginalization of the region or make much dent in widespread poverty, and would do little more than recover the ground lost during the past two decades. The challenge for policymakers is to turn this recovery into a stronger and sustained economic take-off, with the aim of attaining the 6 per cent growth target for Africa set by the United Nations. In the past three years only a handful of countries have been able to sustain growth rates reaching or surpassing this target.

However, there should be no illusions about the difficulties in meeting this challenge. Nor should faith be placed in quick fixes or outside panaceas. Certainly, there are lessons that can be drawn from other developing countries which have emerged from economic and social instability into periods of fast and sustainable economic growth. But Africa must also regain the developmental momentum which underpinned the social and economic gains of many African countries in the decade following their independence.

Since the early 1980s many governments have pursued reforms under structural adjustment programmes that place emphasis on macroeconomic stability, a reduced role for the State, greater reliance on market forces and a rapid opening up to international competition as the key to unlocking growth potential. Greater macroeconomic stability and removal of large price distortions in key areas have no doubt made an important contribution to economic recovery in some countries. However, despite many years of policy reform, barely any country in the region has successfully completed its adjustment programme with a return to sustained growth. Indeed, the path from adjustment to improved performance is, at best, a rough one and, at worst, a disappointing dead-end. Of the 15 countries identified as "core adjusters" by the World Bank as recently as 1993, only three are now classified by IMF as "strong performers". Mainstream assessments of Africa's growth prospects have almost invariably proved over-optimistic largely because they have been based on an act of faith in growth-enhancing market forces, rather than on a careful examination of constraints and opportunities.

Such assessments, as well as the policy advice proffered, have not always taken proper account of the external constraints. Indeed, declining export prices and a sharp deterioration in external financial conditions in the early 1980s brought the already shaky foundations of many African economies to a state of near collapse. These losses were not offset by rises in official development assistance (ODA) or official lending; less than 15 per cent of the trade loss was compensated by ODA. Predictably, the resulting adjustment took the form of severe import compression and a sharp decline in investment; the share of investment in GDP, which had averaged over 25 per cent in the 1970s, had fallen to 16 per cent by the early 1990s. The region was caught in a vicious circle: the existing economic structure was unable to generate the growth in export earnings needed to maintain imports and investment, which in turn impeded structural change and economic growth.

The recent recovery has been greatly helped by improved external conditions. The 25 per cent rise in non-oil commodity prices from 1993 to 1996 accounts for much of the increase in export earnings. However, the medium-term outlook for commodities does not suggest that these gains will be lasting; the recent downturn in prices is accentuated by the weakening of global demand due to the East Asian crisis. Moreover, the downward trend in real ODA that emerged at the beginning of the decade continues unabated.

The international community should not, and need not, adopt a passive stance on African economic development. Indeed, on one key issue, that of debt, it can make a demonstrable commitment to the new generation of African policymakers.

There is now ample evidence that Africa's external debt burden is having a severe adverse impact on investment and renewed growth. Not only does it impede public investment in physical and human infrastructure, but also it deters private investment, including foreign investment. As a proportion of exports and GDP the external debt of Africa is the highest of any developing region. Most of it is public and owed to official creditors, and a good deal is simply unpayable. The extent of the debt overhang is indicated by accumulated arrears which, by 1996, had reached over $64 billion, amounting to more than a quarter of the total debt. Of even more concern is that two thirds of the increase in debt since 1988 has been due to arrears.

The launching of the Heavily Indebted Poor Countries Debt Initiative (HIPC Initiative) has allowed a more comprehensive, coordinated and equitable approach to be taken. However, it needs significant revision if it is to help decisively in establishing the conditions for sustained growth; the basic concerns relate to eligibility for, and the adequacy of, debt reduction as well as to the speed at which relief should be granted. A comprehensive assessment of the sustainability of African debt is now needed; it should be carried out by an independent body that would not be unduly influenced by the interest of creditors. Such a body could be composed of eminent persons experienced in questions of finance and development who could be appointed by mutual agreement between creditors and debtors, with a commitment by creditors to implement fully and swiftly any recommendations that may be made. Such a course of action would be in complete harmony with the recognized principles of debt workouts.

Raising net resource transfers through debt relief will not succeed, however, unless it is accompanied by appropriate domestic policies to overcome low productivity and heavy dependence on a small number of primary commodities. Expanding investment in both primary and secondary industries and in both the public and the private sector is a vital prerequisite for, if not a guarantee of, rapid structural change and productivity growth. Whilst there is a growing consensus on this point, the analysis in this *Report* suggests that the current approach to structural adjustment is unlikely to achieve such an outcome.

The most disturbing feature of policy reforms in SSA is their failure so far to bring about an investment recovery; the average ratio of investment to GDP during 1995-1997 was 17 per cent, only slightly above that of the early 1990s and well below that of other developing regions. Public investment has borne the brunt of the adjustment impact, but private investment has not, as conventional wisdom might suggest, stepped into the breach. Indeed, as a share of GDP, it is lower than in the 1970s.

One important reason for poor economic performance is slippage in programme implementation. Another is the failure to address the debt problem and to provide adequate external financing in designing the programmes. More importantly, while there is consensus that structural constraints and institutional weaknesses prevent an effective functioning of markets and impede a positive response to private incentives, these obstacles are often neglected. Thus, policies are promoted to get prices "right" when some of the more important agents and institutions of a modern market economy are underdeveloped or totally absent. Again, there is no proper sequencing of liberalization of product and factor markets with prior institutional reforms needed for its success. The outcome has been sadly predictable: greater instability in key prices and failure to generate appropriate incentives. Even when incentives are generated, structural constraints and institutional weaknesses prevent their resulting in a vigorous supply response:

- Weak supply response to liberalization of agricultural markets largely reflects inadequate assessment of the factors constraining production. Evidence strongly suggests that the assumptions about the taxation of agricultural producers through pricing policies which underline these reforms are not entirely valid. While for some products African farmers have been heavily taxed compared with more successful exporters in other regions, that has not been so for all products or all countries;

- Agricultural liberalization has not been associated with a strengthening of price incentives. The domestic terms of trade have generally turned against farmers more in those countries which have sought to link domestic prices to world prices. The shift from public to private marketing agents has not increased the proportion of export prices passed on to producers, mainly because of imperfect and underdeveloped markets;

- Dismantling of marketing boards has tended to enlarge the institutional hiatus, as private institutions are generally unable to take up many of the functions previously rendered by marketing boards;

- Financial liberalization has often been undertaken without first ensuring the conditions for its success, including a high degree of price stability and fiscal discipline, sound financial institutions and corporate finance, depth in financial markets, and effective prudential regulation. Consequently, it has lead to high and unstable interest rates, widespread insolvencies, a rapid accumulation of public domestic debt and fiscal instability;

- While there was certainly a need to move towards more realistic and flexible exchange rates, the pendulum has swung too far. Leaving exchange rates to markets has resulted in highly unstable rates as markets proved to be very thin. Instability has further been exacerbated by arrangements that have resulted in *de facto* liberalization of the capital account;

- Trade policy reforms have largely been driven by theoretical notions of neutral incentives, to be attained through low and uniform tariffs, rather than by pragmatism. Nor have tariff reforms

always been supplemented by adequate arrangements to support exports and investment. As a result, while exports and investment are sometimes too heavily taxed, imports of luxury goods occasionally receive favourable treatment. Numerous exemptions from duties, large-scale smuggling, and tariff reductions create serious difficulties for domestic firms with the potential to form the basis of a more export-oriented industrial base.

A rethinking of policies is now needed that recognizes and addresses directly the structural constraints and institutional hiatus that pervade the African economies. It should draw on successful development experiences in Africa and elsewhere, and focus on capital accumulation and nurturing and building the institutions needed for an efficient market economy.

Policy intervention should also be based on the recognition by governments that in market-based systems capital accumulation is closely linked to the consolidation of property rights and the emergence of a strong and dynamic indigenous entrepreneurial class willing to commit its resources to investment. Fears associated with the emergence of such a class as a rival economic power to ruling elites need to be overcome if market-based development is to succeed.

There is no universal recipe, but some general principles can be laid down that are appropriate to Africa, in the light of its market imperfections and volatile economic environment:

- As elsewhere, private investment requires complementary public investment in physical and human infrastructure. Undercapitalization, including inadequate public investment, is the principal obstacle to sustained agricultural development in Africa. Neglect of agriculture in public spending is a more serious source of urban bias than pricing policies. At less than 5 per cent of GDP the current level of public investment is barely sufficient to meet the development challenge;

- The poor past performance of many marketing boards and *caisses de stabilisation* does not imply that their original rationale is no longer valid. Some of the needs which they were established to satisfy can now be met by the private sector, but government action remains indispensable in several areas of commodity trade such as financing, risk management, market promotion, and the provision of infrastructure and services unlikely to be forthcoming from other sources. Thus there is a strong case for institutional pluralism in which reformed and depoliticized marketing boards and *caisses* are part of a landscape that also includes private organizations, parastatals and co-operatives;

- A more pragmatic approach would be to reconsider the case for financial restraint linked to administered interest rates and institutions that would mobilize domestic savings, direct credits toward investment and meet the diverse needs of small- and medium-sized enterprises in the primary and secondary sectors;

- In a continent seeking export-led growth, the exchange rate is too important a variable to leave to shallow and volatile markets and the vagaries of capital flows. Its management requires, *inter alia*, the kind of regulations and control noted above. Opening up the capital account is not likely to bring back flight capital, which on some estimates accounts for 70 per cent of non-land private wealth in SSA. Much of the flight capital appears to have originated from the illicit diversion of public funds rather than to have been constituted by business incomes seeking economic stability or high yields abroad. A change in the banking regulations of those developed countries where these funds are hidden could produce effective results in this respect;

- The marginalization of SSA in world trade is a reflection of its inability to expand productive capacity, rather than a consequence of its resistance to openness. A gradual approach to trade liberalization is desirable in view of the existing weaknesses in supply capabilities. A trade regime that provides exporters with easy access to inputs at world prices, facilitates investment and discourages luxury consumption should also be built on a differentiated approach, supplemented by arrangements such as duty drawbacks and export retention schemes. The case for

infant industry protection and industrial policies to promote learning and develop skills in domestic firms is no less relevant today in SSA than it has been for all successful late developers in this century. While WTO Agreements have reduced the scope for some policy options, selective strategies can still be applied, and exemptions provided under the agreements cover most countries in Africa. However, any such support must be time-bound and closely tied to performance criteria.

The experience of countries which have successfully launched a sustained process of economic growth based on a dynamic investment-export nexus built around primary activities gives ground for optimism that a similar process can be initiated in SSA. For most countries in the region the opportunities are ample, and their exploitation should be the initial focus of policy. As the successful experiences of resource-rich countries in Latin America and East Asia have shown, policy requirements at such early stages of export promotion and accumulation are less demanding and can yield rapid results. Those countries have indeed succeeded in initiating strong and sustained export and output growth following many years of instability and economic stagnation, and they did not always start from more favourable conditions than those now prevailing in Africa.

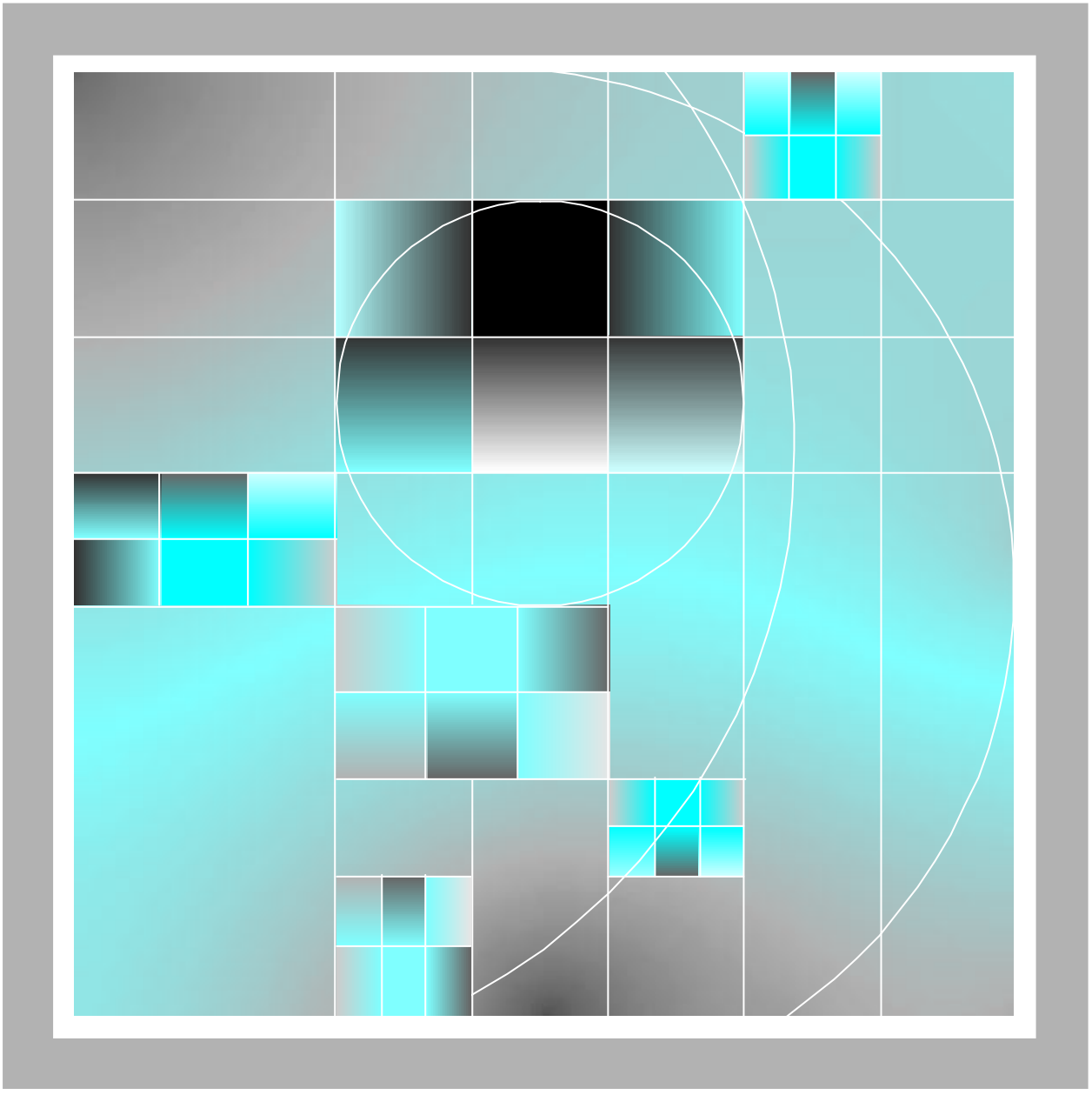
After a decade or more of reform in SSA premised on the assumption that government failures are far worse than market failures, the need to ensure complementarity between States and markets is now increasingly recognized. However, acknowledging market imperfections should not give way to a false ideology of state infallibility. Reforms are desperately needed if the African State is once again to assume its developmental role. This is a daunting task, and any comprehensive agenda of institutional reform can only emerge at the country level, where ownership of reforms can be ensured and the chances of success thereby increased. In general, governments need to diffuse a sense of national purpose. More specifically, there is an urgent need for a more efficient, dedicated and better remunerated civil service. At the same time, it is necessary to build greater trust and partnership between the state and private actors.

Political instability on account of social, especially ethnic, fragmentation is not an intrinsically African problem. While Africa is highly diversified in terms of social and ethnic minorities, there is less discrimination than in most other regions. But efforts since independence to build multi-ethnic political coalitions have entailed heavy economic costs. The experience of some South-East Asian countries illustrates that it is possible to achieve social and political harmony while nevertheless accelerating growth.

African countries should strengthen their regional economic ties, as they have already begun to do with their political ties. Special attention should be paid to a division of labour whereby trade and investment flows link countries at different levels of development. Intra-regional trade has been growing in SSA but is still very small. However, even marginal increases in such trade can help develop export capacities, which in turn can generate regional growth dynamics by easing balance-of-payments constraints and providing learning effects which will eventually make African exporters competitive globally.

Rubens Ricupero
Secretary-General of UNCTAD

INTERNATIONAL FINANCIAL INSTABILITY AND THE WORLD ECONOMY



Chapter I

THE WORLD ECONOMY: PERFORMANCE AND PROSPECTS

A. Global trends

1. World output

The East Asian crisis has come at a time when certain weaknesses and imbalances in the global economy were also prevalent. Before the crisis, global growth depended on expansion in the United States and East Asia. With the notable exceptions of China and its Taiwan Province, the fast-growing economies of East Asia, together with the United States, were the major contributors to global demand, running large external deficits financed by private capital inflows. In virtually all industrial countries except the United States and the United Kingdom exports were the engine of faster growth, especially so in Japan and continental Europe, where domestic demand was sluggish owing to restrictive fiscal policies. These disparities were reflected in increased exchange rate instability and trade imbalances, with Western Europe and Japan running large surpluses.

In East Asia the attempt to adjust exchange rates and reduce external deficits to sustain rapid growth has had the opposite effect: it has eliminated or reduced the deficits but only by disrupting growth. The East Asian crisis has thus increased the magnitude of the global demand gap and produced even greater trade imbalances and currency volatility. The policy response, in turn, has done nothing to alleviate the risks to global trade and growth posed by these imbalances; rather, it has tended to accentuate them.

The direct impact of the Asian crisis on global economic developments was not significant in 1997, although growth in the East Asian countries dropped sharply in the last quarter of the year. Slower growth in Asia and Africa was more than offset by accelerated growth in other countries and regions. Growth in world output increased slightly in 1997, to reach 3.2 per cent (table 1), while inflation remained low in most countries at levels not experienced since the 1950s – in large part owing to a continued decline in commodity prices, notably the price of oil.

Growth in developed market economies registered only a slight improvement in 1997, reaching 2.7 per cent, and was largely due to an acceleration of growth in the United States. Improvements in economic conditions in the European Union, where the larger members had been struggling to initiate a sustained recovery, was also a contributory factor. Exports remained the major source of demand growth in the European Union, although investment demand had started to recover in a number of countries. By contrast, growth continued to be erratic in Japan, falling from 3.9 per cent in 1996 to less than 1 per cent in 1997.

For the transition economies of Central and Eastern Europe, 1997 marked the very first year of positive growth for the region as a whole since 1989, though performance continued to diverge widely among countries. In the Russian Federa-

Table 1

WORLD OUTPUT, 1990-1998

(Percentage changes over previous year)

Region/country	*1990-1995*	*1996*	*1997[a]*	*1998[b]*
World	1.9	3.0	3.2	2.0
Developed market-economy countries	1.7	2.5	2.7	1.8
of which:				
United States	2.3	2.8	3.8	2.3
Japan	1.4	3.9	0.9	-1.3
European Union	1.3	1.7	2.5	2.6
of which:				
Germany	1.7	1.4	2.2	2.3
France	1.1	1.5	2.4	2.5
Italy	1.1	0.7	1.5	2.2
United Kingdom	1.2	2.2	3.3	2.1
Transition economies	-8.2	-1.6	1.4	2.2
Developing countries	4.9	5.9	5.4	2.3
of which:				
Latin America	3.3	3.6	5.2	3.1
Africa	1.1	4.6	3.3	3.7
Asia	6.4	7.1	5.9	1.8
of which:				
China	12.4	9.6	8.8	6.0
Other countries	5.1	6.4	5.0	0.5
Memo item:				
Developing countries, excluding China	4.0	5.3	4.9	1.7

Source: UNCTAD secretariat calculations, based on data in 1990 dollars.
a Estimate.
b Forecast.

tion the contraction of the economy appeared to be coming to an end, although contagion from the Asian crisis will probably prevent any significant expansion. In 1997 growth averaged only a little over 1 per cent, nevertheless constituting a significant improvement on the nearly 2 per cent decline in 1996.

In contrast to both the developed and the transition economies, growth in developing countries as a whole declined in 1997, in part as a consequence of the financial turmoil in East Asia. Nevertheless, at 5.4 per cent, it was still far above the rates attained in those economies. Growth slowed down in China, but the decline was even more pronounced in the Asian countries hit by the financial crisis. Growth in Africa also fell sharply, to a level barely adequate to keep pace with population, because of declining commodity prices and adverse weather conditions, as well as continued civil strife in some countries. Unlike in the other developing regions, economic performance in Latin America in 1997 was the best for a quarter of a century. Continued expansion of exports and a strong recovery in investment resulted in an acceleration of growth, which reached 5.2 per cent in 1997, while price stability was consolidated with a decline in the rate of inflation.

2. World trade

The volume of world exports rebounded to an impressive increase of 9.5 per cent in 1997, after slowing down from 9.0 per cent in 1995 to 5.0 per cent in 1996 (table 2); in value terms the expansion was only one third as high. As a consequence, the divergence which has been evident between the growth trend of world trade and that of world output in recent years widened further. The stronger than expected volume growth of world exports in 1997 is the second highest in more than two decades and comes close to the record rate of 10 per cent in 1994. With the exception of African exports and Chinese imports, there was a widespread acceleration, at varying rates, in the volume growth of individual countries' and regions' exports and imports. Latin American imports in particular grew by over 21 per cent because of strong GDP growth, compared with 12.5 per cent for exports. For the same reason, the growth rates of both export and import volume in the United States reached double digits (12 per cent). Also notable is the performance of the European Union, where exports grew faster than imports, and that of the transition economies, where imports grew faster than exports.

Of particular significance in 1997 is the recovery of growth in export volume in Japan and other Asian countries, and more so in China, where exports rose by over 20 per cent, compared with a reduction of 1 per cent the previous year. Japan, China, and South and East Asia all had rates of growth of exports exceeding that of imports. And despite the slump in GDP growth in Japan and the countries affected by the financial crisis, there was a slight increase in the rate of import growth in all these developing countries of Asia, except China.

For 1998, expectations are for a reduced expansion of world trade. The outcome, however, is clouded by uncertainties, especially those relating to an export-led recovery in Asia. For the most affected Asian economies, the sharp fall in their real effective exchange rates and the existence of spare production capacity, together with sound economic fundamentals and past performance records, argue in favour of a reasonably strong export-led recovery. On the other hand, there are offsetting factors such as higher import costs and a severe liquidity crisis and credit crunch. Currently discernible in these countries are a greater contraction of imports and a lack of any significant

Table 2

EXPORTS AND IMPORTS BY MAJOR REGIONS AND ECONOMIC GROUPINGS, 1995-1997

(Percentage changes in volume over previous year)

	1995	1996	1997
Exports			
World	9.0	5.0	9.5
Developed market-economy countries	7.6	4.2	8.8
of which:			
Japan	4.0	-0.5	9.5
United States	8.7	6.3	11.9
European Union	8.5	4.0	8.0
Transition economies	17.5	7.5	11.0
Developing countries	11.5	6.0	11.5
of which:			
Africa	5.0	7.0	5.5
Latin America	12.0	11.0	12.5
South and East Asia	13.0	6.5	10.5
China	17.5	-1.0	20.5
Memo item:			
Six major East Asian economies[a]	14.5	6.5	10.0
Imports			
World	9.0	5.0	9.0
Developed market-economy countries	8.2	3.8	7.9
of which:			
Japan	12.5	2.0	2.5
United States	7.0	5.7	12.0
European Union	7.5	2.5	6.5
Transition economies	17.0	14.5	16.0
Developing countries	11.0	6.5	10.0
of which:			
Africa	6.5	0.5	11.5
Latin America	3.0	11.5	21.5
South and East Asia	15.5	5.5	6.5
China	9.0	7.0	5.0
Memo item:			
Six major East Asian economies[a]	15.5	4.5	5.5

Source: WTO Press Release, 19 March 1998, table 2; UNCTAD secretariat estimates.

a Hong Kong, China; Republic of Korea; Malaysia; Singapore; Taiwan Province of China; Thailand.

expansion of exports. The behaviour of imports is perhaps to be expected in view of the experience of previous episodes of large devaluations, when imports first contracted before expanding. The behaviour of exports, however, appears to be a departure from the previous experiences of rapid recovery, which tended to continue for about three years after devaluation.

The effects of the crisis differ considerably among the most severely affected countries, and there is the potential for spillover in various ways into other countries and the world economy in general. As a group, the five most affected countries (Indonesia, Malaysia, the Philippines, the Republic of Korea and Thailand – hereafter referred to as Asia-5) account for only a relatively modest share of global economic activity. In 1996, for instance, they accounted for 3.6 per cent of output, around 7 per cent of both exports and imports, 6 per cent of FDI inflows, 4 per cent of FDI stocks and less than 4 per cent of gross international bank lending. In terms of trade flows, these five countries accounted for less than 10 per cent of the exports or imports of countries outside Asia. Their share in both imports and exports was 2.5 per cent in the EU, but around 8.5 per cent in the United States. Hence a substantial change in the economic performance of these countries is unlikely to have a major impact on the trade and growth of countries outside Asia.

However, the Asia-5 countries constitute a key part of the trade-investment network in the Asian region. Their shares in the exports of Japan, China and Singapore, for instance, are considerably higher than those of the United States, and they also trade intensively with one other. The crisis is affecting seriously all the countries in the region which, taken together, have provided an important impetus to the expansion of global output and trade in recent years. Therefore, as discussed in greater detail in chapter II, the implications of the crisis for global trade can go well beyond what might be expected on the basis of the relative importance in the world economy of the countries suffering from the financial crisis.

3. Commodity markets

In 1997, while non-oil primary commodity prices remained at the same level as in the previous year, prices of both oil and manufactured products fell by some 6 per cent (table 3). Underlying the apparently stable price for non-oil commodities was a sharp increase in the prices of tropical beverages, in contrast to falling prices for agricultural raw materials. While there was an increase in the prices of commodities that had suffered significant damage from unfavourable climatic conditions caused by El Niño, commodity prices in general were on a declining trend. During 1985-1997, the rise in non-oil primary commodities as a group was a mere 2.2 per cent per annum in current dollar terms, giving a yearly decline of 0.5 per cent in real terms. The decline in real terms was particularly pronounced for all the major tropical beverages (coffee, cocoa and tea) and some metals (particularly tin and tungsten). Despite recovery in both nominal and real terms during the 1990s, prices of non-oil commodities remained relatively depressed.

Worth noting is the apparent lack of correspondence between commodity prices and industrial demand during the current cycle. Prices of agricultural raw materials, for instance, declined by around 10 per cent in 1997 even though GDP in developed market-economy countries grew by 2.7 per cent. In contrast, when GDP in those economies grew by 3 per cent in 1994, there was an increase of 14.6 per cent in the prices of agricultural raw materials. While it is evident that some commodities were in ample supply (sugar, for instance), the relatively low rate of inflation in developed economies was a disincentive to speculative buying of commodities, as was the sharp appreciation of the dollar in both 1996 and 1997 after relative stability during the first half of the 1990s.

Oil prices in 1997 started to decline later than prices of most other primary commodities. There were various contributory factors in addition to a slowing of demand growth in a number of countries affected by the Asian crisis. An unseasonably warm winter in the Northern Hemisphere reduced the demand for heating oil, while there was a marked expansion in supplies, particularly in OPEC member countries where a 10 per cent increase in quotas was approved in November 1997, and a considerable build-up of inventories – from the previous year – of crude and oil products at all stages of the marketing chain.

While the prices of agricultural commodities appeared to have more or less stabilized, albeit at lower levels than those prevailing in mid-1997,

Table 3

WORLD PRIMARY COMMODITY PRICES, 1995-1998

(Percentage changes over previous year)

Commodity group	*1995*	*1996*	*1997*	*April 1998*[a]
All commodities[b]	**9.9**	**-4.2**	**0.0**	**-4.5**
Food and tropical beverages	**4.5**	**2.1**	**2.1**	**-6.9**
Tropical beverages	1.1	-15.2	33.3	-11.5
Coffee	0.7	-19.1	54.7	-15.3
Cocoa	2.7	1.2	11.2	-0.6
Tea	-10.3	8.8	25.8	15.5
Food	5.9	6.8	-4.0	-6.1
Sugar	10.8	-9.9	-4.9	-25.1
Beef	-31.2	-6.4	4.0	-3.1
Maize	15.5	25.0	-25.3	-9.5
Wheat	18.5	16.2	-22.6	-8.9
Rice	-10.1	5.0	-10.7	17.8
Bananas	0.1	7.5	4.3	49.3
Vegetable oilseeds and oils	**10.3**	**-4.2**	**-0.9**	**9.7**
Agricultural raw materials	**15.0**	**-9.9**	**-10.3**	**-2.5**
Hides and skins	4.3	-23.7	-19.8	-10.5
Cotton	22.3	-17.4	-1.5	-13.3
Tobacco	-11.2	15.6	15.5	-1.3
Rubber	38.6	-11.9	-28.3	1.0
Tropical logs	5.4	-20.1	-5.5	-2.0
Minerals, ores and metals	**20.2**	**-12.1**	**0.0**	**-1.7**
Aluminium	22.3	-16.6	6.2	-7.3
Phosphate rock	6.1	8.6	7.9	0.0
Iron ore	5.8	6.0	1.1	2.8
Tin	13.7	-0.8	-8.4	3.6
Copper	27.2	-21.8	-0.8	2.2
Nickel	29.8	-8.8	-7.6	-9.3
Tungsten ore	49.6	-17.9	-9.3	0.0
Crude petroleum	**9.3**	**20.8**	**-6.0**	**-21.4**
Memo item:				
Manufactures[c]	**11.1**	**-3.6**	**-5.7**	**..**

Source: UNCTAD, *Monthly Commodity Price Bulletin*, various issues; United Nations, *Monthly Bulletin of Statistics*, various issues.

a Change from December 1997.

b Excluding crude petroleum.

c Unit value index of exports of manufactures from developed market-economy countries.

most metal prices and the price of petroleum continued to decline until April 1998. The problems faced by commodity markets have been compounded by the adverse effects of the Asian crisis. From June 1997 to April 1998, non-oil commodity prices declined on average by 10.6 per cent, with larger falls in agricultural raw materials (12.0 per cent) and metals (17.3 per cent) than in food and beverages (10.1 per cent). The corresponding decline in the price of oil was 24.6 per cent. To a large extent, these price falls were associated with the Asian crisis, notably in the case of copper, nickel and natural rubber. Many of the fast-growing economies in Asia have become major markets for a wide range of commodities, including high-value foodstuffs, agricultural raw materials, metals and fuel, which are supplied by other developing countries. Many of them are also major commodity suppliers. The ASIA-5 are in fact themselves major exporters of a wide range of food items and agricultural raw materials, such as vegetable oilseeds and oils, coffee, bananas, tea, cocoa beans, natural rubber, tin and copper.

While lower oil prices will benefit oil-importing developing countries, some 25 developing countries are dependent on petroleum for 20 per cent or more of their foreign exchange earnings. Again, the decline in commodity prices in general will help to keep inflation down in developed countries, but as discussed in greater detail in chapter II, it will adversely affect a large number of developing countries highly dependent on commodity export earnings.

B. Regional economic performance and short-term prospects

The impact of the Asian crisis is the major factor responsible for the expected slowdown in the growth of the world economy in 1998. As the effects of the Asian turmoil continued to unfold, the forecasts for 1998 made by international and national organizations as well as other institutions were subject to continuous downward revision (see also box 1). For example, the IMF reduced its forecast of global output growth for 1998 from 4.3 per cent in its *World Economic Outlook* of October 1997 to 3.5 per cent in its *Interim Assessment* in December of the same year. A further revision in its *World Economic Outlook* of May 1998 brought the rate down to 3.1 per cent. Continual downward revisions of such magnitude within a period of only a few months bear witness to the significance of the Asian developments for global growth and to uncertainties about the depth of the crisis and the impact of the policies adopted in response. The downward revisions in GDP growth forecasts have been more substantial for developing than for developed countries. Indeed, developing countries are expected to be affected more than the developed countries by adverse movements in trade volumes and prices. Moreover, a number of developing countries have been responding to the crisis by pre-emptive monetary and fiscal tightening designed to maintain market confidence and reduce their vulnerability to an interruption of capital inflows.

1. Developed market-economy countries

(a) United States

Now in its eighth year of growth, the United States economy must normally be considered to be in the late stages of a long cyclical expansion when the growth of output should be declining. Yet growth rose by a full percentage point to 3.8 per cent in 1997, driven by strong private sector demand. Domestic demand grew even faster, but because of the deterioration of the current account, the growth of output remained below that of domestic demand. The external balance was greatly influenced by a continuation of the tendency of the dollar to appreciate; in real effective terms the exchange rate of the dollar reached its highest level since 1986. Growth was also dampened by the continued increase in the fiscal surplus.

Despite growth well above official estimates of trend potential, and a gradual increase in real wages, inflation continued to lessen in 1997, thanks

to the strength of the dollar and the fall in the prices of oil and other commodities, as well as an improvement in productivity. With stable nominal interest rates since spring 1997, the decline in inflation has produced a moderate increase in real interest rates which has also served to slow expansion. Strong growth and low inflation have continued to support the continued rapid rise in equity prices, despite admonitions from the Chairman of the Federal Reserve that markets should guard against irrational exuberance. The strong performance of stock prices has helped to improve fiscal balances by increasing capital gains tax receipts. In addition, it has had a positive impact on growth by lowering the cost of capital and stimulating consumer expenditures. However, equity prices have now reached the level where they are susceptible to substantial short-term correction or contagion from the worsening of economic conditions in East Asia. While this could produce a contraction of domestic demand by reducing household wealth and increasing financing costs, such effects would be partly offset by reduced tax payments worsening the fiscal balance.

In 1998 the adjustment process in East Asia is expected to increase the United States payments deficit substantially. A large build-up in inventories at the beginning of the year, together with a continued increase in the fiscal surplus, expected to reach $40 billion in the current fiscal year, will all cause growth to slow. However, United States GDP growth is expected to fall back only to 2.3 per cent, since part of the negative impact from East Asia has been offset by declining petroleum and commodity prices which have brought about an improvement in the terms of trade. Following an expansion in the first quarter of 5.4 per cent at an annual rate, growth is expected to slow dramatically in the second half of the year. Signs of impending slowdown in the economy are evident from the fall in corporate profits in the last quarter of 1997, down by 2.3 per cent at a quarterly rate from the previous quarter. This decline continued at about the same pace in the first quarter of 1998, and is beginning to be reflected in increased volatility of equity prices. Thus, although the forces sustaining growth are relatively strong, there are substantial risks represented by the negative impact on domestic demand growth of a possibly sharp correction in equity values and the drag produced by the fiscal surplus and external deficit. Should such forces prevail and come on top of a deepening of deflation in East Asia, the economy may have a rougher landing than currently foreseen.

(b) Japan

The attempt to reduce the fiscal deficit, and the effects of the East Asian crisis, were too much for the fragile recovery in the Japanese economy during late 1996 and early 1997. Growth had been strong in the first quarter of 1997 as a result of an increase in consumer spending in anticipation of the restoration of value-added taxes on consumption expenditures. There was consequently a sharp decline in subsequent quarters that was aggravated by the continued weakness of the financial system, resulting in the closure of several well-known large banks and brokerage houses. The fall in consumption was also due to the slower growth of nominal labour compensation from 3.6 per cent on an annual basis in the third quarter of 1997 to only 1.2 per cent in the first quarter of 1998. It is likely that this reflects a decline in profits-linked bonus payments, indicating weakness in the manufacturing sector. Both business and public investment had fallen by the end of the year. The latter reflects the absence of special government budget measures, which caused a sharp fall-off in construction activity and added further to deflationary pressures. Unlike in 1996, the economy did not recover in the last quarter, as the impact of the East Asian crisis started to be felt. By the spring of 1998 unemployment had risen to 4.1 per cent, and imports contracted more rapidly than exports as the economy slipped into outright recession.

In late December 1997, the authorities announced a series of measures designed to restore confidence, including a temporary tax cut of 2 trillion yen and the provision of public funds amounting to 6 per cent of GDP to protect depositors of failed institutions and to recapitalize weak but solvent banks. Because of concern that the increased stringency of capital requirements due to be announced in April was causing banks to reduce lending, a proposal was made to channel 2.4 per cent of GDP from the Fiscal Investment and Loan Programme through state-owned financial institutions to small and medium-sized enterprises facing difficulty in borrowing from commercial banks.

Increasing international pressure on Japan to use fiscal policy to stimulate domestic demand as the economy entered recession, together with chronic yen weakness, led to the announcement in June 1998 of a new fiscal stimulus package, including another 2 trillion yen in temporary tax reductions and an increase in total public works

Box 1

INTERNATIONAL COMPARISON OF GDP ESTIMATES

The conceptual difficulties and limitations of using national accounts statistics to measure economic growth are well known: they reflect only economic, and not social, costs or values and have little to say about output composition, income distribution or the quality of life. In measuring the *change* in the level of economic activity over time, further complications arise from (a) changes in definitions used; (b) changes in prices of products and services; and (c) changes in the quality of available products and services. Depending on the period in question, changes in technology, resources, tastes and institutional structure may also be relevant. In addition, there are alternative index-number formulas as well as growth-rate formulas that can be used for computing the average growth rates over a given period.

Real GDP has traditionally been measured by using the prices of a particular base year to calculate value-added in each sector and aggregating to obtain total GDP. This fixed base-year method is simple to use and yields a measure of real GDP that equals the sum of its components, so that it is easy to gauge the relative importance of a given sector in the economy. Such a measure of aggregate real output is obviously dependent not only on the distribution of production by sector, but also on the distribution of prices by sector in the base year. It follows that, especially in periods of substantial structural change, the entire history of real GDP growth changes every time the base year changes.[1]

For the purpose of aggregation across countries to derive regional or group totals, it is necessary to convert the value of each country's output into a common currency. Traditionally, market exchange rates have been used for this purpose. The set of exchange rates used affects not only the relative weights of individual countries, but also the dollar value of the aggregate and thus the rate of growth. The choice of a given base year should avoid periods of abnormally high dollar exchange rates or large external imbalances and that is why in some cases period averages are used.

Available studies have shown that market exchange rates may, for a variety of reasons, fail to reflect properly the relative purchasing power over domestic goods among economies, even those with uniform and stable exchange rates. Factors responsible for this failure include speculative bubbles, exchange market interventions, asymmetrical speed of adjustment in goods and asset markets, macroeconomic shocks, and significant discrepancies in the relative prices of traded and non-traded output, which are a feature of most developing countries.

Studies show a tendency for official exchange rates to understate the purchasing power of national currencies to a relatively greater extent in countries with a low per capita GDP than in those with a high one. Thus, the conversion of GDP into dollars using market exchange rates when aggregating national data would tend to understate the dollar value of output in low-income countries relative to that in high-income countries. China provides a striking example. Although its average real growth during 1970-1990 was more than double that of the world economy, its share of world output in 1990, calculated on the basis of the market exchange rate, was less than in 1970 because of the substantial depreciation of the yuan over this period.[2]

In response to the need for more satisfactory international comparisons of output, the International Comparisons Project (ICP)[3] developed a methodology for computing benchmark indices which can be used to convert time series of GDP in constant dollars into "international dollars", so that the output of each country in each year is expressed in a common set of international prices representing purchasing power parity in the base year. To obtain a more accurate measure of the relative sizes of economies, the IMF decided to use weights based on purchasing power parity (PPP) for the purpose of aggregating the GDP of individual countries, beginning with its *World Economic Outlook* of May 1993. The PPP-based weights were derived from PPP estimates of GDP made by the ICP, supplemented by the World Bank and IMF staff estimates for countries not covered by that project.

Such PPP-based weights, derived from *estimates* of PPP rather than from data for exchange rates, are open to criticism on a number of technical grounds. Nevertheless, the IMF considered the bias associated with the weights based on PPP to be less than that stemming from weights based on market exchange rates. The differences in GDP weights for 1990 between using exchange rates derived from a three-year moving average for 1987-1989 and PPP are striking. The shares of industrial countries and

Box 1 (concluded)

developing countries were respectively 73.2 per cent and 17.7 per cent on the basis of market exchange rates but 54.5 per cent and 34.4 per cent in PPP terms.[4] Among the industrial countries, particularly sharp was the reduction in the relative importance of the Japanese economy (from 14.6 per cent to 7.6 per cent) and to a lesser extent that of the United States economy (from 26.7 per cent to 22.5 per cent). Among developing regions, the gain in relative importance was particularly striking for Asia (from 7.3 per cent to 17.7 per cent), owing in part to the greater weight of China in PPP terms.

With respect to the difference in terms of the implication for GDP growth between the two methods, the use of PPP-based weights logically led to a somewhat stronger growth of the world economy during 1983-1992 according to IMF computations, and especially for the developing countries as a group. In contrast, the outcome for industrial countries as a whole was marginally negative. Extension of the procedure to 1993-1995 resulted in significantly higher average annual rates of GDP growth not only for the global economy, but also for both developing and developed countries as a whole.[5] In a more recent comparison of individual country GDP weights based on PPP relative to those derived by converting 1992-1996 averages of nominal GDP into dollars using annual average market exchange rates,[6] the relative importance of Japan declined from 18.1 per cent to 9.4 per cent, in contrast to a corresponding increase from 2.4 per cent to 11.9 per cent for China. However, the PPP-based weights of the individual country are not the same as those given by the IMF, mentioned earlier. It is not clear whether the discrepancy is the outcome of using a different methodology in estimating PPP or of applying more up-to-date PPP estimates, or whether it is simply due to a difference in country coverage.

There are clearly advantages and disadvantages associated with alternative approaches to measuring real GDP. It is perhaps best not to regard one method as superior to another, so much as to consider each as a means of providing a different perception of the performance of an economy or of a group of countries. No single method of aggregating data across countries can be expected to be appropriate for all purposes. Indeed, PPP-based weights would not be appropriate, for instance, for aggregating international trade or capital movements which are transacted at market exchange rates. Accordingly, caution should be exercised in comparing growth in world trade with growth in output based on PPP weights.

What is also clear is that estimates of real GDP growth for a given region and period provided by different agencies may be somewhat different for a variety of reasons, including differences in weighting schemes, base year and country coverage, even if the database is the same. In comparing data on GDP growth at the regional or global level available from alternative sources, it is essential to keep such differences in mind.

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1 For the United States economy, because of the spectacular fall in computer prices, changing the base period to more recent years results in a significant drop in both the share of the computer industry in real GDP and its contribution to GDP growth. To avoid overstating growth in recent years, the Bureau of Economic Analysis of the Department of Commerce switched to a chain-weighted procedure to measure real GDP growth – i.e. computing an index which is the geometric mean of values based on current prices and those of the preceding year. By continually moving the base period forward rather than using some distant year as a base, the chain-weighted procedure eliminates the problems associated with the fixed base-year method. In particular, switches in production between similarly priced products will not distort the measure of growth, and the historical growth record will be unaffected by an arbitrary shift of the base year. The chain-weighted procedure, however, is not without its limitations and disadvantages. Current prices are not so readily available and are subject to revisions. In addition, an error in any of the elements in the chain will remain uncorrected, and there is a tendency for such errors to cumulate over time. A more serious difficulty is that the components of GDP no longer add up to the total.

2 See *The Economist*, 28 November 1992.

3 The ICP was coordinated by the United Nations and supported by the World Bank, the OECD and other international agencies.

4 IMF, *World Economic Outlook*, May 1993, annex IV, table 33.

5 With regard to industrial countries, output growth in 1995 came out the same for both methods; see Asian Development Bank, *Asian Development Outlook 1994* (Hong Kong, China: Oxford University Press, 1994), pp. 229-230.

6 Morgan Guaranty Trust Company, "Measuring the world economy", *World Financial Markets*, New York, 2 January 1998, p. 114.

expenditures to 7.7 trillion yen. It is officially estimated that the entire package will produce a 2 per cent increase in GDP. While the tax reductions are to be immediate, the higher public expenditure will take more time to work through to an increase in income. The impact on growth in the current year is thus likely to be substantially lower. The ultimate success of the package will depend on how far it reverses the decline in private spending. At the same time, plans were announced to force banks to fully write off or sell existing bad loans.

The crisis in East Asia poses a particular problem for Japan since the majority of foreign lending by banks, as well as over 40 per cent of merchandise exports and 37 per cent of service exports, go to the region. Asia-5 accounts for almost 20 per cent of merchandise exports and 16 per cent of imports (see also chapter II). The risk of a deepening of the recession is especially critical, for it comes on top of continued weakness in the financial sector. A deepening of the recession will make it more difficult to clear the existing assets that have to be liquidated, and will exacerbate the problem of non-performing loans and the asset overhang, thus further weakening the banks. A severe contraction that placed banks in difficulty would certainly lead to repatriation of dollar assets held by Japanese financial institutions, putting pressure on United States interest rates and equity prices, making debt servicing in East Asia more difficult, and creating turbulence in global exchange rates and asset markets. Furthermore, given the role that Japan has played as a source of direct investment and as a market for exports from the rest of Asia, recession in that country would preclude recovery in the region. It is unclear whether the new government expenditure package will be capable of permanently restoring growth in Japan, since the recent temporary tax reductions appear to have had only a marginal impact on consumer spending.

In the current state of the global economy, Japan cannot rely on external demand to compensate for the deficiency in internal demand. Increasing net exports by shrinking both imports and exports is largely self-defeating. The only alternative is to attempt to increase exports by allowing the yen to weaken further against the dollar, but that could also be self-defeating as Japan would be competing with the rest of Asia for United States markets – something that would certainly lead to further competitive devaluations in the region, possibly including China. Furthermore, there is the risk that this strategy would be interpreted as a purely temporary policy move, generating expectations of an early reversal and anticipation of yen appreciation, and hence causing a reversal of capital flows back to Japan, which would again put pressure on global equity markets.

As a mature developed economy Japan can no longer depend on the rest of the world for its demand growth. It clearly needs to find an internal source of demand. In *TDR 1996* the UNCTAD secretariat recommended boosting demand by decreasing domestic costs through liberalization of the retail and service sectors. This is a necessary first step towards the exploitation of the new technologies in the transportation and telecommunications industries along the lines of what was done in the United States, where the deregulation of air and road transport, and antitrust actions in the computer and telecommunications industry, created additional employment and technological innovation. Furthermore, it could bring about substantial changes in the way the wholesale and retail sectors operate. In this sense, Japan resembles the other East Asian economies which have experienced a decline in their terms of trade relative to the information-based products that have come to dominate the growth process in the United States.

There is also a need to take steps to clear the asset overhang resulting from bad loans and bankruptcies in order to restore normal market conditions. The rationale for avoiding a rapid disposition of assets has been to allow time for economic conditions to improve and for balance sheets to be strengthened; there has been no such improvement or strengthening, however. Furthermore, all of East Asia will be entering a period of asset disposal. Japan finds itself in a position similar to that of the Eastern European countries attempting to privatize; namely, there are insufficient domestic buyers, and thus sellers will have to look to foreign buyers. The recent policy of speeding the removal of bad loans from bank balance sheets is certainly a step in the right direction. However, in all probability only a small proportion of asset values will be recovered and most bad loans will end up as losses to be covered by the public sector. This outcome should not be used to justify expenditure reductions in other areas, as has been done in Thailand and the Republic of Korea.

(c) European Union

The United Kingdom was the first EU member to emerge from recession in the 1990s, and continues to enjoy economic expansion. During 1997 a number of the smaller economies, such as Denmark, Finland, Ireland, the Netherlands, Norway and Portugal, also grew at or well above their potential growth rates. The larger continental economies have been unable to match the United Kingdom's continuous performance or the recent rapid growth of the smaller economies, Spain being the exception. These core European economies appeared to be entering a period of more sustained growth as conditions improved in the fourth quarter.

During 1997 inflation, as measured by the rise in consumer prices, was uniformly low at 2.2 per cent or below in all countries except the United Kingdom, where the rise was 3.1 per cent, and Greece, where it was at 5.5 per cent. Despite the nascent recovery in economic activity, unemployment has remained at over 11 per cent in France, Germany and Italy. Policies designed to cut fiscal deficits to 3 per cent or below in order to qualify for the third stage of monetary union continued to restrain growth in domestic demand, while high unemployment and weak real wage growth kept consumption down.

Because of close trade links and increasing integration among the countries in the European Union, the recovery in domestic demand has had a strong multiplier effect that has produced sustained export growth. However, the major support for demand came from outside the region, including North America, the transition economies and developing countries outside East Asia. The increase in net exports was concentrated in those countries whose currencies have recently declined relative to the dollar, including France and Germany. Export performance in 1997 remained moderate in countries whose currencies had depreciated earlier, such as Greece, Italy, Sweden and the United Kingdom.

The Asian crisis is expected to reduce both GDP and export growth in the European Union by over 0.5 percentage points. The impact is likely to be spread unevenly across the region, as well as among sectors. However, steady and more balanced growth in 1998 will require strengthening domestic demand to replace the reliance on exports. The introduction of the single currency, the euro, in January 1999 is expected to provide some stimulus to domestic demand. By that date, the 11 countries entering the third stage of monetary union will have a uniform rate of interest. The convergence of long-term rates has now been more or less completed, but short-term rates in high-yield countries such as Italy and Spain will have to be reduced significantly towards the uniform rate, which is likely to be below 4 per cent.

There are other aspects of the introduction of the single currency that may be less positive. The current European Monetary System will cease to exist as from January 1999 and be replaced by the new European Central Bank, which will be in charge of monetary policy in the eurozone. Its primary objective will be the stability of the euro. Given the significant differences in financial structure and economic performance of the 11 countries involved, it is clear that a centralized monetary policy will not always be precisely that which would otherwise have been pursued by central banks acting on the basis of national conditions and priorities. Of course, this was one of the reasons for requiring substantial economic convergence before initiating monetary union. Nevertheless, differences remain and there is uncertainty whether the monetary policy which suits the area as a whole will err on the side of restriction or expansion. Since the new European Central Bank will be working in uncharted areas, it is likely to err more on the restrictive side. Although fiscal policy will remain largely within the competence of national governments, the scope for independent national fiscal action to counter a centralized monetary policy that is deemed inappropriate from the point of view of an individual country will be, for all practical purposes, constrained by the provisions of the Stability and Growth Pact of June 1997. Until there is sufficient experience and convergence, it is thus likely that overall policy will remain restrictive and offset many of the benefits of the lower short-term interest rates that may result from the single monetary policy. Fears of a weak euro may thus be exaggerated.

With a single currency, trade among participating EU members will no longer be influenced by movements in national exchange rates, nor will capital movements be influenced by interest rate differentials, but there will still be differences in wages, productivity and real incomes. Economic adjustment will consequently have to be made in terms of greater variations in levels of output and employment, since exchange rate adjustment is no

longer an available instrument and the scope for national policy measures is diminished. Performance will thus be determined by relative competitiveness and purchasing power as determined by the growth of relative wages and productivity.

For example, if, as is currently the case, nominal wage rates in Germany grow by less than labour productivity, German goods will become increasingly competitive, and the profitability of domestic firms and sales of German goods in the rest of the EU will be enhanced. Demand will thus be transferred to German producers, lowering output and employment in the rest of the Union. Since reducing interest rates relative to Germany is no longer possible, and since any increase in demand through fiscal expenditure would be limited by the Stability and Growth Pact and would in large part be drained off to Germany, the only available alternative policy would be to counter with reduced unit labour costs. Such a result can be achieved either through changes in nominal wages or through increased productivity. Since wages can be adjusted more rapidly than productivity can be increased, it is likely that policies to defend domestic producers will hold back wages and prices, with the risk of deflation greater than that of inflation. On the other hand, if a reduction in real wages is impossible because of social resistance, unemployment will rise. Either response will not only make it more difficult to expand domestic demand, but also tend to strengthen the euro, thereby reducing the contribution of external demand to growth. The major challenge facing the new European Central Bank is thus unlikely to be the prevention of inflation, but rather to sustain domestic profitability and demand at levels compatible with acceptable rates of unemployment.

2. Developing countries

(a) Latin America

Since the debt crisis of the 1980s the major challenge in Latin America has been to reconcile growth fast enough to keep unemployment at acceptable levels and reduce poverty with a sustainable external payments position. The recovery that has taken place since the Mexican crisis suggests that this dilemma is still present, as the payments position has continued to worsen, although the deficits now involve a higher proportion of capital goods in total imports than in the past. These difficulties have been compounded by the impact of the East Asian crisis on commodity and petroleum prices. The heavy reliance on private capital inflows to finance the growing payments deficits has meant that Latin American countries are still subject to the risk of contagion.

There was a particularly strong recovery in 1997 in countries such as Argentina, Chile, Mexico, Peru and Uruguay, which all had GDP growth of 6.5 per cent or more (table 4). The Chilean economy, in particular, experienced its fourteenth year of consecutive growth in spite of restrictive policies imposed to check the overheating of the economy that became evident in 1996. The consumption-led boom in Brazil in 1996 was similarly moderated in 1997 by a tightening of monetary policy and the introduction of budget reductions in response to the East Asian crisis. Although GDP growth at 3.5 per cent was below the regional average, it was nevertheless an improvement over the preceding year, and was the fifth year of uninterrupted growth, with declining inflation but a rising external deficit.

Responsible for the surge of growth in Latin America was a strong recovery in investment, together with continued expansion in exports. Owing in large part to the impact of the East Asian crisis, export prices were virtually at the same level as the previous year for the region as a whole, and higher export earnings were due entirely to the increase in export volumes, which was 2.5 times that of GDP. The trend in export prices will be downward in 1998 as the impact of the East Asian crisis works its way through the global economy.

Intraregional trade continued to play an important role in the growth dynamics of the region, reinforcing economic interdependence among countries, particularly those associated with the Southern Cone. The nearly complete implementation of the Southern Cone Common Market arrangement led to an expansion of intraregional trade in general, and of trade in grains in particular. Argentina has continued to capitalize on export opportunities, chiefly in the Brazilian market, whereas Mexico's exports, concentrated on manufactures to North America, continued to benefit from its post-crisis currency depreciation.

On the other hand, because of a sharp increase in imports of capital goods associated with in-

Table 4

LATIN AMERICA: OUTPUT AND TRADE, 1995-1997

(Percentage changes over previous year)

Country	Output[a]			Export volume			Import volume		
	1995	1996	1997[b]	1995	1996	1997[b]	1995	1996	1997[b]
All countries	0.6	3.6	5.2	12.0	11.0	12.5	3.0	11.5	21.5
of which:									
Argentina	-5.0	3.5	8.0	20.3	5.6	7.3	-14.4	19.7	27.6
Bolivia	3.8	3.9	4.0	5.2	9.4	5.5	13.2	-0.3	23.3
Brazil	3.9	3.1	3.5	-2.3	3.7	7.3	31.4	6.1	21.2
Chile	8.2	7.2	6.5	11.5	14.5	9.6	23.1	12.4	14.9
Colombia	5.9	2.2	3.0	2.2	5.0	12.3	6.8	0.4	11.1
Costa Rica	2.2	-0.6	2.5	8.7	10.8	7.2	-2.9	6.0	18.7
Ecuador	2.7	2.0	3.5	7.1	3.3	3.5	14.5	-8.0	20.4
El Salvador	6.3	2.5	4.0	15.3	5.8	21.2	21.6	-8.8	14.4
Guatemala	5.0	3.1	4.0	19.4	12.4	13.2	10.7	-1.5	17.9
Mexico	-6.6	5.2	7.0	24.4	16.0	19.2	-13.8	18.8	24.6
Paraguay	4.5	1.0	2.5	19.7	-10.7	-1.6	20.2	-10.6	4.8
Peru	7.8	2.5	7.0	8.2	6.1	12.7	27.5	1.7	14.2
Uruguay	-2.3	4.8	6.5	-0.7	16.8	13.9	-5.3	15.7	17.1
Venezuela	3.5	-1.4	5.0	6.0	3.2	8.1	24.9	-22.0	34.4

Source: WTO Press Release, 19 March 1998; ECLAC, *Preliminary Overview of the Economy of Latin America and the Caribbean 1996,* Santiago, Chile, 1996 (United Nations publication, Sales No. E.96.II.G.13), tables A.9 and A.10 (for trade in 1995); and *ibid.*, tables A.1, A.8 and A.9.

a Based on values in 1990 prices.

b Preliminary.

creased investment, imports in 1997 expanded in volume terms at rates much higher than those of exports for practically all countries in the region, with the major exceptions of Colombia and El Salvador. The growth in import volume in Argentina, for instance, was an unprecedented 28 per cent. In Brazil and Mexico, currency appreciation and a surge in capital inflows led to a corresponding rate of 21 per cent and 25 per cent respectively, although rising domestic demand was also important in Mexico. The faster growth of imports than of exports led to a substantial widening of the current account deficit for the region, which amounted to $60 billion, up from $35 billion in 1996, and is attributable to large deficits in Argentina, Brazil and Mexico together with a smaller than usual surplus in Venezuela.

While average export prices for 1997 in the region as a whole remained stable, coffee prices, which are important for Colombia and the Central American countries, were strong. On the other hand, oil exporters such as Bolivia, Ecuador, Mexico and Venezuela and exporters of industrial raw materials such as Chile suffered terms of trade losses to varying degrees. Chile's terms of trade were also affected by falling prices for fishmeal and fresh fruits.

Accompanying the acceleration in output growth was a continuation of the sharp downward trend in inflation, which fell to its lowest level in half a century. The rate of inflation in 1997 was lower than in 1996 in 10 countries and remained stable in 11 others. Argentina had one of the low-

est rates of inflation in the world. In contrast, the rate soared to a record high in Venezuela following price liberalization and a major devaluation.

Capital inflows in 1997, following the sharp reversal of the declines recorded in 1995 because of the Mexican peso crisis, surged to a record $73 billion, or some 4 per cent of regional GDP, and were more than sufficient to cover the substantial increase in the current account deficit. The composition of capital inflows has shifted since the early 1990s, with FDI now constituting nearly two thirds of the total, compared with less than one fifth in 1994. Currently, short-term capital inflows from banks represent only a moderate portion of total inflows in most countries (and are primarily the result of foreign trade financing). The magnitude of capital inflows led to currency appreciation, especially during the first half of 1997, when the dollar strengthened in international markets. Overall, the region's currencies appreciated at an average rate of 4 per cent against the dollar in 1997, but by as much as 20 per cent in Venezuela. Three countries experienced depreciations – El Salvador, Nicaragua, and Trinidad and Tobago.

Growth for the region in 1998 is expected to slow to around 3 per cent primarily as a result of developments in East Asia. As the East Asian financial crisis intensified towards the end of 1997, some of the emerging financial markets in Latin America came under pressure, most markedly in Brazil, but also in Argentina, Chile and Mexico. In most countries, pressure was relieved primarily through the immediate adoption of restrictive monetary and fiscal policies, the effects of which continue to be felt throughout the region.

The Central Bank of Brazil, faced with a sharp decline in share prices and growing pressures on foreign exchange reserves in October 1997, increased interest rates to over 40 per cent, and the Ministry of Finance announced a package of expenditure cuts and tax increases worth $18 billion, aimed at reducing the public sector deficit by the equivalent of almost 2.5 percentage points of GDP. Although monetary policy was relaxed in subsequent months and the public sector deficit continued to increase, to some 6-7 per cent of GDP, growth in the economy has fallen back and can be expected to be less than 2 per cent in 1998. However, interest rate differentials remain high and the offer of dollar-linked returns has caused a sharp increase in capital inflows, which exceeded $10 billion in March 1998.

In Argentina, stock market prices also retreated in response to the October 1997 crash and interest rates rose. The main source of concern was the potential impact of a spread of the East Asian crisis to Brazil, since Argentina has become increasingly dependent on exports to its principal MERCOSUR partner. In Chile, in spite of raising interest rates in real terms from 6.5 per cent to 8.5 per cent between October 1997 and January 1998, the Central Bank had to allow the peso value of the dollar to float upwards, and can be expected to maintain tight monetary conditions in order to prevent further depreciation.

Latin American exports are expected to slow down in 1998 as East Asian demand continues to weaken. In addition, countries in the region are likely to lose competitiveness to varying degrees because of the depreciation of several Asian currencies. To maintain its competitiveness, for instance, Brazil in early 1998 widened the bands within which its currency is permitted to fluctuate against the dollar. The expected lower international prices of oil and non-oil commodities will also tend to reduce export revenues of many countries in the region; and the collapse of copper prices has already produced a serious decline in earnings in Chile.

Although the focus of concern stemming from the East Asian crisis has shifted from capital flows to trade, the region is likely to remain vulnerable to the volatility of capital inflows, notwithstanding the progress that has been made in the composition of capital inflows and strengthening of the banking sector in recent years. For the region as a whole, short-term foreign debt is currently equivalent to 35 per cent of export earnings (ranging from 11 per cent in Venezuela to 78 per cent in Peru among the large countries) and to 70 per cent of total reserves (ranging from 33 per cent in Venezuela to 154 per cent in Mexico). Prospects for 1998 as a whole will be crucially affected by developments in both the United States and Japan.

(b) Asia

The spread of the financial crisis across the Asian economies during the second half of 1997 had a varying impact on countries in the region (table 5) and was greatest in South-East Asia, where growth rates fell by almost half from 1996 levels. Growth in South Asia also declined, but

Table 5

DEVELOPING ASIA: OUTPUT AND TRADE IN SELECTED SUBREGIONS AND COUNTRIES, 1995-1997

(Percentage changes over previous year)

	Output[a]			Value of exports			Value of imports		
Region/country	*1995*	*1996*	*1997*	*1995*	*1996*	*1997*	*1995*	*1996*	*1997*
Newly industrializing economies	7.4	6.4	6.0	20.9	4.5	3.4	22.9	5.2	3.0
of which:									
Hong Kong, China	3.9	5.0	5.2	14.8	4.0	4.0	19.1	3.0	5.1
Republic of Korea	8.9	7.1	5.5	31.5	4.1	7.2	32.1	12.2	-2.3
Singapore	8.7	6.9	7.8	21.0	6.4	-3.1	21.6	5.4	0.1
Taiwan Province of China	6.0	5.7	6.8	20.0	3.8	5.2	21.2	-0.1	10.1
South-East Asia	8.2	7.1	3.9	24.3	6.0	8.7	29.7	6.3	2.4
of which:									
Indonesia	8.2	8.0	4.6	18.0	5.8	11.2	26.6	8.1	4.8
Malaysia	9.5	8.6	7.5	26.6	7.3	6.0	30.4	1.7	7.0
Philippines	4.8	5.7	5.1	29.4	17.7	22.8	23.7	20.8	14.0
Thailand	8.8	5.5	-0.4	24.8	-1.9	3.2	31.9	0.6	-9.3
South Asia	6.6	6.8	4.8	20.5	5.5	5.1	25.7	7.7	5.6
of which:									
Bangladesh	4.4	5.4	5.7	37.2	12.2	13.7	39.4	17.8	3.0
India	7.2	7.5	5.0	20.8	4.1	5.0	28.0	5.1	8.2
Nepal	2.8	6.1	4.3	-9.6	1.7	10.3	21.9	9.0	10.3
Pakistan	5.2	4.6	3.1	16.1	7.1	-2.7	18.5	16.7	-5.0
Sri Lanka	5.5	3.8	6.3	18.7	7.9	13.0	11.6	2.5	7.0
China	10.5	9.6	8.8	24.9	17.9	20.0	15.5	19.5	2.5

Source: *Asian Development Outlook 1998* (Hong Kong, China: Oxford University Press for the Asian Development Bank, 1998), tables A1, A11 and A13.

a Based on data in constant prices.

for the first time in this decade exceeded that in South-East Asia. Export and import growth rates were comparable to those of the preceding year, but much lower than in 1995.

In October 1997 the financial crisis reached Hong Kong, China, where the stock market suffered the biggest loss ever recorded, and subsequently the other first-tier NIEs (the Republic of Korea, Singapore and Taiwan Province of China). To the extent that GDP growth in these economies was affected in 1997 (6.0 per cent, down from 6.4 per cent in 1996) this was due to a sharp fall in world demand and prices for such products as electronics, semiconductors, steel and petrochemicals.

The Chinese economy sustained its strong growth momentum in 1997, although it failed to attain the official target of 10 per cent. Weak domestic demand was partly offset by a surge in exports. The prices of a wide range of consumer goods were reduced through a combination of

administrative measures and macroeconomic policies. Township and village enterprises accounted for nearly half of the country's industrial output and one third of its exports in 1997, and they were also responsible for GDP expansion at about double the rate for the economy as a whole. The Asian crisis has brought into sharper focus the need for government to give greater attention to problems in the financial sector and to adopt measures to enhance the effectiveness of monetary policy and restructure the assets of state banks.

In South-East Asia, GDP growth at less than 4 per cent in 1997 was the lowest for two decades. The financial difficulties in the countries of the region were compounded by the abnormal weather created by El Niño, which has so far brought the severest drought in 50 years to Indonesia, Malaysia, the Philippines, Singapore and Thailand. For the first three countries, which were the hardest hit, the economic effects will continue to be felt in 1998.

Growth in South Asia in 1997 fell to less than 5 per cent (from 6.8 per cent in 1996). There were wide disparities in performance among countries, reflecting differences in performance in the agricultural and manufacturing sectors. The significant decline in output growth in both India and Pakistan is attributable in part to the impact of adverse weather on agriculture. In Pakistan, cotton viruses also played a part. Growth in Bangladesh was the most rapid it had been in the 1990s, primarily because of an impressive expansion in agricultural production, notably for rice. Faster growth in Sri Lanka, on the other hand, was the outcome of a recovery in agriculture together with sustained growth in manufacturing, which continued to be the most dynamic sector.

The impact of the Asian financial crisis on South Asia has been less dramatic because of restrictions on capital account convertibility and more limited exposure to short-term foreign debt. The currencies of India and Pakistan depreciated by around 10 per cent in the latter half of 1997. Unlike in South-East Asia, the economies of the subregion remain less closely integrated with the global economy because of a gradual approach to trade liberalization, financial deregulation and privatization. The creation of new regional arrangements such as the South Asian Preferential Trade Agreement is a step towards closer integration within the region and also with the world economy.

Economic performance in West Asia continued to be dominated by developments in the oil sector and by political conditions in the subregion. GDP grew by 7.6 per cent in 1997, compared with 10.4 per cent the previous year, mainly because of higher oil production which more than compensated for the decline in price. Governments in the region gave increasing importance to the private sector and foreign investment, and continued to implement policies designed to correct internal and external imbalances as well as to enhance efficiency and productivity. The pace of progress, however, varied widely from country to country and, with the exception of Jordan, Lebanon, the Syrian Arab Republic and Yemen, there is continued heavy dependence on oil. In view of the less than bright prospects for oil prices, growth for the region in 1998 is expected to decline further, to less than 6 per cent.

All first-tier NIEs are expected to grow more slowly than in 1997, most markedly the Republic of Korea, where output is projected to contract by 6 per cent. The slowdown is expected to be least in Taiwan Province of China, falling to around 4-5 per cent. The declines are likely to be more substantial for Singapore and Hong Kong, China, as a result of the fall in South-East Asia's demand for their exports, reduced tourist earnings and the impact of tighter monetary policy. Growth in Singapore is unlikely to exceed 1 per cent, while Hong Kong, China, is likely to go into recession with a contraction of the economy of 2-3 per cent. Growth in China is also likely to slow in 1998, to around 6 per cent. Unemployment is expected to become more serious with further lay-offs from public enterprises during the three years of scheduled reform that started in 1997, and there is also the likelihood of reduced export growth due to loss of competitiveness.

For South-East Asia, the outlook for 1998 is extremely uncertain and will depend, *inter alia,* on how and to what extent governments fulfil the conditions associated with borrowing from the IMF. Of particular concern is the case of Indonesia, where massive lay-offs and soaring prices of essential foodstuffs have increased unemployment and poverty levels dramatically and given rise to social unrest. Other countries severely affected in social terms by the crisis include Thailand and the Republic of Korea. (The social impact of the crisis on the most affected countries is discussed in chapter III.)

In South-East Asia exports have yet to respond to the dramatic currency depreciations that have taken place. The improvement in the trade balance in the most affected economies so far has been due primarily to a sharp decline in imports. Because of the huge burden of private sector debt, Thailand is expected to have a negative growth rate in 1998 of 8 per cent, while contraction in Indonesia may exceed 12 per cent. Malaysia is also likely to experience recession, while growth in the Philippines may remain positive but substantially reduced.

Growth in 1998 for South Asia is expected to revert back to the 1996 level with the recovery of Pakistan and India, but in most countries it will continue to be constrained by inadequate infrastructure as well as political instability. Without further adjustments in exchange rates, major export sectors, such as garments, textiles, plastics and synthetic fibres, which compete with exports from other Asian economies will be adversely affected. Pakistan in particular, with its exports largely in textiles and clothing, will face keener competition. Following their nuclear tests, India and Pakistan have been subject to economic sanctions by some of their major trading partners. Should such sanctions be intensified, both economies may face payments difficulties and a slowdown in growth even though they may avoid a serious financial crisis and currency turbulence associated with capital flight.

(c) Africa

Growth continued in 1997, albeit at a much slower pace than in 1996. At 3.3 per cent it was barely above the rate of population growth and well below the 4.6 per cent achieved in 1996. There was considerable variation in performance among subregions and individual countries, where much depended on weather conditions, the behaviour of commodity prices, as well as the existence or absence of armed conflicts and social unrest (table 6).

In spite of the progress made in export diversification, regional exports continued to be dominated by minerals in South Africa; oil and gas in Algeria; oil in Nigeria; crude and refined oil in Egypt; phosphates and phosphoric acid and citrus in Morocco; cocoa and coffee in Côte d'Ivoire; oil and diamonds in Angola; diamonds in Botswana; copper in Zambia; oil, timber and

Table 6

OUTPUT GROWTH OF AFRICAN COUNTRIES, 1990-1997

(Percentage changes over previous year)

Country	*1990 -1995[a]*	*1995*	*1996*	*1997*
Algeria	0.4	4.5	4.0	4.5
Angola	-2.4	6.2	7.2	8.0
Benin	4.3	4.8	5.6	5.9
Botswana	4.7	4.5	6.2	4.9
Burkina Faso	3.3	4.5	5.5	6.6
Burundi	-1.7	-3.4	-12.9	4.3
Cameroon	-1.4	4.4	5.0	5.1
Cape Verde	4.3	4.7	4.2	4.5
Central African Republic	1.1	4.1	-3.9	-3.3
Chad	2.7	5.5	2.8	6.3
Comoros	0.2	-2.4	-0.4	0.0
Congo	-0.4	0.8	5.9	-17.6
Côte d'Ivoire	1.1	6.9	6.8	6.1
Dem. Rep. of the Congo	-7.6	1.6	1.3	-5.0
Djibouti	-2.0	-3.1	-5.0	0.8
Egypt	1.4	2.3	4.3	5.0
Equatorial Guinea	8.2	14.9	38.9	96.7
Eritrea	2.0	5.5	6.9	4.4
Ethiopia	2.0	5.4	11.9	5.3
Gabon	2.4	3.7	3.2	4.5
Gambia	0.6	-6.5	2.8	2.2
Ghana	4.3	4.0	5.2	3.0
Guinea	3.6	4.4	4.5	4.8
Guinea-Bissau	3.3	1.6	5.8	5.2
Kenya	1.6	4.4	4.3	2.0
Lesotho	6.0	9.3	12.6	7.2
Libyan Arab Jamahiriya	-1.0	-1.1	2.0	2.0
Madagascar	-0.3	1.8	2.0	3.5
Malawi	1.2	9.0	16.1	5.6
Mali	2.7	6.3	4.0	6.6
Mauritania	3.9	4.6	4.5	4.3
Mauritius	4.9	4.4	6.1	5.6
Morocco	1.0	-7.2	11.8	-1.1
Mozambique	5.8	1.5	6.4	6.6
Namibia	4.1	2.5	5.0	4.0
Niger	0.8	3.2	3.3	4.5
Nigeria	2.7	2.6	2.4	3.2
Rwanda	-10.0	23.2	11.4	12.7
Sao Tome and Principe	1.7	1.9	1.9	1.8
Senegal	2.3	9.8	5.1	4.7
Seychelles	2.8	-1.8	1.7	2.1
South Africa	0.8	3.4	3.1	2.2
Sudan	5.9	4.5	4.3	5.0
Swaziland	2.0	3.5	2.5	2.5
Togo	-0.6	8.4	6.2	5.8
Tunisia	3.9	2.9	6.9	5.1
Uganda	7.5	9.6	9.4	4.2
United Rep. of Tanzania	4.1	3.8	4.2	4.1
Zambia	-0.5	-3.1	6.4	4.6
Zimbabwe	0.8	0.1	7.4	4.5

Source: UNCTAD secretariat calculations, based on data in 1990 dollars.

a Annual average.

manganese in Gabon; metals, tobacco and cotton in Zimbabwe; and tea and coffee in Kenya. Primary-commodity-exporting countries were adversely affected by a reversal of favourable commodity prices, particularly oil prices.

In addition, drought and flood conditions caused by the El Niño weather pattern undermined agricultural production in countries as diverse as Morocco in North Africa, Ethiopia, Kenya, Somalia and the United Republic of Tanzania in East Africa, Zambia and Zimbabwe in Southern Africa, as well as several countries in the Sahel region. Rain-fed agricultural production in various countries (Eritrea, Ethiopia, Kenya, Somalia, Uganda and the United Republic of Tanzania) was devastated by the vagaries caused by El Niño, which brought excessive rain in parts of East Africa, but drought in parts of Southern and North Africa. As a result of extensive damage to crops as well as losses of large numbers of livestock, there was a collapse in food production. Food shortages were especially severe in the countries of Southern and East Africa. At the same time, damage to infrastructure (roads, bridges and railway lines) seriously disrupted the movement of goods both within and between countries.

Although a large number of countries in the region registered growth rates of above 4 per cent in 1997, some large economies, including the Democratic Republic of the Congo, Morocco, Nigeria and South Africa, experienced low or negative growth. In many countries, sustained policy efforts and macroeconomic stability have created an environment conducive to investment and increased production. Although traditional commodities continued to dominate total exports, diversification into non-traditional exports has been progressing in several countries in North and Southern Africa, such as Egypt, Tunisia and Botswana. Also notable were a spread and strengthening of economic growth among countries in the region, in contrast to the early 1990s when one third of the countries had declining output. Countries of the franc zone (CFA), such as Côte d'Ivoire, Mali and Senegal, continued with further recovery following their exchange rate adjustments in 1994. However, growth in Uganda was more than halved compared with the previous two years, while economic performance remained disappointing in Nigeria and South Africa.

On a subregional basis, only Central Africa had less than 3 per cent growth in output in 1997. For the other subregions, it was 3.4 per cent in Southern Africa and a little below 4 per cent in East, West and North Africa. However, with the exception of West Africa, which managed to sustain the previous year's rate, all subregions had significantly slower growth than in 1996. In East Africa, growth declined not only in Ethiopia and Uganda, but also in Kenya, by far the largest country in the subregion, owing to the effect of drought on agricultural output, although policy uncertainty also played a part. In West Africa, lower oil prices together with an uncertain business environment weakened recovery in non-oil sectors in Nigeria. In Ghana, mining activity was depressed by the sharp fall in the price of gold to its lowest level in 18 years, although the country benefited from higher cocoa production and prices. The phenomenal increase in output in Equatorial Guinea was due to a new discovery of oil. The growth momentum in the CFA economies in the subregion, such as Benin, Burkina Faso, Côte d'Ivoire, Mali, Senegal and Togo, was sustained by increased exports. In North Africa, the decline in output in Morocco was in sharp contrast to the acceleration of growth in Egypt, or the relatively good performance of Tunisia. In Central Africa, output declined by 5 per cent in the Democratic Republic of the Congo, which is the largest economy in the subregion, whereas Cameroon, Gabon and other CFA countries continued to maintain their growth momentum. In Southern Africa, agricultural production was seriously affected by El Niño. The slowdown in agriculture, together with that in mining as well as in investment and exports, led to a sharp fall in Zimbabwe's GDP growth. On the other hand, strong oil exports and the return of stability to some parts of the country led to an acceleration of growth in Angola. Output growth in South Africa, the largest economy on the continent, suffered from the downturn in the gold mining sector as a result of the sharp fall in the price of gold.

Financing the current account deficit remains the major challenge facing African countries. The overall current account deficit increased slightly, from $7 billion in 1996 to $7.2 in 1997. As a share of GDP, however, it fell from 2.6 per cent to 2.0 per cent, in contrast to high and persistent current account imbalances in the past. Indeed, only a few countries, such as Equatorial Guinea, Lesotho, Mozambique and Sudan, had current account deficits above 20 per cent of GDP. In some 10 countries, including Burundi, Cameroon, Morocco, South Africa, Tunisia, Uganda and Zimbabwe, the

deficit was less than 3 per cent, and in others, such as Algeria, Botswana, Gabon, Namibia and Nigeria, there was a surplus. Current account deficits are increasingly financed by non-debt-creating capital flows. Foreign direct investment, however, is highly concentrated in a few countries. In 1996, for example, Algeria, Angola, Côte d'Ivoire, Egypt, Ghana, Morocco, Nigeria, South Africa and Tunisia accounted for over two thirds of FDI flows to Africa, with Nigeria alone absorbing about a third of the total. FDI flows are also highly concentrated with respect to country of origin and economic activity. France, the United Kingdom, Germany and the United States are the major investors, and oil, gas, metals and other extractive industries are the key investment targets. Flows are likely to be affected by the Asian crisis now that some developing Asian countries, particularly Malaysia, have become significant investors in the region in recent years.

For 1998 growth in Africa as a whole is not expected to be much better than in 1997. The Asian crisis will directly affect a number of countries with increased trade links with that region. Export expansion may also weaken on account of the indirect effect of the crisis on the continent's major trading partners in Europe and North America. The prices of commodities that are of interest to Africa are likely to be depressed. Prospects for higher oil prices are not promising and may not favour improved economic performance of major economies, such as Algeria, Angola, Egypt, the Libyan Arab Jamahiriya, Nigeria and Tunisia. The crisis will mean somewhat smaller earnings from exports of raw materials, such as ores, and more competition for such products as rubber and copper. Countries that will be affected in this way include the Democratic Republic of the Congo, Ghana, South Africa and Zambia. In addition, it is not certain that the effects of El Niño have worked themselves out.

3. Transition economies

The major economic development in 1997 was the turnaround in the transition economies as a group, and in the economies of the Commonwealth of Independent States (CIS) in particular, after years of declining output following the break-up of the USSR. It was attributable to a strengthening of the incipient recovery in a number of countries together with the bottoming out of a persistent decline in economic activity in the Russian Federation. There continued to be much divergence among countries, with a fall in GDP of over 7 per cent in Bulgaria at one extreme and a rise of over 11 per cent in Estonia at the other (table 7). At the subregional level, the marked deceleration in growth in Central and Eastern Europe is in sharp contrast to the spectacular acceleration in the Baltic States and to some extent in the CIS.

The favourable developments in 1997 are a reflection of the success of economic reforms and gradual economic consolidation in an increasing number of countries, which allowed them to take advantage of the stronger than expected growth in Western Europe's import demand. Outside the CIS, and with the exception also of Albania, Bulgaria, the Czech Republic and Romania, growth remained strong or accelerated in 1997, notably in Croatia, Poland, Slovakia and the three Baltic States. The sharp slowdown following currency adjustment in the Czech Republic, widely regarded as one of the leading reform countries, was a major disappointment. The economy was shaken by a serious currency crisis which affected economic activity and disrupted the financial markets.

The setback was even more severe in Albania, Bulgaria and Romania, where output fell considerably. Albania continued to be affected by the financial crisis that flared up in March 1997 with the collapse of numerous large-scale pyramid schemes. Bulgaria has so far suffered the most. The speculative attack on the currency in 1996 was accompanied by a run on the banking system and a fiscal crisis, and prompted a drastic policy response which included the introduction of a currency board in July 1997 and a comprehensive programme of structural reforms. As a result, output declined for the second consecutive year. In Romania, delays in the implementation of fiscal and structural reforms together with considerable loosening of monetary policy led to a drop in output and a resurgence of inflation.

Within the CIS, output in 1997 declined only in Turkmenistan and Ukraine. Accompanying the acceleration of growth in a number of countries, notably Azerbaijan, Belarus, Georgia, Kyrgyzstan and Uzbekistan, was a turnaround in the Russian Federation, which is by far the largest economy in the region and also the principal trading partner of the other CIS countries.

Table 7

TRANSITION ECONOMIES: SELECTED ECONOMIC INDICATORS, 1995-1997

	GDP			Consumer prices			Current account balance ($ million)		
	Change over previous year[a] (Percentages)								
Region/country	*1995*	*1996*	*1997*	*1995*	*1996*	*1997*	*1995*	*1996*	*1997[b]*
Central and Eastern Europe	6.1	4.1	2.9	..	..	..	-1083	-13212	-13194
of which:									
Bulgaria	2.9	-10.1	-6.9	33.0	311.1	578.7	-26	16	441[c]
Croatia[d]	6.8	6.0	6.5	3.7	3.5	4.0	-1283	-881	-1300
Czech Republic	6.4	3.9	1.0	7.9	8.7	9.9	-1362	-4292	-3156
Hungary[e]	1.5	1.3	4.4	28.5	20.0	18.4	-2480	-1678	-981
Poland[e, f]	7.0	6.1	6.9	22.0	18.7	13.2	5455	-1352	-4280
Romania	7.1	3.9	-6.6	27.7	56.8	151.7	-1774	-2571	-2118[g]
Slovakia	6.9	6.6	6.5	7.4	5.5	6.5	646	-2098	-1500
Slovenia	4.1	3.1	3.8	9.0	9.0	8.8	-23	39	100
Baltic States	2.1	3.7	6.5	..	..	..	-816	-1425	-1236
of which:									
Estonia	4.3	4.0	11.4	28.8	14.9	12.3	-185	-423	-317
Latvia	-0.8	3.3	6.5	23.3	13.2	7.0	-16	-279	-325
Lithuania	3.3	4.7	5.7	35.5	13.1	8.5	-614	-723	-594
CIS	-5.5	-4.4	0.7	..	..	..	8145[h]	9699[h]	1268[h]
of which:									
Belarus	-10.4	2.8	10.4	244.2	39.1	63.4	-567	-503	-641
Republic of Moldova[i]	-1.9	-7.8	1.3	23.8	15.1	11.1	-115	-214	-252
Russian Federation	-4.1	-3.5	0.8	131.4	21.8	11.0	9979	11601	3032
Ukraine	-12.2	-10.0	-3.0	181.7	39.7	10.1	-1152	-1185	-870

Source: ECE, *Economic Survey of Europe 1998 (No.1)* (United Nations publication, Sales No. E98.II.E.1), table 3.1.1 and appendix table B.15, with updates provided by ECE.

a For consumer prices change from December to December.
b Full year except for the Baltic States and the listed CIS members, which are January-September.
c January-November.
d Revised data for current account.
e Current account balance has reference to transactions in convertible currencies, but only for 1995 in the case of Hungary.
f Including non-classified current account transactions.
g Official forecasts.
h Total for the four countries listed.
i Excluding Transnistria for GDP and consumer prices.

Disinflation continued in 1997, in spite of serious setbacks, notably in Albania, Belarus, Bulgaria and Romania. The reduction in inflation was widespread and varied considerably from country to country, but was particularly pronounced in the Baltic States and the CIS countries. Particularly noteworthy was the steep decline in the Russian Federation, from an annualized quarterly rate of 400 per cent in early 1995 to 2.8 per cent in the last quarter of 1997. In one or two countries, however, the lower inflation rate reflects a reluctance to implement price liberalization and is an indication more of the problems yet to come than of the success of stabilization policy.

With the exception of Bulgaria, Slovenia and the Russian Federation, all countries continued to run current account deficits, which became a matter of concern in the wake of the Asian crisis and prompted some countries to introduce measures to curb their expansion, even though the deficits were not excessively large as shares of GDP. The persistently high and increasing deficits were of particular concern in Croatia, Slovakia and the Baltic States.

Most countries in the region were not directly affected by the Asian crisis to any important extent, primarily either because they still have relatively closed economies or because they have made substantial progress in implementing policies to correct macroeconomic imbalances in earlier years. Following the collapse of equity prices in Hong Kong, China, in October 1997, only stock markets in the Russian Federation, Ukraine and Estonia suffered similar losses. In the first two of those countries, structural weaknesses in the banking system combined with financial market pressures arising from fiscal imbalances increased their vulnerability to changes in market sentiment.

For 1998, prospects are somewhat mixed. Vigorous growth is expected to continue in the three Baltic States, but with a slight slowdown in Estonia. As regards countries in Central and Eastern Europe, of those which suffered a severe setback in 1997 Albania and Bulgaria are expected to have some positive growth, but in Romania the expectation is for zero growth. A relatively high rate of growth is expected in Hungary and, to a lesser extent, the Czech Republic. In contrast, some slowdown is expected in countries which grew particularly fast in 1997 (Croatia, Poland and Slovakia), because of the need to check the worsening of external imbalances.

The general decline in the prices of some commodities, especially oil, is expected to have an adverse impact on CIS countries, where exports of such goods constitute a significant share of their total exports. Despite the progress made in 1997, the overall economic situation in the Russian Federation remains fragile and highly uncertain. Because of high exposure to foreign capital (particularly to short-term portfolio investment for financing the budget deficit), the economy is at risk from contagion and much will depend on the stability of the financial markets and the behaviour of foreign portfolio investors. Moreover, recent economic instability in the Russian economy has increased the risk of a setback in 1998.

The uncertain prospects for the countries in the region stem from various sources, some of which are inherent in the ongoing process of fundamental structural changes. There remain key areas of instability which make the economies vulnerable to various disturbances and shocks. These may result not only from external developments such as the East Asian crisis, but also from institutional and structural weaknesses that pervade most of these economies.

C. Prospects for recovery and uncertainties

The current Asian financial and economic crisis is more serious, in terms of its scope and repercussions, than any other crisis in the past two or three decades, including those in Latin America. The recent Mexican crisis of 1994-1995 was rather isolated and limited, and its impact was quite localized and relatively short-lived. In contrast, the East Asian financial crisis had a significant impact on capital markets not only in the South, but also in the North, and is the major cause of the slowdown in global growth, even though its full effects have yet to be felt. The importance of this crisis is indicated not only directly by the number of countries which are seriously affected, but also by their close ties in trade and financial flows with major economies in the region – China; Hong Kong, China; Taiwan Province of China; and above all Japan.

There is considerable uncertainty regarding the speed of recovery in East Asia. The experience of Mexico has given rise to expectations that recovery could be rapid. In that country, industrial production bottomed out four months after the crisis and had fully recovered its initial level ten months later. If this experience were to be

Table 8

GDP GROWTH IN SELECTED OECD COUNTRIES IN 1997: COMPARISON OF ACTUAL GROWTH WITH FORECASTS BY VARIOUS INSTITUTIONS

(Percentages)

Country	*LINK*	*ECE*	*OECD*	*EU*	*IMF*	*NIESR*	*NRI*	*UNCTAD*	***Actual***
United States	2.6	2.5	3.6	2.3	3.0	2.8	2.6	2.9	3.8
Japan	1.5	1.6	2.3	1.8	2.2	2.0	1.1	1.9	0.5
Germany	2.5	2.0	2.2	2.2	2.3	2.5	1.8	2.2	2.2
France	2.5	2.2	2.5	2.1	2.4	2.6	1.8	1.9	2.3
Italy	1.1	1.2	1.0	1.4	1.0	1.1	0.6	1.2	1.3
United Kingdom	3.2	3.0	3.0	3.0	3.3	3.0	2.7	2.5	3.4

***Source*:** Table 1 for actual growth rates; *TDR 1997,* table 9.

replicated, there should already have been signs of recovery in February 1998 (since the crisis broke out in September 1997). However, output and exports in most countries in Asia are still falling and the declines are spreading to other countries that had initially been spared.

Another important difference is that Mexico suffered from a clearly overvalued exchange rate, and that the composition of its imports was heavily biased in favour of consumer goods, associated with a rapid expansion of credit. Devaluation was thus able to provide for expenditure switching, while the collapse of the banking system reduced domestic absorption. The bailout of the banks brought a large increase in the public debt and in debt service, which required fiscal austerity that further reduced domestic absorption. Recovery was achieved primarily because the United States supplied the needed financial package without unnecessary delay, and robust expansion in that country provided a major market for the goods of its NAFTA trading partner.

In East Asia the problem was not one of excessive consumption; private savings were high and there were fiscal surpluses. There was a long-standing payments deficit in a number of countries that was aggravated by a downturn in external demand, a fall in export prices and a strengthening of the dollar. The real problem was the increasing vulnerability to external shocks brought about by excessive reliance on unhedged short-term foreign borrowing to finance the deficits, and its use by domestic financial institutions to fund property and finance companies. The collapse of currencies has brought massive capital losses on foreign exposure for banks and firms, forcing them to reduce lending and spending and to restructure balance sheets. They have thus had difficulty in obtaining even short-term working capital to finance production and exports. Widespread bank and corporate insolvencies have decimated the productive capacity and financial fabric of the economy, reducing its ability to adjust to the crisis through output and export expansion.

Mexico responded to its financial crisis by acting quickly to restructure the banks, taking their bad loans onto the books of a special government agency, creating a facility for the short-term financing needs of productive enterprises and providing new capital through the sale of banks to foreign owners. In Asia this policy has not been pursued; banks and enterprises have been largely left alone, but they are unable to operate effectively. Lastly, the major economy in the region – that of Japan – unlike that of the United States at the time of the Mexican crisis, has fallen into a full-scale recession and is unable to provide a stimulus to Asian recovery.

Recovery is thus likely to be much slower than it was in Mexico. A crisis of over-investment and financial fragility tends to be more difficult to unravel than one of over-consumption. Restructuring of corporate and bank balance sheets takes much longer than realigning consumer spending. Moreover, the crisis has come on top of a number of structural weaknesses in South-

Table 9

ALTERNATIVE FORECASTS OF GDP GROWTH IN 1998 FOR SELECTED OECD COUNTRIES

(Percentages)

Country	*LINK*	*ECE*	*OECD*	*EU*	*IMF*	*NIESR*	*NRI*	*UNCTAD*
United States	2.7	2.5	2.7	2.6	2.9	2.6	2.7	2.3
Japan	0.0	0.1	-0.3	2.3	0.0	0.8	-0.6	-1.3
Germany	2.6	2.5	2.7	3.2	2.5	2.4	2.4	2.3
France	3.0	2.8	2.9	3.1	2.9	2.8	2.8	2.5
Italy	2.4	2.5	2.4	2.5	2.3	2.0	..	2.2
United Kingdom	2.3	2.0	1.7	2.1	2.3	2.2	2.1	2.1
Memo item:								
European Union	2.5	2.7	2.7	3.0	2.8	2.6	2.2[a]	2.6

Source: United Nations, University of Pennsylvania and University of Toronto, "Project Link World Outlook" (mimeo), post-LINK meeting forecast (May 1998); ECE, *Economic Survey of Europe 1998 (No.1)* (United Nations publication, Sales No. E.98.II.E.1); OECD *Economic Outlook* (June 1998); Commission of the European Communities, *European Economy, Supplement A* (October 1997); IMF, *World Economic Outlook* (May 1998); National Institute of Economic and Social Research (NIESR, London), *National Institute Economic Review* (April 1998); Nomura Research Institute (NRI, Tokyo), *Quarterly Economic Review* (May 1998); and table 1.

a Total OECD.

East Asia that were already threatening to decelerate the growth of exports and output. As noted in some detail in *TDR 1996*, growth has relied excessively on foreign resources and the easy stage of export promotion was coming to an end. Without effective policies designed to diversify the manufacturing base, upgrade industrial production and increase productivity, it was argued that the region would suffer from erosion of competitiveness, interruption of capital flows and loss of growth momentum, particularly in view of the emergence of low-cost competitors in labour-intensive manufactures, such as China and India. Even though exchange rate movements have been helpful in restoring competitiveness, these structural weaknesses remain, and the crisis and contraction in the region have certainly made it more difficult to deal with them.

The prospects of the affected countries cannot be divorced from developments in the entire East Asian region, including Japan, China and the first-tier NIEs. The crisis will certainly have serious consequences for growth dynamics and integration in the whole region, which have been referred to as the *flying geese* process. In this process countries at different levels of industrialization and development are expected to move together on the basis of a progressive upgrading of their industries, through intraregional trade and investment which help locate production according to comparative advantages. In the context of the flying geese paradigm, the recession in Japan can be expected to have important implications for the sustainability of the growth process in the East Asian NIEs.

Equally important, given the increased integration of the global economy, can the rest of the world enjoy satisfactory growth if the economies in East Asia, including both first- and second-tier NIEs and Japan, falter? The crisis has greatly increased the complexity of the conditions that underlie short-term forecasts, and even more so longer-term projections. Even before the financial turmoil started, projections for 1997 by various international organizations and research institutions for OECD countries consistently underestimated the growth of the United States economy but overestimated that of Japan (table 8). Their forecasts for 1998 clearly reveal a great degree of uncertainty for Japan, the figures ranging from -1.3 per cent to 2.3 per cent (table 9). With the growing interdependence of countries as regards trade and capital flows, forecasting errors for one country can have significant implications for the forecasts relating to others. ■

Chapter II

TRADE IMPLICATIONS OF THE EAST ASIAN CRISIS

Global economic developments in 1997 were overshadowed by the financial and economic crisis in Asia, the impact of which was severely felt in the region during the last quarter of the year, especially in Indonesia, the Republic of Korea and Thailand. Adjustments in the seriously affected countries have barely begun, and their direct and indirect repercussions on other economies in the region, as well as on the rest of the world, are still working themselves out. As discussed in the previous chapter, the crisis has led to a slowdown, in varying degrees, in the prospective output growth of all regions.

A precise assessment of the implications of the crisis for the global economy is difficult to make, not only because the changes in the economic and financial situation in many of the countries concerned have not yet played themselves out, but also because it is not yet clear how other regions will react in terms of policy. There are various channels by which the repercussions of the Asian crisis can be transmitted to other countries. Much of the adjustment will probably take place through changes in both the direction and the composition of trade flows, particularly for primary commodities.

A. The significance of Asian trade

Asia's linkages with the rest of the world are strong. Built on the "flying geese" pattern of economic development involving a division of labour among countries at different levels of industrialization,[1] most of the economies in East and South-East Asia have been active participants of growing importance in international trade and at the forefront of the increasing participation and integration of developing countries in the world economy. The Asian economies are highly integrated through trade. For example, in 1996 about 52 per cent of Asia's total merchandise exports were sold within the region, while 54 per cent of total imports were also intraregional. For various categories of merchandise, the share of exports absorbed by regional partners is even higher – for example, 63 per cent for agricultural products and 85 per cent for mining products – while the share for manufactured products is about 48 per cent. As regards services, it is notable that the large tourism industry in Asia, with its vast array of backward- and forward-linked industries, is dominated by intraregional trade. Intraregional tourists account for almost 80 per cent of total tourist arrivals in Asia. The dynamic Asian economies have now become not only major competitive suppliers on global markets for a wide range of products, but also increasingly a "locomotive" for the world economy through their large and rising import demand.

Table 10

WORLD MERCHANDISE TRADE BY REGION, 1996

(Billions of dollars and percentages)

	Exports			Imports		
	Value	Share	Change over 1995	Value	Share	Change over 1995
Exports from/imports to	*($ billion)*	*(Per cent)*		*($ billion)*	*(Per cent)*	
World	5115	100.0	4	5 265	100.0	4
North America	827	16.2	6	994	18.9	6
United States	625	12.2	7	818	15.5	6
Latin America	249	4.9	11	273	5.2	11
Mexico	96	1.9	21	90	1.7	24
Western Europe	2 282	44.6	3	2 235	42.5	2
European Union (15)	2 110	41.2	3	2 053	39.0	2
Transition economies	169	3.3	6	174	3.3	13
Central and Eastern Europe	81	1.6	2	108	2.0	13
Africa	116	2.3	12	127	2.4	3
Middle East	165	3.2	16	143	2.7	8
Asia	1 309	25.6	1	1 318	25.0	5
Japan	411	8.0	-7	349	6.6	4
China	151	3.0	2	139	2.6	5
ASEAN	336	6.6	5	372	7.1	6

Source: UNCTAD secretariat calculations, based on WTO data.

1. Asian imports

At $372 billion, the total merchandise imports by members of the Association of South-East Asian Nations (ASEAN)[2] in 1996 ranked as the third largest in world trade, after the European Union and the United States, and before Japan, which is in fourth place. The dynamism of these markets is attested by the fact that their share in world imports more than doubled from 1985, to reach 7.1 per cent in 1996 (table 10). No other market has experienced such import growth. If ASEAN's imports are combined with those of other emerging markets in Asia and Japan, the group accounted for about 25 per cent of world merchandise imports in 1996. Furthermore, the region's imports have a broad-based product composition and it is also a major importer of primary commodities, including fuels, food, ores and metals, and agricultural materials (table 11).

In recent years, practically all regions have increased the share of their exports going to Asia. Among the OECD countries in 1996, Japan had the largest share (48.5 per cent), followed by the United States and Canada (31.1 per cent) and Western Europe (9.7 per cent); see table 12. For particular categories of exports, the share is even higher. For example, it is about 40 per cent for United States agricultural exports.

In the developing regions, dependence on the Asian market is also notable. Currently, in Latin America, about 16 per cent of agricultural exports and 13 per cent of mining product exports go to Asia. In Africa, the corresponding shares for agricultural and mining exports are around 20 per

Table 11

SHARE OF SELECTED ASIAN ECONOMIES IN WORLD IMPORTS OF SELECTED PRODUCT GROUPS, 1996

(Percentages)

Region/economy	Shares in world imports of							
	All products	*Food*	*Cereals*	*Agricultural raw mat.*	*Fuel*	*Ores and metals*	*Manufact. goods*	*Textiles and clothing*
Developing East and South-East Asia (excl. China)	**15.3**	**9.9**	**22.2**	**16.0**	**14.3**	**36.0**	**6.4**	**14.7**
Indonesia	0.8	1.0	4.4	1.7	0.9	2.5	0.3	0.7
Malaysia	1.5	0.9	2.5	0.8	0.5	3.7	0.4	0.5
Philippines	0.7	0.6	2.3	0.6	0.7	1.6	0.2	0.4
Republic of Korea	2.8	1.9	5.9	5.0	5.5	9.0	0.9	1.8
Thailand[a]	1.3	0.6	0.8	2.2	1.1	4.7	0.5	0.7
Hong Kong, China	3.8	2.4	1.3	2.4	1.0	5.1	2.6	8.5
Singapore	2.5	1.2	1.0	0.7	2.8	3.1	0.8	1.0
Taiwan Province of China	1.9	1.3	3.9	2.8	1.9	6.5	0.7	1.0
China	**2.7**	**1.8**	**5.8**	**5.3**	**1.6**	**8.3**	**1.3**	**4.6**
Japan	**6.7**	**11.6**	**15.3**	**12.4**	**13.7**	**14.8**	**2.7**	**7.5**
Total of above destinations	**24.6**	**23.2**	**43.2**	**33.7**	**29.6**	**59.1**	**10.3**	**26.8**

Source: UNCTAD secretariat calculations, based on United Nations, *Commodity Trade Statistics* (tapes).
a 1995.

cent and 13 per cent, respectively. Fifty-seven per cent of Middle Eastern countries' exports of mining products (basically oil), which constitute the bulk of their exports, go to Asia. As already noted, Asian countries also provide important markets for each other; more than half of Asia's total merchandise exports go to other countries in the region.

In world commercial services trade, Asia is the second largest importing region, with a share of around 28 per cent of world imports in 1996. It is surpassed only by Western Europe (with a 45 per cent share) and is followed by North America (with a 13 per cent share). Services account for a large proportion (about 20 per cent) of the region's total imports, exceeding the share of services in world imports. Asia maintains its ranking as the second largest importing region for all three of the major service categories constituted by transportation, travel and other commercial services. In the area of tourist travel, which dominates the travel category, outbound tourism from Asia has grown rapidly in recent years, to stand at about 15 per cent of the world total.[3]

2. Asian exports

Through their phenomenal trade and industrial growth over the past three decades the countries of East and South-East Asia have become major competitive suppliers on global markets for a wide range of products. Asia as a whole now accounts for about 26 per cent of world merchandise exports. The growth and share of Asian exports in world trade in particular catego-

Table 12

SHARE OF SELECTED ASIAN ECONOMIES IN THE EXPORTS OF VARIOUS REGIONS AND COUNTRIES, 1996

(Percentages)

Region/economy	Shares in exports of: Africa	Latin America	West Asia	Transition economies	North America	Western Europe	Japan	Australia and New Zealand
Developing East and South-East Asia (excl. China)	**5.5**	**5.1**	**23.3**	**4.3**	**16.6**	**5.6**	**40.5**	**26.7**
Indonesia	0.6	0.4	1.0	0.3	0.8	0.4	2.1	3.7
Malaysia	0.4	0.4	0.4	0.3	1.6	0.6	4.7	3.0
Philippines	0.1	0.3	1.7	0.3	0.9	0.2	1.8	1.4
Republic of Korea	1.3	1.7	9.1	1.2	4.5	1.0	7.7	6.3
Thailand[a]	0.7	0.4	1.6	0.8	1.1	0.6	5.3	1.8
Hong Kong, China	0.2	0.5	0.6	0.4	2.2	1.1	6.6	3.3
Singapore	0.6	0.6	6.5	0.2	2.8	0.9	5.8	2.9
Taiwan Province of China	1.7	0.8	2.5	0.8	2.7	0.8	6.7	4.3
China	**0.9**	**1.4**	**1.9**	**3.1**	**2.4**	**1.0**	**7.1**	**5.1**
Japan	**2.5**	**4.3**	**21.4**	**2.4**	**11.4**	**2.5**	**-**	**21.7**
India	3.0	0.2	3.4	0.4	0.5	0.5	0.5	1.8
Pakistan	0.4	0.1	1.8	0.1	0.2	0.1	0.3	0.3
Total of above destinations	**12.2**	**11.2**	**51.9**	**10.3**	**31.1**	**9.7**	**48.5**	**55.8**

Source: See table 11.
a 1995.

ries of products are noteworthy (table 13). In machinery and transport equipment, the Asian share in world exports in 1996 (which was not a favourable year for Asian exports) was more than 30 per cent, surpassed only by that of Western Europe. For the subcategory of office machines and telecommunication equipment, its share of the world export market has grown rapidly and stands at about 50 per cent. Asia is also a major and growing exporter of automotive products, with a share in world exports of around 20 per cent. It predominates in textiles, particularly clothing, with a share of over 40 per cent. However, during 1990-1996, whereas Asian exports of clothing to North America grew at an annual rate of 3 per cent, and to Western Europe at an annual rate of 4 per cent, those of Latin America to North America grew at 20 per cent per annum and those of Eastern Europe to Western Europe grew at 23 per cent per annum. What this reflects is a discernible shift in East Asia's production towards more skill-intensive products.

Apart from intraregional trade discussed below, Asia's merchandise exports in 1996 were mainly to North America (23 per cent) and Western Europe (16.2 per cent), followed by the Middle East (2.6 per cent), Latin America (2.3 per cent) and Africa (1.5 per cent). Its exports to other regions are dominated by manufactures, which accounted for 82 per cent in 1996. With respect to services, although Asia is the second largest exporting region, after Western Europe, in world commercial services trade, it is also the largest net importing region for commercial services. A number of Asian countries are among the leading world exporters of transportation, travel and commercial services.

Table 13

SHARE OF EXPORTS FROM ASIA AND OCEANIA IN WORLD EXPORTS 1996, BY MAJOR PRODUCT GROUP

(Percentages of respective product group total)

	Share of Asia and Oceania[a]	*of which:* Japan
Agricultural products	19.1	0.7
Food	18.0	0.4
Raw materials	23.0	1.9
Mining products	15.2	1.1
Ores and other minerals	23.3	1.2
Fuels	13.8	0.5
Non-ferrous metals	16.6	3.7
Manufactures	28.8	10.4
Iron and steel	22.0	10.8
Chemicals	16.0	6.1
Other semi-manufactures	20.5	4.9
Machinery and transport equipment	31.6	14.4
Automotive products	19.8	15.9
Office and telecommunication equipment	49.9	15.0
Textiles	42.7	4.6
Clothing	42.6	0.3
Other consumer goods	29.3	7.5
Total merchandise exports	25.6	8.0

Source: UNCTAD secretariat calculations, based on statistics from WTO, *Annual Report 1997*, Vol. II (Geneva, 1997).
a Australia and New Zealand.

B. Impact on regional trade

Given the relative economic size of the East and South-East Asian countries as a whole and their strong economic linkages with one another, developments in international trade in the period ahead are likely to be affected by the financial and economic crisis which has spread throughout the region since mid-1997. The crisis is the first major economic setback that the region has faced since its period of high growth began. Its seriousness, in terms of its scope and its repercussions, is increasingly felt in trade and related areas.

As can be seen from table 14, the five most affected Asian countries (Indonesia, Malaysia, the Philippines, the Republic of Korea, and Thailand – hereafter sometimes referred to as "Asia-5") trade intensively with other developing countries in the region: between 25 per cent and 45 per cent of their exports go to those partner countries, and between 17 per cent and 35 per cent of their imports originate from them. If the developed Asian countries are also included, the intraregional share rises to 45-65 per cent for both imports and ex-

Table 14

NETWORK OF TRADE AMONG SELECTED ASIAN ECONOMIES, 1996

(Percentage shares in total trade)

	Destination of exports					
Exporter	*Total Asia and Oceania[a]*	*Japan Australia New Zealand*	*Developing Asia*	*China*	*Asia-5[b]*	*Other*
China	59.4	21.7	37.7	-	8.3	29.4
Hong Kong, China[c]	55.4	8.1	47.4	34.3	5.3	7.8
domestic exports	51.4	6.5	45.0	29.0	5.6	10.3
Indonesia	63.0	28.5	34.6	4.1	11.8	18.6
Japan	46.4	2.2	44.2	5.3	19.6	19.3
Malaysia	62.1	15.3	46.9	2.4	9.9	34.6
Pakistan	31.6	8.3	23.3	1.3	6.4	15.6
Philippines	44.5	18.8	25.8	1.6	9.6	14.6
Republic of Korea	52.1	13.7	38.4	8.8	9.3	20.3
Singapore[c, d]	62.9	10.5	52.4	2.7	30.2	19.5
Taiwan Prov. of China	54.5	13.6	40.9	0.5	10.6	29.7
Thailand	55.8	18.5	37.3	3.4	8.3	25.7

	Origin of imports					
Importer	*Total Asia and Oceania[a]*	*Japan Australia New Zealand*	*Developing Asia*	*China*	*Asia-5[b]*	*Other*
China	59.0	23.8	35.2	-	13.9	21.3
Hong Kong, China[c]	76.7	14.7	61.9	36.7	10.4	14.9
Indonesia	54.6	26.3	28.4	3.7	10.3	14.3
Japan	42.6	4.8	37.8	11.6	16.5	9.7
Malaysia	64.0	28.0	36.0	2.4	11.4	22.2
Pakistan	33.1	12.3	20.7	4.7	10.2	5.8
Philippines	55.0	24.9	30.1	2.2	11.6	16.3
Republic of Korea	43.0	25.6	17.4	5.7	5.9	5.8
Singapore[c, d]	58.5	19.2	39.3	3.3	27.5	8.5
Sri Lanka	63.3	14.9	48.5	3.5	16.1	28.9
Taiwan Prov. of China	50.5	30.0	20.5	3.0	11.8	5.7
Thailand	56.9	30.5	26.3	2.7	10.8	15.5

Source: WTO, based on United Nations, *Commodity Trade Statistics* (tapes).

a Australia and New Zealand.

b Indonesia, Malaysia, Philippines, Republic of Korea and Thailand.

c Includes significant re-exports.

d Adjusted to include Singapore's exports to Indonesia.

ports. Thus, intraregional trade in East and South-East Asia is the natural point of departure for analysis of the impact of the crisis. Indeed, the particular regional dynamics are one of the explanations for the success of the countries in that region, where fast-growing countries have been providing expanding markets and complementary production for each other. This carries with it the risk of a "contagion" effect, which has indeed occurred as a consequence of the crisis.

The economic slowdown in Asia thus encompasses not only those countries in which an acute financial crisis began in July 1997 (i.e. Indonesia, the Republic of Korea and Thailand), but also Japan (where the economy has been stagnant for several years and an economic downturn in 1997 has been exacerbated by the financial crisis). The region-wide spread of the economic downturn means that the economic malaise emanating from the region is likely to have a greater impact on global trade and the world economy than might be supposed by focusing only on those countries where the financial crisis broke out.

Many Asian economies are now experiencing varying degrees of contraction in domestic demand and imports. For countries with a high share of exports in the region, there are already signs of a fall-off in exports and a downward spiral in regional trade. For example, data for Japan for the first quarter of 1998 show that exports to Asia fell sharply: they continued to fall in April. In February alone, the decline in exports to Indonesia, Thailand, the Republic of Korea and Malaysia was 56 per cent, 41 per cent, 38 per cent and 24 per cent, respectively. Imports from Indonesia, Malaysia and Viet Nam fell by 23 per cent, 22 per cent and 30 per cent, respectively.[4] Since the beginning of 1998, the growth of Japanese exports valued in yen has continued to slow, becoming negative during April on a year-on-year basis. On this basis and in dollar terms, Japanese exports have fallen since November 1997. Since the beginning of 1998, imports have also been contracting sharply (year-on-year) each month.

For the first quarter of 1998, Taiwan Province of China recorded its first quarterly trade deficit in 17 years. The fall in exports reflects contracting demand in the Asian region, which has in recent years absorbed around 50 per cent of its exports. From January to March, exports to South-East Asia dropped by 27 per cent, to Japan by 24 per cent, and to Hong Kong, China, by 3.2 per cent.[5] The Republic of Korea's exports declined in absolute terms in May 1998 for the first time since the crisis started. Exports to Asia, which account for 50 per cent of all outbound shipments, fell by 10.8 per cent in the first four months of 1998, the decline in exports to South-East Asia being 27.1 per cent.[6] Although China's exports for the first five months of 1998 rose by 8.6 per cent over the corresponding period of the previous year, they fell in May alone by 1.5 per cent, for the first time in 22 months. From April to November 1997, India's rate of growth of exports to Asia was less than in the same period of 1996, with absolute declines in exports to the Republic of Korea, Thailand and Singapore, and reduced growth in exports to Indonesia and Hong Kong, China. In addition, there is concern in the developing countries about an acute loss of competitiveness vis-à-vis Indonesia, Malaysia, Thailand and the Republic of Korea because of their currency devaluations.

C. Trade effects outside the Asian region

The impact of the Asian crisis on other regions and countries will vary depending on a number of factors, including the pattern of trade and competitiveness. In addition to the direct effects on the volume and prices of traded goods, there are reinforcing and offsetting indirect effects through competition in third markets as well as access to, and the cost of, finance.

The adoption of restrictive monetary and fiscal policies to deal with the financial crisis, particularly in the most seriously affected countries, has significantly reduced the level of economic activity and domestic demand.[7] A consequent rise in unemployment has also added to the initial expenditure reduction effect (see chapter III). The reduction in aggregate expenditure

can be expected to reduce overall imports, affecting to varying degrees different products and supplying countries.

The large depreciations in the region's currencies (in some cases exceeding 86 per cent against the dollar), if sustained, will also have direct trade implications. To the extent that currency alignments are passed on, they may lead to a substantial across-the-board shift in the prices of traded goods and services produced in the region relative to those produced in other regions. While exports will become more competitive, imports will become more expensive. The overall impact will vary from one sector to another. For example, the scope for reducing export prices in foreign currency would be less than the devaluation to the extent that imported inputs are required in the production of an export good.

Given the past trade and growth performance of the most affected Asian economies, the substantial depreciation of their real effective exchange rates, together with excess capacity in export-oriented production, has given rise to expectations of a reasonably strong export-led recovery. However, as noted in chapter I, the responsiveness of exports so far has been hampered not only by higher import costs, but also by a severe liquidity crisis and an export credit crunch. Adjustments in the trade balance of these countries have been due more to a reduction of imports than to an expansion of exports.

Another factor that can influence adjustment in Asia and its impact on trade is that those countries which are close competitors of Asian countries in export markets may be tempted to devalue in order to maintain their international competitiveness, as they begin to lose market shares to cheaper Asian exports. This could engender a process of competitive devaluations. Similarly, an increased inflow of cheap products from Asia could trigger a domestic backlash in major import markets (particularly North America and Western Europe), leading to a proliferation of anti-dumping and related actions and growing trade frictions.[8]

Because of the importance of the Asian economies and the relative dependence of both developing and developed countries on Asian markets, an economic slowdown in the region is likely to result in a deceleration in world import demand, with multiplier effects on the exports and incomes of countries in various regions, particularly developing countries. Indeed, real output growth in developed market-economy countries as a group is expected to slow to 1.8 per cent in 1998 from 2.7 per cent in 1997, with the Japanese economy going into outright recession (see chapter I, table 1). This slowdown will in turn impact negatively on developing country exports and growth.

With regard to Latin America as a whole, while exports to Asia represent about 10 per cent of the region's total merchandise exports, for some countries (Chile, Peru and Ecuador) the proportion is much higher (as much as around 35 per cent for Chile); see table 15.[9] While exports to Asia grew quite rapidly in the first nine months of 1997, there appears to have been a sharp fall-off towards the end of the year, particularly in Chile, whose Asian exports are concentrated mainly on the countries in crisis.

In Africa, the impact of the Asian crisis could be felt particularly in Zambia, the United Republic of Tanzania and Congo, since over a quarter or more of these countries' exports go to Asia (table 16). Furthermore, the crisis may result in a re-

Table 15

SHARE OF ASIA[a] IN EXPORTS OF SELECTED LATIN AMERICAN COUNTRIES, 1990-1997

(Percentages)

Country	*1990*	*1996*	*1997 (Jan.-Sep.)*
Argentina	10.2	12.1	15.0
Brazil	16.8	16.2	15.3
Chile	24.6	33.3	38.1
Colombia	4.5	4.3	3.9
Mexico	6.7	3.3	3.3
Peru	20.9	23.8	25.3
Venezuela	4.0	1.9	1.9
Group average	11.3	9.5	10.3
Memo item:			
Total exports of group to Asia *($ million)*	12 410	21 230	17 860

Source: SELA, "The impact of the Asian crisis on Latin America" (Caracas, February 1998).

a Developing Asia and Japan.

Table 16

SHARE OF ASIAN DEVELOPING COUNTRIES IN EXPORTS OF SELECTED AFRICAN COUNTRIES, 1994 AND 1996

(Percentages)

Country	1994	1996	1996 value ($ million)
Angola	2.3	11.2	494
Congo	13.1	24.7	411
Egypt	11.1	7.7	401
Morocco	7.5	7.3	509
Nigeria	5.0	7.5	1 112
South Africa	9.8	12.9	4 613
United Rep. of Tanzania	24.6	30.4	244
Zambia	37.7	33.8	338

Source: UNCTAD secretariat calculations, based on IMF, *Direction of Trade Statistics*, 1997.

duced FDI flow to Africa owing to a general change in business sentiment. Some developing Asian countries, such as Malaysia, have become large investors in Africa, but may have to cut back their outward investments during the next few years.

Among the economies in transition, the ones likely to be most affected by the crisis are Kazakhstan, the Russian Federation, Ukraine and Romania (table 17). These countries may be faced with a reduction in the volume of their exports to Asia and with the impact of the Asian recession on world prices of export products.[10]

Table 17

SHARE OF ASIAN DEVELOPING COUNTRIES IN EXPORTS OF SELECTED TRANSITION ECONOMIES, 1994 AND 1996

(Percentages)

Country	1994	1996	1996 value ($ million)
Czech Republic	3.2	2.6	563
Kazakhstan	6.6	12.6	786
Poland	4.9	3.3	816
Romania	9.5	6.8	519
Russian Federation	8.6	10.2	8 335
Ukraine	10.7	7.7	1 303

Source: See table 16.

D. Competitiveness effects of the currency depreciations

The large depreciations in the region's currencies will have major implications for the pattern of international competitiveness both within and outside the region. Between July 1997 and 10 June 1998, the currencies of the region depreciated substantially against the dollar, by between 17 per cent (the Singapore dollar) and more than 80 per cent (the Indonesian rupiah). Other currencies within and outside the region have also weakened significantly against the dollar (table 18). These exchange rate movements are likely to alter international competitiveness among countries and trade shares in third-country markets.

Since March 1998, some of the region's currencies, notably the yen, have continued to decline against the dollar, thus altering once again the pattern of competitiveness. By the second week of June 1998, the dollar was traded at more than 140 yen, implying a nearly 10 per cent depreciation of the yen since March. The renewed slide of the yen means a rise in many East Asian currencies against the Japanese currency, thus cancelling out to some extent their sharp depreciation against the yen since June 1997. The weaker yen is likely to boost Japan's competitive position in the United States and other markets (for example, vis-à-vis other

Table 18

MOVEMENTS IN EXCHANGE RATES[a], JUNE 1997 - MARCH 1998

(Percentage changes of monthly averages)

Country	Bilateral exchange rate with		Real effective exchange rate[b]
	US dollar	Japanese yen	
United States	-	13.0	8.6
Japan	-11.5	-	-4.1
Germany	-5.4	6.8	-0.8
France	-4.8	7.5	-0.1
United Kingdom	1.1	14.2	7.7
Italy	-5.8	6.4	-0.2
Canada	-2.3	10.4	1.5
Australia	-11.1	0.4	-5.6
New Zealand	-16.8	-6.0	-10.6
China	-0.2	12.7	2.9
India	-9.5	2.2	-0.2
Hong Kong, China	-	12.9	11.2
Republic of Korea	-39.0	-31.0	-30.3
Singapore	-11.9	-0.5	-1.0
Taiwan Province of China	-14.1	-3.0	-9.6
Indonesia	-73.9	-70.6	-63.2
Malaysia	-32.3	-23.5	-23.6
Philippines	-31.0	-22.1	-21.8
Thailand	-37.5	-29.4	-27.1
Argentina	-	12.9	4.7
Brazil	-2.6	10.1	6.6
Chile	-7.9	4.1	1.5
Mexico	-7.1	5.0	7.8
Poland	-6.4	5.7	3.2
Hungary	-11.5	-	3.9
Turkey	-38.8	-30.8	11.1
South Africa	-9.5	2.2	-2.2

Source: IMF, *World Economic Outlook,* May 1998.

a A negative sign signifies a depreciation of the currency of the country.

b Nominal trade-weighted exchange rates, deflated by consumer price indices.

East Asian countries, notably the Republic of Korea) and reduce already contracting Japanese imports, including those from East Asia.

One measure of international competitiveness is provided by multilateral trade-weighted exchange rates, deflated by some measure of domestic inflation.[11] IMF-computed real effective exchange rates are reported in table 18.[12] The difference between the depreciation against the dollar and the depreciation of the real effective exchange rate reflects (i) the significance of trade with other countries whose currencies have fallen against the dollar, as well as competition between one another in third markets; and (ii) the partial offset of competitiveness gains from currency depreciation by higher domestic inflation, due in part to an accompanying rise in traded goods prices.

A first approximation of the impact of the Asian currency depreciations on exports to third markets can be derived from a recent study focusing on Latin American exports to OECD markets.[13] The study seeks to identify at the six-digit level of the Harmonized System (HS) those products exported by each Latin American country to OECD markets which are also exported to those markets by seven Asian countries (Indonesia, Malaysia, the Philippines, the Republic of Korea, Singapore, Taiwan Province of China and Thailand). For each Latin American country, products subject to competition from the Asian countries are defined as those for which the share of the Asian countries in the sum of OECD imports from both the Latin American country and the Asian countries is greater than or equal to 10 per cent.

The study finds that around 58 per cent of Latin American exports to OECD markets are potentially vulnerable to Asian competition through the relative price effects of currency depreciations (table 19). Exports to North America and to Asian OECD countries have the largest shares of products exposed to Asian competition (62 per cent and 71 per cent, respectively). However, exports to the latter countries are only around 9 per cent of Latin American exports to the OECD as a whole. There is also a wide range of degrees of exposure across Latin American countries, with the smaller economies (plus Colombia and Mexico) at the higher end, with more than 60 per cent exposure. For manufactured products, just under 36 per cent of total Latin American exports to the OECD (with a value of $61 billion) are exposed to Asian competition. Again, the study finds that the smaller economies of Central America and the Caribbean are the most exposed, reflecting the large share of articles of apparel and clothing in their manufactured exports to the OECD, as well as exports of electrical apparatus and appliances and their parts in some cases.

Consideration of the competitive advantage provided by the currency devaluations in Asia also needs to take into account the import intensity of Asia's exports. There are few systematic studies of the import content of the manufactured exports of countries.[14] In recent months, various estimates have been put forward of the import content of the manufactured exports of some of the South-East and East Asian countries. One report indicates that the manufacturing sectors of Indonesia, Thailand, Malaysia and the Philippines use on average 30 per cent imported parts, raw materials and equipment in the production process, with the electronics and motor vehicle assembly sectors deriving 60-90 per cent of their export value from imported parts.[15] Another report suggests that Thailand's exports contain on average 60 per cent imported components and raw materials.[16]

Table 19

SHARE OF LATIN AMERICAN EXPORTS TO OECD COUNTRIES POTENTIALLY VULNERABLE TO ASIAN COMPETITION, BY DESTINATION, 1995

(Percentages)

Market	*Share subject to competition*	*Share in exports of Latin America to OECD*
All products		
OECD (weighted average)	57.8	100.0
of which:		
United States and Canada	61.7	66.5
Japan and Rep. of Korea	70.7	9.4
OECD Europe	41.9	24.1
Manufactures		
OECD (weighted average)	35.7	100.0

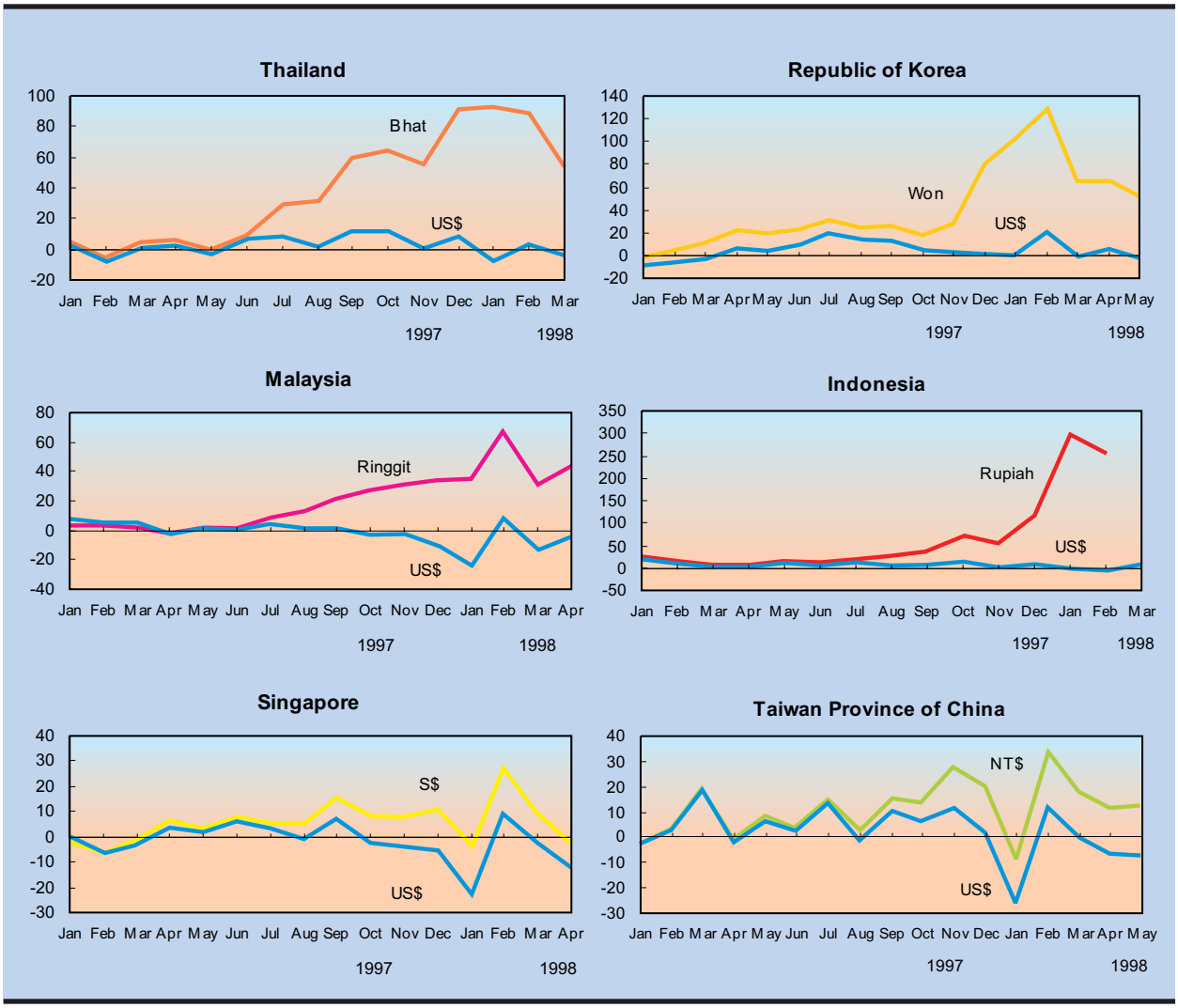
Source: R. E. Saez, "Latin American exporters to the OECD markets potentially more exposed to the Asian Crisis: A first look" (Washington, D.C.: Inter-American Development Bank, March 1998), mimeo.
Note: For explanations see text.

As already mentioned, the improvement in the current account of the countries at the centre of the turmoil is due essentially to import compression rather than to a significant expansion of exports. Indeed, as can be seen from chart 1, monthly exports on a year-to-year basis for Indonesia, the Republic of Korea, Malaysia, the Philippines, Singapore and Thailand show that rates of growth in dollar terms since the beginning of 1997, in contrast to those in national currency, have tended to stagnate or decline rather than accelerate.[17]

There may be several reasons related to the crisis that are responsible for the sluggishness of export growth. Given the large share of the regional market in exports (ranging from 41 per cent

Chart 1

EXPORT GROWTH IN SELECTED ASIAN ECONOMIES, IN NATIONAL CURRENCIES AND DOLLARS, 1997 AND 1998



Source: UNCTAD secretariat calculations, based on data from Datastream.

in the Philippines to 57 per cent in Indonesia), the continuing and gathering recession in most countries of South-East and East Asia is a major factor affecting export performance. In addition, the fall in imports (in dollar terms) of basic industrial material, intermediate goods and manufacturing equipment, together with the general contraction of imports in the region, is hurting exports that rely on imported inputs. This may be related to tighter domestic credit conditions and high interest rates due to the process of domestic financial restructuring. These conditions have deprived exporters, especially small and medium-sized enterprises, of funds needed to expand exports. Also, the currency depreciations have reduced the ability of firms to source capital from international markets, owing to the prohibitive cost of repayment. Finally, in some cases, the dollar value of exports may be sluggish because of downward pressure on export prices stemming from the global overcapacity in the electronics and electrical appliance industries. For example, officials of the Ministry of Commerce, Industry and Energy of the Republic of Korea indicate that the poor performance of their country's exports in recent months is due in part to the substantial fall in the prices of leading exports in the first quarter of 1998. The prices of semiconductors fell by 48.6 per cent, those of electronic products by 38.5 per cent and those of petrochemicals by 19.5 per cent.[18]

E. Impact on markets for primary commodities

The rapid expansion of the economies in East Asia has led to a significant increase in their demand for primary commodities. In general, their import potential for such goods had been judged to be high, since initially their consumption of a wide range of commodities, including food, agricultural raw materials, minerals and metals, was relatively low by world standards. The energy- and material-intensive pattern of their economic development contributed to increasing their consumption of agricultural raw materials, minerals and metals during the years of rapid economic expansion. The share of the Asia-5 in world consumption of both agricultural and mineral raw materials more than doubled from 1984 to 1994 for a large number of commodities (table 20). In all of these products except cotton, the Republic of Korea has the largest share among the five countries, with Indonesia having the largest share for cotton.

Domestic supply capabilities could not keep up with this growth in demand either for food and other agricultural products, or for minerals and metals, in spite of intensified exploration and development in countries with geological potential. Consequently, the increase in demand had to be met largely from imports. For example, all the East Asian countries import most of the cotton and wool they use. The Republic of Korea, which has a smaller endowment than the other countries in natural resources, imports almost all the cotton, natural rubber, aluminium and tin that it uses.

In the mid-1990s, South and East Asia, including China, absorbed about 7 per cent of Latin America's food exports, almost 14 per cent of its exports of agricultural raw materials, and 12 per cent of its exports of ores and metals. The growth of Latin America's exports of primary commodities to Asia was relatively rapid: exports of both food and agricultural raw materials grew at an annual average rate of over 10 per cent during 1980-1994, while the corresponding rate for exports of ores and metals was well over 13 per cent (the corresponding rates of growth of Latin America's exports to the world were 2.5 per cent, 4.0 per cent and 3.1 per cent, respectively). Asia was also a relatively large market for Africa, accounting for about 20 per cent of exports of agricultural raw materials and ores and metals from that region. The growth of these exports (13.8 per cent annually for agricultural materials and over 16 per cent for ores and metals during 1980-1994), far exceeded that of Africa's total exports of these commodities (2.1 per cent and -3.1 per cent, respectively).

The rapid increase in their imports has made the East and South-East Asian economies, particularly the Republic of Korea, important export destinations for many commodities. Their share in world imports is in many cases large enough

Table 20

SHARE OF ASIA-5[a] IN WORLD CONSUMPTION OF SELECTED PRIMARY COMMODITIES, 1984 AND 1994

(Percentages)

Product	*1984*	*1994*
Cotton	4.7	7.3
Wool	1.6	4.2
Natural rubber	9.1	15.2
Aluminium (primary)	1.5	5.4
Refined copper	2.7	7.4
Lead metal	2.1	8.1
Nickel (unwrought)	0.4	4.5
Tin (primary)	3.4	11.3
Zinc metal	3.9	7.8

Source: UNCTAD database.

a Indonesia, Republic of Korea, Malaysia, Philippines and Thailand.

Table 21

SHARE OF ASIA-5[a] IN WORLD IMPORTS OF MINERALS, ORES, AND AGRICULTURAL COMMODITIES

(Percentages)

Minerals and ores	*1996*
Lead ore	10.9
Lead metal	19.1
Copper ore	12.5
Copper, refined	14.8
Aluminium	10.1
Zinc ore	8.9
Zinc metal	16.6
Iron ore	9.1
Tin, unwrought	9.2
Manganese ore	6.1
Ferromanganese	4.2
Nickel, unwrought	4.4
Crude petroleum	8.0
Agricultural commodities	*1995*
Meat, bovine	4.6
Fish	3.9
Wheat and flour	9.7
Maize	15.1
Sugar	8.6
Tobacco	6.5
Hides and skins	18.6
Natural rubber	9.7
Non-coniferous wood	10.8[b]
Wool	8.4
Jute and products	2.4[b]
Cotton	22.5

Source: UNCTAD database.
a Indonesia, Republic of Korea, Malaysia, Philippines and Thailand.
b 1994.

for changes in their demand to have a significant impact on world markets (table 21). Four of the five most seriously affected countries are also important suppliers of several commodities to the world market (table 22).

Table 22

SHARE OF ASIA-5 IN WORLD EXPORTS OF SELECTED PRIMARY COMMODITIES, 1995

(Percentages)

Commodity	*Country[a]*	*Share*
Rice	Thailand	26.5
Sugar	Thailand	10.8
Coffee	Indonesia	5.3
Cocoa beans	Indonesia	10.6
Palm oil	Indonesia	16.5
	Malaysia	67.3
Fishery commodities	Thailand	8.6
Natural rubber	Indonesia	28.6
	Malaysia	21.9
	Thailand	35.2
Non-coniferous wood	Indonesia	19.9[b]
	Malaysia	23.2[b]
Hard fibres[c]	Philippines	22.7[b]
Jute and jute products	Thailand	6.0[b]
Copper ore	Indonesia	17.2
Nickel intermediate products	Indonesia	19.6

Source: UNCTAD database.
a Countries with shares greater than 5 per cent.
b 1994.
c Including hard fibres, manufactured.

1. Overall impact

Since the East and South-East Asian economies are important both as exporters and importers of commodities, the Asian crisis can affect international commodity markets on both the demand and the supply side.

(a) Supply effects

In general, primary commodities produced in the region have a larger share of domestic value-

added than manufactures, which are much more dependent on imported inputs. Therefore, after a devaluation, their relative competitiveness on world markets would increase more than that of manufactures. In spite of this advantage, and the relatively high proportion of world exports supplied by the crisis countries, a significant impact on world markets through increased production by these countries has not yet been felt, and is not very likely. The impact has been principally through reduced domestic consumption because of a decline in real incomes or reduced demand for inputs owing to problems in the export-oriented manufacturing sector. For products imported by these countries, this has diverted important quantities to other markets. For products supplied by these countries themselves, larger exportable surpluses have resulted. So far, it appears that increased commodity production is not widespread; market reports focus almost exclusively on the increase in available supplies due to reductions in regional consumption.

Because of inevitable lags in supply response for most commodities, production cannot be increased markedly in the short run to benefit from increased profit opportunities presented by devaluation. Although some increase may be possible through more intensive production practices in the current production period, such as better care and cultivation in agriculture, an increase in capacity utilization in mining and commodity processing, or an intensification of logging activities in forestry, decisions to increase output significantly would require new plantings and/or new investments, and thus be reflected in supplies only with a certain time lag. Apart from annual crops (rice being the only major one for which the region is a significant exporter), this lag would be several years for both agricultural and mineral commodities even if decisions to invest were made now. However, given the generally low level of commodity prices, and the past success of the region in manufacturing, it is doubtful whether the commodity sector would be accorded higher priority than before in the allocation of scarce investible resources or disrupt commodity markets by considerably increasing production as a result of the crisis.

(b) Demand effects

The decline in commodity imports by the Asia-5 since the advent of the crisis has been substantial. In analysing this decline, a distinction needs to be made between a reduction in imports for domestic consumption and one that is related to inputs for export-oriented activities. The most affected countries have indeed reduced their domestic consumption and, where possible, substituted domestic products for imports. All imports of food and feedstuffs, as well as construction materials are essentially for domestic consumption. With regard to food, the United States Department of Agriculture expects that the Asia-5 will particularly reduce their imports of high-value products such as horticultural products, red meats and poultry, and processed products, which are more price- and income-sensitive than bulk products.

Metals and agricultural raw materials, on the other hand, are mostly imported for use in export-oriented manufacturing. Imports of these products will mainly be determined by the performance of the export sector. Thus, while the import demand for domestically consumed products may be expected to stay low for a relatively long period owing to changes in consumption patterns and domestic import-substituting supply responses, imports of industrial inputs should rebound when exports of manufactured products pick up. In fact, imports of these products may recover (barring finance problems) even earlier than exports, because in the face of import difficulties firms have been running down their stocks of raw materials to keep production going. Moreover, in order to alleviate the import constraint for its manufacturing sector, the Government of the Republic of Korea has released 10,000 tons of copper, 2,200 tons of lead, 700 tons of tin and 700 tons of nickel from its stockpiles, and reduced by 10 per cent the mandatory amount of crude oil that refineries must store, so as to allow the partial use of these strategic reserves during the crisis.[19] When the breathing space permitted by such measures is exhausted, imports will have to increase even with the same level of production and exports.

(c) Financing imports of commodities

A solution to the problem of import financing will be crucial in spurring import growth. The importance of the problem is exemplified by a comparison between the textile sectors of Indonesia and the Republic of Korea. While in the former, financing problems have led to a 35 per cent drop in textile export earnings due to a shortage of raw materials,[20] in the Republic of Korea

an important textile-exporting company – Samsung – for which financing problems are less acute is expecting a 30 per cent rise in export earnings.[21]

There have been reports of various assistance measures by industrialized countries to alleviate the import-financing problems of the Asia-5. It has been reported that apart from the general contributions to bailout packages, some financial support has been specifically earmarked for enabling these countries to obtain the necessary raw material imports. In most cases, these are designed to support imports of products originating from the countries providing the financial support. For example, the United States has provided $2.1 billion in export credit guarantees to the Republic of Korea and other Asian countries to enable them to buy farm goods in the United States. A total of $1 billion has been allocated to the Republic of Korea for importing grains and meat[22] and $460 million will be provided as guarantees for Indonesian letters of credit for imports of raw materials by export industries, such as cotton, and other commodities for domestic consumption such as corn, wheat, flour, meat, rice and soybeans. Australia is also providing letter-of-credit guarantees for its commodities such as cotton, meat, dairy products, sugar and aluminium, for which imports into Indonesia have been hampered by financial problems. Germany's contribution is DM 250 million in export credit guarantees to Indonesia for small and medium-sized enterprises facing difficulties in importing raw materials.[23] Such measures are likely to increase the shares in trade with the region of the countries providing financial support, at the expense of other suppliers of commodities, particularly developing ones.

(d) Possible trade liberalization in the Asia-5

One crisis-related factor that may affect agricultural trade is the conditionality regarding trade liberalization imposed by the IMF on the countries in the region. In this respect, it is reported that the Republic of Korea is eliminating restrictive import-licensing practices for various products, including corn grits, soyflakes and peanuts. It is also eliminating trade subsidies, reducing price support for rice and beef, and reducing the number of agricultural products subject to tariff rate quotas.

It is also reported that Indonesia is eliminating import and distribution monopolies covering wheat and wheat flour, soybeans, sugar and garlic. In addition, it is phasing out all quantitative restrictions and other non-tariff barriers except those justified under the WTO regime, reducing tariffs on most imported food products from 20-40 per cent to 5 per cent, and abolishing some domestic content regulations which discourage imports of agricultural products. Reports also mention that Thailand is eliminating tariffs on a number of agricultural products, adapting harmonized import licensing procedures, and establishing more transparent customs valuation procedures.

(e) Are considerably increased commodity exports by the Asia-5 likely?

Considering the part to be played by the commodity sector in the recovery of the region, there are reasons to believe that the countries in the region will not seek to put as much emphasis on expanding their commodity exports as was observed during the debt crisis of the 1980s, when commodity exports from debt-troubled countries increased significantly. In countries without a manufacturing base comparable to that in the East and South-East Asian countries, commodity exports are typically much easier to increase than exports of manufactures. However, when manufacturing capacity is large and idle, the need to increase commodity exports becomes less urgent. Therefore, crisis-induced supply pressure on the commodity markets is unlikely to grow significantly. There are reports from Malaysia that, as a result of the crisis, the Government intends to "exploit the commodity sector more and more",[24] but the aim is to diversify and increase self-sufficiency in order to reduce vulnerability on both the export and the import side, rather than to increase exports of traditional commodities. Moreover, given the recent information on raw material imports, which does not indicate increased purchases, there is reason to believe that Asia's export recovery in 1998, if it takes place at all, is likely to be weak.[25]

2. Recent changes in commodity prices and the impact on developing countries

An overview of changes in monthly prices since the beginning of the crisis is provided in table 23 for products of main export interest to developing countries. From mid-1997 to April 1998, the price of oil fell by 25 per cent, while commodity prices (excluding the price of oil) ex-

perienced an overall decline of over 10 per cent, with larger falls in agricultural raw materials and metals than in food and beverages. Price decreases, some of them very pronounced, were observed for many commodities, which altogether accounted for about one-third of the non-oil primary exports of the developing countries. Of course, factors other than the crisis also contributed to these declines.[26] However, there is no doubt that the prices of agricultural raw materials, timber, metals (particularly copper and nickel) and, to a somewhat lesser extent, energy products were adversely affected by the depressed demand resulting from the crisis.[27] The fall in prices was quite widespread and affected both agricultural commodities and metals. However, while the prices of agricultural commodities appeared to have more or less stabilized, albeit at lower levels than those prevailing in mid-1997, most metal prices and the price of petroleum continued to decline as of April 1998.

The greatest short-run impact on world market prices has been felt with regard to commodities for which the region is an important consumer and supplier (table 23). Thus, forestry products such as timber and plywood, as well as rubber, have experienced the sharpest price declines. Some increase in output may have contributed to this situation, although as mentioned above, market reports focus on reduced demand. A significant impact of the crisis should not be expected on the world markets in the short run for products such as coffee and cocoa, which are produced in some Asia-5 countries principally for export, and of which these countries are not major consumers. Most of the output is exported in any case, and no large increase can be achieved rapidly. Therefore, there would be no reason for exporters to accept prices that are below the current world prices; instead, producers and exporters in these countries will make windfall gains in domestic currencies.

An interesting case is that of palm oil. Almost 90 per cent of world exports originate in the Asia-5, which are also important consumers of the product. Thus, it is a prime candidate for a commodity whose international market could be flooded as a result of both expanded production and reduced domestic consumption. However, after Indonesia completely banned exports of palm oil and palm oil products, prices increased instead of falling (see annex).

For other primary commodities, significant price declines have occured since June 1997. Estimates for 1998 export earnings shortfalls resulting from these decreases and their importance in terms of GDP for selected countries for which the respective commodities constitute a significant part of export earnings can be seen from table 24. Assuming that the volumes exported of these products remained the same as the year before, which in itself is probably an excessively optimistic assumption, up to a quarter of export earnings (for Zambia) and slightly more than 12 per cent of GDP (for the Solomon Islands) would be lost as a result of price falls. Other countries whose economies will certainly be seriously affected by commodity price falls include Cambodia and Swaziland (timber), and Cuba and Guatemala (sugar).

Petroleum prices have declined sharply since the beginning of the Asian crisis, and the impact

Table 23

CHANGES IN MONTHLY PRICE INDICES OF SELECTED PRIMARY COMMODITIES, JUNE 1997 - APRIL 1998

Commodity	*Percentage change*
Tropical beverages	-19.3
Food	-6.7
Sugar	-17.7
Wheat	-10.1
Maize	-9.3
Natural rubber	-32.9
Tropical sawnwood	-32.7
Plywood	-27.7
Wool	-31.8
Cotton	-14.6
Jute	-21.2
Hides and skins	-8.1
Minerals, ores, metals	-17.3
Copper	-31.1
Nickel	-23.6
Zinc	-19.0
Lead	-7.0
Aluminium	-9.5
Crude petroleum	-24.6

Source: UNCTAD, *Monthly Commodity Price Bulletin*, May 1998.

Table 24

ESTIMATED SHORTFALLS[a] IN 1998 EXPORT EARNINGS OF SELECTED DEVELOPING COUNTRIES, DUE TO PRICE DECLINES, BY COUNTRY AND COMMODITY

Country and commodity	Shortfall as percentage of		Country and commodity	Shortfall as percentage of	
	Export earnings	GDP		Export earnings	GDP
Non-oil commodities			**Petroleum**		
Chile: copper	9.9	2.6	Algeria	12.4	3.4
Equatorial Guinea: wood	2.5	1.4	Angola	24.8	18.3
Gabon: wood	4.6	2.8	Bahrain	16.2	16.2
Ghana: aluminium	1.4	0.4	Cameroon	8.1	2.1
Indonesia: plywood	3.3	0.8	Colombia	3.5	0.5
Jamaica: alumina	4.0	2.8	Ecuador	8.4	2.4
Kazakhstan: copper	5.1	1.8	Egypt	5.9	1.2
Lao People's Dem. Rep.: wood	2.3	0.3	Gabon	21.1	12.9
Mongolia: copper	10.2	5.7	Indonesia	3.2	0.8
Myanmar: wood	12.0	-	Islamic Rep. of Iran	21.9	6.6
Papua New Guinea: copper	6.1	3.7	Kuwait	25.4	13.6
Papua New Guinea: wood	6.6	4.4	Mexico	2.7	6.8
Paraguay: cotton	3.8	1.3	Nigeria	24.3	3.9
Peru: copper	6.7	0.7	Oman	20.8	10.2
Solomon Islands: wood	22.4	12.1	Syrian Arab Republic	16.5	3.8
Sudan: cotton	4.8	0.2	Trinidad and Tobago	12.2	4.8
Togo: cotton	2.3	0.7	United Arab Emirates	18.9	14.0
United Rep. of Tanzania: cotton	2.7	0.8	Venezuela	20.3	5.5
Zambia: copper	25.5	8.5			

Source: UNCTAD database.
a Assuming 1997 export volumes.

on the export earnings and GDP of petroleum-exporting countries is particularly strong. For example, Angola's export earnings could fall by one quarter, and its GDP by almost one fifth, on this account.

To recapitulate, the decline in actual consumption of commodities by the Asia-5, either directly for food products, or indirectly for industrial inputs and construction materials, is the main channel through which the impact of the Asian crisis has been felt, and will continue to be felt, in commodity markets. Increased production by these countries of a limited number of commodities also has a direct impact on commodity markets. To the extent that the crisis affects other countries' income and consumption levels, a secondary impact will be generated as well. This, however, may not be significant, given that the estimates of contagion effects on the industrial countries comprising the main commodity markets are rather low, and the link between the prices of most commodities, except industrial raw materials, and GDP growth in industrialized countries is not very strong. Nevertheless, commodity prices have fallen, in many cases substantially, since June 1997, with important effects on commodity-exporting developing countries.

F. Conclusions

The preceding analysis of the impact of the Asian crisis on the trade of developing countries can be only preliminary at this stage for two reasons. First, the crisis is continuing and the real effects may take some time to show up fully. Second, many relevant statistics (e.g. on imports and exports, by partner country and by commodity group) are available only with a lag of several months or up to a year, and are not necessarily comparable. However, the information currently available allows certain conclusions to be drawn.

The initial effects of the Asian crisis on developing countries' trade are mainly in the form of reduced demand for their exports to East and South-East Asia and a decline in world commodity prices due to the recession in that region. The extent to which an individual country has been affected depends on the share of East and South-East Asia in its exports.[28] It also depends on whether the respective country is a net exporter of commodities that have suffered a substantial price decline, such as non-ferrous metals, timber, rubber and petroleum. So far, it is not clear whether the large nominal depreciations of the region's currencies have significantly altered their international competitiveness outside the region. Nor do the data available so far reveal a significant export boost. It is also unclear to what extent the devaluations may be producing competitive pressures on other developing country exporters in third markets.

The scope for an export-led recovery of the East and South-East Asian economies affected by the crisis is limited by the relatively high import content of their exports (such as electronics), which serves to offset to a significant degree the competitive edge provided by the nominal currency depreciations. Moreover, export expansion depends on the availability of financing for the procurement of raw materials and parts as well as for export marketing.

Finally, as many countries in East and South-East Asia are all faced with a contraction of domestic demand at the same time, the region as a whole may require an expansion of net exports in order to resume the pre-crisis rate of growth. This could cause serious strains on the international trading system. There is already increasing pressure for protective action, and in some cases recourse to anti-dumping actions is likely. Such measures are discriminatory. An alternative would be the use of actions under the WTO Agreement on Safeguards, which would normally have to be applied on a most-favoured-nation basis. However, frequent resort to its "quota modulation" provision could undermine the Agreement, which was one of the most positive outcomes of the Uruguay Round. More generally, there is a risk that the concept of balance and mutual advantage upon which the WTO system is based could be weakened if policy conditionality for assistance in coping with the crisis takes the form of demands for unilateral trade concessions.

Open markets and the continued growth in world trade will be important factors in overcoming the crisis. In this context, it is important that the momentum towards increased trade liberalization in respect of products of interest to developing countries be maintained, and be given priority in the work leading up to the third WTO Ministerial Conference. Resort to discriminatory trade remedies such as anti-dumping duties should be subject to increased surveillance. In addition, consideration should be given to allowing the affected countries to benefit from the possible extension of the provisions for differential and more favourable treatment included in the WTO Agreements, notably the Agreement on Subsidies and Countervailing Measures. ■

Notes

1 For a detailed discussion of the flying geese paradigm and the related trade-*cum*-investment pattern, see, for example, *TDR 1996*, Part Two, chap. II.

2 Brunei Darussalam, Indonesia, Malaysia, Philippines, Singapore, Thailand and Viet Nam.

3 For details, see World Tourism Organization, *Yearbook of Tourism Statistics,* 49th ed., Vol.1 (Madrid, 1997).

4 See Japan Tariff Association, *Summary Report on Trade of Japan*, No. 2, 1998; and Bank of Japan, *Monthly Report of Recent Economic and Financial Developments*, June 1998.

5 For further discussion, see "Asia commercial overview – 17 April 1998", United States Department of Commerce, STAT-USA/Internet Service; and "Taiwan: Deteriorating exports", *Oxford Analytica Brief*, 27 May 1998.

6 See "Exports record negative growth in May", *Korea Times Report Page*, 06/01 (http://www.korealink.co.kr).

7 A large body of theoretical literature as well as empirical studies suggest that, contrary to the predictions of textbook analysis, devaluations are in the short to medium term contractionary rather than expansionary. For example, see S. B. Kamin and M. Klau, "Some multi-country evidence on the effects of real exchange rates on output", Working Paper No. 48 (Basle: Bank for International Settlements, 1997).

8 Concerns have also been expressed by some developing countries and some action has been taken. See, for example, ECLAC, "Impact of the Asian crisis on Latin America", LC/G.2026(SES.27/23), Santiago, Chile, 6 May 1998.

9 For further discussion, see SELA, "The impact of the Asian crisis on Latin America" (Caracas, February 1998); and JP Morgan, "Latin American Economic Outlook", New York, 6 March 1998.

10 For further discussion and projections of the effects of the Asian crisis on Eastern Europe, see ECE, *Economic Survey of Europe 1998 (No. 1)* (United Nations publication, Sales No. E.98.II.E.1).

11 These real effective exchange rates are calculated by the IMF with partner weights reflecting (i) the relative importance of bilateral partners in a country's trade in manufactures, primary commodities and tourism services (where significant), and (ii) the importance of competition between countries in third-country markets for trade in manufactures. See A. Zanello and D. Deruelle, "A primer on the IMF's Information Notice System", IMF Working Paper 97/71 (Washington, D.C.: IMF, 1997); and A. Turner and S. Golub, "Multilateral unit-labour-cost-based competitiveness indicators for advanced, developing and transition countries", in *Staff Studies for the World Economic Outlook* (Washington, D.C.: IMF, 1997), pp. 47-60.

12 In the IMF computation consumer price indices are taken as the deflators. It is important to note that the consumer price index is not the best indicator as regards cost developments for traded goods, especially where exports have a high import content. Apart from Indonesia, the increase in the consumer price index has so far been fairly limited in the Asian countries experiencing large currency depreciations. This may be due to significant lags between exchange rate changes and changes in the consumer price index, the effects of price controls or subsidies in some cases, and the strong reduction in domestic demand. Hence, the competitiveness effects of the recent exchange rate may be overstated. On the other hand, potential third-market effects could be understated. It should also be noted that in calculating trade-weighted real effective exchange rates the IMF uses weights based on data for 1988-1990, which do not capture more recent changes in trading patterns, particularly the substantial growth in Asian intraregional trade since the late 1980s. The larger the share of that trade, the smaller would be the depreciations on a real effective basis as compared with those in dollar terms.

13 See R. E. Saez, "Latin American exports to the OECD markets potentially more exposed to the Asian Crisis: A first look" (Washington, D.C.: Inter-American Development Bank, 1998), mimeo.

14 One notable exception is a study of the import content of India's exports which made use of detailed information at the firm and sectoral levels. The study found an overall import intensity of 42 per cent for manufactured exports (i.e. leather and leather products, ready-made garments, chemicals and drugs, and engineering products), and a rise in the import intensity over the period in question (the 1980s) with the growth in and diversification of India's manufacturing exports. See Export-Import Bank of India, "How import intensive are Indian exports?", Occasional Paper No. 16, (New Delhi, 1991).

15 See "Southeast Asia export challenge", *Oxford Analytica Brief*, 31 March 1998.

16 See "Asia commercial overview – 17 April 1998", United States Department of Commerce, STAT-USA/Internet Service.

17 For further discussion see T. Komine, "Currency crisis and financial turmoil in Asia: The potential for future growth", Economic Research Institute, Economic Planning Agency of Japan, March 1998; and JP Morgan, "ASEAN export prospects in 1998", Economic Research Note, Singapore, 30 January 1998.

18 See "Exports record negative growth in May", *Korea Times Report Page*, 06/01 (http://www.korealink.co.kr).

19 "Asian crisis hammers industrial price index; cotton, copper scrap, rubber take a beating worldwide", *Journal of Commerce* (Seoul), 15 January 1998.

20 "Textile export earnings seen to drop about 35%", *Jakarta Post*, 5 March 1998.

21 "Exports play a leading role", *Business Korea*, March 1998.

22 "USDA undersecretary touts IMF backing", *Fresno Bee*, 19 March 1998.

23 "Trading partners agree to give credit guarantees", *Jakarta Post*, 20 February 1998.

24 "Need to fully tap potential of commodities sector", *Business Times*, 29 January 1998.

25 "East Asia's export surge fails to materialize, raising doubts about a recovery", *International Herald Tribune*, 13 April 1998.

26 Except in the case of commodities that have suffered unfavourable weather conditions, the fall in commodity prices is probably due to a combination of factors: the effect of the world business cycle (largely reflecting the industrial slow-down and crisis in Asia), the appreciation of the dollar (which tends to reduce commodity prices expressed in dollars) and supply considerations (particularly new supply facilities for non-ferrous metals coming into production).

27 See IMF, *World Economic Outlook*, May 1998, annex II.

28 Countries where this share is particularly high are Chile, Peru and Ecuador in Latin America; Zambia, the United Republic of Tanzania, Congo and South Africa in Africa; Saudi Arabia in West Asia; and the countries in the region themselves.

Annex to chapter II

IMPACT OF THE ASIAN CRISIS ON SPECIFIC COMMODITIES

Data are not yet available for a meaningful statistical analysis of the impact of the Asian crisis on the markets for specific commodities. However, a picture emerges from recent press reports. Although these originate mostly in developed countries, they give an overview of events that can be generalized, at least in terms of tendencies, to world commodity markets. Estimates of the direct effects of the crisis on trade in specific products, as obtained from such reports, are briefly summarized below.

Beef: United States exports in 1998 are expected to decline by around 5 per cent over 1997. The decline in imports by the Asian countries has led to beef being redirected to alternative markets. It is reported that financial problems have caused even imported beef to be delayed for long periods in refrigerated containers on the docks of the Republic of Korea, and that Canada, Australia and New Zealand, which are the main competitors of the United States in Asian markets, are now sending more beef to the Unites States.[1]

Pork: Regional suppliers such as the Republic of Korea are becoming more competitive, while sales by other exporters such as the United States are expected to fall in 1998 by around 5 per cent compared with 1997. It is noteworthy that this decline is expected in spite of the availability of export credit guarantees.[2]

Fish: Regional suppliers such as Thailand are becoming more competitive, while sales by other exporters such as the United States are expected to fall. Another impact on fish trade is that fishing companies in the Republic of Korea which used to buy fishing licences in many parts of the world can no longer afford them; this will lead to a decline in earnings by the countries issuing the licences. Such losses would not be visible in trade figures.

Vegetable oilseeds and oils: The most affected countries, particularly Indonesia and Malaysia, are very important suppliers of **palm oil**. Their exports could increase, putting significant downward pressure on prices. However, the Indonesian Government banned exports, fearing that cash-starved manufacturers, whose costs are mostly in rupiah and revenues in dollars, would export most of their stock and cause domestic shortages and price rises.[3] This contributed to a significant price rise on the international markets. In March 1998, prices were 19 per cent higher than in December 1997, with similar repercussions on prices of other vegetable oils. Malaysia's export earnings from palm oil are expected to increase significantly. As far as **soybeans** are concerned, the most affected countries have reduced imports, which can be attributed to a reduced demand for meat and thus for feedstuffs. Thus, soybean prices in March 1998 were 7 per cent lower than in December of last year. Trade will also be affected by the situation regarding other oilseeds. For example, the expectation that the ban on palm oil exports by Indonesia would be lifted reduced futures prices for soybeans even further.

Natural rubber: While global consumption growth slowed significantly in the first quarter of 1998, Indonesia, Malaysia and Thailand, which supply more than 80 per cent of world trade, are competing to increase their exports. Thus, although most of the costs in the rubber sector are in local currencies and the receipts are in dollars, international prices are under considerable pressure. A significant increase in the export earnings of these countries is not to be expected; Indonesia expects even a decline in export earnings.[4]

Wood: Timber and plywood trade has been severely hit by the Asian crisis. "Reflecting in part the segmentation of this market, the price decline has been uneven across types of timber and across geographic markets. The price decline for Asian-grown (meranti) hardwood has been greatest."[5] The main reason is that most of these products are used in the construction industry, whose output is a non-tradable good and which experienced a radical slowdown. In addition, as a result of increased supplies from the crisis region, a glut has appeared in the timber and plywood markets, affecting all exporters. For example, it is reported that over half of the logging companies in Papua New Guinea and about one-third of plywood producers in Indonesia have ceased operations, and that 1.2 million cubic metres of unsold Indonesian plywood have accumulated in warehouses over the last few months.[6] The impact of the Asian crisis on the plywood market is felt even in countries as far away from the region as Guyana, whose export earnings from plywood in the first three months of 1998 were down by 60 per cent compared with the same period in 1997, and whose earnings for the whole year are expected to fall by nearly a half.

Aluminium: The market situation has been strongly affected by the decline in demand by the Asian countries. The decrease in demand by the most affected countries has been somewhat counterbalanced by an increase in Western Europe, where demand in 1998 is expected to rise by 5.6 per cent, leading to an overall increase of 1.1 per cent in consumption. However, this represents a significant fall from the earlier expectations of 3.5 per cent growth, which can be attributed to the Asian crisis.[7] Although in 1998 the market will swing from a supply deficit to a surplus and in January 1998 stockpiles of aluminium rose to an 18-month high, market conditions are expected to remain relatively tight.[8]

Copper: The utilization of this commodity is also strongly affected by construction activity. The Asian crisis has created considerable disturbances in the copper market. Assuming zero growth in Asia, the world's copper surplus is expected to rise from 348,000 tons to 603,000 tons in 1998, in spite of a 3 per cent rise in demand in the rest of the world.[9] A significant impact of the Asian crisis has been a cut in investments in the copper sector. Canadian investors are pulling back from the development of copper deposits in Peru, compromising a project which had been expected to earn over $8 billion in foreign exchange over the next few years. More optimistic observers, however, claim that the United States, Central Europe and Mexico had taken over as the engine of growth from the Asian countries even before the beginning of the crisis, and their demand remains strong. Among copper-exporting countries, the experience of Chile merits mention because the price stabilization fund which had been established by the Government has accumulated close to $2 billion. This fund can compensate for several years for lower prices and eliminate most of the negative impact resulting therefrom.[10]

Lead and zinc: As with several of the other metals and minerals, the decline in Asian demand for lead and zinc is being offset to some extent by strong demand in Europe and America. Although the surplus on world markets will increase, lead and zinc mine closures in Canada[11] suggest that this increase will be more muted than initially expected. ■

Notes

1 "Asian fiscal woes reach Alaska", *Anchorage Daily News*, 17 March 1998; and "Estimate of U.S. meat increases 2 percent", *Des Moines Register*, 13 March 1998.

2 "New woes for meat farmers", *News & Observer*, 8 March 1998; and "Asian troubles mean struggle for hog farmers", *Des Moines Register*, 15 March 1998.

3 "The year of living ludicrously", *Economist*, 31 January 1998.

4 "Indonesia losing rubber race", *Financial Times*, 27 February 1998.

5 IMF, *World Economic Outlook*, May 1998, annex II.

6 "Trouble in paradise", *Asian Business*, April 1998; "Plywood industries suffer under Asian woes", *Ja-*

karta Post, 23 February 1998; and "Unsold plywood stock totals 1.2 million cubic meters", *Jakarta Post*, 4 March 1998.

7 "Aluminium analysts hold differing views on prices", *Purchasing*, 12 February 1998; and "Aluminium groups differ over production levels", *Financial Times*, 17 April 1998.

8 "Metals analysts expect drop in most prices", *Financial Times*, 20 January 1998; "Dollar's fall knocks Comalco to $2.7m loss", *Dominion,* 12 March 1998; and "Asian turmoil hits base metals", *African Business*, January 1998.

9 "Copper's downward slide beginning - finally!", *Purchasing,* 12 February 1998.

10 "Peru hangover on horizon", *Financial Times*, 12 March 1998; "Short copper bear market seen", *Financial Times*, 13 February 1998; and "Hit by Asia crisis, Chile loses its lure for investors", *Wall Street Journal*, 21 January 1998.

11 "Lead-zinc mine in Yukon closes", *Financial Times*, 20 January 1998.

Chapter III

INTERNATIONAL FINANCIAL INSTABILITY AND THE EAST ASIAN CRISIS

A. Introduction

In less than a year from mid-1997 the East Asian economies have gone from being examples of the most successful development experience in modern history to economic stagnation and decline. Growth rates that had averaged 8-10 per cent per annum over many years have turned negative, economies that had enjoyed continuous high employment and experienced labour shortages now suffer from extensive and rapidly rising unemployment, and assets in stock markets that had led global diversification into emerging markets have lost half their value and more. In much less time than it took the 1929 stock market crash to turn into the Great Depression of the 1930s, the Asian economies that were once held up as examples of prudent and sustainable economic policies have been transformed in the minds of many from economic "miracles" into structurally unstable systems incapable of formulating their own economic policies and have been assigned to the tutelage of IMF. Never has the economic outlook for such a large group of economies changed so radically and so rapidly.

The curtain rose on the first act of the East Asian crisis in early July 1997, when the Bank of Thailand withdrew support for the baht, allowing it to move outside its exchange rate band with the dollar, a step soon followed by the other countries in the region. However, instead of creating expectations of improved competitiveness and payments adjustment needed to sustain rapid growth, the shift to floating exchange rates triggered massive outflows of capital throughout the region, driving equity prices and currencies down to record low levels. Economic damage usually associated with war or natural disaster was caused when an exchange rate adjustment was transformed into a virulent disease that infected the entire region with financial panic.

A popular explanation of the crisis emphasizes the reaction of currency and equity markets to payments disequilibrium and weakened economic fundamentals. One of the factors most commonly cited as contributing to the crisis is lax regulation and supervision of the financial system. This, together with implicit government guarantees, is considered to have led to moral hazard and produced excessive external borrowing. In addition, pervasive government intervention in economic decision-making led to corruption and cronyism that further distorted incentive structures and reduced the efficiency of investment.

While this diagnosis contains some elements of truth, it does not provide a satisfactory explanation of why the panic broke out when it did, or where it did, or of why it spread to the entire region. More important, this explanation of the crisis relies on characteristics specific to the economic systems of the region and ignores similarities with the crises in developed and developing economies organized under rather different socio-economic systems. Indeed, financial instability has occurred with increasing frequency since the late 1970s, as

evidenced by the banking and debt crisis in the Southern Cone in South America, the Latin American debt crisis of the 1980s, the banking and real estate crises in the United States lasting more than a decade from the late 1970s, and the major slumps in the global stock market in 1987 and 1989. Despite the increased prevalence of sound macroeconomic policies and greater price stability in the 1990s, crises have shaken financial systems at approximately two-year intervals: the European Monetary System (EMS) currency crisis of 1992 was followed by the Mexican crisis of 1994, and the Mexican crisis by the East Asian crisis of 1997. The latter crisis, despite its distinctive features, thus appears to be part of what has come to be an endemic feature of the globalized economy.

This chapter seeks to explain the East Asian crisis in the context of the increase in systemic global financial instability. Section B examines various elements that have characterized financial crises since 1970. An analysis of the factors that created financial vulnerability in East Asia as a prelude to the crisis, and an assessment of the basic factors that spread it throughout the region and globally, are provided in section C. Since there is clear evidence that the policy response to the crisis has contributed to its severity, section D examines this issue, while section E sets out the social consequences of the crisis. The chapter concludes with a brief discussion of the general implications of the crisis for the East Asian model of economic development.

B. Anatomy of the crises in the post-Bretton Woods period

Since the collapse of the Bretton Woods system increased global capital mobility has been accompanied by an increased frequency of financial crises in both the developed and the developing countries. These have taken various forms: domestic financial crises affecting the banking sector and/or the financial market, currency turmoil and external debt crises. Experience shows that in developing countries domestic financial crises often translate into currency turmoil, payments difficulties and even external debt crises. Similarly, reversal of external capital flows or attacks on currencies almost invariably threaten domestic financial stability in developing countries. By contrast, currency turmoil in industrial countries does not usually spill over into domestic financial markets, nor do domestic financial disruptions necessarily lead to currency and payments crises. External indebtedness, together with the dollarization of the economies in the South, accounts for much of this difference.

The annex to this chapter summarizes the salient features of three episodes of crisis in the post-Bretton Woods era: a currency crisis, a banking crisis, and a crisis that combined internal and external financial instability, including external debt-servicing difficulties. In the first one – the EMS crisis of 1992 – there was significant turmoil in the currency markets, but it did not threaten the banking and financial system in the countries concerned. In the second episode – the United States banking and real estate crisis – the major difficulties were in the domestic financial system, but they did not spill over to currency instability. Nor did they during the global stock market slumps of 1987 and 1989 and the bond market crash of 1994. However, in all of these three cases the difficulties were contained within the financial markets, with little impact on the stability of banking systems. The third episode – the Southern Cone crisis of the late 1970s and early 1980s – had features similar to those of the recent East Asian crisis: it combined domestic and external instability, resulting in external debt-servicing difficulties. In both cases, and in contrast to the Mexican crisis of 1994 and the Latin American debt crisis of the 1980s, the build-up of external indebtedness was almost completely within the private sector.

While each episode has its own characteristics, a number of common features have marked the history of the post-Bretton Woods crises. First, many of them have been preceded by liberaliza-

tion of the economy, notably the financial sector. In particular, financial deregulation and capital account liberalization appear to be the best predictor of crises in developing countries. Second, all episodes of currency instability have been started by a sharp increase in capital inflows followed by an equally sharp reversal. Such swings in these flows are related to internal or external policy changes that produce large divergences in domestic financial conditions relative to those of the rest of the world. These divergences are frequently reflected in interest rate differentials and prospects of capital gains. Reversals of capital flows are often, but not always, associated with a deterioration in the macroeconomic conditions of the recipient country. However, such deterioration often results from the effects of capital inflows themselves as well as from external developments, rather than from shifts in domestic macroeconomic policies. Finally, financial crises tend to be associated more closely with certain types of financial flows and certain classes of lenders and borrowers than with others. However, the conditions under which such crises have occurred have been rather diverse with respect to types of financial flows, and of borrowers and lenders.

1. Liberalization and international arbitrage

Liberalization, interest rate differentials and nominal exchange rate stability are the main factors attracting capital inflows. Rapid liberalization often gives rise to expectations of improvements in economic fundamentals and of large capital gains, as well as to perceptions of reduced risks. Interest rate differentials provide a strong incentive for domestic firms and banks to reduce their cost of finance by borrowing abroad (interest rate arbitrage), while allowing foreign investors to increase their return on capital by diversifying their portfolios and lending in developing countries. Such differentials arise from the risk factor, but they can also be due to differences in inflation rates or to differences in the stances of monetary policy. In conditions of generally stable exchange rates, both lenders and borrowers tend to be willing to bear substantial foreign exchange risks. This is particularly true of local borrowers in a recently deregulated economy, who are not always aware of all the risks associated with borrowing in foreign currencies. In most cases exchange rate stability is part of economic policy. Capital inflows themselves often reinforce prevailing market expectations with regard to foreign exchange risks by leading to appreciation.

Indeed, the existence of massive arbitrage flows taking advantage of large international interest rate differentials appears to be an important element in each currency crisis in the post-Bretton Woods period. In the Southern Cone, the decision to remove controls on capital inflows in the presence of tight monetary policy, combined with the introduction of a fixed exchange rate, brought massive inflows. In the Latin American debt crisis it was the combination of excess global liquidity, relatively low international interest rates and the absence of profitable investment opportunities in industrial countries in the aftermath of the oil crisis that encouraged lending to developing countries. In the 1992 EMS crisis, it was again interest rate differentials that played a major role - high rates in Italy and the United Kingdom relative to those in Germany and the United States that attracted arbitrage funds, encouraged by the Italian decision to lift all remaining controls on capital flows and adopt the narrow exchange rate band of the Exchange Rate Mechanism (ERM). In the build-up to the Mexican crisis of 1994, the flows were due to a policy of low interest rates in the United States introduced to deal with debt deflation, and to an exchange-rate-based stabilization policy in Mexico, accompanied by widespread privatization and a speculative boom in equity markets. The East Asian crisis had its origins in the same period, as low rates in the United States drove investors in search of higher returns into emerging markets. The high growth rates and high interest rates in East Asia, together with the problems in Latin American markets, produced large differentials that proved too attractive for international investors to resist. They were encouraged by a 10-year experience of currency pegs producing fluctuations of no more than 10 per cent in rates relative to the dollar.

In its traditional concept, arbitrage is not permanent and is eventually eliminated while being pursued. However, international interest rate arbitrage flows tend to be self-reinforcing rather than self-eliminating, thus making it more difficult to sustain domestic policies. If not sterilized, they lead to an appreciation of the currency, thereby reinforcing capital flows and worsening external payments. Sterilization first increases domestic reserves, giving the impression of strong backing for the exchange rate. However, it requires issu-

ing domestic debt, thereby putting further upward pressure on interest rates, reinforcing the interest rate differential and attracting yet more arbitrage flows. Also, sterilization through high-interest-rate domestic debt may lead to fiscal deficits. Thus, in the absence of controls, capital inflows generally result in an unsustainable combination of an appreciating real exchange rate, a rising foreign deficit and/or a rising fiscal deficit.

2. Nature of financial flows

One factor that differs appreciably among the different experiences of crisis in the post-Bretton Woods era is the form of capital inflow. In the Southern Cone it took primarily the form of lending by foreign banks, and before the Latin American debt crisis syndicated bank lending evolved to meet the needs for recycling the surpluses of oil producers. In the aftermath of the 1982 debt crisis, bank lending virtually disappeared, to be replaced by bond issuance. This process was initiated with the issue of Brady bonds, and sovereign issues were subsequently used to pay off outstanding external debt. In the Mexican crisis the inflows were primarily portfolio investment in equity and government debt, both denominated in pesos.[1] The Asian crisis represents the return of international bank lending, with a high share of short-term lending. Thus, the form of lending has come full circle – from lending by individual banks to syndicated bank loans, to sovereign bonds, to portfolio flows and back to bank lending. The Asian countries originally had relatively high proportions of direct investment flows, and since the Mexican crisis such flows to Latin America have increased substantially.

Similarly, the maturity of the financing has gone from predominantly short-term, to medium-term (some syndicated loans had maturities of up to 10 years), to long-term (bonds and equities) and back to short-term. Interest rates charged on lending have been both fixed and floating. However, despite these differences in the form of the lending, the maturity and the conditions, there is one constant factor, namely the extreme volatility of financial flows in periods of crisis. The divergences in the form of the flows received by a country do not seem to have made a substantial difference to the impact of these flows on domestic conditions and to their subsequent reversal.

There is also variability among the borrowers of funds. In the Southern Cone crisis, borrowers were mainly private banks and firms, as also in East Asia. Although it is often suggested that the 1982 Latin American debt crisis differed owing to the predominance of sovereign borrowers, this is not quite correct. The predominance of loans with sovereign guarantee emerged only after the crisis had broken out and attempts to restructure the debt were under way.[2] The eventual resolution of the crisis was thus effected by banks in conjunction with governments, and discussion of loan rescheduling was conducted between the same two parties.

The distinction between private and public borrowing is of some importance because private sector borrowing takes place in response to market signals, while public sector borrowing is presumed to be driven by political convenience, often leading to an inefficient use of funds. One expression of this view is the famous Lawson doctrine. This states that if there is a private sector savings shortfall that produces borrowing abroad to finance a balance-of-payments deficit, no action needs to be taken to remedy the imbalance, since this merely represents consumption smoothing, i.e. private savings will rise in the future and permit the country to repay what it has borrowed. Alternatively, if foreign borrowing is used to finance investment, the expected higher rates of return from the current investment will produce the revenue to pay off the foreign debt. However, expectations of future conditions may not be fulfilled and the expected future savings or expected higher returns may fail to materialize, leaving the imbalance to produce a crisis. Indeed, the experience of the post-Bretton Woods period suggests that the nature of the borrower does not significantly alter the probability of a crisis.

For every borrower there is a lender. Much of the impetus for the increased capital flows in the post-Bretton Woods period is related to the commercial banking crisis in the major industrial countries. In the early 1970s the share of total assets intermediated by banks in the United States started to decline. Furthermore, banks were suffering from both a loss of quality borrowers and low interest margins as competition from non-bank financial intermediaries increased. Expanding their foreign lending enabled them to increase interest margins, with what were considered to be acceptable increases in risks. In the Latin American episode there was the idea that credit risk was absent in lending to governments. At the same time,

the increased international diversification of the loan portfolio was meant to reduce the volatility of bank earnings. There was thus an increase in the supply of funds as banks attempted to increase their risk-adjusted return on assets by augmenting their foreign lending. However, as it turned out, the assumptions underlying this increase did not turn out to be correct.

Nevertheless, the resolution of the 1980s debt crisis, by rescheduling repayment through the issue of Brady bonds and then of new sovereign bonds, provided banks with the possibility of making a profit from trading the bonds in the secondary market, as well as from the fees and commissions earned by advisory work and underwriting in connection with the new sovereign issues, and with the equity issues for privatization programmes. Thus, the different role of the banks in the 1982 and 1994 Latin American crises reflects their shift in emphasis from increasing income through interest margins to the less risky increase in earnings from fees and commissions on underwriting and trading. This was a major reason for the shift in flows from loan syndication to portfolio investment, as the banks now encouraged investors to use their services to invest in emerging markets. By the time of the EMS crisis commercial banks had become the source of funding for large investment banks and hedge fund arbitragers. The banks thus accepted credit risks, but the market and exchange rate risks were borne by the arbitragers. In the Asian crisis it was the banks themselves that adopted the arbitrage strategy through proprietary trading. Without the pressure on banks to find alternative sources of business to increase returns to capital, much of the increase in capital flows and the shifts in their distribution among countries would most likely never have taken place. Competition in the financial sector caused by deregulation is thus as much a cause of the increased financial instability as anything else.

3. Reversal of capital flows and financial instability

A common characteristic of the recent financial crises is that the large increase in capital inflows was eventually reversed with an equally large and rapid outflow when the conditions that created the inflows were reversed or when the latter had rendered domestic economic policies and conditions unsustainable. In general, almost all episodes of capital outflows and debt crises in developing countries have been associated with rising international interest rates. Again, currency appreciation and/or widening external deficits are among the significant features associated with such crises. Domestic policies that appear sustainable in conditions of rapid growth and high capital inflows appear less so as funds flow out.

Large capital inflows usually lead to an overextension in bank lending that is exposed when the flows are reversed, resulting in instability or a collapse of the banking system. There is now a tendency to relate this instability to inappropriate domestic regulation of the financial sector or lax supervision of the implementation of regulations, and to emphasize the importance of appropriate sequencing of liberalization with an effective system of prudential regulation. This is a welcome but delayed response. For instance, among the 10 lessons drawn by the World Bank from the Latin American debt crisis on its tenth anniversary, the importance of access to international capital markets was given prominence, but no mention was made of sequencing or prudential regulations.[3] On the other hand, as discussed in the next chapter, there is a limit to what prudential regulations can achieve. While it is certainly true that in the crises in Chile, Mexico and East Asia the banking systems had just undergone liberalization and deregulation, and that regulators and supervisors are notoriously slow in adjusting to changes in the structure and activity of financial markets, there is no known case in any country, developed or developing, where a large increase in liquidity in the banking sector has not led to an overextension of lending, a decline in the quality of assets and increased laxity in risk assessment.

Excessive lending by banks during the period preceding a crisis was in general greatly facilitated by their ability to borrow abroad at much lower rates than they charge for domestic lending. While that allowed them to earn higher margins, they often tended to take less care in assessing credit risks. In most crises the increase in bank lending was the result of banks' moving into an area of activity for the first time, and bank lending served primarily to finance a rapid increase in asset prices – so-called asset bubbles. Property and equity prices rose very rapidly in the Chilean case, as well as in the run-up to the Mexican crisis and in most South-East Asian countries. In almost all these cases, banks had recently expanded their involvement in lending against residential and commercial prop-

erty and their investments in finance and property companies. Because they were new to such activities bank loan officers usually had little expertise in valuation of collateral and tended to accept market prices which might be far above any reliable estimate of liquidation values.

In all but the EMS crisis, the reversal of capital flows was accompanied by a crisis in banking systems. This was due not only to overlending, as described in the preceding paragraph, but also to the existence of substantial currency mismatches on balance sheets which accompanied the borrowing in foreign currencies to profit from interest differentials. Dollar lending dominated the expansion of credit in Chile; the Latin American debt crisis almost entirely involved syndicated bank lending of United States dollars; and the Asian crisis was also characterized by large exposure of both banks and firms in foreign currencies. Only in the EMS crisis was this factor absent. In that instance investors were speculating on gains on foreign assets due to interest rate changes, but, even so, the necessity of hedging the currency risk was what eventually brought the crisis to a head.

Foreign currency exposure presents two risks to stability. One is interest rate risk, since foreign currency borrowing is usually short-term and responds quickly to changes in international interest rates, thus making differentials volatile. The second is exchange rate risk. Large changes in exchange rates can produce rapid changes in the domestic value of foreign liabilities, without producing any substantial corresponding change in the value of assets – for banks or companies without foreign sales there will be no immediate impact on the value of assets. A lower exchange rate thus results in an increase in outstanding liabilities relative to assets, leading to instant capital losses and a decrease in equity capital. A sufficiently large exchange rate swing may make foreign exchange borrowers not only illiquid but also insolvent. Since a rapid capital outflow will usually lead to a currency crisis and depreciation, it will be accompanied by an automatic increase in the financial fragility of banks and the vulnerability of firms. Efforts to stem losses through repaying the debt or hedging the remaining risk put further pressure on the currency. Thus, in those cases where foreign currency lending by banks and foreign currency borrowing by firms is substantial, capital outflows are usually accompanied by multiple bank failures and corporate bankruptcies.

4. A typical post-Bretton Woods crisis

Given the large number of common factors in the crises of the post-Bretton Woods period, it is possible to outline the characteristics of a typical financial crisis combining internal and external instability. Such a crisis involves an increased interest rate differential, often associated with tight monetary policy designed to attain or maintain price stability. Financial market deregulation and capital account liberalization are introduced alongside currency regimes that maintain stability of the nominal exchange rate. These combine to produce arbitrage margins large enough to attract liquid and short-term capital and to reinforce the stability of the exchange rate peg. Liberalized and deregulated, banks are free to expand into new areas of business internally, and domestic firms are free to borrow abroad, avoiding high domestic interest rates but building up foreign currency risk exposure. The combination of success in controlling inflation and nominal exchange rate stability tends to cause a real appreciation of the currency, weakening the foreign balance. Attempts to sterilize the impact of the capital inflows on domestic credit expansion lead to greater pressures on interest rates. Since domestic bonds are issued to finance sterilization of the inflows that are then held as reserves in foreign centres at lower interest rates, the fiscal position tends to deteriorate.

Eventually, either the foreign balance or the fiscal balance goes out of control, and domestic financial conditions deteriorate substantially (or both), creating vulnerability to a change in perceptions and to rises in foreign rates which can trigger a rapid outflow and eventually break the exchange rate peg, leading to capital losses on the balance sheets of banks and firms carrying unhedged foreign currency exposure. The increased demand for foreign exchange generated by the attempt to cover these losses can create a free fall in the currency, producing widespread bankruptcies.

Such a process can occur under varying conditions with respect to borrowers and lenders and types of financial flows. It starts not with unsustainable policies, but with the introduction of policies designed to maintain macroeconomic stability and to integrate the economy into the global system and so take advantage of global market opportunities. However, in the absence of effective controls, the impact of capital flows distorts the effects of policies, making it very difficult for them to attain their original objectives.

C. Financial fragility and crisis in East Asia

1. Capital inflows and the build-up of external vulnerability

The crisis in East Asia, like crises almost everywhere else, was preceded by a sharp increase in capital flows to the region. Starting in the early 1990s there was a rapid increase in short-term lending by commercial banks to both banks and firms in the region. The Asian economies had long supplemented high domestic savings rates by foreign borrowing, but their external debt-export ratios never reached levels similar to those that caused difficulty in Latin America in the 1980s; indeed, their economies were considered models of successful management of external borrowing. This was in part because of explicit or implicit government guidance to ensure that foreign borrowing was used to finance investment with a capacity to generate export earnings, and in part because generalized government budget surpluses meant that there was little sovereign borrowing.[4]

In the 1990s some economies – for example, Hong Kong, China; Malaysia; and Singapore – relied primarily on FDI, while others, including the Philippines and the Republic of Korea, obtained external financing mainly through internationally issued portfolio investments.[5] Bank lending, which had virtually disappeared in the aftermath of the Latin American debt crisis, was not significant except in Indonesia until the middle of the decade, when banks became an increasingly important source of financing. Most bank lending was directed to non-financial borrowers in the private sector, but in the Republic of Korea, and to a lesser extent elsewhere, the financial sector was also an important recipient of funds (table 25). In contrast to the syndicated bank lending during the 1970s, this lending was primarily non-syndicated and much of it was at short maturities (table 26).

There are a number of reasons for this increase in short-term bank lending to Asia, on both the supply and the demand sides. In the early 1990s, the major industrial countries adopted low interest rates in response to the recession, those in Japan being reduced dramatically after the failure of its economy to recover from the collapse of property and stock market bubbles in 1989-1990. The relatively higher returns in high-growth, low-risk Asian economies with a record of relatively stable exchange rates made them attractive investment locations. The Mexican crisis reinforced this market perception. By 1994 an increasing volume of this investment consisted of short-term arbitrage funds seeking to profit from the interest rate differentials, rather than funds seeking long-term returns on productive investment.

Short-term borrowing in foreign currency at low foreign interest rates allowed Asian firms to reduce their financing costs and isolate themselves from domestic monetary conditions that were often the result of policies aimed at restraining the economy in order to keep payments balances under control. Also, firms were driven by reduced earnings resulting from a series of external and internal factors to seek lower financing costs. While the 1990-1991 recession in industrial countries had little impact on Asian export growth, paradoxically trade started to slow when recovery started in those countries in 1994-1995, because of a decline in their import propensities. As a result of falls in foreign demand and export prices, the growth rate of export earnings dropped markedly in 1996 throughout the region, notably in Malaysia (by over 15 percentage points) and in Thailand (by over 20 percentage points).

As suggested in *TDR 1996*, for many countries in South-East Asia it was becoming increasingly difficult to maintain competitiveness in labour-intensive manufactures because of the entry of low-cost producers. This fact was reflected in the emergence of global excess supply and rapidly falling prices of many of the manufactured products exported from East Asia. With the increased "commoditization" of low-technology manufactures, the terms of trade declined rapidly in many of the countries in the region just as the developed world was moving to higher rates of expansion and

Table 25

LENDING BY BIS REPORTING BANKS TO SELECTED ASIAN ECONOMIES, BY SECTOR, END JUNE 1997

Economy	All sectors ($ million)	Banks (Percentages)	Non-bank private sector (Percentages)	Public sector (Percentages)
Hong Kong, China	222 289	64.8	33.9	0.5
Indonesia	58 726	21.1	67.7	11.1
Malaysia	28 820	36.4	57.1	6.4
Philippines	14 115	38.9	48.0	13.1
Republic of Korea	103 432	65.1	30.6	4.2
Singapore	211 192	82.8	16.6	0.5
Taiwan Province of China	25 163	61.6	36.8	1.6
Thailand	69 382	37.6	59.5	2.8

Source: BIS, *The Maturity, Sectoral and Nationality Distribution of International Bank Lending*, *First Half 1997*, Basle, January 1998.
Note: Figures relate to consolidated cross-border claims in all currencies and local claims in non-local currencies. The shares of banks, the non-bank private sector and the public sector do not always add up to 100 per cent because of unallocated claims.

Table 26

MATURITY DISTRIBUTION OF LENDING BY BIS REPORTING BANKS TO SELECTED ASIAN ECONOMIES

(Millions of dollars)

Economy	All loans			Loans with a maturity of: Under 1 year			1 to 2 years		
	June 1996	*Dec. 1996*	*June 1997*	*June 1996*	*Dec. 1996*	*June 1997*	*June 1996*	*Dec. 1996*	*June 1997*
Hong Kong, China	211 238	207 037	222 289	179 784	170 705	183 115	5 119	5 248	4 417
Indonesia	49 306	55 523	58 726	29 587	34 248	34 661	3 473	3 589	3 541
Malaysia	20 100	22 234	28 820	9 991	11 178	16 268	834	721	615
Philippines	10 795	13 289	14 115	5 948	7 737	8 293	531	565	326
Republic of Korea	88 027	99 953	103 432	62 332	67 506	70 182	3 438	4 107	4 139
Singapore	189 195	189 235	211 192	176 080	175 228	196 600	2 707	1 799	1 719
Taiwan Province of China	22 470	22 363	25 163	19 405	18 869	21 966	585	483	236
Thailand	69 409	70 147	69 382	47 834	45 702	45 567	4 083	4 829	4 592

Source: BIS, *The Maturity, Sectoral and Nationality Distribution of International Bank Lending, First Half 1997,* Basle, January 1998.
Note: Figures relate to consolidated cross-border claims in all currencies and local claims in non-local currencies.

was increasingly concentrating on more technologically advanced production. Many Asian economies reacted by augmenting investment in productive capacity in the hope of increasing market shares and expanding into new areas of production, but adding in the process to global excess supply.

The drive to expand capacity and market share may be seen in the increase in the ratio of investment to output from already high levels (table 27), which was facilitated by the availability of relatively low-cost foreign funding. This expansion in capacity occurred at a time when growth rates in the region were declining from an average of around 10 per cent to around 8 per cent, a combination which suggested that the return on investment was declining. Indeed, the return on assets of *chaebols* in the Republic of Korea fell to around 1 per cent, despite their extremely high financial leverage, and the return on equity in Indonesia, Thailand and Malaysia between 1992 and 1996 fell below domestic short-term interest rates.[6] There were thus strong incentives for firms to seek to reduce their financing costs or increase their returns on equity. The latter would have required increasing their leverage, while the former was achieved by seeking low-cost financing through short-term borrowing from foreign banks.

Table 27

INVESTMENT AS A PERCENTAGE OF GDP IN SELECTED ASIAN COUNTRIES, 1986-1995

(Annual averages)

Country	*1986-1990*	*1991-1995*
China	27.8	35.3
Indonesia	26.3	27.2
Malaysia	23.4	39.1
Philippines	19.0	22.2
Republic of Korea	31.9	37.4
Singapore	32.4	34.1
Thailand	33.0	41.1

Source: UNCTAD secretariat calculations, based on data from the Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries,* various issues.

These structural difficulties were aggravated by adverse movements in exchange rates originating from swings in the dollar-yen rate. Stable exchange rates were an important ingredient of the export-oriented development strategy of the East Asian countries. Their importance was further increased by the integration process in the context of the "flying geese" pattern of the regional division of labour. Because of the heavy concentration of Asian exports in dollar-denominated markets, exchange rates in the region, although not fixed, had been generally stable within a band of around 10 per cent in relation to the dollar since the late 1980s (see box 2).

The yen-dollar rate was extremely volatile in the 1990s, with the yen appreciating by some 40 per cent to reach 80 yen per dollar in the spring of 1995, and then falling back to around 130-135 yen per dollar by the end of 1997, a depreciation of over 50 per cent. While the earlier appreciation of the yen against the dollar brought an increase in the burden of yen-denominated debt, this was accompanied – unlike in the Latin American countries facing dollar appreciation in the 1980s – by lower interest rates and increased Japanese investment in East and South-East Asia. By contrast, yen depreciation reduced not only the incentive of Japanese firms to invest in East Asia, but also the competitiveness of those East Asian producers that maintained stable exchange rates vis-à-vis the dollar. Thus, the slow appreciation of the dollar that started at about the same time as global demand and the terms of trade began to fall brought declining competitiveness, reduced foreign direct investment from Japan and lower exports to Japan and other markets. Moreover, in the same period China took steps that resulted in an adjustment of the external value of its currency, thus increasing the competitive challenge to East Asian NIEs.

Loss of competitiveness and declines in export earnings increased the exposure to foreign exchange risk, since an export-oriented firm that borrows in foreign currency implicitly hedges against foreign exchange risk with export earnings. The earlier experience of rapid growth in foreign exchange earnings had created expectations of perpetuating such increases. Thus, against the background of a decade of relatively stable exchange rates and sustained high export growth, little of the currency risk in foreign loans needed to be explicitly hedged. The same factors also

Box 2

EXCHANGE RATE REGIMES IN EAST ASIA

At the beginning of the crisis, the East Asian economies most seriously affected (with the exception of Hong Kong, China) operated foreign exchange regimes under which the central bank intervened to stabilize the spot rate according to explicit guidelines. For its part, Hong Kong, China, had a currency board arrangement, with its currency pegged to the United States dollar. The aim of the guidelines was either stability in terms of a particular currency or a basket of currencies, or gradual appreciation or depreciation. The Thai baht, for example, was linked to a basket of currencies of the country's major trading partners (with a weight of 80 per cent for the dollar), and the baht/dollar rate had moved in a narrow range in the 1990s until the crisis. Indonesia allowed the rupiah/dollar rate to fluctuate within a range around a mid-rate, adjusted to depreciate the currency by 4 per cent a year so as to offset the difference between domestic and international inflation. In Malaysia and the Philippines intervention was designed to stabilize the exchange rate in terms of the dollar. For Malaysia this policy had been associated since the beginning of the 1990s with a gradual appreciation of the ringgit, while for the Philippines movements of the peso in relation to the dollar had been small since 1993. Singapore's intervention was designed to stabilize the Singapore dollar against a trade-weighted basket of currencies, while allowing a nominal appreciation of the effective exchange rate of 3.5-4.0 per cent per annum. The won was allowed by the Republic of Korea to float every day within a band of plus and minus 2.25 per cent around the previous day's average won/dollar rate. A period of slight appreciation in dollar terms since 1994 ended in mid-1996, and was followed by one of more rapid depreciation, which amounted to 13 per cent during the 12 months from the end of May 1996.

Movements of the real exchange rates of these countries were mostly fairly limited during 1990-1996: Indonesia experienced a small depreciation followed by a reversal, Malaysia a small appreciation, the Republic of Korea a depreciation until 1993 followed by a reversal, and Thailand a slight appreciation between 1993 and 1996. In the Philippines and Singapore, on the other hand, the currencies appreciated significantly – by almost 30 per cent in the case of the Philippines.

In the face of large capital inflows during the 1990s the governments generally chose to intervene in order to prevent appreciation. Thailand practised limited sterilization by running fiscal surpluses and depositing the proceeds with the central bank. In Indonesia during 1990-1993 Bank of Indonesia certificates were issued and thereafter fiscal surpluses were used for sterilization. Malaysia's response initially involved reliance on heavy interbank borrowing by the central bank, but when this technique proved insufficient, the Government also had recourse to capital controls.

led creditors of exporting firms to consider it unnecessary to explicitly hedge credit risk due to currency fluctuations. As export growth decelerated, the implicit hedging decreased and firms were left with increasing foreign exchange risk exposures.

Thus, after the middle of the decade, the rapidly growing East Asian economies suffered a deterioration in earnings and returns on investment due to changes in the global environment. While short-term foreign borrowing provided some cushion against their financial difficulties, it also rendered firms extremely vulnerable to changes in exchange rates and international interest rates, very much in the same way as in the Southern Cone in the early 1980s (see annex).

2. Financial liberalization and the speculative bubble

The developments described above were accompanied by fundamental changes in the financial system in the region. The East Asian economies were being urged in some quarters to follow Japan

on a path of financial liberalization, granting financial institutions more freedom in their borrowing and lending decisions, and introducing market-based monetary policy by loosening regulatory controls. In the Republic of Korea the departure from the postwar practice of control over private external borrowing coincided with the country's bid for membership of OECD. However, financial liberalization went further among the second-tier NIEs. Thailand created the Bangkok International Banking Facility to intermediate foreign investment expected to be directed to the next tier of Asian NIEs (Cambodia, the Lao People's Democratic Republic, Myanmar and Viet Nam), which might otherwise have gone to Singapore or Hong Kong, China. In reality, it served instead as a conduit for short-term foreign lending to the liberalized Thai banks and finance houses.

Since the financing of Asian development had emphasized the allocation of credits to export-oriented manufacturing, when financial institutions were given more freedom they sought to diversify their portfolios for higher returns. In view of the high levels of private savings, there was little possibility of expansion of consumption lending, while returns on manufacturing were believed to be on the decline. In South-East Asia, with rapid growth and increasing foreign interest, the commercial and residential property sector emerged as an attractive area of high return. Construction and property development companies thus appeared to be good investments from the point of view of both expected returns and diversification by banks, just as they had appeared to the newly deregulated savings and loan associations (S&Ls) in the United States a decade earlier (see annex).

Real estate loans are estimated to have accounted for 25-40 per cent of bank lending in Thailand, Malaysia and the Philippines in 1998, funded to an important extent by short-term foreign borrowing. For example, the net foreign liabilities of the Thai banking system were 20 per cent of its domestic assets. Between one third and one half of Thai GDP growth since 1994 can be attributed to property-related activities. It was associated with sharp increases in property prices, as well as in the equity prices of property investment and development companies, which, together with the expansion of lending to finance stock market speculation, created a bubble on the Thai stock market. The result was an increase in leveraged lending, which made the success of these companies and the banks that financed them dependent on a continuation of the increase in property prices. The value of collateral pledged against bank loans was dominated by the expected increases in asset prices, rather than by a realistic assumption of disposal value in a more modest environment. Banks and property companies were thus extremely vulnerable to a downturn in prices, a rise in interest rates or a depreciation of the baht.

Despite the fact that the East Asian economies had started to improve their regulatory and supervisory systems far earlier than most other developing countries, these were ineffective in checking the excessive build-up of risk and fragility in the financial sector (see box 3). It is notoriously difficult for bank supervisors to prevent real estate bubbles, since the value of the assets involved is based on expected future income growth or, in the case of property companies, on market prices, which are often taken as the correct basis for valuation. It is even more difficult to assess liquidation values, since property always has the aura of having some real objective value that is independent of financial assets, although such considerations are irrelevant to the health of the bank providing the finance. Moreover, not only were Asian regulators and bank supervisory personnel inexperienced in dealing with new liberalized systems, but also many financial institutions were essentially unregulated and, in regimes with lax accounting standards[7] and without proper rules for the reporting of non-performing loans, supervisors had no clear idea of their exposure to risks. Finally, much of the private borrowing from international banks was by non-bank firms – one third in the Republic of Korea, around 60 per cent in Malaysia and Thailand, and even more in Indonesia (table 25).

The search for new and low-cost sources of funding and new forms of high-margin lending produced not only a rapid expansion of short-term foreign borrowing but also of domestic lending, notably in Malaysia and Thailand (table 28). The result was very similar to the situation in the United States in the 1980s, when rapidly increasing commercial property lending created an aura of expansion in real incomes that had no basis in real productive activity and tended to mask the structural and cyclical difficulties faced by the real economy (see annex). However, in the Asian case the leverage was based on foreign borrowing. Instead of creating an export base to earn the foreign exchange needed to service external debt, the foreign borrowing financed investment in the property

Box 3

BANK REGULATION IN EAST ASIA

The quality of financial regulation varies considerably among the countries of East Asia. At one extreme Singapore and Hong Kong, China, have well-developed systems, reflected in the strength of their banks (as indicated by features such as high ratios of capital to risk-weighted assets and low proportions – by regional standards – of non-performing loans in total loans). Interestingly, bank exposure to property is particularly great in Hong Kong, China. Conscious of the banks' resulting vulnerability, the authorities have imposed exceptionally restrictive rules regarding the permitted levels of the value of a loan in relation to that of the property on which it is advanced, with the objective of protecting the sector against the effect of large falls in property values.[1] In other countries affected by the crisis, large parts of the banking sectors have weaknesses in some or all areas, such as the regulation of credit and market risk,[2] control of currency mismatches, the classification of and provisions for non-performing loans, and the quality of banking supervision. Since the beginning of the 1990s steps have been widely taken towards the introduction of proper systems of banking regulation, but at the outbreak of the crisis important gaps in legal frameworks remained and full implementation of existing regulations had often not yet been achieved.

In Thailand, for example, Basle capital standards for credit risk were adopted in 1993 and came fully into force in January 1995, a somewhat more lenient version having been applied to finance companies from July 1994. Many of the problems associated with the crisis were due to financial firms' exposure to market risks in a regulatory regime lacking proper controls for such risks, poor standards of classification and provisioning for non-performing loans, lax collateralization of property loans, and inadequate controls over currency risks. In the Republic of Korea, Basle capital standards had been in force since 1995, and there were plans for a major overhaul of the system of financial regulation and supervision. But in 1997 capital still widely fell short of the 1995 requirements, and lax accounting standards did not permit adequate reporting. The latter was particularly important in the area of non-performing loans, where publicly announced levels were generally believed to be much too low and provisions for loan losses too few. In Indonesia, too, before the crisis, banks were supposed to be subject to Basle capital standards, but enforcement of these standards and other regulations was patchy: in 1996 several banks had capital ratios below the regulatory minimum of 8 per cent, and there was also a widespread failure to observe other prudential rules such as those concerning net overnight positions in foreign exchange.

The East Asian crisis has led to extensive efforts to strengthen regulatory regimes, many of the measures being taken in fulfilment of conditions attached to IMF packages of financial support. In Thailand this strengthening has included the imposition of higher capital requirements on finance companies, more rigorous classification of non-performing loans and a new bankruptcy law. In the Republic of Korea banks with capital ratios below 8 per cent are to establish schedules to meet this level within two years, and adequate provisioning for loan losses is to be introduced within the same time-frame. In Indonesia, which experienced a banking panic in the aftermath of the decision to close 16 insolvent banks as a condition of the IMF support package, regulatory changes have included a wide-ranging guarantee of claims on locally incorporated banks and the use of the Indonesian Bank Restructuring Agency (IBRA) as an instrument to enforce banking standards, with the transfer to IBRA of banks failing to meet certain criteria. In Malaysia, a country with fewer banking problems than the three countries just mentioned, steps are being taken to tighten the rules regarding the classification of non-performing loans and provisions for loan losses, to increase banks' capital ratios from 8 per cent to 10 per cent, and to expand the framework of capital adequacy to include market risk. Moreover, Indonesia, the Republic of Korea and Thailand have all liberalized rules regarding foreign equity participation in local banks. This liberalization will, it is hoped, lead to inflows of foreign equity that facilitate the recapitalization of the countries' banking systems, the cost of which is estimated at 20-30 per cent of GDP. The changes just described indicate the thrust of policy in the countries in question, but effective implementation of the measures can be expected to take place only fairly slowly.

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[1] Useful as they are, these rules were not capable of providing complete protection against large movements in asset prices with an unfavourable impact on banks' profitability, as was illustrated by the scale of the decline in share prices in October 1997, which could be translated into implicit reductions in property prices of as much as 50 per cent. See JP Morgan, *Emerging Markets Data Watch*, 24 October 1997, p. 5.

[2] Credit risk results from the possibility that a bank's counterparty will default on its obligations, and market risk is the risk of loss due to changes in the market value of a bank's asset before it can be liquidated or offset in some way.

and other non-traded sectors which provided much of the stimulus for growth. In consequence, the sustainability of growth depended on continued capital inflows to provide low interest rate financing.

The increased reliance on foreign capital and the new structure of external borrowing thus enhanced the vulnerability of the region to changes in the pace of foreign capital inflows. The clearest result of this situation was the deterioration in external balances in the 1990s that accompanied the change in the size and composition of capital flows into the region (tables 29 and 30). The deterioration was marked in Thailand, where capital inflows were increasingly financing investment in non-traded sectors rather than in activities earning foreign exchange.

International lenders and investors in 1997 were aware of these factors responsible for the increased vulnerability of the East Asian economies, and might have been expected to realize that they pointed to an impending change in the dynamics of growth in the region. However, there were also a number of positive elements to offset the increased vulnerability. Basic macroeconomic fundamentals were good, and the fiscal posture was prudent. The countries in the region received consistent praise from multilateral financial institutions for their economic management. Where the external trade and payments situations were not in equilibrium, policy measures had been introduced which in most cases, notably in Malaysia and the Republic of Korea, showed positive results; also, short-term external indebtedness had started to decline. In financial sectors that were showing clear signs of instability, regulation, supervision and loan-loss disclosure standards were being tightened and rules limiting foreign ownership of property were liberalized.

Thus, at the beginning of 1997, while there was clear evidence of increased vulnerability and instability, there were also a number of encouraging factors, including policy actions. The Thai economy exhibited the most visible symptoms of external disequilibrium and instability in the financial sector. That foreign investors continued, nevertheless, to pour funds into the region does not mean that the problems were not recognized, but simply that they considered that the positive factors outweighed the negative ones. Indeed, sovereign credit ratings remained extremely favourable until the crisis actually started.

Table 28

BANK CREDIT TO THE PRIVATE SECTOR IN SELECTED ASIAN ECONOMIES, 1981-1997

(Percentages)

	Annual real rate of expansion[a]		*Percentage of GDP*
Economy	*1981-1989*	*1990-1997*	*1997*
Hong Kong, China	13	8	157
Taiwan Province of China	15	13	138
Indonesia	22	18	57
Malaysia	11	16	95
Philippines	-5	18	52
Republic of Korea	13	12	64
Singapore	10	12	97
Thailand	15	18	105
Memo items:			
United States	5	½	65
Japan	8	1½	111
G-10 Europe[b]	6	4	89

Source: BIS, *68th Annual Report*, Basle, June 1998, table VII.1.

a Current values deflated by the consumer price index; 1997 data are preliminary.

b Belgium, France, Germany, Italy, Netherlands, Sweden, Switzerland and United Kingdom. Weighted average, based on 1990 GDP and PPP rates .

3. *The outbreak of the crisis and contagion*

What, then, caused the sudden and catastrophic change in the willingness of foreign investors to continue to hold Thai assets and liabilities? It is difficult to identify a particular cause of the shift in market perceptions. Given the need for strong measures to remedy the foreign imbalance and the growing instability of the financial sector, the prevailing political uncertainty was clearly important. Indeed, the baht had been under intermittent speculative pressure since late 1996, but central bank intervention had succeeded in maintaining the currency within the fluctuation band.

Table 29

CURRENT ACCOUNT BALANCE AND EXTERNAL FINANCING OF ASIA-5[a], 1994-1998

(Billions of dollars)

	1994	*1995*	*1996*	*1997[b]*	*1998[c]*
Current account balance	-24.6	-41.3	-54.9	-26.0	17.6
Net external financing	47.4	80.9	92.8	15.2	15.2
Direct equity flows	4.7	4.9	7.0	7.2	9.8
Portfolio flows	7.6	10.6	12.1	-11.6	-1.9
Commercial bank lending	24.0	49.5	55.5	-21.3	-14.1
Non-bank private lending	4.2	12.4	18.4	13.7	-3.3
Net official flows	7.0	3.6	-0.2	27.2	24.6
Change in reserves[d]	-5.4	-13.7	-18.3	22.7	-27.1

Source: Institute of International Finance, "Capital flows to emerging market economies", Washington, D.C., 29 January 1998, p. 2.
a Indonesia, Malaysia, Philippines, Republic of Korea and Thailand.
b Estimate.
c Forecast.
d A minus sign indicates an increase.

Paradoxically, the most important factor in precipitating the crisis seems to have been the sudden reversal of the dollar relative to the yen in early May 1997 and the widespread expectation of a rise in Japanese interest rates that it engendered. This caused the short-term arbitrage funds from South-East Asia to flow back to Japan and generated strong selling pressure on the baht. An all-out defence of the currency left the Bank of Thailand with net foreign exchange reserves of $2.5 billion by the middle of the month. Although official figures put reserves at around $30 billion, the Bank had virtually exhausted its net position, in large part through commitments in forward trade, and could no longer counter baht selling pressure without substantial borrowing from abroad. Further defence of the currency had thus to rely on administrative measures and selective market controls, including restrictions on the sale of baht to non-residents. With the financial sector in near-collapse and no reserves, the Bank of Thailand succumbed to market pressures and formally abandoned the exchange rate band on 2 July.

Because of the financial vulnerability of the Asian economies, the major impact of the exchange rate adjustment was on the foreign exposure of banks, businesses and property developers. First, the floating of the baht made clear the risks of unhedged foreign borrowing. Second, it produced an instant increase in the baht value of the foreign liabilities of Thai firms without providing any equivalent increase in the income-earning capacity of assets, except for exporting firms (as described in section B above). Third, it brought an increase in the cash commitments for the payment of interest on foreign debt. Thus, the first reaction was to depress the net present value of companies; indeed, equity prices had been falling throughout the year as rumours of devaluation dominated the market. Banks, without the cushion of foreign investment earnings, were in even more difficult circumstances.

Recognizing increased risk on their outstanding loans, foreign lenders started to call in loans to firms and banks when they fell due. Reduction of exchange risk and the cost of foreign debt servicing required firms either to hedge their existing exposure or to eliminate that exposure by repaying foreign currency debt. Either response required the selling of baht against dollars. Since the new exchange rate regime did not specify a new band but left the currency to float freely, it was rational

Table 30

CURRENT ACCOUNT BALANCES AS A PERCENTAGE OF GDP IN SELECTED ASIAN ECONOMIES, 1989-1997

Economy	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
China	-1.3	3.9	4.3	1.4	-2.7	1.3	0.2	0.9	1.2
Hong Kong, China	11.5	8.5	6.6	5.3	7.0	2.1	-3.4	-1.0	-1.0
India	-2.3	-2.2	-1.5	-1.5	-1.5	-0.9	-1.7	-1.2	-1.1
Indonesia	-1.2	-2.8	-3.7	-2.2	-1.3	-1.6	-3.4	-3.4	-3.6
Malaysia	0.8	-2.0	-8.9	-3.7	-4.4	-5.9	-8.5	-5.3	-5.9
Philippines	-3.4	-6.1	-2.3	-1.9	-5.5	-4.4	-4.4	-5.9	-4.5
Republic of Korea	2.4	-0.9	-3.0	-1.5	0.1	-1.2	-2.0	-4.8	-3.9
Singapore	9.6	8.3	11.2	11.4	7.3	15.9	17.7	15.0	13.7
Taiwan Province of China	7.6	6.9	6.7	3.8	3.0	2.6	1.9	3.8	3.1
Thailand	-3.5	-8.5	-7.7	-5.7	-5.6	-5.9	-8.0	-8.0	-4.6

Source: UNCTAD secretariat calculations, based on international and national statistics.

for firms and banks and foreign lenders to move as soon as possible. As the exchange rate continued to fall, the costs of delaying became higher, and the pressure to sell became more intense. Thus, much of the increasing pressure on the exchange rate was produced primarily by the attempt by firms and banks to hedge or liquidate debt by buying dollars, and by foreign banks calling in existing loans.

Since the decision to float the baht called into question the assumption of exchange rate stability upon which existing regional dynamics had been built, the Philippine peso and the Malaysian ringgit came under pressure as soon as the Thai move was announced. After market intervention supported by increased interest rates, both currencies were allowed to float. Because it was generally accepted that Indonesia had better underlying fundamentals, particularly regarding its current account, it took some time for the selling pressure to move to that country. The Bank of Indonesia responded quickly, enlarging the intervention band in an attempt to stop contagious speculation, but soon the rupiah was also traded down.

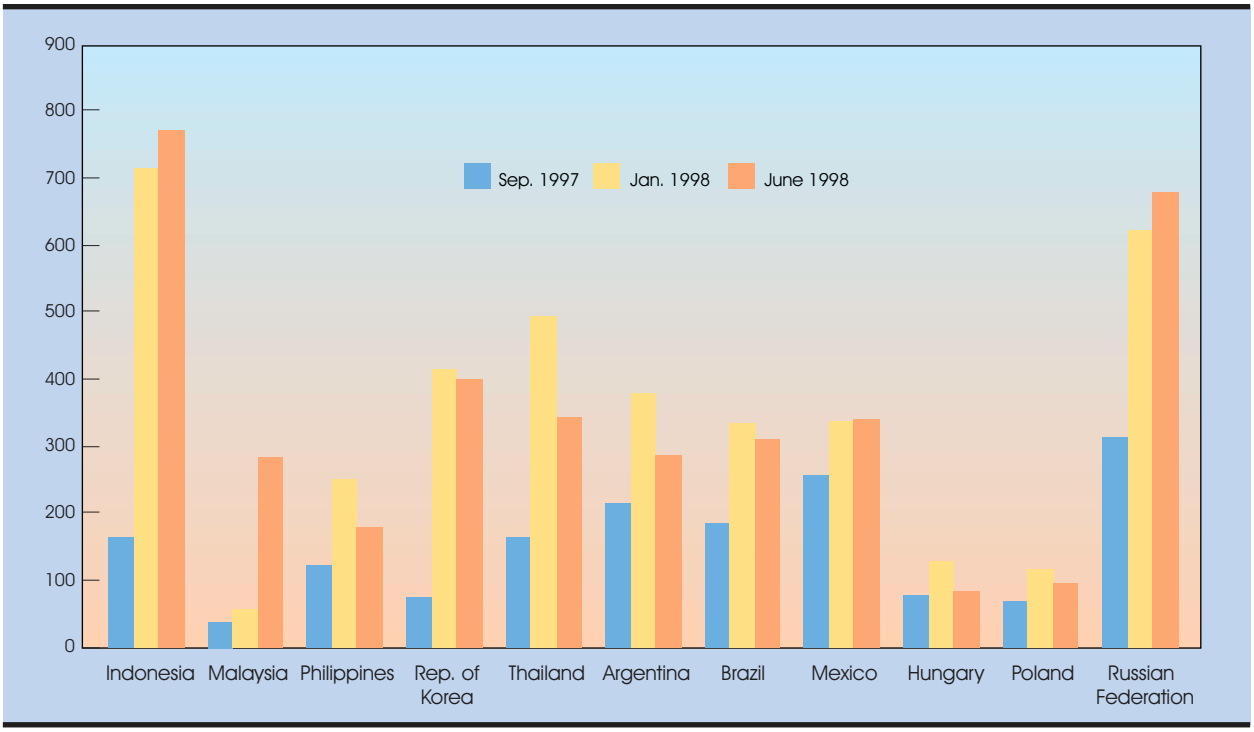
As the panic spread to the whole region and currencies collapsed, foreign exchange traders and speculators selling baht were joined by an increasing number of domestic firms and financial institutions seeking to escape from the squeeze on their balance sheets caused by rising domestic cash needs to service foreign debt and falling cash flows to meet them. This triggered the downward spiral characteristic of a debt deflation in which firms' efforts to escape insolvency simply worsened their balance sheet positions by driving down exchange rates and asset values even further.

The contagion to North-East Asia resulted from the recognition that the extent of the exchange rate adjustments in South-East Asia had reached the point of disturbing relative competitiveness within the entire East Asian region. First Taiwan Province of China and then Hong Kong, China, came under pressure. For the same reason, the Republic of Korea's won also came under speculative attack. Although the Republic of Korea had not experienced a speculative property bubble, it had suffered a number of large corporate bankruptcies and there was speculation that its banks had been weakened by associated losses. Again, much of the foreign exchange reserves were committed under forward cover. Conditions were not helped by the announcement by Taiwan Province of China that it would not intervene in support of its currency. As exchange rates came under pressure in the rest of Asia, market participants soon became aware of the similarities in the vulnerability of financial structures in nearly all

Chart 2

SELECTED EMERGING MARKET BONDS: AVERAGE YIELD SPREAD OVER US TREASURY BONDS

(Basis points)



Source: UNCTAD secretariat calculations, based on data compiled from Datastream.

countries, as well as the inadequate levels of reserves. With currencies depreciating, the South-East Asian scenario was thus repeated in North-East Asia as domestic debtors attempted to hedge or reduce their foreign exposure, causing a downward spiral of currency values. Thus, the implicit assumption of stable exchange rates that had dominated financing behaviour was replaced by the expectation of a free fall, and attempts were made to hedge not only against the current declines but also against the expected future declines, giving an additional impetus to the downward spiral.

The impact of the crisis on exchange rates and asset prices was not restricted to Asia. Exchange rates were under pressure wherever there had been large inflows of foreign borrowing as lenders attempted to repatriate funds. Initially, rates in South Africa, Latin America and Eastern Europe came under attack. South Africa, Brazil and the Russian Federation all suffered substantial capital outflows. Although the Czech Republic had already been forced to abandon its fluctuation band before the difficulties in Thailand, its currency came under additional selling pressure.

Since institutional investors tend to treat emerging markets as an asset class, expectations of losses in one emerging market tend to spread quickly to other emerging markets, irrespective of their economic fundamentals. This was undoubtedly a factor in the spread of the crisis to Eastern Europe and Latin America. However, the increasing globalization of financial relations also played a part. For example, banks in the Republic of Korea and Hong Kong, China, held leveraged investments in a number of developing countries or transition economies, including Indonesia, the Russian Federation and Brazil. Since these positions were financed by borrowed funds, they quickly turned to loss when borrowing rates increased and the value of the assets fell in response to the exchange rate turbulence, causing the banks to withdraw financing to these countries in order to unwind their positions and reduce losses. This led to sales of Latin American Brady bonds and

Russian treasury securities and served to transmit the crisis from Asia to other emerging markets. The extent of this interrelation can be seen in the very rapid and similar increase in the spread of Asian and Latin American bonds traded in secondary markets over benchmark United States government securities (see chart 2).

The existence of a large number of similarities, such as a pegged exchange rate regime with a tendency to real appreciation and a deteriorating current account and fiscal deficit, also led investors to reassess their position in Brazil. After the attack on the Hong Kong dollar, investors reviewed the strength of the currency board regime in Argentina. Both Brazil and Argentina suffered large capital outflows and currency sales in the speculation that hit global markets in October 1997. Brazil responded by increasing interest rates to over 40 per cent and introducing a fiscal austerity package. After the loss of reserves totalling some $10 billion between October and December, confidence in the economy recovered and by March reserves exceeded pre-crisis levels. Argentina committed itself to an IMF programme, even though it had no intention of drawing funds or need to do so.

The impact of the crisis on capital flows to emerging markets in Asia has been substantial: there was an inflow of $97.1 billion in 1996, compared with an outflow of almost $12 billion in 1997. No net inflows are expected in 1998. Current projections by various financial institutions indicate that no significant declines are expected in capital flows to Latin America and Eastern Europe. According to one estimate, the net private financial flow to Latin American emerging markets will fall slightly, from $96.4 billion in 1997 to $94.8 billion in 1998, and to Eastern Europe from $60.9 billion to $58.8 billion.[8] However, it is notable that the spreads on emerging market bonds that increased sharply in the autumn of 1977 have not really declined, indicating that there is a continued perception of high risks in these markets (chart 2). This, together with rising current account deficits in most Latin American and Eastern European countries, suggests that there may be serious downside risks.

D. The policy response

Much as in the 1982 Latin American debt crisis, perceptions of the nature and magnitude of the Asian crisis changed radically over time. Just as in 1982 when the crisis was initially regarded as a short-term liquidity problem, the Asian problem was initially perceived to be about the exchange rate and payments adjustment. Consequently, the crisis was dealt with as a "traditional" payments crisis, aggravated by structural weakness in the banking system. It was indeed argued in a working paper of the IMF that "(a) financial crisis calls for a similar response from the Fund as any other balance of payments problem except that the response must be quicker and possibly larger than in a more traditional case".[9] Thus, the standard instruments of monetary and fiscal tightening and high interest rates were brought in as a remedy even though the payments imbalances were neither caused by budget deficits nor due to a loss of competitiveness because of domestic inflation.

It appears that there were two principal rationales for applying traditional policies in response to the crisis. First, they were expected to help restore market confidence, halt the decline of exchange rates and reverse capital outflows. Second, they were considered necessary for correcting the underlying fundamentals, mainly to reduce payments imbalances. The fiscal restriction was also justified as necessary for funding government expenditure on recapitalization of the banking system without jeopardizing the fiscal surplus. The policies were, however, unsuccessful in achieving the former aim, and unnecessary for the latter. Given the financial vulnerability of indebted firms, they simply served to intensify the debt deflation, pushing the economies deeper into recession.

High interest rates were largely unsuccessful in stopping the downward spiral in exchange rates. They had little impact on the decisions of firms

and banks to reduce their exchange rate exposure, while making the substitution of domestic for foreign sources of funding more onerous. The response was not to reduce the sale of domestic currencies to pay off or hedge foreign debt, but simply to liquidate assets and reduce activity levels. For example, in Indonesia interest rates reached 100 per cent, without any appreciable impact on flight from the currency, even as currency traders were declaring that there was no good reason for its collapse in view of the country's strong economic fundamentals. Although Indonesia and Thailand kept their interest rates higher than Malaysia, they experienced greater difficulties in their currency and stock markets. By the same token, strict adherence to the orthodox programme did not protect the Philippines against contagion.

In this respect, useful lessons could have been drawn from previous experience. For instance, in the 1992 ERM crisis, which has a number of striking similarities to the Asian currency turmoil, high interest rates were not efficient deterrents against market pressure, and were quickly abandoned. As a result, in the aftermath of the crisis, low interest rates and fiscal expansion were part of a successful adjustment policy in the countries most affected.

Clearly, there was a need to reduce the payments deficit in Thailand, which would have called for currency depreciation and some slowdown in growth, but that was not so in the Republic of Korea and Indonesia, where current account deficits were moderate. There was no strong case for a drastic reduction in domestic absorption in any of these countries, since the exchange rate correction itself could have been expected to achieve much of the adjustment needed not only by restoring competitiveness, but also through its adverse effects on indebted banks and firms. More important, since the crisis was not caused by an expenditure imbalance between exports and imports, focusing policy on payments adjustment aggravated financial instability.

The situation was characterized by a stock disequilibrium rather than a flow imbalance that could be corrected by expenditure reduction. Since most of the external borrowing had been undertaken in foreign currency without adequate hedging, the fall of the currency created a balance sheet disequilibrium for indebted banks, property companies and firms; that is, at the new exchange rates, the stock of outstanding foreign debt became too large to be supported by expected income flows. The value of firms, and asset prices more generally, thus declined. Since these assets had been the collateral for much of the increased lending, the quality of bank loans automatically deteriorated. Rather than ease the burden of refinancing on domestic firms by granting additional credit, the recommended policy response was to raise interest rates. This depressed asset prices further and increased the balance sheet losses of firms and their need to repay or hedge their foreign indebtedness quickly by liquidating assets and selling the domestic currency.

While the traditional policies have been applied in response to the crisis, the objective of IMF lending has departed from the traditional adjustment programmes, where such lending is usually designed to support the new exchange rate reached after adjustment. In East Asia, the exchange rates were left to float, in the expectation that market forces would produce new stable rates, and lending was designed to instil market confidence and restore capital flows. Thus, rather than guaranteeing the new exchange rate, the Fund's lending has been aimed at ensuring the maintenance of the domestic currency's convertibility and free capital flows, and guaranteeing repayment to foreign lenders. The latter, unlike domestic lenders, emerge from the crisis without substantial loss, even though they had accepted exposure to risk just as other lenders had done.

Since the currency turmoil was sustained by the attempt of debtors to make a stock adjustment in their balance sheets, the only effective way to deal with the crisis would have been to block the stock adjustment or slow it down. Clearly, this is a problem of inter-temporal allocation. A bank that suffers a run lacks the liquidity to repay every depositor, but if it has the time to allow its investments to mature, it can eventually repay. The bank is in difficulty only if the ultimate recovery value of its portfolio is less than its liabilities, for then it is insolvent. Some of the East Asian debtors engaged in speculative activities may have been in such a position even without the collapse in exchange rates. For most, however, the crisis was initially one of liquidity rather than of solvency. There is no evidence to suggest that any of the East Asian countries would not have been able to generate the foreign exchange needed to repay their external debt with an exchange rate adjustment that would have restored competitiveness (say 10-15 per cent), as long as they were given sufficient time to realize investments. Countries

with savings rates around 40 per cent and high export capacity should not have had difficulty in repaying debt over a reasonable period of time.

However, the use of high interest rates, the extent of currency devaluation and the reduction in growth rates that created conditions of debt deflation quickly acted on financial institutions and company balance sheets to create a solvency crisis. As discussed in the next chapter, under such conditions of a sustained attack on a currency, the appropriate action would be to move quickly to solve the intertemporal problem by introducing a standstill and bringing the borrowers and lenders together to reschedule, even before the commitment of IMF funds. That is what was eventually required and achieved in the Republic of Korea, with the agreement of creditors to roll over a sufficient amount of short-term loans to make repayment possible. However, it would have been much better to have started the process with negotiations of this sort, rather than providing funding to repay creditors and putting together a conditional lending package which ensured an increase in bankruptcies, income loss and debt deflation which would itself destroy the ability to repay. A combination of rapid debt restructuring and liquidity injection to support the currency and provide working capital for the economy would also have made it possible to pursue the kind of policies that enabled the United States to recover quickly from a situation of debt deflation and recession in the early 1990s (see annex).

Table 31

EXTERNAL AND DOMESTIC DEBT IN RELATION TO GDP IN SELECTED DEVELOPING COUNTRIES, 1982 AND 1997

(Percentages)

	External debt	*Domestic debt*
East Asia (1997)		
Indonesia	217.9	65.5
Malaysia	62.4	213.5
Philippines	74.4	105.7
Republic of Korea	50.9	181.0
Thailand	74.1	137.9
Latin America (1982)		
Argentina	51.7	154.1
Brazil	30.4	28.9
Mexico	47.6	38.3
Venezuela	53.7	32.6

Source: Deutsche Bank Research, "Is Asia's debt sustainable?", *Market Issues*, 25 May 1998.

The basic problem still facing the Asian economies is the rescheduling of the accumulated debt. The severity of the current crisis can be seen by comparing that debt with the bank debt accumulated in Latin America in 1982 (table 31). The accumulation of external debt in East Asia is far in excess of that in the Latin American crisis, except for the Republic Korea. Moreover, one of the characteristics of the current crisis is the extent to which foreign debt has been a source of increased domestic lending. A comparison of internal indebtedness in the two periods shows that external borrowing has given rise to a much larger amount of internal lending in the Asian crisis than in the Latin American crisis (table 31). The figures suggest that since Argentina, Brazil, Mexico and the other Latin American debtors required special assistance in resolving the crisis and rescheduling debt service, such assistance will also be required to resolve the Asian crisis.

This can also be seen by reference to estimates of the overall debt burden to be met by the Asian countries. The calculations of scheduled interest payments in table 32 for 1998 are based on current three-month interbank rates. It should be noted that commercial borrowers would have to pay substantially higher rates because of their spreads. It is clear that the major problem of adjustment facing the Asian countries is not servicing external debt, but the resolution of the domestic debt burden. As a result of the high interest rates imposed after the outbreak of the crisis, the interest burden as a percentage of GDP has risen significantly. It is quite likely that the net present value of future earnings associated with feasible rates of income growth is less than the net present value of the future interest obligations; this suggests that without write-offs of domestic debt, there will be continued widespread bankruptcies.

Table 32

INTEREST PAYMENTS AS A PERCENTAGE OF GDP IN SELECTED ASIAN COUNTRIES, 1995-1998

	1995	*1996*	*1997*	*1998[a]*
Interest payments on external debt				
Indonesia	3.4	3.2	4.0	9.5
Malaysia	2.4	2.3	2.7	3.9
Philippines	3.2	2.9	4.3	4.6
Republic of Korea	1.2	1.2	1.5	3.1
Thailand	2.6	2.9	3.6	4.9
Interest payments on domestic debt				
Indonesia	7.0	7.5	16.5	31.7
Malaysia	8.9	11.5	13.7	17.9
Philippines	9.7	11.6	15.8	13.0
Republic of Korea	19.0	19.5	30.1	42.8
Thailand	12.6	11.4	21.0	26.7

Source: See table 31.
a Estimates.

E. Social consequences of the crisis

The adverse impact of the financial crisis in East Asia and of the policies adopted in response on economic growth and development is proving much deeper than was originally expected. During the International Monetary Fund/World Bank annual meetings in Hong Kong, China, in September 1997, it was generally held that the ongoing disturbances in Asian financial markets were no more than a blip and would cause only a temporary setback. For example, in October 1997, two months after the collapse of the Thai currency, the IMF's *World Economic Outlook* predicted that these disturbances would lead to only a slight slowdown of growth in the region (table 33). Within less than three months, however, the IMF lowered its estimate, and in May 1998 lowered it even further. Current (June 1998) projections by a number of institutions paint an even bleaker picture. Original estimates of the likely duration of the crisis also proved to be over-optimistic. The Fund at first expected the affected countries to recover in 1998; now the best guess is 2002.

After decades of rising incomes and living standards, household earnings have fallen and unemployment has risen sharply in the Asian countries most affected by the financial crisis. All income groups have been affected, including the rich, who have suffered a decline in net wealth due to the decline in stock and real estate prices. Of particular social concern, however, has been the impact of job losses on low-income urban workers and the second-round effects on the poor in both urban and rural areas.

Table 33

FORECASTS OF GDP GROWTH IN 1998 FOR SELECTED EAST ASIAN ECONOMIES

	IMF, World Economic Outlook				SSB[a]	UNCTAD
Economy	May 1997	Oct. 1997	Dec. 1997	May 1998	June 1998	
China	8.8	9.0	7.5	7.0	6.0	6.0
Hong Kong, China	5.0	5.0	4.1	3.0	-2.0	-2.0
Indonesia	7.5	6.2	2.0	-5.0	-14.0	-12.0
Malaysia	7.9	6.5	2.5	2.5	-3.0	-2.5
Philippines	6.4	5.0	3.8	2.5	0.8	1.0
Republic of Korea	6.3	6.0	2.5	-0.8	-6.5	-6.0
Singapore	6.6	6.0	6.2	3.5	0.9	1.0
Taiwan Province of China	..	3.0	..	5.0	4.8	5.0
Thailand	7.0	3.5	0.0	-3.1	-8.7	-8.0

Source: IMF, *World Economic Outlook*, Interim Assessment, various issues.

a Forecast by the investment house Salomon Smith Barney, Hong Kong, China, as reported by Agence France Presse, 12 June 1998.

The deeper the economic contraction turns out to be and the more recovery is delayed, the less likely it is that the newly poor will be able to recover from deprivation and regain their previous occupational backgrounds and standards of living. The impact on human resources could even spill over to the next adult generation if primary school enrolments decline and child malnutrition increases.

The loss of jobs has not been limited to the debt-laden, export-oriented manufacturing firms and the construction sector; it has also been substantial in firms serving the domestic market, which have been saddled with large internal debt burdens and the consequences of the collapse of domestic financial relations. These firms are generally labour-intensive ones in the manufacturing or service sectors that had helped reduce poverty in the past by absorbing large numbers of low-skilled workers, many of whom were of rural origin. High food prices and reduced social expenditures have further aggravated social conditions and contributed to the growth of poverty in some of the countries concerned.

As can be seen from table 33, the worst-affected countries to date have been Indonesia, Thailand and the Republic of Korea. The deterioration of employment and social conditions in these countries has led to unrest ranging from labour demonstrations in the Republic of Korea to riots in Indonesia, the latter resulting in the death of over 1,000 people.

Because of its deep recession, large population and low per capita income, Indonesia is the shock-affected country where the greatest increase in underemployment and poverty is expected to occur. The collapse of the rupiah and quickening inflation that could reach over 80 per cent in 1998 have further aggravated social conditions by sapping purchasing power and eroding the real value of savings. There could be an additional strain on livelihoods and the social fabric if hundreds of thousands of Indonesian workers are expelled from Malaysia and Singapore and have to be absorbed into the Indonesian economy. Moreover, any rekindled ethnic hostility toward Indonesians of Chinese ancestry could further aggravate the crisis and discourage future domestic private investment that is essential for economic recovery.

In the light of such considerations, Indonesia's Central Bureau of Statistics forecasts that unemployment could reach 15 million in 1998, or 17 per cent of the workforce. Because of the lack

of unemployment benefit schemes, most of the laid-off workers will turn to informal sector livelihoods rather than remain indefinitely unemployed. Judging from the severe contraction of the economy, the UNCTAD secretariat estimates that the proportion of the Indonesian population that will be living in poverty by the end of 1998 will increase by 50 per cent over 1996.

Although not as severely affected, other Asian economies have also seen unemployment rise to record levels. In particular, Thai unemployment rose from 5.4 per cent of the labour force in 1997 to 8.8 per cent in February 1998. The sector most affected to date has been construction, where 1.1 million workers have been laid off. Roughly half of these were from Myanmar and have been expelled from Thailand, while most of the rest were Thais who in the main have returned to their rural areas of origin to eke out a living. The UNCTAD secretariat estimates that the proportion of the poor in Thailand's population will rise by about one third by the end of 1998 because of the effect of job losses in augmenting rural and urban underemployment and in reducing urban worker remittances to rural families. The reduction of household incomes has, *inter alia*, made it harder for families to afford to send their children to school, as a result of which it is reported that the number of elementary school drop-outs in Thailand has almost tripled compared with a year ago.

Employment conditions in the Republic of Korea have also seriously deteriorated. As of June 1998, unemployment was 7 per cent, up from 4.4 per cent in October 1997. Three categories of workers have in particular borne the brunt of the crisis. One is workers in the construction sector, where employment fell over the same period by 22 per cent, as opposed to 14 per cent in manufacturing. Another is unorganized workers in small and medium-sized enterprises, which unlike most of the *chaebols* have little access to credit and are therefore fast going out of business. The third category consists of female employees, who have been disproportionately the first to be laid off. Besides growing unemployment, there has been a decline in real wages of 2.3 per cent owing to the cuts in overtime payments and annual bonuses. The situation is expected to worsen considerably in the months ahead, with unemployment likely to reach 10 per cent by the end of 1998 since 12 of the largest 30 *chaebols* plan to downsize by 20-50 per cent, and the Government intends to reduce public employment by 10 per cent in the near future. It is also likely that real wages will decline further as growing numbers of workers opt for wage reductions in exchange for guaranteed job security.

The social impact of the crisis in the Republic of Korea has been mitigated by the existence and expansion of unemployment benefit schemes, but much less so in Indonesia, which as a poorer country has only minimal safety-net measures in place, and in Thailand, which has virtually no programmes for protecting the unemployed and underemployed. Past complacency and unpreparedness regarding safety-net provisions are understandable since the governments concerned have for a long time reasonably assumed that rapid and sustained economic growth would of itself raise incomes, reduce underemployment and alleviate poverty.

Until economic output revives, safety-net palliatives are necessary for cushioning the impact of the crisis on vulnerable and poor segments of the population. In the case of Indonesia, short-term humanitarian assistance of over $1 billion is being organized to this end by the international community. The assistance packages will include a public works programme for laid-off urban workers, rice and medicine imports to stabilize wage good prices and satisfy basic needs, and technical assistance aimed at promoting rural development. These elements should prove helpful in mitigating the effects of the crisis on the poor. An additional measure that could be beneficial would be to expand micro-credit schemes for small entrepreneurs, not least because such approaches, unlike public works projects, enable women as well as men to participate in and benefit from them.

Safety-net measures, however, can have only a marginal and temporary impact in alleviating social hardship. They are in no way long-term solutions to the social crisis. The resumption of high and sustained growth is indispensable in order to reverse the effects of economic contraction and bring unemployment and poverty levels back down to pre-crisis levels. The insistence on high domestic interest rates and balanced budgets has been counterproductive in this regard. Policies of increased domestic expenditure and lower interest rates will be necessary in order to overcome financial difficulties and to reflate domestic demand. The alternative is continued economic depression with attendant consequences for the social and political stability of the region.

F. Conclusions: The crisis and the Asian development "model"

As already noted, in the view of some Western commentators, the crisis in East Asia was caused by structural and institutional shortcomings in the countries concerned, which resulted from the environment in which the economies operate. Broadly, two reasons are singled out as the root causes of the financial difficulties in the region: the close relationship between government and business, and market distortions that insulated business from competitive forces and market discipline. Some commentators go even further and suggest that the crisis marks the end of the "Asian model of development". While they accept that the "model" has been very successful in delivering an unprecedented pace of industrialization and growth, and in eliminating poverty, they consider it is now outdated and has been overwhelmed by global market forces, very much as the Western form of free market capitalism has triumphed over central planning.

There is no question that the way the economies are run and businesses are operated in East Asia differs considerably from the "Western model". However, the analysis presented in this chapter shows that the crisis in East Asia does not differ in its essential features from those experienced in developed and developing countries organized under various institutional and socio-economic systems, including those in countries operating under the Western, Anglo-American model. It is yet another episode in a series of crises that have been occurring with increasing frequency since the breakdown of the Bretton Woods arrangements, and with the introduction of floating exchange rates and the unleashing of financial capital.

Furthermore, there are important differences among the East Asian economies in their institutions and economic structures.[10] Indeed, before the financial crisis, there was a tendency to distinguish a South-East Asian development model from the one followed by the North-East Asian countries (Japan and the first-tier NIEs, except Hong Kong, China), and to recommend it to other developing countries for emulation on the ground that it relied less on interventionist policies and more on conservative macroeconomic management and liberal trade and FDI policies.[11] It is notable that two "interventionist" economies – Singapore and Taiwan Province of China – have not experienced serious currency turmoil and financial crisis even though they have suffered from spillovers, just like many other countries linked to the region by strong trade and financial ties. In South-East Asia, too, the problems faced by Indonesia and Thailand are again quite different from those in Malaysia, which has pursued somewhat more activist policies than the other two countries.

As in the earlier episodes of financial crisis and currency turmoil in developing countries, the crisis in East Asia was preceded by financial liberalization and deregulation which, in some cases, constituted a major break with past practices. In this sense the fundamental problem was not that there was too much government intervention and control, but too little. A similar point has been made by Joseph Stiglitz, Chief Economist of the World Bank:

> Some ideologues have taken advantage of the current problems besetting East Asia to suggest that the system of active state intervention is the root of the problem ... But I will argue that the heart of the current problem in most cases is not that government has done too much, but that it has done too little ... The fault is not that the government misdirected credit ... Instead the problem was the government's lack of action, the fact that the government underestimated the importance of financial regulation and corporate governance.
>
> The East Asian crisis is not a refutation of the East Asian miracle. The more dogmatic version of the Washington Consensus does

> not provide the right framework for understanding both the success of the East Asian economies and their current troubles. Responses to East Asia's crisis grounded in this view of the world are likely to be, at best, badly flawed, and at worst, counterproductive.[12]

The break with past practices has been particularly notable for the Republic of Korea, which, together with Japan and Taiwan Province of China, was generally seen as the most successful "model" of modern industrialization based, *inter alia*, on the features that are now considered to be the root cause of the crisis. However, it is the departure from the "model" rather than its pursuit that is the main cause of the crisis in that country. This departure appears to have occurred in two crucial areas: control over external borrowing and state guidance of private investment. The country drew upon external finance in its postwar industrialization primarily through borrowing from international banks, but this was almost always subject to government approval and guarantee. On the other hand, while private investment was the driving force of industrialization, policy always played a major role in coordinating investment decisions in order to avoid excessive competition and excess capacity. Abandoning this coordination seems to be one of the main reasons for misallocation and overinvestment, while the fact that the Government relinquished control over the financial sector explains why the country became vulnerable to an external debt run and an attack on its currency.

Dismantling checks and balances in these areas has proved to be extremely destabilizing and disruptive for the traditional institutional arrangements regarding corporate investment and finance. High corporate leverage, which was one of the key factors in rapid postwar growth and accumulation,[13] proved fatal when corporations were allowed to raise money abroad without the traditional supervision and control, treating external and domestic debt as perfect substitutes, even though there was no international counterpart to the domestic lender of last resort to smooth out liquidity problems. Thus, the problem was not so much with leverage as with liberalization – a point well illustrated by the Indian example: in India the largest corporations are highly geared by international standards, but the economy has been spared the turbulence in the East Asian financial markets because of its gradual and cautious approach to capital account liberalization.[14]

As for the second-tier NIEs, the jury was still out even before the first signs of crisis became evident. As examined by the UNCTAD secretariat in some detail in *TDR 1996* and elsewhere,[15] while following more liberal policies, these countries had been extremely successful in mobilizing domestic resources and establishing competitive resource- and labour-intensive industries. It was argued that such policies were indeed appropriate in the initial and relatively easy stages of export promotion, but that their limits were being reached and there was a need to turn to the kind of strategy pursued by their northern neighbours in order to progress further in industrialization and development. Coming on top of structural difficulties, financial liberalization increased the dependence of these countries on foreign resources and hence their vulnerability to the whims of international finance. This was perhaps most evident in Thailand, where the establishment of an international banking facility (discussed in section C above), the liberalization of the banking sector and the decontrol of property investment were crucial factors in the crisis.

In *TDR 1997* the view was expressed that successful examples of modern industrialization are distinguished by the way profits and integration into the global economy are managed. This was one of the main lessons drawn from the postwar experience of Japan and the first-tier NIEs. The main lesson of the Asian crisis leaves this conclusion unshaken: when policies falter in managing capital and integration, there is no limit to the damage that international finance can inflict on an economy. There is certainly considerable scope for national policies in preventing and better managing crises of this sort. However, these crises are a systemic problem, and action is therefore needed also at the global level. The next chapter addresses these more fundamental and systemic issues. ■

Notes

1 However, as foreign capital started to leave, the peso-denominated *cétes* were converted into dollar-indexed *tesobonos*.

2 The lending was almost wholly through loan syndications, 53 per cent of which were organized by United States commercial banks in the period 1974-1977, against 39 per cent for 1978-1982. In 1981 over 50 per cent of lending went to private sector borrowers, compared with 45 per cent in 1979. Around two thirds of the lending of United States banks was to private sector borrowers. In 1983, the first year of debt restructuring, the share of publicly guaranteed lending rose to two thirds and eventually reached 85 per cent in 1985. For example, Argentina reported that two thirds of foreign banks' total loan exposure was to private sector borrowers in 1979, 75 per cent in 1982 and under 25 per cent in 1986. Some of the change in the statistical measures of public lending was caused by the nationalization of private banks; see United Nations Centre on Transnational Corporations, *Transnational Banks and the International Debt Crisis* (United Nations publication, Sales No. E.91.II.A.19), New York, 1991.

3 M. Ahmed and L. Summers, "A tenth anniversary report on the debt crisis", *Finance and Development*, Vol. 29, No. 3, September 1992.

4 According to the World Bank categorization, only Indonesia was a "severely indebted" country, while Malaysia, the Philippines and Thailand were all "moderately indebted"; see World Bank, *Global Development Finance 1998* (Washington, D.C., 1998), pp. 65-73.

5 See *TDR 1996*, table 11.

6 World Bank, *op. cit.*, p. 33.

7 The absence of clear rules concerning consolidated accounting for industrial groups has in some cases been of particular importance in this context.

8 Institute of International Finance, "Capital Flows to Emerging Market Economies", Washington, D.C., 30 April 1998, p. 5, table 4.

9 J. M. Boughton, "From Suez to Tequila: The IMF as crisis manager", IMF Working Paper No. 97/90 (Washington, D.C.: IMF, 1997).

10 The common and different features of East Asian economies are discussed in a number of papers prepared as part of UNCTAD research into East Asian industrialization; see *Journal of Development Studies – Special Issue on East Asian Development: New Perspectives*, Vol. 34, No. 6, August 1998.

11 World Bank, *The East Asian Miracle: Economic Growth and Public Policy* (Oxford: Oxford University Press, 1993). For a discussion of this issue see Y. Akyüz et al., "New perspectives on East Asian development", in the *Special Issue* of the *Journal of Development Studies* referred to in the preceding note.

12 J. Stiglitz, "More instruments and broader goals: Moving toward the Post-Washington Consensus", The 1998 WIDER Annual Lecture, Helsinki, January 1998, p. 3.

13 See R. Wade and F. Veneroso, "The Asian financial crisis: The high-debt model and the unrecognized risk of the IMF strategy", Working Paper No. 128 (New York: Russell Sage Foundation, 1998).

14 See A. Singh, "Asian Capitalism and the financial crisis", paper presented at the conference on Global Instability and World Governance, Robinson College, Cambridge, United Kingdom, May 1998; and J. Glen, A. Singh and R. Matthias, "How competitive are the emerging markets? An analysis of corporate rates of return from 9 emerging markets", paper presented at a seminar at the Research Department of the IMF, Washington, D.C., July 1998.

15 See the *Special Issue* of *Journal of Development Studies,* referred to above.

Annex to chapter III

THREE POST-BRETTON WOODS EPISODES OF FINANCIAL CRISIS

I. The Southern Cone experience

There are many points of similarity between the experience of the Southern Cone countries in Latin America during the late 1970s and early 1980s, particularly the Chilean experiment during that period, and the recent East Asian financial crisis: excessive borrowing abroad in foreign currencies intermediated by recently deregulated banks without adequate supervision in conditions of fixed exchange rates and large interest differentials, eventually leading to widespread bankruptcies, and banking and foreign exchange crises.[1]

In Chile the liberalization process started in 1974 with the return of fully nationalized banks to the private sector through auctions supported by generous credit arrangements. As part of a strategy to eliminate financial repression, interest rates were freed, reserve requirements were reduced and the newly created *financieras* were allowed to operate without any restriction. Despite earlier announcements by the authorities that deposits were not insured and that there would be no bailouts, the Government intervened heavily in 1977 when an important bank was in serious trouble and rescued both the depositors and the bank.

The experiment took another turn in 1979 when the nominal exchange rate of the peso against the dollar was fixed and restrictions on convertibility and capital movements, including private borrowing abroad, were relaxed. The rationale for the latter was expressed at the time by a high IMF official in the following terms:

> In the case of the private sector, I would argue that the difference between domestic and foreign debt is not significant – barring government interference with the transfer of service payments or other clearly inappropriate public policies – if it exists at all. The exchange risks associated with foreign borrowing are presumably taken into account as are the other risks associated with borrowing, whether it be from domestic or foreign sources. More generally, private firms can be expected to be careful in assessing the net return to be derived from borrowing funds as compared with the net cost since their survival as enterprises is at stake.[2]

Capital inflows surged in 1981 and the real exchange rate rose rapidly. This was a period of sharply rising dollar interest rates, when a capital outflow might have been expected, but real domestic rates were over 30 per cent since monetary policy was kept tight in view of a rapidly rising current account deficit brought about by the currency appreciation, a consumption boom and bubbles in financial and real assets. The trade deficit rose from around $350 million in 1979 to $2,700 million in 1981 as consumer imports surged. Domestic borrowers quickly shifted from

peso to dollar loans to reduce financing costs, expecting that international interest rates would fall more quickly than domestic rates. The capital inflows were primarily loans from international banks denominated in dollars. They were mostly on-lent by the newly privatized banks to local borrowers in dollars: in 1981 dollar-denominated local bank loans to the building sector increased by 280 per cent compared with a 13 per cent rise in peso lending. Much of the increased lending was used to finance the purchase of public assets that were being privatized. The ratios of bank debt to income rose sharply to over 50 per cent for most sectors of the economy, and debt-equity ratios for large conglomerates exceeded 90 per cent.

The exchange rate regime collapsed in 1982. An important part of the banking system was already insolvent when foreign lending started to expand rapidly in 1980. In 1981 the Government liquidated three commercial banks, four *financiera* banks and a development bank, which accounted for 35 per cent of total lending. In 1983 another eight banks, with 45 per cent of financial system loans, were taken under the control of the central bank, which by 1988 held bad bank loans equal to nearly 20 per cent of GDP. Only one commercial bank survived without government support. It was at this point that serious thought was given to prudential supervision and regulation of the banking system.

II. The United States banking and real estate crisis and debt deflation

The sharp rise in United States interest rates that created difficulty for Latin American borrowers in the early 1980s also created problems for United States savings and loan associations (S&Ls).[3] The phasing out of Regulation Q, which gave the Federal Reserve powers to set limits on deposit rates, led from 1980 onwards to increased competition for deposits both among banks and between banks and other institutions. It left S&Ls with large portfolios of 30-year fixed-rate mortgage loans at low interest rates when competition was pushing up the deposit rates. The result was to render most of these institutions instantly insolvent; they faced the choice of either raising their deposit rates above the rates they received on their loans, or watching their deposits drain out until they no longer had liquid resources to meet withdrawals. Consequently, pressures developed for deregulation on the asset side of the balance sheets, which eventually resulted in excessive risk-taking and debt creation. Congress granted S&Ls increased freedom to engage in new areas of activity with higher returns, including non-investment grade (junk) bonds, futures and options contracts, commercial real estate loans, and consumer and credit card loans, while the size of the minimum deposit benefiting from the Federal Deposit Insurance guarantee was increased. In effect, the new legislation was an invitation to the S&Ls to grow out of their difficulties by investing in high-risk, high-yielding assets.

This created a potential for fraud and moral hazard. Since most of the S&Ls were already insolvent, their only chance of survival was to expand into high-risk areas of activity, financed by deposits that were now guaranteed up to the limit of $100,000 but were no longer subject to maximum interest rate limits. Investment banks soon developed a lucrative business as insured deposit brokers, providing funds in $100,000 federally insured bundles to the S&Ls, which in turn invested them in high-risk projects. Commercial banks, pension funds and insurance companies all followed the S&Ls in acquisition, development and construction loans that gave rise to a bubble in the property markets. Opportunities for alternative business were also provided by lending to consumers during the recovery that started in 1983, and by providing highly leveraged financing for mergers and acquisitions.

In this process, business firms and consumers raised their indebtedness to unprecedented levels, while financial institutions increased their lending against risky assets. Consequently, both corporate and household incomes and spending became increasingly sensitive to interest rates.

Thus, when the Federal Reserve started tightening monetary policy after the 1987 stock market crash in order to throttle asset-price inflation, the result was one of the deepest postwar recessions. Falling property prices caused capital losses and widespread insolvency, reducing the willingness and ability of banks to lend and of business and consumers to spend. However, in reaction to the weakness in the financial system and the economy, short-term interest rates were reduced in the early 1990s almost to negative levels in real terms, thus providing relief not only for banks, but also for firms and households, which were able to ride the yield curve and refinance debt at substantially lower interest-servicing costs. This eventually produced a boom in the securities market, thereby lowering long-term interest rates and helping to restore balance sheet positions, thus producing a strong recovery.

A number of important lessons emerged from the United States experience of financial liberalization. First, it confirmed what had been learned from the Chilean experience, namely that appropriate prudential regulations must accompany the accelerated liberalization of deposit-taking institutions. Second, it showed that while deposit insurance is seldom the initial cause of morally hazardous behaviour that gets a bank into difficulty, its existence can generate such behaviour once a bank finds itself in difficulty; it then leads to substantial additional losses since there is no longer any downside risk. The proper policy response is not to eliminate insurance, but to ensure prompt closure so that an insolvent bank cannot use deposit insurance to gamble on a recovery in earnings. This has now been made part of formal federal prudential regulations that provide precise guidelines for the rapid closure or take-over of banks in difficulty.

Finally, the policies pursued in the early 1990s were exemplary in the way they addressed debt deflation, making it possible for the United States economy to enjoy one of the longest postwar recoveries.

III. The EMS currency crisis

Much like the Asian crisis, the 1992 crisis in the EMS which forced Italy and the United Kingdom to opt out of the ERM was driven by large movements of short-term arbitrage funds responding to interest rate differentials and prospects of capital gains in conditions of fixed exchange rates and increasing external imbalances. The outflow of arbitrage funds was triggered by an appreciation of European exchange rates and a rise in interest rates in Germany. There was also a rapid contagion, as the decision to devalue the Italian lira led to heavy speculation against the pound sterling that eventually drove both currencies from the ERM, and a delayed contagion that produced a speculative attack on the French franc in the summer of 1993. In addition, deregulation was involved, since Italy had lifted all its remaining capital account restrictions and adopted the narrow fluctuations band in the EMS in 1991.

Given the relative stability of exchange rates after 1987, there was a widespread expectation that the then existing ERM exchange rates would remain stable and become the conversion rates for the creation of the single European currency in the third stage of Economic and Monetary Union (EMU). In the high-inflation, high-growth economies of Italy and the United Kingdom the exchange rate stability during this period was achieved through tight monetary policies that created large interest rate differentials with the rest of Europe, particularly Germany. This triggered large capital inflows, financed by funds borrowed at low interest rates in Germany and the United States. These inflows were initially dominated by United States banks, which were also speculating that the creation of the common currency would bring a downward convergence of interest rates and so produce capital gains on their holdings of Italian

and British securities. Thus, unlike in East Asia, the lending was in the domestic currency in order to take advantage of the expected capital gains. On the other hand, the exchange rate risk was expected to be small; since the EMS had always had "within band" realignments, the largest possible exchange rate movement would be less than 4.5 per cent.

United States banks also invested borrowed dollar funds in these high-yielding markets, but since the dollar was floating against the European currencies, the currency risk was greater. Nevertheless, given the difficulty of hedging against the lira, the large size of the differentials and the weakness of the dollar, these positions were initially unhedged, and then hedged through the DM against an appreciation of the dollar on the assumption that the lira/DM rate could not diverge by more than the narrow exchange rate band of 4.5 per cent. Sterling could be hedged directly.

The large capital inflows generated by the interest rate differentials and prospects of capital gains strengthened these currencies, and the large build-up in reserves led to the belief in their stability. However, because of inflation differentials, they also produced real appreciation and rising current account deficits. At the beginning of 1992 it became clear that the increasing external deficits could not be sustained, and there were large capital outflows from Italy. The continued depreciation of the dollar made the loss of competitiveness even greater, while increased interest rates set by the Bundesbank reduced the attractiveness of the arbitrage gains. The view gained ground that the lira would require an adjustment that was greater than the traditional "within band" adjustment, probably as much as 10-15 per cent. As Italian reserves declined, the markets in September 1992 forced a lira devaluation, leading to an exchange rate that proved unsustainable, and pressure soon spread to sterling; Italy and the United Kingdom then suspended their participation in the ERM. Unlike East Asia, both countries experienced a very rapid recovery on the back of a strong rise in exports, using the freedom they had gained as regards monetary policy to reduce interest rates relative to those in Germany.[4] ■

Notes

1 For this experiment see C. Diaz-Alejandro, "Goodbye financial repression, hello financial crash", *Journal of Development Economics*, Vol. 19, No. 1/2, 1985; S. de la Cuadra and S. Valdes, "Myths and facts about financial liberalization in Chile", in P.L Brock (ed.), *If Texas Were Chile: A Primer on Banking Reform* (San Francisco: Institute for Contemporary Studies Press, 1992); and R. Ffrench-Davis, M. Agosin and A. Uthoff, "Capital movements, export strategy, and macroeconomic stability in Chile", in R. Ffrench-Davis and S. Griffiths-Jones (eds.), *Coping with Capital Surges: The Return of Finance to Latin America* (Boulder, Colorado: Lynne Rienner Publishers, 1995).

2 The statement was by A.W. Robichek, the then Director of the Western Hemisphere Division of IMF, quoted in Diaz-Alejandro, *op. cit.*, p. 9.

3 For a more detailed account of this episode see *TDR 1991*, Part Two, chapter II; *TDR 1992*, Part Two, chapter II; and *TDR 1994*, Part Two, chapter II.

4 For a further discussion of these developments see *TDR 1993*, Part Two, chapter I; and *TDR 1994*, Part Two, chapter II.

Chapter IV

THE MANAGEMENT AND PREVENTION OF FINANCIAL CRISES

A. Introduction

This chapter discusses key issues regarding both the management or containment of financial crises and policies that could help to prevent them. Here it is necessary to distinguish between banking crises (which frequently include runs on parts of the banking sector) and currency crises (which involve flight from the currency by residents and non-residents), although the two may be, and (as discussed in chapter III) in developing countries usually have been, closely connected. In the case of banking crises a conceptual distinction cannot reasonably be made between management, on the one hand, and prevention on the other; strengthened financial regulation and supervision, for example, are manifestly directed at meeting both objectives. Chapters III and IV focus principally on crises where attacks on the currency were accompanied by threats to the banking system. In such cases the distinction between management and prevention is useful, and the section which follows concerning crisis management and resolution discusses policies which can be adopted in response to a currency attack for the purpose of halting or reversing it and so limiting the resulting damage to the domestic economy.

The subjects taken up under crisis management are macroeconomic policies, management of reserves and access to credit, international lender-of-last-resort financing, and international standstill and workout procedures for debtor countries. In view of the high costs and uncertain outcomes associated with reliance on domestic policies in the debtor country under attack and on external financing under arrangements which are currently in place or can reasonably be envisaged, special attention is focused on the last of the approaches mentioned, i.e standstill and workout procedures.

Measures for crisis prevention can be taken at global, national or regional levels, and the treatment here takes up policies and proposals classified under headings which broadly follow that order. However, the policies and proposals surveyed do not always fit neatly into this pattern. Global surveillance, for example, clearly belongs to the first of the three levels mentioned, and regional consultation and collaboration to the third. But in the case of other measures (such as financial regulation, controls over international lending and portfolio investment, capital controls and exchange rate policies), even though action generally takes place at the national level, in recent years such measures have been increasingly the subject of global or regional initiatives because they have significant cross-border spillovers, involve free-rider problems (arising from the advantages accruing to a country from other countries' compliance with rules, standards or norms which it does not itself observe), or restrict national policy autonomy. As explained below, the first two considerations have been particularly important for

international initiatives regarding financial regulation and supervision, and also for multilateral cooperation at regional and global levels to prevent disorder in currency markets and competitive devaluations. The third consideration motivates the global regime for currency convertibility for current international transactions, and various regimes agreed by smaller groups of countries for the removal of restrictions on capital transactions. The WTO regime for international trade in goods and services reflects all three considerations, and its agreements contain provisions explicitly designed to deal with problems under each of them.

B. Managing and resolving financial crises

1. Self-fulfilling debt runs

While every financial crisis in developing countries is different, such crises have a common feature: the rush of investors and creditors to exit and the consequent financial panic. Indeed, whatever the proximate causes of financial crises or the events that trigger attacks on currencies, international investors and creditors of developing countries often manifest herd-like behaviour in exiting as well as investing or lending. The debt crisis of the 1980s witnessed a drastic cutback in lending by international banks to sovereign debtors, while during the 1994-1995 Mexican crisis the rush for the exits by international creditors took the form of rapid liquidation of government paper and conversion of the proceeds into dollars. Again, in the more recent turmoil in East Asia, the refusal to roll over short-term loans together with the attempt of unhedged debtors to avoid exchange rate losses was the principal factor deepening the crisis.

Creditor overreaction to debtors' financial difficulties is often explained in terms of a collective action problem. Even though the creditors as a group are better off if they continue to roll over their maturing claims on a debtor, an individual investor has an incentive to rush for the exits. A debtor who could normally generate sufficient resources to service his outstanding stock of debt would face a liquidity problem if more than a certain number of creditors refused to renew their maturing claims. Without access to liquidity, he would be forced to curtail operations or to resort to distress sales of assets, which in turn would lower his income and wealth, thereby further constraining his ability to service debt and hence damaging the interest of creditors as a group. In this sense, debt runs reflect the failure of markets to coordinate individual decisions so as to generate a superior outcome for the creditors as well as the debtors.

The consequences of a generalized debt run by international creditors triggered by a loss of confidence are much more serious than those of the debt run by creditors of domestic debtors. Such behaviour can easily turn a liquidity problem into widespread insolvencies and defaults by altering key asset prices, interest rates and exchange rates. In the absence of a large stock of reserves or access to international liquidity, the ability of a debtor developing country to repay its entire stock of short-term external debt on demand is no greater than the ability of a bank to meet a run by its depositors. Where external liabilities are in the form of direct securities denominated in domestic currencies, as was the case with Mexican *cetes* and *tesobonos*, the demand for foreign currency comes directly from the creditors. In the case of bank lending, withdrawal of loans by foreign creditors could trigger a rush by unhedged debtor banks and firms into foreign currency as they seek to pay debt or cover their open positions. That would in turn drive down the value of the domestic currency and raise interest rates, making it more difficult for debtors to service their debt and forcing them to liquidate assets, thereby deepening the debt deflation process. It is not only the international debtors that would thus be hurt; there would also be broader macroeconomic consequences, including a sharp decline in employment and output.

Additional pressures on exchange rates and asset prices would arise from two other sources.

First, residents tend to flee from domestic currency assets, and can do so easily when the economy is dollarized and there is easy access to foreign exchange assets. Second, debt runs by foreign creditors are often associated with a flight from non-debt instruments held by non-residents, notably from the equity market. Since such investors face a decline in prices when they attempt to liquidate their holdings, the selling pressure in the currency market would be weakened. Moreover, since they would also suffer from depreciations, they may have less inducement to exit. However, investor overreaction could still amplify destabilizing feedbacks between equity and currency markets. Indeed, there has been a very close correlation between the collapse of equity prices and exchange rates in recent episodes of financial crisis in developing countries, and this linkage has been particularly strong in East Asia.

Theoretically, there are four lines of defence against a massive attack on the currency of a debtor country:

- domestic policies, particularly monetary and interest rate policy, to restore market confidence and halt the run;
- hedging by keeping sufficient foreign reserves and credit lines;
- use of an international lender-of-last-resort facility to obtain the liquidity needed;
- a unilateral debt standstill and exchange restrictions, and initiation of negotiations for an orderly debt workout.

The last three mechanisms affect not only crisis management but also the likelihood of emergence of debt crises by discouraging runs against the currency. The threat of a unilateral debt standstill could also dampen short-term capital inflows, thereby reducing the build-up of external financial fragility.

The following sections discuss the feasibility and costs and benefits of establishing and/or using such mechanisms. The policy response to a debt run has generally proved ineffective, and building up reserves to meet speculative attacks is extremely costly and barely practicable. In addition, there are serious difficulties in setting up an international lender-of-last-resort facility to provide the kind of liquidity needed to counter such attacks on a currency. An effective way of dealing with them would be to establish an international framework for debt standstills and workouts to prevent the resulting liquidity crises from leading to insolvency.

2. Monetary policy and market confidence

Interest rate differentials are undoubtedly an important determinant of international capital flows. Higher domestic interest rates, *ceteris paribus*, would stimulate capital inflows by increasing the profitability of arbitrage with foreign money markets. Also, they could signal the determination of policymakers to remove certain macroeconomic imbalances, such as excess domestic spending and large external imbalances, when these threaten to put pressure on the currency. Under such circumstances, restrictive monetary policy and higher interest rates can play an important role in stabilizing capital flows.

However, as the events in East Asia show, when financial markets panic the likely effects of monetary tightening and higher interest rates on capital flows are quite different, because they exert a strong influence on credit risk. The withdrawal of foreign lending and flight from the currency began in the first place because lenders and investors did not expect to receive the return on their assets. Higher interest rates simply signal declining creditworthiness and rising default risk, and the expected rate of return adjusted for risk will tend to fall as interest rates are raised.

For international lenders with claims denominated in dollars, higher domestic interest rates in the debtor country do not alter the rate of return on their assets. But by increasing the financial difficulties of their debtors and reducing their incomes and net worth, they increase the likelihood of default. Thus, they provide no incentive for foreign lenders to roll over their existing loans or extend new credits.

Again, high interest rates are not always effective in stemming capital flight into foreign currency triggered by expectations of sharp depreciations. Even double-digit rates are unable to persuade people to keep their capital in domestic currency assets when they believe that such rates are politically difficult to maintain, as seen in some European countries during the 1992-1993 European Monetary System (EMS) crisis, and domestic assets have high default risks.

If persistently applied, monetary tightening and high interest rates can no doubt eventually stabilize the currency by intensifying the difficulties of the debtors and increasing bankruptcies and defaults – that is, by reducing the sales rather than by increasing the purchases of domestic currency. As debt deflation and recession deepen, debtors will become increasingly insolvent and unable to raise funds to purchase foreign exchange to service their debt or to hedge against the exchange rate risk. However, markets would be stabilized by depressing the economy and increasing defaults rather than by bringing back the foreign capital.

Quite apart from the ineffectiveness of monetary tightening in stemming self-fulfilling debt runs, there is also little economic justification in defending the exchange rate at the expense of a hike in interest rates. Devaluations tend to hurt primarily those who have currency mismatches between their asset and liability positions, which often reflect speculative behaviour. By contrast, a hike in short-term interest rates also hurts domestic investors with maturity mismatches. Moreover, traded goods sectors are hurt more by high interest rates than by devaluations; this makes it more difficult to undertake a payments adjustment based on export expansion rather than on import compression.

3. Reserve policy

It is sometimes suggested that debtor countries should maintain adequate reserves to meet their short-term obligations in order to avoid currency turmoil in the face of a massive withdrawal of foreign loans and investment. Proponents of such a policy point to the experience of economies with large reserves (e.g. China; Taiwan Province of China; and Hong Kong, China), arguing in this respect that large reserves would also deter speculative attacks on the currency.

However, the consequences of building up a large stock of reserves by borrowing are quite different from when the reserves are accumulated through trade surpluses. One way of building up such reserves is to sterilize a large proportion of capital inflows, i.e. to purchase the proceeds through the issue of domestic debt instruments. However, there is a certain degree of circularity in such a strategy. In effect, it means that a country should borrow short only when it does not use the proceeds of such loans to finance investment and imports. Such a strategy can be very costly to the economy since the return on foreign reserves generally falls short of the cost of external borrowing.

Moreover, the cost of sterilizing private borrowing falls entirely on the public sector. Indeed, public sector losses will exceed the foreign exchange cost of carrying such reserves since real domestic interest rates on government debt exceed by a large margin the rates earned on reserves. There will thus be a net transfer from the public to the private sector in addition to the net cost incurred by the economy as a whole. Indeed, experience shows that such a strategy can give rise to large fiscal deficits or central bank losses (quasi-fiscal deficits).

A variant of this proposal is for the public sector to fully cover the external short-term liabilities of the private sector by borrowing long and investing short abroad. However, not all governments have access to long-term foreign borrowing. More important, the cost of such an operation could be prohibitive, particularly when the international long rates exceed short rates by a large margin and the risk premium on long-term sovereign debt is high.

A similar strategy is to maintain credit lines with foreign private banks and to use them when faced with an attack, which is tantamount to arranging a private lender-of-last-resort facility. Again, however, this will work only if the amounts are small. Moreover, the costs involved can be very large and there is no guarantee that the banks will keep to such arrangements when there is a massive withdrawal of foreign lending.

A further problem is that vulnerability to withdrawal of funds is not confined to short-term liabilities. In this respect, what matters is liquidity rather than maturity of liabilities. Massive withdrawal of funds from equity and/or bond markets can cause similar difficulties in the currency market, even though declines in the prices of such assets tend to alleviate the pressures on the exchange rate. When stock and bond markets are sizeable and foreign presence is significant, bearish moods in such markets can easily translate into a flight from the national currency, necessitating large-scale interventions to stabilize the exchange rate. The cost of maintaining reserves large enough to meet this eventuality would be prohibitive.

4. Bailouts and international lender-of-last-resort facilities

Provision of liquidity from an international lender of last resort to stabilize currency markets has not been the policy response to currency crises in developing countries. Rather, assistance coordinated by the IMF has usually come after the collapse of the currency, in the form of bailout operations designed to meet the demands of creditors and to prevent default. Such operations, however, pose problems for a number of reasons. First, they protect creditors from bearing the full costs of poor lending decisions, thereby putting the burden entirely on debtors. Second, they consequently tend to create moral hazard for international lenders, encouraging imprudent lending practices. Not only do they reduce the concern of creditors about liquidity risk, but often, by securing *ex post* public guarantees for private debt, they also tend to reduce the perceived default risk. Third, the international financing required has involved increasingly large amounts that have been difficult to raise.

However, there are also serious impediments to creating a genuine international lender of last resort to avoid such problems. The effective functioning of such a facility depends on two conditions: there should be reasonably well defined rules and conditions that the borrower must satisfy, and the lender of last resort should have the discretion to create liquidity in fulfilling its function.

Amongst existing multilateral arrangements for the provision of external financing the facilities available within the EU perhaps come closest to meeting these two conditions. These facilities provide short-term support both for EU member countries participating in the EMS exchange rate mechanism (ERM) and for non-participants in this mechanism, as well as other longer-term financing. Access to short-term external financing is guaranteed to an ERM participant for intervention in exchange markets to keep its currency within prescribed fluctuation limits; borrowing under this facility becomes subject to additional conditions only if the maturity of the loan is extended beyond an initial period, which may be as long as approximately two and a half months. Other short-term external financing is available to EU member countries up to certain limits after agreement has been obtained in accordance with established procedures. Medium-term external financing is also available up to specified limits subject to similar multilateral agreement concerning the borrowing country's need (after taking account of policies it undertakes to overcome its difficulties).

Strictly speaking, the IMF does not satisfy either of the above conditions to qualify as a lender of last resort. Indeed, that institution was not originally conceived to provide financing to its members encountering liquidity problems associated with capital flows. Article VI of its Articles of Agreement specifically precludes lending to finance persistent capital outflows. So far in its interventions for this purpose the IMF has relied on the provision of funds by its major shareholders. A proposal was made on the eve of the Mexican crisis to create a new "short-term financing facility" (STFF) for this purpose.[1] The facility was to be used by countries with close integration with international capital markets, including industrial countries and emerging markets. However, a number of difficult issues were raised by this proposal.

The first issue concerns the conditions under which financing should be made available to countries facing liquidity problems. In the STFF proposal two kinds of drawing were envisaged: an automatic right to draw (analogous to the gold tranche) and a drawing subject to the approval of the Executive Board. Such a two-tier approach was thought to strike a balance between speed and risk. While automatic access would ensure a timely response to market pressures, it could also create a greater risk to the IMF and give rise to moral hazard for the borrower. By contrast, conditional withdrawal would reduce the risk to the Fund, but negotiations and approval could cause long delays and uncertainties which might in turn further undermine market confidence. The Fund paper suggested that for conditional withdrawal the request should be made at the time of the article IV consultations, and that the facility should not be made available to finance unsustainable current account deficits. In that sense, the Fund's agreement to access would indicate a seal of approval of the country's underlying external payments position.

In principle, access to a lender-of-last-resort facility should depend on the fulfilment of specified conditions in advance, rather than on a commitment to undertake certain actions after the crisis occurs. Such conditions may relate not only to the sustainability of exchange rates and current

account positions, but also to factors that affect financial stability, such as the size and maturity structure of external debt and effective prudential regulations. The lender of last resort should have the authority and capacity to monitor the extent to which these conditions are fulfilled and to determine eligibility.

There are, however, serious difficulties in implementing such a procedure. First of all, it may require considerable extension of article IV consultations regarding matters related to the capital account, and it is not clear whether this would necessitate amending the Articles of Agreement in order to give the Fund jurisdiction over such matters. Second, it may not be easy to agree on what constitutes the relevant set of policies and institutions. For instance, there has been considerable controversy over the policies demanded by the Fund as part of its rescue package for the Republic of Korea; indeed, some of the conditions imposed have been regarded as interfering "unnecessarily with the proper jurisdiction of sovereign government" rather than as technical matters for dealing with the payments problem.[2] Moreover, the adequacy of national policies for exchange rate sustainability and financial stability when a country is integrated with international capital markets involves matters of interpretation going beyond those traditionally raised under IMF surveillance. Thus, considerable differences may emerge between the Fund and the member concerned during the article IV consultations over the fulfilment of eligibility conditions. Finally, while experience strongly suggests that financial crises can occur despite effective prudential regulations and sustainable macroeconomic positions, there is a tendency to assume that they are caused primarily by poor policies and the weakness of the institutional machinery. For instance, a number of flaws in policies and institutions in East Asia came to light only after the crisis, although the policies and performance of these countries had been highly praised earlier. If the simple fact that a crisis has occurred is taken as *prima facie* evidence of poor policies and institutions, it may never be possible for developing countries to be eligible for recourse to a lender-of-last-resort facility without additional and as yet unspecified commitments to undertake certain actions.

A second set of problems relates to the level of access and the adequacy of funds. In the 1994 proposal these were envisaged to be commensurate with the size of reserve losses that countries could sustain, but the facility was not envisaged to finance shocks fully. Three hundred per cent of quota was considered as a possible upper limit. Such an amount would indeed be quite modest in relation to possible needs arising from sudden outflows, but it could absorb an important proportion of Fund resources. For instance, in the 1994-1995 Mexican crisis, the initial offer of IMF funding of $7.8 billion was three times the country's quota. Even though this was subsequently raised to $17.8 billion, representing no more than one third of the total rescue package, this amount was widely regarded as unusually high and risky for the Fund.

The recent intervention by the IMF in East Asia was again far above the quotas of the countries concerned, and was funded through special arrangements under emergency financing procedures established after the Mexican crisis on the assumption that "use of these emergency procedures [was] expected to be rare, and the IMF's role [would] remain catalytic".[3] With the deepening of the crisis in East Asia, the IMF Executive Board approved in December 1997 the Supplemental Reserve Facility to provide financing to countries experiencing exceptional payments difficulties under a highly conditional Stand-By or Extended Arrangement for up to one year.[4]

Ideally, the SDR could play a key role in creating a lender-of-last-resort facility, so that it would become a true fiduciary asset and enhance its role and share in global reserves. Indeed, after the outbreak of the Mexican crisis, in his statement to the Copenhagen Social Summit in March 1995, the Managing Director of the IMF suggested that an effective cure depended on "convincing our members to maintain, at the IMF level, the appropriate level of resources to be able to stem similar crises if they were to occur", adding that this would imply a decision, *inter alia*, for "further work on the role the SDR could play in putting in place a last-resort financial safety net for the world".[5] Such a step would require an amendment of the Articles of Agreement and could face opposition from some major industrial countries. Since it is insisted that the IMF should remain largely a quota-based institution, funding through bond issues by that institution is also ruled out. This leaves the Fund's normal resources, together with its borrowing facilities, as the only potential sources of funding. However, they alone would not provide financing on the scale made available by the IMF and other sources during the recent Mexican and East Asian crises.

Bailout operations by the IMF will thus continue to rely on ad hoc arrangements with major industrial countries. In view of the increased public concern over burden-sharing and moral hazard, and the constantly growing size and risk of such operations, there is no guarantee that the required funds will always be forthcoming in the future. Critics point increasingly to the non-transparent nature of such operations. Moreover, there is also concern about the risk of default to countries providing the funding for bailouts. Although Mexico was able to repay quickly its debt to the United States from the bailout operation by refinancing it in international capital markets, there is no guarantee that other distressed borrowers will be equally capable. Questions are thus raised whether such a transformation of external debt could not be achieved without going through IMF bailout operations and creating risks for taxpayers in creditor countries.[6] In this respect, the application of insolvency principles, discussed in the next subsection, may provide an effective alternative.

5. Insolvency procedures and international debt crises

(a) Insolvency principles

Commenting on the debt crisis of the 1980s more than a decade ago, the UNCTAD secretariat expressed the main dilemma facing the debtor countries as follows:

> The lack of a well-articulated, impartial framework for resolving international debt problems creates a considerable danger, which has in part already materialized, that international debtors will suffer the worst of both possible worlds: they may experience (and many are experiencing) the financial and economic stigma of being judged *de facto* bankrupt, with all the consequences that this entails as regards creditworthiness and future access to financing. At the same time, they are largely without the benefits of receiving the financial relief and financial reorganization that would accompany a *de jure* bankruptcy handled in a manner similar to chapter 11 of the United States Bankruptcy Code.[7]

Bankruptcy procedures are especially relevant to international debt crises resulting from liquidity problems because they are designed to address financial restructuring rather than liquidation. In the United States Bankruptcy Code they are based on the premise that the value of the firm as a going concern exceeds the value of its assets in the event of liquidation. No receiver or trustee is appointed to manage the debtors' business, and debtors are usually left in possession of their property, with all the powers of a trustee.[8] The aim of these procedures is to facilitate orderly workouts in three stages.

At the outset such procedures allow for an automatic standstill on debt servicing in order to provide the debtors-in-possession with a breathing space from their creditors, who are not allowed to pursue lawsuits or enforce the payment of debts. The automatic-stay provision is based on the recognition that a "grab race" for assets by the creditors is detrimental to the debtor as well as to the creditors as a group. It allows the debtor the opportunity to formulate a reorganization plan and ensures that creditors are treated equally. The filing of a bankruptcy petition also fixes all claims against the debtor whereby claims for future interest on pre-petition indebtedness cease to accrue as of the petition date and may not be asserted against the debtor.

In the second stage, between the filing of the petition and the exit from bankruptcy through the reorganization of the debtor's affairs, the Code provides the debtor with access to working capital needed to carry out its operations. This it does by granting a seniority status to debt contracted after the filing of the petition. This debtor-in-possession financing does not depend on the permission of existing creditors, and is approved whenever it is judged that continued operation of the firm will enhance its value.

The final stage is the reorganization of assets and liabilities of the debtor and its operations. The Code discourages holdouts by a certain class of creditors and accelerates the process towards a rapid resolution. The plan does not require unanimous support by the creditors (acceptance by 50 per cent in number and two thirds in amount of the claims is sufficient), and the debtor can obtain court approval of the reorganization plans under the "cramdown" provisions.

These procedures are used not only for private debt. Chapter 9 of the Code deals with public debtors (municipalities) and applies the same principles as chapter 11. The recent successful workout of the Orange County debt was under chapter 9.

Similar arrangements exist in most other industrial countries. Although they do not always go as far as the United States in safeguarding the interests and the needs of the debtor, they do not apply a rigid and legalistic approach designed to satisfy the interest of the creditors at any cost.[9]

(b) International application

International private debtors may enjoy insolvency protection subject to provisions in their contracts with the creditors even though the application of such provisions involves a number of complex legal questions such as the determination of the relevant law and forum, and enforcement.[10] However, under debt runs such protection does not offer much relief to the country concerned even if the bulk of the external debt is owed by private banks and firms. If there are numerous debtors, it is very difficult to simultaneously initiate insolvency procedures in respect of them all so as to halt the "grab race" by the creditors. Moreover, as in East Asia, most private debtors may indeed be solvent and hence unwilling to file a petition for insolvency, but the country may not have the reserves to meet the demand for foreign exchange.[11] However, as noted above, debt runs can make such debtors insolvent, and this danger is greater when external debt is owed by the private sector and exchange controls have been dismantled. With sovereign debt a "grab race" on the currency is limited, and exchange controls can help contain the flight of residents from domestic assets. The task falls on the government to take action to secure the kind of protection provided under the insolvency procedures, particularly debt standstill.

However, current judicial practices and government policies in the major industrial countries do not allow debtor governments to benefit from debt standstill provisions in the case of external obligations (see box 4). In this context, a question arises as to whether the relevant provisions of the Articles of Agreement of the IMF can provide a statutory basis for action by debtor governments through exchange controls. The most relevant provisions are in article VIII, section 2(b):

> Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any member. In addition, members may, by mutual accord, cooperate in measures for the purpose of making the exchange control regulations of either member more effective, provided that such measures and regulations are consistent with this Agreement.

This article has given rise to a number of different and conflicting interpretations.[12] On one view, it allows governments to take unilateral action for standstill on debt payments, since under article VI, section 3, members are free to impose capital controls without IMF approval. The courts of the member countries cannot refuse to recognize such controls if they are consistent with the Articles of Agreement. It therefore follows that any suspension of debt servicing introduced in the context of exchange controls approved by the IMF would render debt contracts unenforceable in the courts of any IMF member.

On another view, this was not the original intent of the clause. Indeed, there are considerable ambiguities regarding concepts such as exchange controls and exchange contracts, allowing different interpretations. While the courts in France appear to favour a broader interpretation, those in the United States and the United Kingdom tend to define exchange contracts to include only contracts having as an immediate objective the exchange of international means of payments, rather than any contract that affects a country's foreign exchange reserves. Consequently, on this interpretation, international loan agreements are not "exchange contracts", and hence do not fall within the ambit of the article.[13]

In practice, governments are reluctant to resort to unilateral suspension of debt servicing and exchange controls even in the extreme event of financial panic. The reasons put forward by the IMF are that:

> Because there exists no well-defined and accepted legal process that is applicable in such cases, the process of debt resolution by involuntary restructuring is necessarily ad hoc with an uncertain outcome. Bond holders may try to seek redress, on an individual or coordinated basis, by attempting to seize the assets of the borrowers or by threatening to disrupt their trade and payments systems ... "Free riders" may also undermine any negotiated solutions by trying to attempt to enforce their individual claims. In addition, involuntary debt restructuring will damage creditworthiness

> and may increase the cost of accessing international markets in the future.[14]

However, the Fund also recognizes that "there may be sound economic and political reasons for involuntary restructuring supported by an economic calculus that trades off higher future financing costs against the deadweight loss of rapid and deep domestic adjustment".[15]

In view of the deficiencies of current institutional arrangements for dealing with debt crises, and the increased capacity of financial markets to inflict serious damage, there is now a growing recognition of the need for reform. As noted above, there are serious difficulties in using national insolvency procedures for resolving international debt crises. Moreover, it would be difficult to replicate these procedures at the international level for cross-border loan contracts. It also has to be recognized that reorganization of international debt inevitably has a substantial political dimension. All this has to be borne in mind in designing a global framework for dealing with international debt problems.

Discussions of reform have so far concentrated on sovereign debt and the ways and means of applying internationally the type of bankruptcy principles and procedures in chapter 11 (or chapter 9) of the United States Code. One proposal is to create an international bankruptcy court in order to apply an international chapter 11 drawn up in the form of an international treaty ratified by all members of the United Nations. Under such an arrangement, the international court would be empowered not only to impose automatic stay and allow debtor-in-possession financing status, but also to restructure debt and to grant debt relief. Arbitrators would be nominated by both creditors and debtors, and to ensure impartiality no court in either a creditor or a debtor country should chair the proceedings.[16]

A less ambitious and perhaps more feasible option would be to establish a framework for the application of key insolvency principles, namely debt standstill and debtor-in-possession financing, to international debtors, and to combine them with the established practices for restructuring debt, including negotiations involving the IMF, which would play a major role in the application of these two principles.

On one view, standstills would need to be sanctioned by the IMF: "upon determination by the Executive Board of the IMF, the debtor government would be protected from legal challenges by its creditors for immediate debt collection".[17] This would require a broad interpretation of article VIII(2)(b), which could be provided either by the IMF Executive Board or through an amendment of the Articles of Agreement so as to cover debt standstills. The latter could be authorized once a certain proportion of reserves is lost and/or the currency falls below a certain threshold.

On another view, a more informal process would suffice:

> Encouraging the IMF to advise the debtor or another agency on the justification (or not) for a suspension of debt service payments would allow the Fund to carry out an important signalling function; a government which received approval for its standstill would suffer relatively little damage to its reputation, while the possibility that the Fund would not approve would discourage governments from utilizing the option strategically. Naturally, the IMF should limit its *ex ante* advice to the debtor government and share its opinion with the markets only *ex post* to avoid inciting a panic. A definitive reinterpretation of article VIII(2)(b) would support the IMF in this role even if it did not have legal effect in national courts.[18]

However, several objections have been raised against giving the Fund so much power, on grounds of conflict of interest. It has been argued that the Executive Board of the IMF is not a neutral body which could be expected to act as an independent arbiter, because countries affected by its decisions are also among its shareholders. Moreover, since the Fund itself is a creditor and a source of new money, and acts as the authority imposing conditionality on the borrowing countries, there can be conflicts of interest vis-à-vis both debtors and other creditors.[19]

An alternative procedure would thus be to establish an independent panel to determine whether the country concerned is justified in imposing exchange restrictions with the effect of debt standstills according to article VII(2)(b). Such a ruling would need to have legal force in national courts for the debtor to enjoy insolvency protection. The decision for standstill could be taken unilaterally by the debtor country, and then submitted to the panel for approval within a specified period. Such a procedure would help avoid "inciting a panic", and be similar to WTO safeguard

Box 4

COURT RULINGS IN THE UNITED STATES ON THE APPLICATION OF CHAPTER 11 OF THE BANKRUPTCY CODE TO INTERNATIONAL DEBT

In 1982 payments difficulties prompted the Costa Rican Government to suspend debt servicing by three state-owned banks. Initially, the case opened by the creditors in the District Court in New York in 1983 was dismissed on the grounds that the action by the Costa Rican Government constituted an act of State – i.e. that it was "governmental" (as opposed to commercial) – both in nature and in purpose.[1] The Court of Appeals upheld this ruling, though on different grounds; namely, that the action was consistent with the law and policy of the United States, with reference in particular to chapter 11 of the Bankruptcy Code. It ruled that Costa Rica's action was "not a repudiation of the debt but rather was merely a deferral of payments while it attempted in good faith to renegotiate its obligations", and was "in entire harmony with the spirit of bankruptcy laws, the binding force of which, upon those who are subject to the jurisdiction, is recognized by all civilized nations", prompting such remarks in the financial press as that New York was "unsafe for loan agreements".[2]

However, after rehearing the case the same court reversed itself in 1984, when it was "bluntly told by the US Government that the court's earlier decision had incorrectly interpreted US policy as supporting the enforcement of the Costa Rican decrees".[3] The court ruled that the Justice Department's brief clearly established that the Government's policy was to support "the debt resolution procedure that operates through the auspices of the International Monetary Fund", and that "Costa Rica's attempted unilateral restructuring of private obligations ... was inconsistent with this system of international cooperation and negotiation, and thus inconsistent with United States policy".

This final ruling in effect established that for foreign governments to enjoy insolvency protection in United States courts, their actions should be in conformity not only with United States law, but also with the policy of that country with respect to international debt restructuring. Indeed, this ruling gave rise to such remarks as "existing US legal doctrines ... could not easily be stretched into creating what amounted to a code of international bankruptcy practice when there was no statutory or other basis for such a result ... Absent some guidelines as to what constituted a good-faith renegotiation of sovereign debt, the suspension of creditor legal remedies might empower a foreign sovereign to act unilaterally and arbitrarily in matters directly affecting US banks and indirectly affecting the stability of the US banking system".[4]

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1 For an extensive discussion of this case see L.C. Buchheit, "Act of State and comity: Recent developments", in Sassoon and Bradlow, *op. cit.*; and *TDR 1986*, box 6. The quotations below from court rulings are taken from these two sources.

2 *Financial Times*, 24 May 1984.

3 Buchheit, *op. cit.*, p. 103.

4 *Ibid.*, p. 102.

provisions allowing countries to take emergency actions.

There would also be a need to combine debt standstills with debtor-in-possession financing in order to replenish the reserves of the debtor country and provide working capital. This would mean IMF "lending into arrears". The funds required for such emergency lending would be much less than the scale of bailout operations. Moreover, the Fund could also help arrange emergency lending from private capital markets with seniority status.

As regards sovereign debt to private creditors, reorganization could be carried out through negotiations with the creditors, and the IMF could be expected to continue to play an important role

by providing a forum for bringing all creditors into negotiation with the debtor government. Special arrangements might be needed for bonds, which are often more difficult to restructure. For private debt, negotiations could be launched with private creditors immediately after the imposition of debt standstill. Judicial procedures might also be applied to individual debtors according to the law and the forum governing the contracts at issue. Their application would be greatly facilitated by the existence of proper bankruptcy procedures in debtor countries.

In past episodes of debt crisis, negotiated settlements often resulted in the socialization of private debt when the governments of developing countries were forced to assume loan losses.[20] This leads not only to a regressive redistribution of wealth in the debtor country, but also to moral hazard for both private debtors and creditors. The introduction of automatic stay, together with debtor-in-possession financing, could help relieve such pressures.

Certainly, a number of issues would need to be addressed in establishing procedures that would protect the debtors from the consequences of self-fulfilling debt runs and allow them to carry out their operations without creating moral hazard and opportunities for abuse of exchange controls. The recent East Asian crisis has shown once more that there is a need to safeguard debtor countries from the overreaction of financial markets, "in entire harmony with the spirits of bankruptcy laws, the binding force of which, upon those who are subject to the jurisdiction, is recognized by all civilized nations" (see also box 4).[21] Adoption of the principle of automatic stay for international creditors and investors is certainly one of the most helpful steps which might be taken in that direction.

C. Prevention of financial crises

1. Global surveillance

Global surveillance has not been successful in preventing international financial crises. In part this failure reflects belated, and so far only partial, adaptation of existing procedures to the problems posed by large autonomous private capital flows. But perhaps more fundamentally it is due to the unbalanced nature of these procedures, which give too little recognition to the disproportionately large global impact of monetary policies in a small minority of OECD countries.

In view of the growing size and integration of financial markets, every major financial crisis now has global ramifications. Consequently, preventing a crisis is a concern not only for the country immediately involved, but also for other countries which are closely integrated into the global trading and financial system and which can be affected in a number of ways. As already noted, contagion can occur through various channels, including those resulting from liquidity and credit interdependencies among major financial institutions and markets in the world, from expectations of competitive exchange rate adjustments, and from changes in perceptions regarding risks associated with a certain class of markets. Global surveillance of national policies is thus called for, with a view to ensuring stability and sustainability of exchange rates and external payments positions.

However, financial crises are not always home-grown. As noted in the preceding chapter, international financial crises are typically connected with major shifts in macroeconomic indicators external to the countries where the crises first manifest themselves. This is true of the debt crisis of the 1980s and of the Asian financial crisis. The origins of the former are to be found in shifts in the macroeconomic policies of major OECD countries in response to inflationary pressures. The inconsistency between contractionary mon-

etary policy and expansionary fiscal policy in the United States, combined with the overall deflationary stance of macroeconomic policies in other major industrial countries, resulted in a sharp rise in interest rates in the United States and the appreciation of the dollar, both of which played a crucial role in the developing country debt crisis.[22] The Asian crisis was influenced by similar factors. The large capital flows before the crisis to East Asian countries (which over-financed their current account deficits) began in the early 1990s to a significant extent in response to an easing of monetary conditions in major OECD countries, on the one hand, and high interest rates and relatively stable exchange rates in the Asian countries, on the other. Again, as discussed above, the reversal of these flows was closely connected with the swings in exchange rates and monetary conditions in the United States and Japan. Various other recent examples of external influences on capital movements and currency markets come easily to mind, such as the fluctuations in private external financing for Latin American countries, an important determinant of which has been shifts in monetary conditions in the United States. Indeed, econometric research indicates that internal and external factors were about equally important in the surge in capital flows to Latin America during the early 1990s.[23]

The objectives of IMF surveillance, as formally stated, are limited to exchange rate policies, focusing primarily on the sustainability of exchange rates and external payments positions and on the appropriateness of the associated economic policies of individual countries. However, its scope has tended to broaden over time. For instance, the guidelines established in 1977 for surveillance made an explicit reference to the obligations of a member to avoid manipulating exchange rates or the international monetary system to gain an unfair competitive advantage over other members.[24] Again, in the 1980s the major members of the Fund came to favour a broader interpretation and recognized that "to be effective surveillance over exchange rates must concern itself with the assessment of all the policies that affect trade, capital movements, external adjustment, and the effective functioning of the international monetary system".[25]

However, the modalities of IMF surveillance do not include ways of responding to and dealing with unidirectional impulses resulting from changes in the monetary and exchange rate policies of the United States and a few other OECD countries which exert a strong influence on international competitiveness and capital movements. In the absence of incentives and enforcement procedures linked to the process of peer review under IMF surveillance, countries elsewhere in the world economy lack mechanisms under the existing system of global economic governance for redress or dispute settlement regarding these impulses. In this respect, governance in the area of global finance lags behind that for international trade, where such mechanisms are part of the WTO regime.[26]

The need for strengthening IMF surveillance in response to conditions produced by greater global financial integration and recurrent financial crises has been recognized by the Interim Committee. For example, at its meeting in April 1998, the Committee agreed that the Fund "should intensify its surveillance of financial sector issues and capital flows, giving particular attention to policy interdependence and risks of contagion, and ensure that it is fully aware of market views and perspectives". It made special reference to the risks posed by abrupt reversals of capital flows and to the need for efforts by the Fund and the World Bank to help member countries to strengthen their financial sectors, and for an improved communication process between the IMF and member countries, requesting the Executive Board to develop a "tiered response" involving increasingly stern warnings to countries believed to be following policies seriously off course.[27]

However, despite the reference to interdependence, it is not evident that these proposals extend to weaknesses arising from the lack of balance in existing procedures. The focus of attention continues to be on the impact of domestic policies in generating financial fragility and crisis rather than on external influences produced by monetary and exchange rate policies of the major industrial countries.

Moreover, even within the current limits of surveillance, the IMF has a mixed record of diagnosis of build-up of financial fragility and external vulnerability. Thus, various questions emerging from recent experience can be posed regarding the direction which should be taken by more concrete guidelines for article IV surveillance as a follow-up to the Interim Committee's Communiqué:

- In the context of such surveillance can confidence be placed in the improvement of capacities to identify factors likely to cause

such crises in a world of increasingly liberalized capital flows?[28]

- In the absence of such capacities might it not be more prudent to place greater reliance as a matter of course on capital controls and other measures at the national level directed at external assets and liabilities (such as those discussed in subsection 5 below)?
- If the latter approach is adopted, should new guidelines for IMF surveillance not specify circumstances in which the Fund should actually recommend the imposition or strengthening of capital controls?
- How far should IMF surveillance be extended to cover subjects such as financial regulation and standards for financial reporting and accounting?
- What should be the relations between IMF policy surveillance and the consultation and collaboration procedures of regional bodies, which in future are likely to include not only existing agreements such as those of the EU but also new ones among developing countries, an example of which is described in subsection 7 below?
- Finally, how can more effective implementation of the policy recommendations put forward as part of surveillance be achieved?

These are clearly delicate questions involving not only formulation of an appropriate framework and development of technical competence, but also powers and responsibilities in areas where multilateral bodies other than the IMF already exist.

2. Information and transparency

The Asian financial crisis has accelerated initiatives to improve the timeliness and quality of information concerning key macroeconomic variables as well as the financial reporting of banks and non-financial firms. The first of these subjects was accorded by the IMF's Interim Committee in April 1998 an essential position in its proposals for strengthening the architecture of the international monetary system.

The central element of the IMF's own initiatives in this area is the Special Data Dissemination Standard (SDDS), established in April 1996 to guide member countries in the public dissemination of economic and financial information in the context of seeking or maintaining access to international financial markets. At the time it was hoped that the new, more stringent rules associated with the SDDS would serve as an early warning system that would help to prevent future financial crises. However, in the event the rules did not make such a contribution in the case of the Asian crisis.

Countries subscribing to the SDDS commit themselves to certain standards regarding data dissemination in four areas: coverage, periodicity and timeliness; public access; integrity of the data; and quality of the data. The subjects to be covered comprise national accounts, production, conditions in the labour market, prices, the determinants and principal features of the government's fiscal balance and debt position, the accounts of the central bank and of the financial sector (which include monetary aggregates and credit), interest rates and stock prices, the balance of payments and international reserves, international investment, and spot and forward exchange rates. In April 1998 the Interim Committee proposed a broadening of the SDDS, clearly inspired in part by what it considered to be the role of informational deficiencies in the Asian crisis, so that the system would also cover additional financial data such as net reserves (after allowance for central banks' liabilities under forward or derivative transactions), the debt (especially the short-term debt) of economic agents, and other indicators bearing on the stability of the financial sector.

While initiatives such as the SDDS are capable of furnishing additional, more timely and reliable information to investors and policymakers, emphasis on inadequate information as the major reason for failure to forecast the Asian crisis appears misplaced or exaggerated. Data were generally available concerning key variables in the countries concerned, such as their balance of payments, both their short- and longer-term external debt and net external assets (in particular in the periodic reports of the Bank for International Settlements [BIS] concerning international bank lending), their capital inflows, the exposure of banks and other financial firms to different sectors or categories of economic activity, the problems of the property sector, and (in the Republic of Korea) the precarious balance sheets and low recent profitability of many non-financial firms. The crisis has pointed to weaknesses in available information pertinent to governments' ability to

manage capital flows and external debt: for example, in some cases existing data systems provided inadequate indications about the scale and nature of the exposure of Asian banks to other countries in the region, and about the country of ultimate risk in international inter-bank lending involving such banks. But these weaknesses were not an essential part of the failure to forecast the crisis. Rather, what was missing was adequate evaluation of the implications of available information for countries' ability to continue to obtain funding from the international financial markets.

Furthermore, it should be noted that quicker access to macroeconomic and financial information may also be a source of instability. General dissemination of certain up-to-date data (including some bearing on unfavourable developments affecting countries' external assets and liabilities) is capable actually of increasing the volatility of capital flows. If, in consequence, a decision were to be taken to restrict the availability of such information in the interest of avoiding volatility, a difficult and perhaps invidious choice might have to be made regarding the parties to whom disclosure would be made.

The Asian crisis has also focused special attention on standards of accounting and financial reporting. Efforts in these areas were already under way before the crisis as part of the upgrading of financial markets not only in Asia but also in other regions. But the crisis has provided additional impetus to the process, particularly as part of the strengthening of bank regulation and supervision, of which adequate accounting and reporting are integral components.

3. *Domestic financial regulation and supervision*

Weak credit evaluation and speculative lending, as well as failure to control currency risk among banks and other financial firms, contributed both to the outbreak of the Asian financial crisis and to its amplitude. The growth of doubtful and non-performing loans, accompanied in some countries by widespread insolvencies in the financial sector, will create major problems for government budgets and be a drag on the availability of lending for a considerable time to come. There is general agreement that regulatory reform is an essential part of the strengthening and restructuring of the financial sectors of most countries affected by the crisis. However, such reform is not a fail-safe way of preventing financial crises, though it can reduce their likelihood and help to contain their effects.

In recent years there has been widespread reform and strengthening of financial regulation at the national level, accompanied by a proliferation of international initiatives to raise regulatory standards and to improve cooperation among supervisors. These processes have been largely driven by concerns raised in relation to financial liberalization and global financial integration. On the one hand, the diversification of their services and the increased competition that are associated with liberalization have exposed financial firms to new levels of risk, which have necessitated overhaul not only of financial regulation but also of firms' systems of internal control. On the other hand, global financial integration has brought in its train much greater exposure among countries to each other's financial and macroeconomic conditions and increased possibilities for the cross-border transmission of destabilizing influences. Such exposure has been dramatized by various events since the beginning of the 1970s. For example, the insolvencies of two international banks in 1974 (Bankhaus Herstatt and Franklin National Bank) pointed to the danger of cross-border spillover effects from the failures of financial firms, and provided the initial impetus for international initiatives regarding financial regulation and supervision. Subsequent efforts to strengthen standards and international cooperation in this area have also been partly a response to, and their substance has been influenced by, such events as the developing-country debt crisis of the 1980s and failures of individual financial firms such as Banco Ambrosiano (1982), Bank of Credit and Commerce International (1991) and Barings (1995), each of which in their different ways exposed weaknesses in banking regulation and in cross-border cooperation among banking supervisors.

The main vehicles for international initiatives regarding financial regulation and supervision have been the Basle Committee on Banking Supervision and other bodies with close links to the BIS, other groups of financial supervisors, associations of exchanges, and organizations concerned with accounting standards. The initiatives of the Basle Committee have included the adoption of principles designed to ensure that no international bank escapes adequate supervision and the prescription of levels of capital commensurate with

the risks that banks run: agreements under the latter heading were reached concerning credit risks in 1988 and concerning market risks in 1996.[29] The Basle Committee has also devoted considerable attention to the improvement of banks' systems of internal control and, together with the International Organization of Securities Commissions (IOSCO), has developed guidelines for the disclosure by banks and securities firms of their trading and derivatives activities. Furthermore, the Committee on Payment and Settlement Systems has made several proposals designed to reduce the risks due to financial firms' exposure to the possibility of non-payment by their counterparties in international transactions.

Membership of the various bodies linked to the BIS which are concerned with different aspects of banking supervision is limited to a small group of countries. However, efforts have been made to promote Basle standards through contacts with other groups of banking supervisors, and special attention has recently been paid to regulation and supervision of emerging financial markets. One important outcome of these efforts is the recent release of the statement entitled *Core Principles for Effective Banking Supervision*, the drafting of which involved extensive consultations with parties in developing countries. The coverage of these principles includes the permissible activities of banks, licensing criteria, the vetting of banks' controlling interests, capital and risk management, guidelines on lending to related companies and individuals, "know your customer" procedures intended to prevent the criminal use of banks, the information and methods required for effective supervision, the powers of supervisors, and consolidated supervision of international banks. However, the introduction of improved standards in this field takes considerable time and the full benefits of international initiatives so far are unlikely to be experienced soon. Moreover, the coverage of international regulatory and supervisory cooperation is incomplete, thereby restricting its effectiveness: offshore financial centres and several increasingly important actors in international capital flows such as investment funds are still only partly included or not included at all. And the networks of cooperation and information exchange among financial supervisors required for the effective implementation of international agreements are still being developed.

Strengthened financial regulation can at best reduce the probability of financial crises. But the periodic incidence since the beginning of the 1980s of banking crises in industrial countries such as the United States, the United Kingdom and parts of Scandinavia exemplifies its inability to eliminate them. This inability stems partly from imperfections in the regulatory process itself, such as its tendency to lag behind changes in financial firms' practices, and the difficulty of imposing regulatory transparency on such firms.[30] Perhaps more fundamentally for the assessment of what regulation can and cannot do, no loan or other asset on a bank's balance sheet should be classified generically as "good". However reasonable the original managerial decision to make a loan and however justified its initial classification as low-risk by banking supervisors, the loan is vulnerable to the possibility of an eventual deterioration in its status. Unfavourable changes in macroeconomic conditions (of external as well as domestic origin) are a factor frequently cited here. Arguably, the deterioration in the status of many loans is in fact an intrinsic feature of the boom-bust process often associated with financial crises. During this process risks take time to build up and to become widely evident. Indeed, for a time the quality of a loan can be validated or even enhanced by the effects on values of the very financing boom of which it is a constituent part. Thus, during booms the incentives for herd-like behaviour are not limited to speculative lenders. As a result, "risk-based competition propels the entire system towards excessive levels of indebtedness",[31] but excess capacity generated by the boom itself (widely exemplified during the savings and loan crisis in the United States discussed in the annex to chapter III) as well as the over-extended positions of financial firms do eventually make themselves felt, often in conjunction with rises in interest rates or downturns in economic activity.

The limits on the crisis-preventing potential of financial regulation are generally recognized by specialists in the field,[32] so that its primary objectives are regarded as having more to do with reducing financial firms' liquidity and solvency problems, protecting depositors, and preventing systemic risks due to contagion effects. This is not to deny that beneficial connections among regulation, incentives and internal controls are capable of enhancing the safety of financial firms. Capital requirements appropriate to the credit and market risks run by these firms can improve the quality of their lending and their portfolio management, and lead to better pricing of the services which they supply. But as should be evident from

the argument above, some of the risks faced by financial firms arise from circumstances over which they have little or no control. Against such risks robust financial regulation provides cushions both to individual firms and to the financial system. However, the protection thus afforded has repeatedly been shown to be only partial.

If absence of complete protection from crises is characteristic even of financial sectors subject to relatively developed regimes of regulation and supervision, then unsurprisingly the same is *a fortiori* true of those subject to weaker regimes in the great majority of developing countries, whose vulnerability has been graphically illustrated by some of the examples discussed in chapter III above. Moreover, the financial sectors in the latter countries frequently have to withstand more severe macroeconomic shocks than their counterparts in industrial countries.[33] The severity and frequency of such shocks cannot always be reduced by macroeconomic policy. True enough, financial regulation and supervision can be improved until they attain the levels of prevailing best practice (though, as already suggested, that will generally take several years), but even then financial crises will remain possible.

4. Tighter control of international lending and portfolio investment

It could be argued that in a well functioning world economy no separate rules or restrictions would be required for international lending and portfolio investment beyond those associated with national prudential regulation of financial firms in both the source and recipient countries, and with the regulation of issuance and trading procedures for organized exchanges and other markets for financial assets and instruments. In such a world international capital flows would be closely related to payments and financing in international trade and investment, and driven by the economic fundamentals of firms and other recipients. But reality is otherwise. Much bank lending and portfolio investment in short-term debt securities is a response to interest rate arbitrage margins, which reflect the exigencies of monetary policy and can persist for long periods (frequently being eliminated by large eventual devaluations), or to differences among countries in the regulatory and tax treatment of external borrowing. Furthermore, much international portfolio investment responds less to the long-term economic prospects of individual firms than to expectations of short-term capital gains and losses, of which a major determinant in many cases is the ebb and flow of international portfolio investment itself, because effects on equity prices reflect the disparity between the limited capitalization of many stock markets and the large size of funds at the disposal of investment institutions of major industrial countries. The frequently tenuous connections between the forces influencing international lending and portfolio investment, on the one hand, and the fundamentals of economies and firms, on the other, have led to booms and busts in such financing which bear many similarities to the analogous fluctuations in bank lending at national level described under domestic financial regulation.

Risks of loss in this system are unevenly distributed. While during financial crises large losses may be incurred by external investors in stock markets, banks are often protected from losses on their international lending in various ways – by formal or informal protection against insolvency provided by the governments of borrowing countries to their domestic banks (often large recipients of funds borrowed from abroad),[34] in some cases by explicit guarantees extended by governments on foreign deposits in their banks, and (as noted in chapter III) by the IMF bailouts.

Controls over international lending and portfolio investment can be imposed at source, by the recipient, or at both levels. Controls by the recipient belong under the heading of those over capital transactions and are discussed above. The motivation of proposals for control at source is the belief that not all the responsibility for, and the costs of, such controls should be borne by recipients, and that even when controls by recipients are in place, controls at source are capable of further reducing the probability of potentially destabilizing capital flows and financial crises. Many ideas for controlling capital flows at source have been put forward in recent years, several of those directed at international bank lending having originally been a response to the developing-country debt crisis of the 1980s.[35] Proposals for checking excessive international bank lending typically involve mechanisms for capping external indebtedness which could not be expected to emerge through the operation of competitive financial markets, such as cartel-like arrangements among banks to impose country credit ceilings or the acceptance by lenders of guidelines regarding

a country's sustainable level of borrowing set by a multilateral institution. Unsurprisingly, the Asian financial crisis has served as a stimulus for new proposals, and greater attention has been given to portfolio flows, which were not prominent in the debt crisis of the 1980s. The general conclusion of the discussion of proposals which follows is that the more ambitious ideas have features which are an obstacle to their adoption, while the contribution of ameliorative changes which seem more likely to be within reach is not such as to remove the need for capital controls imposed by recipient countries.

One proposal, which would lead as a by-product to better control of international lending, is for a radical strengthening of existing supervision of financial firms through the establishment of an international body – the Board of Overseers of Major International Institutions and Markets – with wide-ranging powers for the oversight and regulation of commercial banking, securities business and insurance (activities now bestrode in some cases by financial conglomerates). For this purpose, it would be "empowered to set mutually acceptable standards for all major institutions, to establish uniform trading, reporting and disclosure standards for open credit markets, and to monitor the performance of institutions and markets under its jurisdiction".[36] This proposal would address problems associated with the significant differences which still characterize national regimes for financial regulation. Such differences, as mentioned above, are one of the causes of capital flows in the form of international bank lending with often only a limited connection with real economic activity. But despite progress under recent international initiatives concerned with financial regulation and supervision towards objectives which include both the raising of standards and greater convergence among national regimes, the proposal seems utopian.

Another proposal, which focuses more narrowly on international bank lending, is for the establishment of an International Credit Insurance Corporation (ICIC) "as a sister institution to the IMF".[37] This body would guarantee international loans for a modest fee but would set a ceiling on the amount of borrowing by particular countries which it was willing to insure. The ceiling would be based on evaluation of data concerning all of its borrowings, which a country would be obliged to furnish to the ICIC. In consequence, countries would be able to borrow at low rates of interest up to their ceilings, but beyond them lenders would be much more cautious and money would be available only at rates of interest incorporating a substantial risk premium (or not at all). The likelihood of excessive credit expansion would thus be reduced, as would that of the financial crises which can follow in its wake.

This proposal poses questions concerning feasibility, the quality of credit rating and the powers which would be conferred on such an institution. Feasibility does not appear to be an insurmountable problem: more widespread application of well-established modalities for the provision of credit insurance would be involved. These modalities comprise establishment of risk criteria, decisions about particular borrowers' creditworthiness as measured by these criteria which enable the setting of insurance premiums, and the administration of the insurance facilities. Such tasks are already carried out by export credit agencies (ECAs) of OECD countries. The major departure under the heading of an ICIC would be conferring on a single body the responsibilities regarding the risk criteria and creditworthiness indicators for the lending covered by its insurance facilities.[38] Administration might actually be carried out by existing institutions such as ECAs. However, it is questionable whether generally acceptable indicators could be developed by an ICIC, given the current state of the art in this area. The record of credit rating agencies, for example, in assessing the creditworthiness of developing-country borrowers exemplifies the difficulties entailed by the evaluation required, although an ICIC would not have to depend, as the agencies sometimes do, largely on published information.[39] Surveillance by the IMF, on the other hand, which involves evaluation similar in some respects to that carried out for credit rating, not only has been characterized on occasion by failures to identify weaknesses which could result in financial crises but also illustrates the political sensitivities associated with the disclosure of the evaluations of an official multilateral body bearing on countries' creditworthiness (even when, as in this case, the disclosure is less directly linked to access to borrowing than it would be under the proposal for an ICIC). Nevertheless, better information concerning borrowers could be expected to lead in time to the possibility of improved evaluation of countries' creditworthiness.[40] On the final question posed above concerning an ICIC's powers, however, the prospect of international agreement to confer such powers on either a new or existing international agency seems remote.

In debate about ways to exercise better control over international bank lending attention has also focused on inter-bank flows. There is widespread agreement that improved monitoring of such flows could contribute to better decision-making by participants in financial markets and better management of the international financial system.[41] But it is also believed that inter-bank lending is often associated with weaker credit assessment and with levels of bank capital which do not adequately reflect the credit risk involved. This has led Alan Greenspan, for example, to suggest that international inter-bank lending is an area requiring regulatory changes which would have the consequence of raising the cost to banks of such lending so that they better reflected its risks.[42] Steps in this direction would represent a reversal of long-term tendencies to reduce the costs associated with international bank lending.[43] One possible starting-point for action here would be the 1988 Basle Capital Accord, under which claims incorporated on banks outside the OECD area with a residual maturity of up to one year and all claims on banks incorporated in the OECD area are attributed a low (20 per cent) risk weight for the purpose of calculation of capital requirements. Yet the short-term exposure of international banks has been a major feature of recent external debt crises. Thus one way of causing tighter control to be exercised over banks' international inter-bank exposure would be to increase the risk weight for such exposure in the setting of capital requirements.

Such a step should lead to better internal accounting by banks for the risks of this type of international lending but would none the less be a crudely calibrated method of dealing with problems caused by banks' inter-bank exposure to countries with deteriorating creditworthiness. A more flexible approach might be based on existing country-specific procedures for monitoring banks' external exposures as part of bank supervision. These procedures frequently provide supervisors with authority to determine the levels of reserves appropriate to banks' external exposures, and could easily be used for the purpose of a more rigorous treatment of their inter-bank exposures to riskier countries (though, again, the effectiveness of the measure would depend on the quality of supervisors' systems for credit rating).

As already noted, proposals for controlling capital inflows triggered by the Asian crisis have also covered forms other than bank lending. One such proposal is designed to increase the stability of mutual funds' investments in securities issued by entities in developing countries by requiring the funds to hold liquid reserves amounting to some proportion of such securities.[44] These reserves could then be tapped into in the event of large declines in the securities' market value and would thus reduce the incentives to dump such securities for the purpose of obtaining the liquidity needed to meet redemptions. Also, the hope is expressed that although such reserve requirements would reduce the speculative returns to mutual funds' investments in emerging financial markets, the resulting reduction in market risk would none the less increase their attractiveness to long-term investors.

Mandatory requirements for mutual funds to hold liquid reserves of this kind would represent a radical break with existing regulatory practice. Moreover, another feature of this proposal which would entail variations in these liquidity requirements in accordance with the creditworthiness of the countries in which mutual funds made their investments (making the requirements "risk-weighted" in the author's words) would require the introduction of supervisory procedures for such funds analogous to those for banks (and under this heading an agreed system for rating creditworthiness – a task involving problems that have already been mentioned).

Nevertheless, despite the problems it poses, this proposal represents an attempt to confront a source of potential volatility for an increasingly important category of financial flows to emerging financial markets. As such it may serve to stimulate discussion concerning other possible measures for this purpose. An alternative approach, for example, might build on the exit fees which are a feature of some mutual funds.[45] These fees can vary with the holding period of investments and might thus be expected to act as a disincentive to investors seeking short-term returns. If this approach were deemed appropriate, ways could be sought to generalize exit fees for emerging-market mutual funds. It has the advantage that it would build on existing market practice. However, it would require agreement among the countries serving as major domiciles of emerging-market funds in order to prevent a flight of such funds to jurisdictions not imposing the exit fees, and an agreement of this kind would not be easy to achieve.

5. Capital controls and other measures for the management of external assets and liabilities

Management of a country's external assets and liabilities is linked to many other dimensions of economic policy, such as good macroeconomic fundamentals, effective financial regulation and supervision, and even good corporate governance. However, experience shows that these are necessary but not sufficient conditions for the avoidance of financial crises. It also shows that a key role here is played by policies aimed specifically at external assets and liabilities – most importantly capital controls but also certain other measures designed to influence borrowing, lending and asset holding.

Controls on capital flows are imposed both as part of macroeconomic management and in pursuit of long-term policy objectives related to national economic development and autonomy. Controls imposed for macroeconomic reasons are typically closely related to other monetary and fiscal measures, their function being to reinforce such measures or to substitute for them when reliance on other policy instruments is thought likely to be ineffective or to cause undesirably large movements of key variables such as interest and exchange rates. Controls under the second heading have such aims as ensuring that the capital of a country's residents is invested locally or that certain types of economic activity are reserved partly or wholly for residents.

The transactions which may be subject to capital controls are manifold and from some points of view avoid simple categorization. This applies, for example, to attempting to distinguish between short- and longer-term transactions: certain assets or instruments are clearly associated mostly or exclusively with short-term transactions, but others serve equally for short- or longer-term transactions so long as there exists a liquid secondary market for them.[46] Moreover, legal and administrative distinctions embodied in national regimes of capital control do not necessarily correspond neatly to the conceptual classification used by economists (for example, with respect to direct as opposed to portfolio investment). A by no means exhaustive list of the assets involved in capital transactions might include direct investments, long-term and short-term loans, cross-border holdings of real estate, domestically and internationally issued equity and debt (the latter ranging in maturity from money-market instruments to longer-term notes and bonds), collective investment securities (such as in shares in mutual funds), deposits with banks and other financial firms, guarantees and financial back-up facilities, life insurance contracts, various assets associated with personal capital movements (such as gifts, dowries and inheritances), blocked funds owned by non-residents, and derivative instruments.

Because of institutional and regulatory features of financial systems and of effects on incentives, controls imposed on capital inflows or external liabilities may also influence capital outflows and external assets, and vice versa. Such influences can be seen, for example, in controls on portfolio equity and direct investment, where rules concerning the repatriation of capital clearly affect the incentives for inflows. Likewise, rules applying to the portfolios of foreign firms regarding such matters as the freedom to engage in outward as well as inward investment transactions will influence their willingness to establish a commercial presence through direct investment. More generally, rules concerning the cross-border capital transactions open to financial firms in a country, as well as the matching of the currency denominations of their assets and liabilities, affect their willingness to depend on such inflows and their efforts to attract them.

In view of the close connections between capital controls, on the one hand, and certain other instruments of policy, on the other, classification of measures under one or the other heading may be somewhat arbitrary. For example, special reserve requirements concerning banks' liabilities to non-residents (a policy to which frequent reference is made in the following discussion) can reasonably be classified as either an instrument of monetary policy or a capital control. Moreover, since such requirements affect the quality of financial firms' balance sheets, they can equally be (and often are) classified as a "prudential" measure. Similar alternative classifications might also be attributed to restrictions on banks' net assets or liabilities in foreign currencies.

Traditionally, capital controls focused mainly on cross-border transactions of residents and non-residents. However, owing to deregulation and developments in banking technique making possible the supply of increasingly diversified services, accounts and transactions denominated in foreign

currencies are now often available to residents, and they affect macroeconomic conditions, particularly exchange rates, in much the same way as cross-border financial transactions.

Many different measures are available for controlling capital movements, some with a broad incidence and others aimed at more narrowly defined transactions. Controls on inflows of FDI and portfolio equity investment (not always clearly distinguished in the regulations, as mentioned earlier) may take the form of licensing, ceilings on foreign equity participation in domestic firms, official permission for international equity issues, differential regulations applying to domestic and foreign firms regarding establishment and permissible operations, and various kinds of two-tier markets. For example, under a two-tier market investments in a country's securities by non-residents may be limited to those purchased from other non-residents, and transfers of the country's currency for such transactions may be limited to those made possible by purchases and sales of such securities by non-residents (a measure designed to reduce the likelihood of falls in securities prices being accompanied by depreciations in the currency or declines in reserves).

Some of these controls can also be imposed on capital inflows associated with debt securities, both bonds and other instruments. Such inflows can thus be subject to special taxes or be limited to transactions carried out through a two-tier market. Ceilings (possibly as low as zero) may apply to non-residents' holdings of the debt issues of both firms and the government, or approval may have to be sought for the purchase of such issues by foreigners. Moreover, non-residents may be excluded from auctions for government bonds and government paper.

Various other controls are commonly used to restrict external borrowing from banks: the special reserve requirements concerning liabilities to non-residents already mentioned (to raise the costs and reduce the profits associated with on-lending of the capital inflows); forbidding banks to pay interest on the deposits of non-residents or even requiring negative interest rates ("commission") on such deposits; taxing foreign borrowing to eliminate the arbitrage margin between domestic and foreign interest rates;[47] and the imposition on both financial and non-financial firms of cash deposits at the central bank amounting to a certain proportion of their external borrowing (a measure pioneered by Germany in 1972 under the name of "Bardepot").

Controls on outward transactions for direct and portfolio equity investment can apply to residents as well as to non-residents. Restrictions on the latter can be directed at the repatriation of capital, for example, in the form of statutory periods before such repatriation is allowed or regulations providing for phasing of repatriation in accordance with the availability of foreign exchange or the need to maintain an orderly market for the country's currency. Residents may be restricted as to their holdings of foreign stocks, either directly or through limitations on the permissible portfolios of the country's investment funds. Two-tier exchange rates may also be used to restrict residents' foreign investment by requiring that capital transactions be undertaken through a market in which a less favourable rate than for current transactions generally holds. Some of these techniques are also used for purchases of debt securities issued abroad and for other forms of lending abroad. In the case of bank deposits by residents abroad, their availability can be restricted by law.

As already mentioned, the question of controlling "dollarization", in particular residents' bank deposits denominated in foreign currencies, as well as banks' lending to residents in foreign currencies, also falls under the heading of capital controls. Such loans and deposits can increase currency mismatching, which is a potential source of financial instability, and can precipitate and facilitate large shifts between currencies during financial crises, putting pressure on the exchange rate and resulting in widespread insolvencies among debtors.

The Asian crisis has drawn attention to issues deserving separate mention under the heading of measures to manage external assets and liabilities. During that crisis attention focused on the flight to foreign currencies which accompanied depreciations, but it was impossible to distinguish between flight which was due to speculation and flight due to belated attempts to cover foreign exchange exposures. However, as discussed in chapter III, there can be little doubt that mismatches between the currency denominations of the assets and liabilities of non-financial and financial firms made an important contribution, and were facilitated both by the ease of borrowing in foreign currencies and, in some cases, by the issuance to residents of bank deposits denominated in foreign currencies.[48]

To the extent that such liabilities are matched by assets (including loans) denominated in the same currencies, the foreign exchange risks are shifted to debtors, for whom such risks may be hedged by export earnings but frequently translate into credit risk. To the extent that the liabilities are not so matched, the resulting risks fall directly on the banks. The existence of such assets and liabilities, if sufficiently widespread, may thus pose a threat to the financial system.

Part of the solution to this problem can be found in strict enforcement of prudential rules regarding the matching of the currency denominations of financial firms' assets and liabilities and measures increasing the costs of foreign borrowing through the imposition of taxes, special reserve requirements or cash deposits at the central bank. But, as already suggested, tighter restrictions might also be applied to "dollarization" itself. These might take the form of limiting bank lending and deposits in foreign currencies. Non-interest-bearing reserve requirements could be imposed on deposits in bank accounts in foreign currencies, thus reducing or eliminating the interest paid on them and diminishing their attractiveness.

The Asian crisis has also starkly demonstrated the risks that can result from failure to enforce adequate separation between the onshore and offshore activities of a country's banks. A number of Asian countries have established offshore centres, whose activities are subject to lighter regulation and certain tax privileges, with the aim *inter alia* of facilitating participation by their banks in regional or global banking business. One such centre is the Bangkok International Banking Facility (BIBF), established by Thailand in 1992. As discussed in chapter III, BIBF entities increasingly served as a conduit for interest rate arbitrage between the domestic and international financial markets, much of the financing made available through such arbitrage being used to finance speculation in stocks and property.

There is a contrast between this relatively uncontrolled use of offshore financing in Thailand and the functioning of Singapore's offshore banking centre established in 1968.[49] Offshore banking in Singapore is conducted through Asian Currency Units (ACUs), which are integral parts of licensed banks. Indeed, except with respect to the segregation of its activities for accounting, fiscal and regulatory purposes, an ACU has no identity distinct from that of the bank in which it is located. The legal framework for ACUs is designed to facilitate their participation in regional banking business, while restricting the use of the Singapore dollar as an international currency and controlling ACUs' involvement in domestic banking business. ACUs can accept deposits in Singapore dollars only above a certain amount and only from non-residents and from other banks and financial firms, and loans to domestic firms in Singapore dollars are also subject to a ceiling. Since 1983 ACUs have had to obtain official approval for the granting of credit facilities to non-residents of above 5 million Singapore dollars or to residents for use outside the country, a requirement that hinders short selling of the Singapore dollar in currency trading and the use by non-residents of such facilities for portfolio and property investment.

The success of these policies in maintaining the offshore character of Singapore's ACUs can be illustrated from data on their assets and liabilities: 63 per cent of their liabilities in 1996 were from sources outside the country, and 42 per cent of their assets consisted of loans to banks outside the country. By contrast, there are estimates that as much as 95 per cent of the money raised by BIBF entities was lent domestically. The example of ACUs points both to the feasibility of a measure of insulation of offshore banking from the domestic market and to its benefits in terms of the contribution to financial stability.

Use of capital controls has been a pervasive feature of the experience of the last few decades. In early post-war years capital controls for macroeconomic reasons were generally imposed on outflows as part of policies for dealing with balance-of-payments difficulties and for avoiding, or reducing the size of, devaluations. Moreover, there was widespread use by both developed and developing countries of controls on capital inflows for the longer-term developmental or structural reasons mentioned above. With the return to freer capital movements from the 1960s onwards, large capital inflows posed problems at various times for the governments of certain industrial countries such as Germany, the Netherlands and Switzerland, which responded with various controls such as those already discussed on purchases by non-residents of domestically issued debt securities and the bank deposits of non-residents. More recently, a number of developing countries experiencing similar macroeconomic problems as a result of large capital inflows have resorted to capital controls as part of their policy response.[50]

- In Malaysia, initial reliance on sterilization served to widen the difference between domestic and external interest rates, leading to an accelerated surge in short-term capital inflows. In January 1994 the Government responded with the imposition of the following capital controls (gradually removed from 1995 onwards): banks were subjected to a ceiling on their external liabilities not related to trade or investment; residents were prohibited from selling short-term monetary instruments to non-residents; commercial banks were required to deposit at no interest in the central bank monies in ringgit accounts owned by foreign banks; and commercial banks were also restricted in the outright forward and swap transactions they were permitted to engage in with foreigners.[51]

- In Chile, too, reliance on sterilization in the early 1990s in response to increasing capital inflows led to a rise in interest rates and an acceleration of the inflows. In consequence, the Government had recourse to various policies designed to slow short-term inflows and even to encourage certain categories of outflow, including the imposition of an unremunerated reserve requirement on foreign borrowing of 20 per cent (subsequently raised to 30 per cent), to be deposited at the central bank for a year.

- In Colombia, sterilization was eventually abandoned as a response to capital inflows in the 1990s, and in its place was established a reserve requirement on loans (other than short-term trade-related credits) with maturities up to five years, which was to be maintained for the loan's entire duration but whose magnitude was a decreasing function of its maturity.

- In Brazil, sterilization policies adopted to deal with increased capital inflows after the implementation of the country's currency reform in mid-1994 were supplemented by an increase in the tax paid by Brazilian firms on bonds issued abroad, the imposition of a tax on foreigners' investment in the stock market, and an increase in the tax on foreign purchases of domestic fixed-income investments.

- In the Czech Republic, a large increase in capital inflows in 1994-1995 led initially to a policy of sterilization, but this was followed by the imposition of a tax at a rate of 0.25 per cent on foreign exchange transactions with banks, as well as by limits on, and a requirement of official approval for, short-term borrowing abroad by banks and other firms.

Evaluation of these controls suggests that in most cases they were effective to varying degrees: inflows significantly declined as a percentage of GDP after their imposition except in Brazil and Colombia, with short-term inflows actually becoming negative for a time in Chile and Malaysia; and in Chile and Colombia there was shift away from short-term in the composition of inflows.

This recent recourse to capital controls, sometimes for significant periods of time, has taken place in a context marked by international initiatives aimed at restricting countries' freedom to deploy such measures. A major target of these initiatives is the only global regime applying to such movements, that of the IMF.[52] The primary original aim of this regime with respect to such movements was the promotion of world trade and economic activity through the elimination of restrictions on current transactions. Freedom of capital movements was not a principle of the IMF's original Articles of Agreement. Indeed, under article VI, section 3, members are explicitly accorded the right to regulate international capital movements so long as the controls do not also restrict current transactions, and under article VI, section 1(a), resources from the Fund's General Resources Account are not to be used to finance a large or sustained outflow of capital.[53]

However, gradual relaxation of initial limitations on the IMF's involvement in the liberalization of capital transactions has been evident in a number of decisions and other changes since the late 1970s. In the amended version of the Articles of Agreement which took effect in 1978, article IV contains the statement that an essential purpose of the international monetary system is to provide a framework that facilitates the exchange of capital among countries. In April 1995 the list of developments that may trigger discussions between the Fund and a member country under IMF surveillance of exchange rate policies was extended to include "unsustainable flows of private capital".[54] In December 1997 approval was given to the establishment of the Supplemental Reserve Facility, under which financial assistance is extended to a country experiencing balance-of-payments difficulties due to sudden, disruptive

losses of market confidence which are reflected in pressures on its capital account and reserves. Lastly, under a current initiative approved by the Interim Committee the Fund's articles are to be amended to include the liberalization of capital movements amongst the organization's purposes and to provide a formal extension of its jurisdiction to such movements.[55]

If such an amendment is adopted, it is capable of having knock-on effects on other internationally agreed rules. For example, under the WTO agreements regulating trade in goods and services, when a country has recourse to restrictions to safeguard its balance of payments, these restrictions are to be consistent with its obligations under the IMF's Articles of Agreement, and the Fund has the role of assessing the restrictions' justification on the basis of the country's balance-of-payments and reserves position. The proposed extension of the Fund's formal jurisdiction to capital transactions might thus result in a reduction of countries' existing autonomy regarding control of capital transactions under the WTO regime.[56] But recent financial crises and the frequent recourse by countries to controls to contain the effects of swings in capital flows point to the case for continuing to accord governments such autonomy. The discussion in this chapter does not suggest that ways have yet been found at a global level to eliminate cross-border transmission of financial shocks associated with greater global financial integration or other pressures connected with capital movements which are capable of triggering financial crises. These weaknesses in the existing armoury of policy measures raise serious questions as to the appropriateness of current steps to promote the liberalization of capital movements as an international policy objective. Indeed, for the foreseeable future, flexibility rather than additional constraints or obligations would appear to be necessary.

6. Exchange rate policies

Questions about connections between exchange rate regimes and financial crises have been raised by the contribution of stable exchange rates (with their accompaniment of excessive short-term external borrowing and increased currency risk) to the build-up of financial fragility in East Asia, and by the role of the subsequent movements in exchange rates in triggering the crisis and spreading it throughout the region. The conclusion of the discussion which follows is that no regime is likely to provide foolproof protection against such crises. However, managed exchange rates, in combination with controls on capital transactions, can do much to prevent large swings in capital flows, thus making an important contribution to macroeconomic stability.

As described in box 2, at the outbreak of the crisis the East Asian economies most seriously affected, except Hong Kong, China, operated foreign exchange regimes under which the central bank intervened to stabilize the spot rate according to generally understood guidelines, while Hong Kong, China, had a currency-board arrangement. During 1990-1996 many East and South Asian countries were recipients of large capital inflows. Faced with such inflows, monetary authorities can either let the currency appreciate or intervene to prevent an appreciation, and most of the East Asian recipients chose the latter course.

The question has been posed whether freely floating exchange rates would have been preferable to the managed rates in force in several East and South Asian countries before the crisis. Floating rates in the early 1990s would probably have led to sharp appreciations in comparison with the levels actually observed, which would almost certainly have provoked stiff political resistance owing to their effects on exports. If freely floating exchange rates had brought about greater instability in relative rates, they might have discouraged arbitrage flows but also ultimately have threatened the pattern of relatively stable exchange rates which underpinned economic development in the region, and might have risked causing tensions in trading relations.

At the other extreme, the suggestion has been made that crises like the Asian one might be avoided by the establishment of currency-board systems involving exchange rates rigidly pegged to an anchor currency. Under such a system there is an unequivocal commitment to supply or redeem monetary liabilities of the monetary authority at a fixed rate. Moreover, these are the only terms on which such liabilities are exchanged. Two particularly well known systems of this kind are those of Argentina and Hong Kong, China, but a number of other countries, including some transition economies, also operate them. In their purest form currency boards cannot extend credit to the government, the banking system or other borrowers,

and interest rates are market-determined, the monetary base being rigidly linked to the country's foreign exchange reserves. These conditions do not hold strictly in so far as the currency board has external reserves in excess of the economy's monetary base (which has recently been the case, for example, in Hong Kong, China) or in so far as the legal framework permits some of the reserves backing the monetary base to be held in forms other than foreign currency (as in Argentina).

The benefits attributed by its advocates to a currency board include the credibility conferred by such a regime on the monetary authority and the elimination of the problems of external debt management which result from mismatches between the currency denomination of borrowings and that of revenues generated by the activities they finance. However, as recent experience demonstrates, such regimes do not insulate economies from instability of external origin since the impact of capital inflows and outflows is transmitted, via their effects on the monetary base, to levels of economic activity and to goods and asset prices. Moreover, in the absence of a lender of last resort, the contraction of deposits which typically follows capital outflows under such a system can threaten banking stability.[57] A currency-board system may serve an important purpose in certain circumstances, such as to halt hyperinflation. But the consequent reduction in policy autonomy means that such systems will remain acceptable and appropriate only for a small minority of countries.

There is thus no reason to condemn managed exchange rate regimes on the basis of recent experience (though their restoration in East and South Asian countries is impossible in the absence of a return to more orderly conditions in their currency markets). The alternatives of floating or rigidly fixed exchange rates can also impose costs which can outweigh their benefits. However, recent experience has also shown that managed exchange rate regimes are vulnerable to large accumulations of short-term external bank debt and of other potentially volatile external investment. Occasionally, introducing greater flexibility by widening the band of intervention could help to eliminate one-way bets and discourage arbitrage flows. But such regimes are likely to be sustainable only if accompanied by active management of external liabilities, which may often entail recourse to capital controls.

7. Regional consultation and collaboration

Regional economic arrangements often include modalities for mutual consultation and collaboration covering a broad range of subjects of economic policy. Among the aims of these modalities is frequently prevention of financial crises in member countries which might have unfavourable cross-border effects and thus prejudice achievement of the objectives of the arrangement concerned.

There is a comprehensive set of procedures of this kind for the European Union (EU), with the objective of ensuring that the functioning of the common market is not adversely affected by macroeconomic or financial developments in member States. The Treaty of Rome establishing the European Economic Community (Part Three – Title II, chapters 1-3) covered cooperation and consultation among members regarding monetary and other conjunctural policies as well as the balance of payments. Article 107, for example, enjoined members to treat exchange rate policies as a matter of common concern.[58] Furthermore, consultation and surveillance have been part of EU procedures for the provision to members of financial support for intervention in currency markets and for helping to solve balance-of-payments difficulties.

Collaboration and consultation at the regional level have also been proposed elsewhere for the purpose of helping to prevent financial crises, much of the impetus behind such initiatives coming from the objective of avoiding contagion effects. Some of the ideas put forward in this context involve mutual surveillance intended to help ensure that policies for economic and financial stability designed by the IMF are properly applied. But particular policies are not an integral part of regional collaboration and consultation in pursuit of financial stability. An ongoing initiative in ASEAN, for example, involves a mechanism for monitoring aspects of members' economic positions and policies in accordance with guidelines mutually agreed for this purpose.

Awareness among ASEAN members of the need for cooperation to prevent financial crises was already evident during the period before and leading up to the crisis. For example, at a meeting in March 1997 the ASEAN finance ministers acknowledged that a regional surveillance mecha-

nism might be established for this purpose. Two months later, pressure on the Thai baht prompted coordinated intervention by a number of Asian central banks in support of the currency. However, no such intervention took place at the time of the widespread abandonment of managed exchange rate regimes in July 1997, a fact which suggests a decision by governments that an attempt to defend exchange rates at that stage would have been too costly.

Nevertheless, consultations within ASEAN on mutual surveillance continued and at a meeting in December 1997 the ASEAN finance ministers recommended implementation of the proposal for the establishment of a regional surveillance mechanism, which has subsequently come to be known as the ASEAN Monitoring Mechanism. The function of the Monitoring Mechanism would be to help ASEAN governments to prevent future financial crises *inter alia* by serving as an early warning system which would enable corrective actions to be taken by individual countries or collectively and by protecting the region's interests during the process of global financial integration via examination of financial and monetary issues raised in international forums. This initiative responds to an urgently felt need among ASEAN members but might also eventually lead to the extension of such cooperation to other Asian countries. If in the future a decision were to be taken by ASEAN and possibly other East and South Asian countries to establish more formal arrangements for the provision of mutual external financial support than those deployed in May 1997 in defence of the baht (which might be similar to some of the EU facilities mentioned above), it would be possible to envisage a link between these arrangements and whatever surveillance mechanism is then in place. ■

Notes

1 This idea actually goes back to the Committee of Twenty. It was revived by the IMF in 1994, and elaborated in a paper by the management, "A short-term financing facility" (Washington, D.C.: IMF, September 1994). For discussions of the issues raised see E.V.K. Fitzgerald, "Intervention versus regulation: The role of the IMF in crisis prevention and management", *UNCTAD Review*, 1996; and J. Williamson, "A new facility for the IMF", in UNCTAD, *International Monetary and Financial Issues for the 1990s*, Vol. VI (United Nations publication, Sales No. E.96.II.D.7), New York and Geneva, 1995.

2 M. Feldstein, "Overdoing it in East Asia", *Foreign Affairs*, March/April 1998, p. 26.

3 *IMF Survey, Supplement on the IMF*, September 1996, p. 15.

4 *IMF Survey*, 12 January 1998, p. 7

5 *IMF Survey*, 20 March 1995, p. 86.

6 See, for example, A.J. Schwartz, "The world's Central Bank: Time to terminate the ESF and IMF" (Washington, D.C.: National Bureau of Economic Research, 1998), mimeo.

7 *TDR 1986*, annex to chapter VI.

8 See also J. Sachs, "External debt, structural adjustment and economic growth", in UNCTAD, *International Monetary and Financial Issues for the 1990s*, Vol. IX (United Nations publication, Sales No. E.98.II.D.3), New York and Geneva, 1998; and UNCTAD, *World Investment Report 1992*, box XI.1.

9 For a comparison between the United States, the United Kingdom and German bankruptcy codes see B. Eichengreen and R. Portes, *Crisis? What Crisis? Orderly Workouts for Sovereign Debtors* (London: Centre for Economic Policy Research, 1995); and J. Franks, "Some issues in sovereign debt and distressed reorganizations", *ibid.*, annex 2.

10 For such issues see D.M. Sassoon and D.D. Bradlow (eds.), *Judicial Enforcement of International Debt Obligations* (Washington, D.C.: International Law Institute, 1987).

11 This was also the case in Mexico during 1994-1995 when the Government was solvent, in the sense that it could repay all the outstanding holders of dollar-linked *tesebonos* in pesos, but the contract bank did not have sufficient reserves to allow these holders to convert the pesos into dollars.

12 See L. Nurick, "The International Monetary Fund Articles of Agreement", in Sassoon and Bradlow (eds.), *op. cit.*; and Eichengreen and Portes, *op. cit.*

13 For a number of rulings based on such an interpretation see Nurick, *op. cit.*, pp. 111-113.

14 *International Capital markets. Developments, Prospects, and Policy Issues* (Washington, D.C.: IMF, 1995), p. 11.

15 *Ibid.*, p. 11.

16 This suggestion has been put forward by K. Raffer. See his "Applying chapter 9 insolvency to international debts: An economically efficient solution with a human face", *World Development*, Vol. 18, No. 2, 1990.

17 Sachs, *op. cit.*, p. 52.

18 Eichengreen and Portes, *op. cit*., pp. 49-50.

19 For a discussion of these objections see Eichengreen and Portes, *op. cit*., pp. 43-44; and Raffer, *op. cit.*

20 One of the best-known cases is the Chilean debt crisis of the early 1980s, resulting from the so-called Southern Cone experiment with liberalization. A very large part of Chile's external debt during the late 1970s and early 1980s was accumulated by private banks and corporations and without government guarantees. "Those private debts have been included in debt rescheduling being negotiated between the Chilean state and the foreign bank advisory committee for Chile. Apparently the Chilean government caved in under pressure from the bank advisory committee ... To make their viewpoint absolutely clear, foreign banks apparently tightened up their granting of very short-term commercial credits to Chile during the first quarter of 1983, a technique reportedly used with some success 10 years earlier vis-à-vis the same country. The International Monetary Fund, also active in the debt rescheduling exercise, has not publicly objected to this threat" (C. Diaz Alejandro, "Good-bye financial repression, hello financial crash", *Journal of Development Economics*, Vol. 19, No. 1/2, September-October 1985, p. 12).

21 From the ruling of the New York Court of Appeals in the Costa Rican case of 1984.

22 See *TDR 1986.*

23 G.A. Calvo, "The management of capital flows: Domestic policy and international cooperation", in UNCTAD, *International Monetary and Financial Issues for the 1990s*, Vol. IV (UNCTAD/GID/G24/4), New York, 1994.

24 Executive Board Decision No. 5392-(77/63) of 29 April 1977.

25 Group of Ten, "The functioning of the international monetary system", a report to the Ministers and Governors by the Group of Deputies (Washington, D.C., June 1985), para. 40. For further discussion see J. Williamson and M. Gavin, "International monetary issues in 1985", and Y. Akyüz and S. Dell, "Issues in international monetary reform", both in UNCTAD, *International Monetary and Financial Issues for the Developing Countries* (United Nations publication, Sales No. E.87.II.D.3), New York and Geneva, 1987.

26 During relatively short periods a country's real effective exchange rate can vary by amounts which are large in percentage terms in comparison with its average tariff level, and the resulting changes, even away from the equilibrium level of the country's exchange rate, may persist for some time. Thus the economic impact of movements in exchange rates can substantially exceed that of multilaterally agreed tariff changes, even though the estimated elasticities of trade flows with respect to tariff changes are considerably higher than those with respect to variations in exchange rates; see for example C.F. Bergsten and J. Williamson, "Exchange rates and trade policy", in W. Cline (ed.), *Trade Policy in the 1980s* (Washington, D.C.: Institute for International Economics, 1983).

27 Interim Committee Communiqué of 16 April 1998.

28 There has been much recent econometric analysis of the determinants of currency and banking crises as part of attempts to develop leading indicators of them. While this work has served to clarify the issues involved in the development of such indicators, substantial reliance on them for forecasting financial crises under global surveillance seems unlikely (as indeed is their replacement of existing quantitative and qualitative, if more ad hoc, indicators currently used by banking supervisors and financial analysts in investment banks). Efforts so far have produced indicators which significantly over-predict banking crises. For a brief discussion of these issues see M. Goldstein, "Early warning indicators of currency and banking crises in emerging economies", in *Financial Crises and Asia*, CEPR Conference Report No. 6 (London: Centre for Economic Policy Research, 1998).

29 Credit risk results from the possibility that a bank's counterparty will default on its obligations, and market risk is that of loss due to changes in the market value of a bank's asset before it can be liquidated or offset in some way.

30 For example, William McDonough, President of the Federal Reserve Bank of New York, has made this point as follows: "... formerly, you could look at the balance sheet of a financial institution and quickly get a sense of exposure and risks. Today balance sheet information is clearly inadequate for this purpose ... the fast pace of activity in today's market renders financial statements stale almost before they can be prepared". See J.A. Leach, W.J. McDonough, D.W. Mullins and B. Quinn, "Global derivatives: Public sector responses", Occasional Paper No. 44 (Washington, D.C.: Group of Thirty, 1993), pp. 15-16.

31 R. Dale, *The Regulation of International Banking* (Cambridge: Woodhead-Faulkner, 1984), p. 83. The author's argument concerns crises in international bank lending but could easily be extended to financial crises more generally.

32 See, for example, M. Goldstein, "The case for an international banking standard", in *Policy Analyses in International Economics*, No. 47 (Washington, D.C.: Institute for International Economics, 1997), p. 33.

33 See M. Goldstein and P. Turner, "Banking crises in emerging economies: Origins and policy options", BIS Economic Paper No. 46 (Basle: BIS, 1996), pp. 9-14.

34 The nature of these guarantees has been well described in a recent book on the Asian financial crisis

as follows: "In every economy, public authorities stand behind the *viability of their domestic financial system* ... This cannot be interpreted as a market distortion; it is a feature of a capitalist economy, in which markets for financial assets are an indispensable feature. These markets, however, cannot be liberalized in the same manner as one would a goods market ... This creates at least an implicit, if not explicit, guarantee that monetary authorities stand behind the foreign liabilities of, as a minimum, the explicitly supervised part of their financial system". M.F. Montes, *The Currency Crisis in Southeast Asia*, updated edition (Singapore: Institute of Southeast Asian Studies, 1998), p. 26.

35 For a survey of proposals generated by that crisis see D.F. Lomax, *The Developing Country Debt Crisis* (London: Macmillan, 1986), pp. 255-280.

36 H. Kaufman, "Ten reasons to reform", *Euromoney*, November 1992, p. 57. Kaufman has returned to this proposal since the outbreak of the Asian crisis, for example in his speaking notes for the Extraordinary Ministerial Meeting of the Group of 24 in Caracas in February 1998.

37 G. Soros, "Avoiding a breakdown", *Financial Times*, 31 December 1997 and 1 January 1998.

38 The Multilateral Investment Guarantee Agency (MIGA), an affiliate of the World Bank, provides insurance against certain risks (such as transfer risks) associated with foreign investment and selected other international transactions, including loans linked to insured investments. There is some overlap between its insurance facilities and those of national export credit agencies, but the coverage of risks connected with international lending by the latter is generally more extensive and thus more suitable as a model for an ICIC.

39 See, for example, S. Irvine, "Rating agencies: Caught with their pants down", *Euromoney*, January 1998.

40 It should be noted, however, that contagion effects of the kind witnessed during recent crises in emerging financial markets, which from the point of view of insurance bear some resemblance to natural catastrophes, would complicate the task of setting the premiums which would be charged by the ICIC. The majority of the ECAs of OECD countries experienced long series of cash-flow deficits on their operations after the developing-country crisis of the 1980s.

41 It has been suggested by M. Mayer that "the international community needs some sort of registry that would call attention to any bank's or national banking system's continuing increase in short-term borrowings from financial firms". For most firms which are significant participants in international financial markets such information exists at national level (though for a market such as that for inter-bank transactions, which operates on a continuous basis, the choice of the time at which inter-bank positions must be disclosed may not be easy). See M. Mayer, "The Asian disease: Plausible diagnoses, possible remedies", Jerome Levy Economics Institute Working Paper No. 232 (Annandale-on-Hudson, New York, April 1998), pp. 31-32.

42 As reported in an editorial in the *Financial Times*, 11 May 1998.

43 These tendencies have been especially evident in banks' Eurocurrency operations. Traditionally, such operations were defined as those in currencies other than the currency of the country of domicile of the participating bank (originally mainly United States dollars but subsequently also those of other major OECD countries). But with the establishment of international banking facilities (IBF) in the United States and Japan the definition has been extended to specified transactions of banks in their domestic currencies, mainly with non-residents or in connection with international activities, subject to a regulatory regime similar to that for traditional Eurocurrency operations. These regimes are generally characterized by lighter regulation than those for domestic banking (though recent deregulation has led to a reduction in these divergences), and they have often also benefited from tax advantages.

44 See S. Griffith-Jones, "Regulatory challenges for source countries of surges in capital flows", in J.J. Teunissen (ed.), *The Policy Challenges of Global Financial Integration* (The Hague: Fondad, 1998). As set out there, the proposal is characterized by the somewhat unfortunate term "prudential capital charge" for the liquid reserve requirements of mutual funds, institutions whose liabilities consist of shareholder capital.

45 This idea was broached in A. Cornford and J. Kregel, "Globalization, capital flows and international regulation", Jerome Levy Economics Institute Working Paper No. 161 (Annandale-on-Hudson, New York, May 1996), p. 29. For more detail on the exit fees of mutual funds see J.C. Bogle, *Bogle on Mutual Funds* (Burr Ridge, Illinois: Irwin, 1994), pp. 193-194.

46 The situation is further complicated by derivatives. Recent innovations have increasingly made possible the engineering of "synthetic" financial instruments and portfolios with cash flows through time that match those of more traditional assets. As a result, if a government wishes to target certain traditional assets in controlling capital movements, it may need to expand the scope of its action to "synthetic" instruments or portfolios.

47 This tax is sometimes referred to as an "interest equalization tax". The original tax so designated was imposed by the United States on foreign lending, initially in 1964 on foreign securities with a maturity of more than three years and subsequently, in 1965, extended to bank loans.

48 Accounts denominated in foreign currencies are available in the East Asian countries most affected by the crisis, in most cases subject to only limited restrictions. But in most OECD countries such availability is a relatively recent development associated

with the more general liberalization of capital transactions. As late as the mid-1980s such accounts were still not permitted in some instances.

49 Concerning the origins of offshore banking in Singapore see M. Ishihara and H.C. Kim, "Financial system of Singapore", in R.C. Effros (ed.), *Emerging Financial Centres* (Washington, D.C.: IMF, 1982). For more recent developments the discussion in the text relies on an unpublished paper by M.F. Montes and T.K. Giap.

50 The account which follows of capital controls in selected developing countries relies heavily on an unpublished paper by C.M. Reinhart and R.T. Smith, "Temporary capital controls", August 1997 (mimeo); and on V.G. Le Fort and C.L. Budnevich, "Capital-account regulations and macroeconomic policy: Two Latin American experiences", in UNCTAD, *International Monetary and Financial Issues for the 1990s,* Vol. VII (United Nations publication, Sales No. E.97.II.D.5), New York and Geneva, 1997.

51 An outright forward exchange transaction involves an agreement between two parties to exchange currencies after a period of more than two days hence, while a foreign exchange swap has two separate legs, one consisting of the sale or purchase of a foreign currency and the other of a repurchase or resale of the currency at a subsequent date (thus reversing the first leg).

52 Developed countries are also subject to obligations in this area under the OECD Code of Liberalization of Capital Movements and (for members of the EU) under the EEC Council's 1988 Directive on capital movements and the Maastricht Treaty. Some developing countries have undertaken such obligations as part of treaties of friendship, commerce and navigation or of regional agreements such as the North American Free Trade Agreement (NAFTA).

53 This restriction does not necessarily apply to the IMF's special facilities, which use borrowed resources.

54 IMF Executive Board Decision No. 10950-(95/37) of 10 April 1995 (amending Decision No. 5392-[77/63] of 29 April 1977).

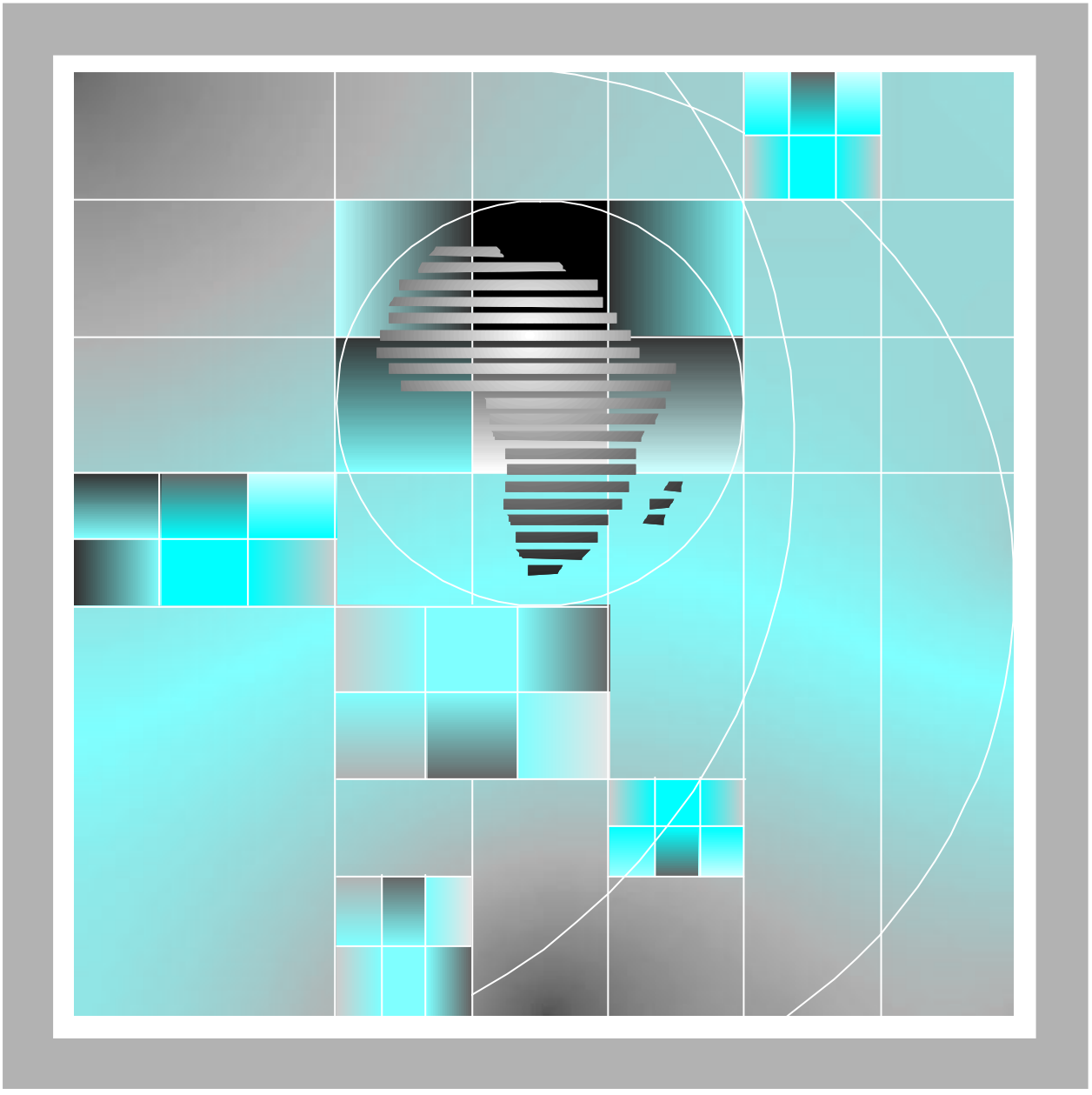
55 The financial rescue package presented by the IMF to the Government of the Republic of Korea contained conditions relating to the liberalization of capital transactions.

56 For further discussion see A. Cornford and J. Brandon, "The WTO agreement on financial services: Problems of financial globalization in practice", section E, in UNCTAD, *International Monetary and Financial Issues for the 1990s*, Vol. X (forthcoming).

57 With the objective of avoiding another liquidity squeeze like that experienced owing to capital outflows in the aftermath of the Mexican crisis in 1995, Argentina has arranged a stand-by financing facility from private international banks for use in the event of the resumption of such outflows.

58 These articles were amended by the Maastricht Treaty, which provided for the establishment of Economic and Monetary Union.

AFRICAN DEVELOPMENT IN A COMPARATIVE PERSPECTIVE



Introduction

After about a decade of relatively satisfactory growth, economic performance worsened in most countries in sub-Saharan Africa (SSA)* in the second half of the 1970s; with few exceptions, the region as a whole experienced thereafter two decades of almost continuous economic decline. Since the early 1980s, many countries have adopted economic policy reforms under structural adjustment programmes sponsored by the Bretton Woods institutions. Emphasis has been placed on a reduced role for the State, greater reliance on market forces and a rapid opening up to international competition as the keys to unlocking Africa's growth potential. However, despite many years of policy reform, hardly any country in the region has successfully completed its adjustment programme with a return to sustained growth.

The recovery that began in 1994, with per capita income rising by about 1 per cent per annum in the subsequent three years, has given grounds for renewed optimism. Indeed, policy efforts may have been able to arrest Africa's long-standing economic decline, and the medium-term prospects may not be as bleak as the performance over the past two decades. However, during the past three years, only a few countries have been able to sustain growth rates reaching or surpassing the 6 per cent target set by the United Nations New Agenda for the Development of Africa in the 1990s. Moreover, the recovery is not underpinned by a strong investment performance. Rather, it reflects a greater utilization of existing capacity and owes much to what appears to be a temporary upswing in commodity prices. Even if the growth of the past three years could be sustained in the coming decade, that would not reverse the marginalization of the region or have much of an effect on widespread poverty, and would constitute little more than the recovery of ground lost during the past 20 years.

A bold vision is now needed for African economic development, involving a comprehensive reassessment of international and domestic policy approaches in order to translate the current recovery into stronger and sustained growth. This Report makes an initial attempt in that direction.

At the international level, the Report emphasizes a rapid removal of the debt overhang as the single most important step that should be taken. While representing an important departure in terms of its coverage, the HIPC Initiative needs significant revision if it is to help decisively in establishing the conditions for rapid and sustained growth.

However, increasing net resource transfers through debt relief will not succeed unless it is accompanied by appropriate domestic policies designed to break out of the vicious circle of low productivity and heavy dependence on a small number of primary commodities prevailing in a large majority of African economies. Such a structural change calls for a considerably higher rate of investment than has so far been achieved, in both primary and secondary industries and by both the public and the private sector. Although there is a growing consensus on this point, the Report suggests that the current approach to structural adjustment is unlikely to achieve such an outcome.

While it is recognized that structural constraints and institutional weaknesses prevent an efficient functioning of markets, in practice these obstacles are often neglected, and policies are designed to get the prices "right" in economies characterized by the total absence of markets or their imperfection. Furthermore, there is also often no proper sequencing of liberalization of product and factor markets with the institutional reforms needed for its success. Consequently, liberaliza-

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* In this Part the term "North Africa" denotes Algeria, Egypt, Libyan Arab Jamahiriya, Morocco and Tunisia. The term "sub-Saharan Africa" (and the abbreviation "SSA") refers to the rest of Africa, other than South Africa, unless otherwise specified.

tion often leads to greater instability and fails to generate appropriate incentives, while structural constraints and institutional weaknesses prevent incentives from being translated into a vigorous supply response through new investment for the expansion and rationalization of productive capacity.

A new policy orientation is now needed that recognizes and addresses directly the structural constraints and institutional hiatus in the African economies. In identifying these impediments and the policies needed to overcome them, the Report places the African experience in a comparative perspective and draws on successful development experiences elsewhere. It focuses on capital accumulation and on nurturing and building the institutions needed for an efficient market economy, including a dynamic indigenous entrepreneurial class.

It is argued that to achieve the required structural change accumulation needs to be linked to trade so as to enhance productive capacity, efficiency and competitiveness. In this respect, the existence of ample unexploited opportunities in primary sectors gives reasonable grounds for optimism. Realizing this potential will provide the focus for initial policy efforts in many countries, since increasing productivity and output in the primary sector is essential for generating investable resources needed for structural change. The successful experiences of resource-rich countries show that policy requirements at early stages of export promotion are relatively less demanding and can yield rapid results. A number of such countries in East Asia and Latin America have managed to initiate strong and sustained export and economic growth based on primary sectors, after many years of stagnation and instability, and not always starting from better initial conditions than those currently prevailing in Africa.

Chapter I briefly reviews the African growth experience during the past three decades and examines prospects over the medium term. While recognizing the importance of domestic policies, the chapter stresses the role of the external environment in shaping the economic performance. It is argued that the mainstream assessment of prospects for Africa is based on faith in growth-enhancing market forces, rather than on a careful examination of constraints and opportunities. Also, such an assessment serves to underestimate the importance of removing the debt overhang in initiating a self-sustaining process of growth.

Chapter II discusses the structure and performance of African agriculture. While there has been some improvement in agricultural performance over the past decade, undercapitalization, including inadequate public investment, remains the principal obstacle to sustained agricultural development. Chapter III examines agricultural policy reforms and supply behaviour. The evidence presented strongly suggests that the assumptions about the taxation of agricultural producers through pricing policies in the 1970s, which underlie the subsequent reforms are not entirely valid. Rather than generating the desired incentives, the recent emphasis on liberalization and dismantling of marketing boards has tended to exacerbate the institutional hiatus, since private institutions are generally unable to take up many of the functions previously performed by marketing boards.

Chapter IV deals with trade, accumulation and industry. It argues that the marginalization of SSA in world trade is a reflection of its failure to expand its productive capacity, rather than a consequence of its resistance to openness. The conventional emphasis on trade, as opposed to investment and accumulation, is thus misplaced. The chapter goes on to examine the composition of African trade, in terms of the relative importance of primary products and manufactures. Although some countries appear to be underperforming in exports of manufactures compared to their capacity, for most countries in the region the challenge is to increase total exports while diversifying their composition in favour of more dynamic and high-value-added products. Intraregional trade offers important opportunities in this respect.

Chapter V considers the domestic policy options open to governments and the institutional reforms that need to be pursued to create a pro-investment climate and reinvigorate growth. It attempts to identify the principal weaknesses of financial, trade and agricultural policies and their effects on stability, private incentives and public investment, and discusses alternative policy options. The purpose is not to offer a recipe that works under all circumstances, but to highlight the kind of approach that could be adopted when some of the more important agents and institutions of a modern market economy are underdeveloped or missing. The chapter ends with a discussion of policy challenges to be met in filling the institutional hiatus in Africa. ■

Chapter I

GROWTH AND DEVELOPMENT IN AFRICA: TRENDS AND PROSPECTS

A. Post-independence take-off

It has become increasingly common to describe Africa as a continent of missed growth opportunities, subjected to heavy-handed state interventions and misguided, inward-looking development strategies from which it is only now escaping. The historical record is not so simple. The conventional account downplays the challenges that faced many African countries at independence and overlooks the respectable, and for some countries spectacular, growth rates achieved immediately after independence. Nor is it always appreciated that Africa's integration into the world economy has been long and close, albeit shaped in large part by colonial ties and legacies.

Although there were considerable differences in initial conditions and income levels in African countries at independence, in almost all cases little had been done to create the necessary conditions for national economic development, including in particular physical infrastructure and sufficient educational opportunities. The main positive colonial legacy was the development of primary export sectors which appeared to offer strong growth potential.

Set against the very high expectations of the newly independent African States, the practical difficulties of building vibrant national economies and the problems posed by demographic transition, Africa's growth performance was quite strong from the mid-1960s until the first oil shock.[1] Although GDP growth in sub-Saharan Africa was faster than in the 1950s under colonial rule, averaging an annual rate of 4.5 per cent or more than 1 per cent per capita, it was lower than in other developing regions, with the exception of South Asia, during the same period.

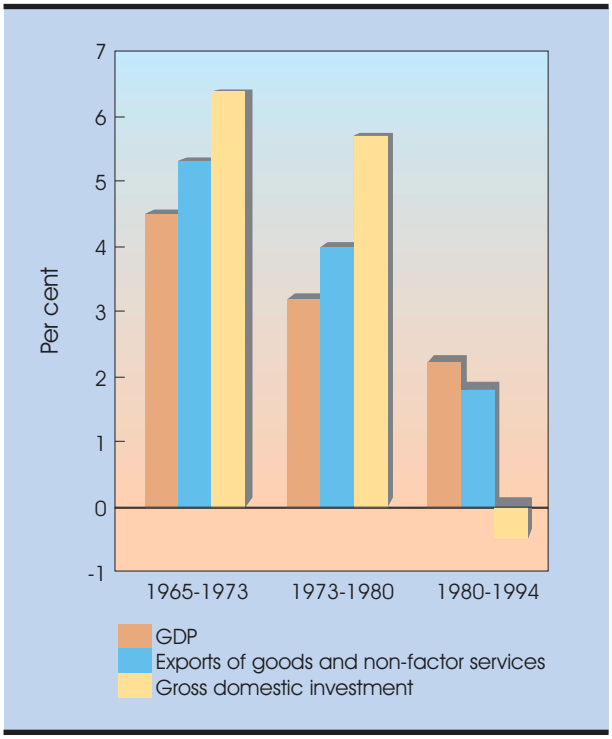
There were, however, considerable differences in growth among SSA countries, with average rates ranging from 0.5 per cent per annum (in Chad) to 14.7 per cent per annum (in Botswana). Many of the countries that performed least well after independence were ones that suffered years of civil turmoil. Others experiencing stagnation included those lacking natural resources in demand in the developed countries, and countries that were landlocked and did not have adequate transport links and port arrangements with neighbouring countries. On the other hand, a group of star performers emerged during this period with growth rates comparable to those of the best-performing economies elsewhere in the developing world. In this group of eight countries six achieved growth in excess of 8 per cent per annum (Botswana, Burundi, Côte d'Ivoire, Kenya, Nigeria and Zimbabwe) and two had growth rates of more than 6 per cent (Congo and Gabon).

This post-colonial growth was driven by a strong investment performance. On average, investment in SSA grew in volume by 6.4 per cent annually during 1965-1973 (chart 3). Investment shares were rising steadily everywhere, from less than 14 per cent of GDP in 1965 to over 18 per cent in 1973 for the region as a whole, and exceeding 20 per cent in many countries as protectionist

Chart 3

AVERAGE REAL GROWTH RATES OF GDP, EXPORTS, AND INVESTMENT IN SUB-SAHARAN AFRICA, 1965-1994

(Per cent per annum)



Source: UNCTAD secretariat calculations, based on World Bank, *Trends in Developing Economies 1990* (Washington, D.C., 1990); and World Bank, *World Development Report 1996* (Washington, D.C., 1996).

Note: The figures underlying the chart are unweighted averages.

barriers increased average returns on investment. In agriculture, investment in the cultivation of new land helped to increase output. In most cases, public sector investment played a leading role in the accumulation process, made possible both by development aid and by a growing revenue base.

Before independence, foreign direct investment (FDI) had been limited mainly to minerals and oil extraction, and in some cases to the production of wage goods such as beverages and textiles. This pattern continued after independence, albeit with a growing enthusiasm to attract FDI into infant industries by using various incentives, including import protection. The stock of FDI doubled between 1960 and 1970, and as a percentage of GDP was in fact twice the amount directed to East and South-East Asia at the time.[2]

It has become fashionable to dismiss Africa's post-independence performance on the grounds that it was accompanied by only weak integration into the world economy. This is a partial assessment. The colonial experience had led policymakers in Africa, as elsewhere, to adopt a cautious approach to integration into the world economy. Nevertheless, most post-colonial economic strategies accepted that Africa's growth prospects lay in exploiting its comparative advantage in natural resources, on which basis it could begin to industrialize and diversify its exports. Moreover, and contrary to accounts that assume a radical policy shift in the early years of independence, this starting point coincided in many cases with the establishment of institutions and structures towards the end of the colonial era, such as export marketing boards, multi-purpose state development corporations and import-substitution measures.[3]

Between 1965 and 1973 export revenues in SSA grew very strongly, averaging over 15 per cent per annum. Export volumes rose with rapid growth in key commodities such as tea, coffee and cocoa, and were helped by preferential treatment of exports by the former colonial powers. Moreover, the earlier trend of falling terms of trade came to a halt in 1965 and the share of exports in GDP grew steadily for most countries after independence. Increasing export revenues eased the foreign-exchange constraint in the non-CFA countries, and whilst import volumes grew more slowly than exports in this period, the share of imports in GNP remained high.

Faced with small domestic markets and restrictive colonial trading legacies, some African countries sought to create new regional trade arrangements or to strengthen existing ones. However, different initial conditions among members often led to tensions (as in East Africa), and more generally such arrangements were constrained by the export composition of most African economies, and by infrastructural weaknesses. Consequently, the share of regional trade in total external trade stagnated at around 5 per cent, and more than half of SSA's external trade continued to be conducted with Europe.[4]

The rhetoric of the post-independence economic strategy emphasized structural change away from dependence on primary sector employment and traditional exports. However, even as growth accelerated, the pace and pattern of structural change in many African economies lagged behind.

Box 5

NURTURING INDIGENOUS CAPITALISM IN SUB-SAHARAN AFRICA

Compared with other developing regions, indigenous capitalism developed late in SSA.[1] During the colonial period, little industrial investment took place that could have been a threat to foreign enterprises. Most manufacturing was in small-scale, light-industry consumer goods such as soap, beverages, textiles, footwear and furniture. Apart from isolated cases such as that of Kano in northern Nigeria, Africans owned very few of even these small enterprises. Indigenous entrepreneurs were largely relegated to artisanship and commercial activities in the informal sector. In the years leading up to independence, colonial businessmen in many cases sought to avoid expropriation by entering into partnership arrangements with African entrepreneurs.

As for the rural areas, the best land had been alienated to colonial settlers. Indigenous rural capitalism was discouraged by the colonial authorities, which preferred cooperating (through marketing boards) with small African cocoa and coffee producers with limited bargaining power. Other factors that conspired to discourage large-farm capitalism were the region's abundant land, which limited the number of landless labourers available to work for wages on large farms, and property systems that were based on traditional rather than freehold forms of tenure. Only starting in the 1950s did the colonial countries encourage the emergence of African agricultural capitalism as part of their effort to secure national successors for continuing production and export of those primary commodities that the metropolitan countries needed. Agricultural capitalism took root in those pre-independence years among, for example, the Bugandan producers of coffee in Uganda, the Yoruba cocoa farmers of Nigeria and the Kikuyu cash-crop growers of Kenya.

After independence, African farmers continued the process of accumulation in the countryside, but part of the rural surplus was channelled into urban property, and much of it was taxed to help finance government investments. In some cases, as in Côte d'Ivoire, the new land-based capitalists included many Africans holding high political and administrative positions after independence.

As for town-based investments, African civil servants were sometimes able to obtain loans to invest in urban businesses, but such credits were generally more easily available for investment in land and property, which, given the region's rapid urbanization, provided attractive and reasonably secure returns. Most private urban businesses and industries, therefore, were launched by African small-scale entrepreneurs with initial capital from private savings or relatives, and further capital for expansion coming mainly from reinvested profits. Many of these enterprises, however, found it difficult to compete with local subsidiaries of TNCs with superior access to imported technology. Also, indigenous capitalists were sometimes discriminated against by their governments, as when special privileges such as tax exemptions were conferred on foreign interests, or when large public enterprises were established with the aim of rapidly increasing the pace of industrialization and growth. Indeed, upon independence only a few countries, such as Kenya and Nigeria, nurtured indigenous capitalists as a primary vehicle for capital accumulation, modernization and economic growth. However, even under the best conditions it proved difficult for them to make the leap from micro- and small-scale to medium- and large-scale entrepreneurship in manufacturing. The principal constraints were high costs due to unreliable supplies, inadequate infrastructure and deficient human resources, as well as limited demand due to small market sizes.

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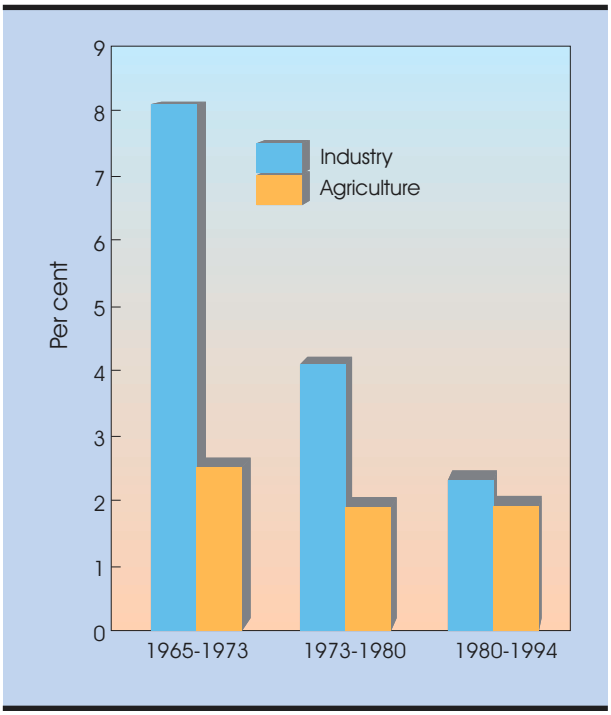
[1] For a more detailed account of the history of capitalist development in sub-Saharan Africa, see J. Iliffe, *The Emergence of African Capitalism* (Minneapolis: University of Minnesota Press, 1983).

Industry was the fastest-growing sector, thanks in large part to mining and transportation. Manufacturing activity grew by a robust 7.3 per cent per annum during 1965-1973, but in most cases from a very low starting point. By 1973, in only one country (Zimbabwe) was more than 20 per cent of output generated by manufacturing; in the large majority of countries the proportion was less than 10 per cent. However, in some countries, including Côte d'Ivoire, Kenya and Nigeria, robust infant industries emerged during this period. In some instances, private entrepreneurs were prominent in this early industrialization drive, but in most cases the State took the lead (see box 5).

Chart 4

GROWTH IN INDUSTRY AND AGRICULTURE IN SUB-SAHARAN AFRICA, 1965-1994

(Per cent per annum)



Source: See chart 3.
Note: See chart 3.

Despite these desirable structural shifts, a process of "positive" de-agrarianization did not begin in most African economies during this period. Growth of agricultural value-added in SSA was generally very weak, averaging only 2.5 per cent per annum (chart 4). This rate was much lower than in other developing regions, and in many countries agricultural growth did not keep up with population increases. While there was an expansion in the cultivated land area during this period, private and public investment was not forthcoming on a scale needed to transform the technological profile of agricultural production and to enhance productivity growth. Consequently, export expansion was in most cases based on very traditional commodities with little diversification, either vertically towards processed commodities and manufactures, or horizontally within the primary sector.[5]

In the light of these broad developments it is interesting to consider trends during this period in the group of star performers mentioned above. Investment took the lead in most cases, often linked to strong export performance. Even when export growth was relatively slow, as in Kenya, the countries concerned were often starting from a high level. In all these countries, an emerging investment-export nexus was linked both to a shift towards industrial activity, with an average rise in output of 11 per cent per annum compared with 7 per cent for SSA as a whole, and to strong agricultural growth, averaging close to 7 per cent per annum compared with only 2.5 per cent for the SSA average. Nevertheless, even for these star performers export diversification was quite limited.

B. Faltering growth in the 1970s

The 1973 oil price increase and the subsequent slowdown of growth in the developed world had a particularly adverse impact on Africa, except for a few oil exporters, since exposure and vulnerability to external influences were greater than in other developing regions. Indeed, countries registering a break in growth performance between 1973 and 1980 were far more numerous than in other developing regions, where the break came primarily in the early 1980s.[6] With population growth still accelerating, this meant a fairly significant drop in average per capita growth rates in Africa, from 1.2 per cent per annum in the previous period to 0.7 per cent per annum. Moreover, almost half the countries in Africa actually experienced negative per capita growth rates in this period.

Two persistent features characterized African growth performance in the 1970s: increased diversity among economies and lack of continuity in growth. Variations among countries' growth rates increased significantly compared with the previous period, with declines in output reaching as much as 7 per cent per annum in some countries while other countries were growing at 10 per cent per annum. The lack of continuity resulted from the weakening performance of earlier star performers. Significantly slower growth occurred in all these economies, but the weakening of growth in some of the larger countries, which had grown strongly in the earlier period, was of particular importance. On the other hand, many smaller African countries witnessed a dramatic revival of growth.

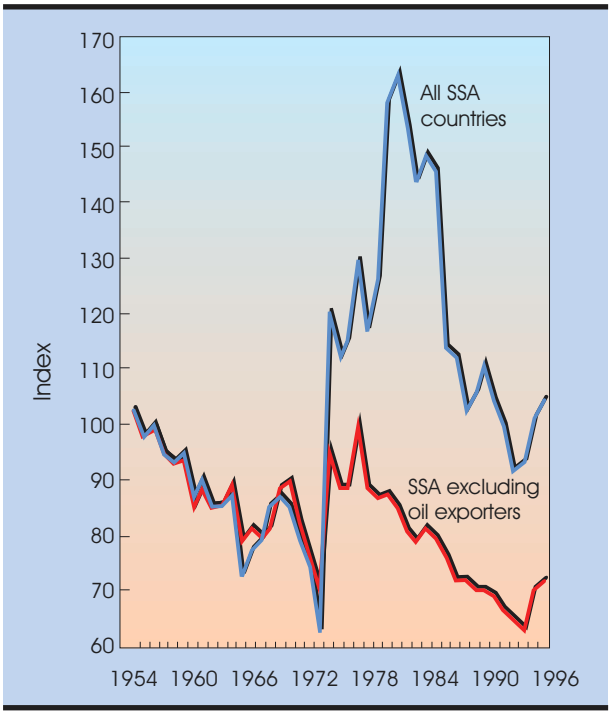
The slowdown reflected a continued deterioration in agriculture, where the average growth rate for SSA as a whole fell from 2.5 per cent in the previous period to below 2 per cent during 1973-1980, failing to keep pace with population growth (chart 4). More significantly, industrial growth was halved compared with 1965-1973, and there was a sharp deceleration in manufacturing growth, which fell to 3 per cent per annum for the region as a whole. While a number of countries achieved high rates of growth in manufacturing during this period many countries, including Zimbabwe (which had been among the star performers in the previous period), experienced negative manufacturing growth, whereas in no country had manufacturing output declined in the earlier period.

There was a significant volatility of growth rates from year to year that tended to coincide with fluctuations in countries' external terms of trade (chart 5). These fluctuations reflected not only the negative effects on most SSA countries of the 1973 oil price shock and the recession that followed in the developed countries, but also the short-lived boom that resulted from the rebound in world prices for a number of non-oil primary exports in 1976. While a large majority of SSA countries were hurt by the 1973 oil shock, oil-exporting countries such as Gabon and Nigeria benefited substantially from the 1973 windfall, although their growth subsequently contracted when oil prices declined during 1977-1979. For the non-oil-exporting countries in the region, export volumes, which had been increasing almost constantly for two decades, peaked in 1973 and showed a slight downward trend during the rest of the 1970s. Despite rising nominal prices of a number of non-oil commodities, export earnings

Chart 5

TERMS OF TRADE OF SUB-SAHARAN AFRICA, 1954-1996

(Index numbers, 1954-1956 = 100)



Source: UNCTAD, *Handbook of International Trade and Development Statistics*, various issues.

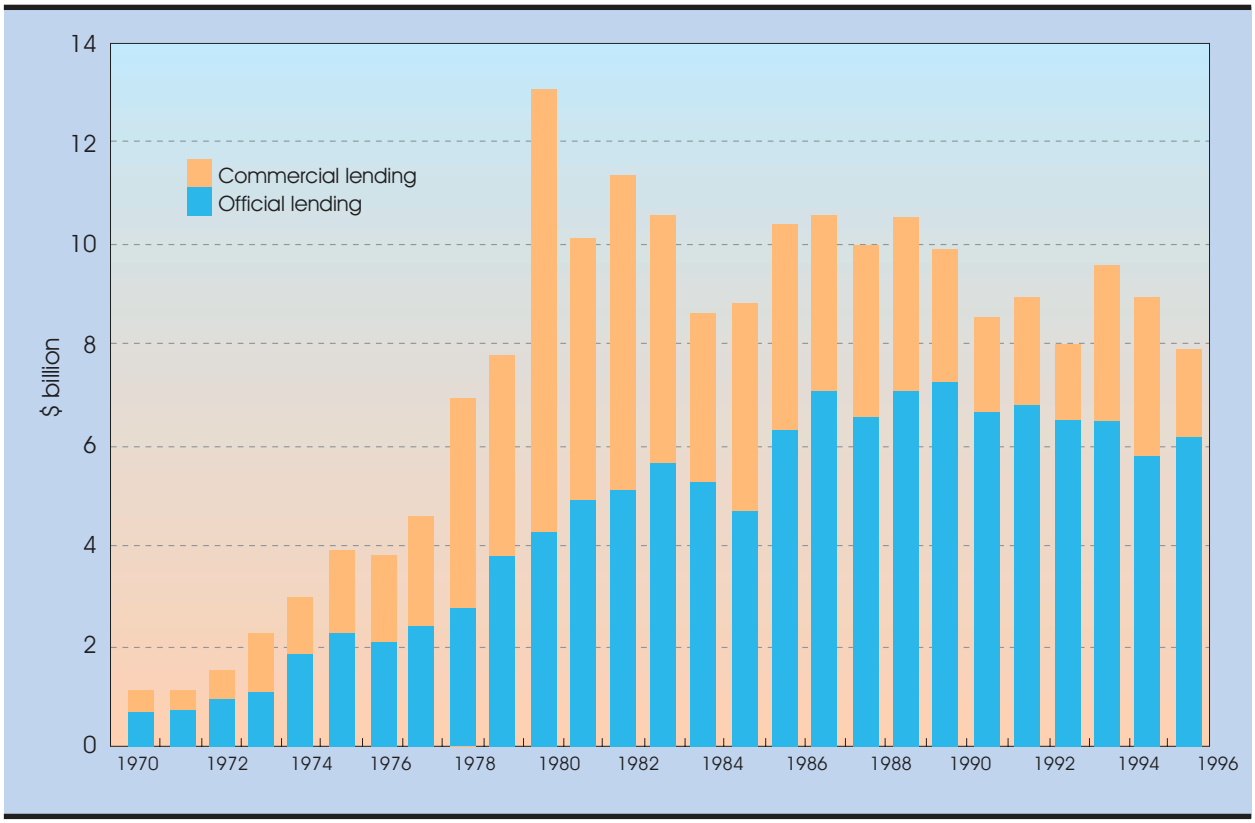
slowed down, growing at an average rate of 4 per cent per annum during 1973-1980. However, as import prices rose dramatically because of oil and accelerating inflation in the industrialized countries, the purchasing power of the non-oil countries' exports stagnated in the mid-1970s, whereas that of the oil exporters increased sharply.

In the 1970s many SSA countries benefited from the expansion of international bank lending to developing countries. Initially, this expansion improved the access to international finance for a number of countries, and some countries, notably the oil exporters, used such lending to finance additional import growth. From 1976 onwards, however, bank lending was increasingly used to compensate export shortfalls due to terms-of-trade losses and declines in the purchasing power of exports in non-oil countries. Net new long-term borrowing by SSA from all sources rose from $3 billion in 1976 to $11.5 billion in 1980. The share of long-term commercial bank lending in total disbursements increased rapidly, accounting for more

Chart 6

DISBURSEMENTS ON LONG-TERM DEBT TO SUB-SAHARAN AFRICA, 1970-1996, BY SOURCE OF LENDING

(Billions of dollars)



Source: World Bank, *Global Development Finance 1997* (Washington, D.C., 1997).
Note: Figures are for public and publicly guaranteed debt.

than two-thirds of the total borrowing at the end of the decade (chart 6). The major borrowers from this source were Cameroon, Côte d'Ivoire, the Democratic Republic of the Congo, Gabon, Kenya and Nigeria. Short-term lending to SSA also rose dramatically, from $2.5 billion in 1976 to $22.6 billion in 1980.

This increase in international private lending to SSA coincided with sharp declines in the return on investment. Such declines were not generally experienced elsewhere in the developing world; indeed, figures for South Asia show that returns there increased slightly. Although investment decelerated during this period, it rose as a share of GDP, averaging over 20 per cent, compared with 15 per cent in 1961-1973. In a small number of countries, investment accelerated in response to favourable price shifts in traditional exports and export diversification linked to the exploitation of previously untapped oil and mineral reserves. By contrast, other countries experienced a sharp slowdown in investment growth and in some cases absolute declines.

Only government expenditure maintained its strong growth and consequently accounted for a rising share of GDP, with government consumption equivalent to 4 per cent more of GDP in 1980 than in 1973. However, declining revenues led to growing fiscal deficits and inflationary pressures. Because many SSA countries had pegged the value of their currencies to major convertible currencies, exchange rates appreciated significantly in real terms; according to some estimates, they appreciated on average by some 40 per cent between 1973 and 1980. The current account deficit (before official transfers) for SSA as a whole in this

period more than doubled compared with the earlier period, averaging 15 per cent of the regional GDP. This situation was also reflected in a rapid rise in total SSA long-term external public and private debt, from 18 per cent of GDP in 1970 to 40 per cent in 1980. The growing fiscal and current account imbalances and rising debt and inflation levels of the 1970s were exceptional by the standards of the post-independence period.

Thus, many countries in SSA ended the decade with increased external indebtedness, greater macroeconomic imbalances and instability, a lagging agricultural sector, and a weak and uncompetitive industrial base. Coming on top of such structural weaknesses, the external shocks of the 1980s drove a large majority of the countries into a deep crisis that wiped out the earlier gains in living standards.

C. The crisis of the 1980s and thereafter

The period between 1980 and 1994 witnessed a noticeable deterioration in the performance of most SSA countries. Population grew faster than output, with per capita incomes falling, on average, by 0.6 per cent per annum. The dispersion of growth rates among countries, which had increased during the 1970s, was greatly reduced and there was a downward convergence of growth rates during these years of crisis. For every country which experienced positive per capita output growth during 1980-1994, two had negative per capita rates of growth. There were in fact only nine countries that had positive per capita growth and of these only in Botswana and Mauritius (both already middle-income countries in 1980) was growth sufficient to tackle the challenges of economic development and poverty alleviation. The fact that the star performers of the previous period also registered negative growth rates further underscores the damaging lack of continuity in Africa's growth performance.

The performance of agriculture did not deteriorate drastically in the 1980s compared with the previous decade: for SSA as a whole agricultural growth was maintained, on average, at about 2 per cent per annum between 1980 and 1994, mostly on account of a turnaround after the mid-1980s (see chapter II). In many countries, growth was faster in agriculture than in industry, where it dropped to around 2 per cent per annum – a dramatic decline from the 8 per cent attained in the initial post-independence period.

The factors underlying the poor economic performance in Africa are well known and were discussed in some detail in previous *TDRs*. Africa, like many other parts of the developing world, failed to adjust to a more hostile external environment characterized by terms-of-trade deterioration, sharp increases in international interest rates, and stagnation and declines in net transfer of external resources, resulting from a turnaround in the policy stance in the major industrial countries. However, Africa fell further behind than other developing regions, in large part because its structural weaknesses were deeper and its room for manoeuvre was narrower.

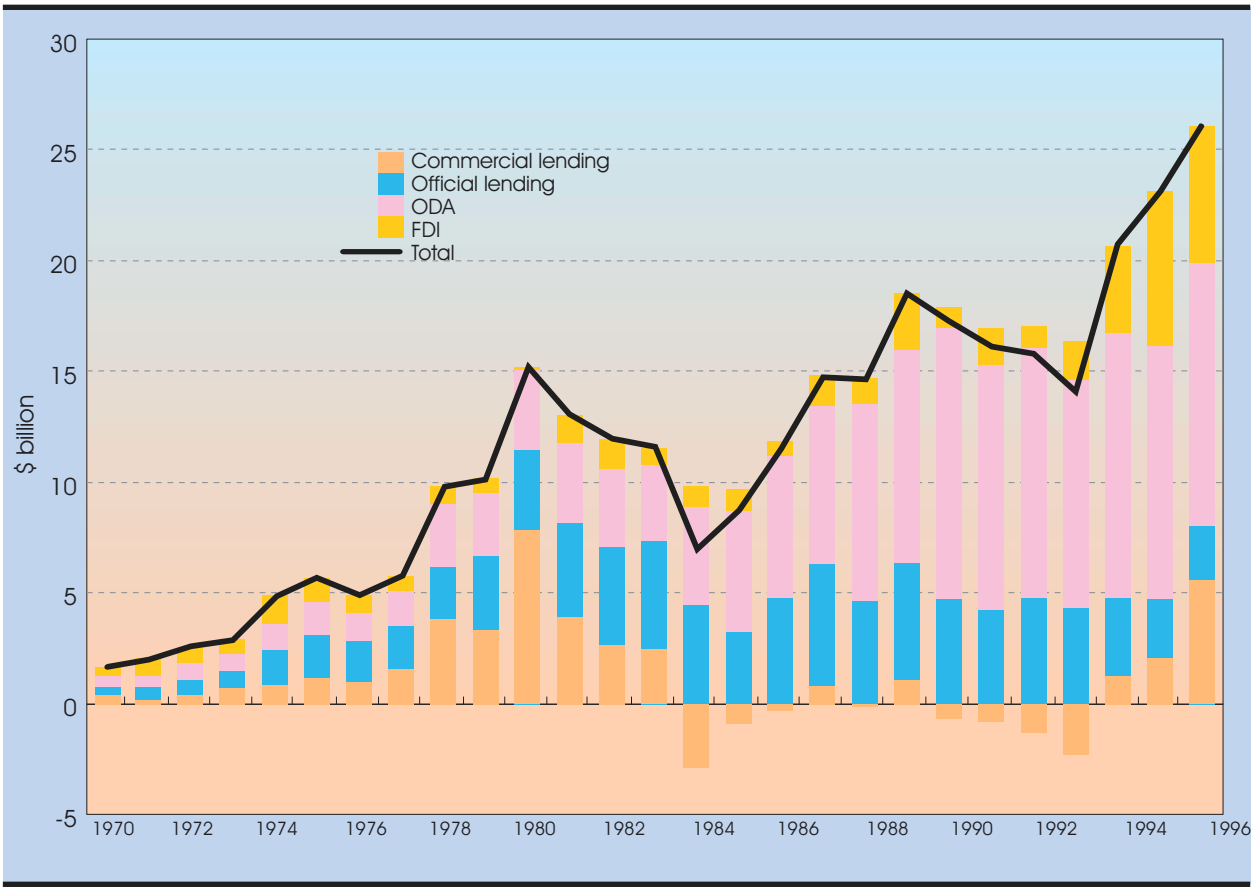
After peaking in 1977, the terms of trade of non-oil SSA countries declined almost every year until 1994 (chart 5). For North Africa and the SSA oil exporters the downward trend started after 1981; it was steeper but did not last as long. Unlike previous episodes, when the terms of trade declined in the context of rising prices of both primary commodities and manufactures, the declines in the 1980s were associated with rising prices of manufactures and falling prices of commodities. Deflationary policies in the major industrial countries took much longer to have a tangible impact on prices of manufactures than on commodity prices, which tend to be much more sensitive to market pressures.[7]

World prices for most commodities exported by SSA were at historically low levels in the late 1980s and early 1990s. In real terms, prices for coffee and cocoa – two of SSA's main non-oil commodity exports – were down from their levels in the 1950s by around 40 per cent. In 1992, coffee prices were at a 17-year low. Real prices of other

Chart 7

COMPOSITION OF NET RESOURCE FLOWS TO SUB-SAHARAN AFRICA, 1970-1996

(Billions of dollars)



Source: As for chart 6.
Note: FDI includes portfolio investment; ODA excludes technical cooperation grants.

major export items were also well below the level of the 1950s – by over 50 per cent for tea and cotton, one third for copper and sugar, and a quarter for tobacco.

The terms of trade of the SSA non-oil countries fell by more than one third between 1977 and 1993, compared with a decline of about 20 per cent for other non-oil developing countries. Thus, in 1993, the SSA countries would have needed to increase the volume of their exports by more than 50 per cent above their 1977 level in order to be able to import the same volume of goods as in that year. In the event, export volumes did rise, but not enough to compensate for this decline in the terms of trade. In some cases (e.g. cocoa) success in increasing export volumes proved self-defeating by depressing prices further.[8]

Of the 29 non-oil countries in the region for which data are available, there are only two (Mauritius and Zimbabwe) that did not suffer terms-of-trade losses between 1977 and 1993, while in 16 countries of the other 27 such losses exceeded 30 per cent. The countries relying heavily on exports of tropical beverages (Cameroon, Ethiopia, Ghana, Kenya, Rwanda, Uganda and the United Republic of Tanzania) were hit the hardest, with terms-of-trade losses of between 50 and 77 per cent. Among the 27 countries, only six (Benin, Cameroon, Côte d'Ivoire, Mauritania, Niger and Rwanda) were able to offset the fall in export prices by expanding export volumes.

The decline in export prices and earnings during the first half of the 1980s coincided with a sharp rise in international interest rates. The av-

erage interest payable on outstanding commercial debt rose from 8.4 per cent in the 1970s to 11.4 per cent because an increasing part of long-term loans had been contracted at variable interest rates, and the ratio of interest payments to export earnings rose from less than 2 per cent to more than 8 per cent. Simultaneously, new private lending collapsed, and this was responsible for the decline in the net new long-term borrowing by SSA from $10.8 billion in 1980 to about $7 billion per annum in the three years that followed. The region in fact started making net negative transfers to private lenders as interest payments exceeded net new lending.

However, aggregate net resource flows and aggregate net transfers to SSA as a whole remained positive as a result of the response of the international community to increasing payments difficulties in the region. Since 1980 SSA's external financing has increasingly been from official sources. ODA and official lending both rose, the latter in large part in the context of stabilization and adjustment programmes (chart 7), and there was a marked shift in total ODA flows in the 1980s in favour of SSA.

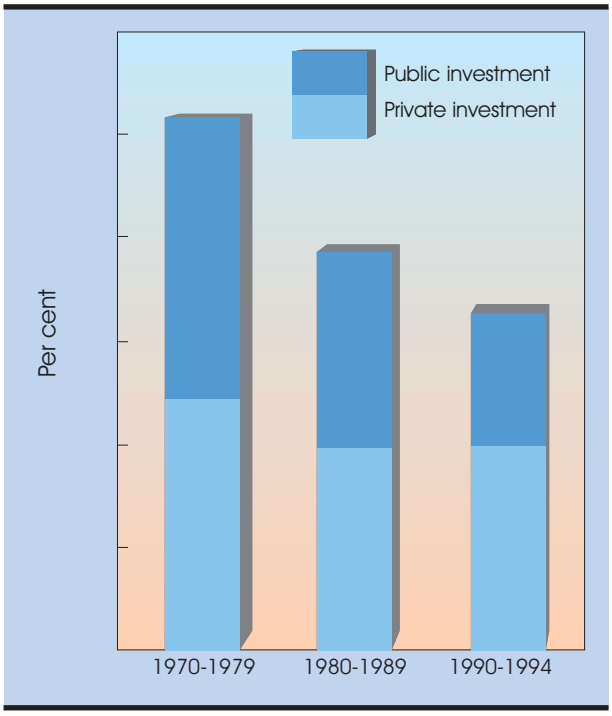
However, for the region as a whole and for most SSA countries individually, the additional resource flows were not sufficient to offset the impact of terms-of-trade losses on foreign exchange earnings, let alone the increased debt service. According to one estimate, between 1980 and 1990 only six out of 21 countries for which data are available were able to cover their terms-of-trade losses with net ODA inflows.[9] There was a GDP loss in SSA of $16.4 billion due to the terms of trade, and an ODA net inflow of $2.4 billion, which shows that less than 15 per cent of the terms-of-trade losses were compensated by ODA.[10]

The burden fell on imports and investment. Imports were reduced drastically during the first half of the 1980s. Although they recovered slowly from 1987 onwards, in per capita terms import volumes were still one third lower in 1993 than in 1980. The impact of the worsened terms of trade on import compression was particularly severe. Indeed, if the terms of trade had remained at their 1976-1978 levels, SSA imports could have been higher by one quarter of their actual value in every year between 1981 and 1993 even without any increase in export volumes. Additional ODA during that period made up for only one quarter of the loss in export purchasing power.

Chart 8

PUBLIC AND PRIVATE INVESTMENT IN SUB-SAHARAN AFRICA, 1970-1994

(Per cent of GDP, weighted averages)



Source: F.Z. Jaspersen et al., *Trends in Private Investment in Developing Countries - Statistics for 1970-1994,* IFC Discussion Paper, No. 28 (Washington, D.C.: World Bank, 1996).

Import compression inevitably led to a lower utilization of existing capacity and a fall in new investment. Part of that capacity became unusable, giving rise to the phenomenon of "de-industrialization". Investment fell continuously throughout the period and failed to recover. For 1980-1994 the average decline amounted to 0.5 per cent per annum, and in per capita terms it was much greater. The share of investment in GDP, which had averaged around 26 per cent in the 1970s, fell to below 20 per cent in the 1980s and to 16 per cent in the first half of the 1990s (chart 8). Public investment was cut by more than half, while private investment fell from over 12 per cent of GDP in the 1970s to around 10 per cent.

The decline in investment had a major influence on the pace of structural change. It meant that SSA was unable to make a positive adjustment to the changed global environment and shifts in key prices affecting its economic performance. Such adjustment would have required a restruc-

turing of agriculture and industry, but the region was caught in a vicious circle whereby the existing accumulation and production structures were unable to generate the growth in export earnings needed to maintain imports, which in turn constrained investment and income growth. The dilemma was further accentuated by the downward trend in the terms of trade and insufficient aid flows to compensate the loss of purchasing power of exports.

D. Adjustment, recovery and prospects

The recovery that began in 1994 and continued during the subsequent three years has given grounds for renewed optimism. Indeed, in 1995 the African region as a whole achieved positive per capita income growth for the first time in many years, a performance that was repeated in 1996 and again, although to a lesser extent, in 1997. The recovery was greatly helped by much better weather conditions as well as by diminished civil strife in a number of countries. It was underpinned by strong growth in export earnings, and a consequent improvement in the trade and current account balances as well as in debt and debt servicing ratios. After a drop in 1993 and an increase of around 3 per cent in 1994, the export earnings of SSA rose by 16 per cent in 1995 and 10 per cent in 1996. Although export volumes improved, particularly in 1996, much of the increase in export earnings resulted from a sharp turnaround in non-oil commodity prices, which rose by 25 per cent between 1993 and 1996 and accounted for much of the 13 per cent improvement in SSA's terms of trade in that period.

In assessing whether the present recovery constitutes a turning point in Africa it is essential to examine the underlying economic conditions. These conditions have been influenced significantly by the structural adjustment programmes (SAPs) that many African countries have been pursuing since the early 1980s with the help of the Bretton Woods institutions. The main policy elements of the SAPs were discussed in *TDR 1993* and an assessment was made of their impact on economic performance. It was noted that despite a decade-long adjustment hardly any country had successfully completed its SAP with a return to sustained growth. The high frequency and persistence of SAPs suggested that SSA countries were locked into adjustment programmes, unable to restore self-sustained growth. A main shortcoming of these programmes was their failure to restore investment. Indeed, in many instances, application of SAPs was associated with declines in investment. However, this feature was considered at the time by the World Bank as the reflection of an "investment pause" resulting from stabilization measures and changes in key relative prices associated with the removal of distortions, rather than as an inherent weakness of the policies promoted.[11]

There can be little doubt that an improved policy environment and, in particular, greater macroeconomic stability have made an important contribution to economic recovery in a number of countries. Nevertheless, it is not clear whether the structural adjustment policies adopted so far have been able to reduce sufficiently the major structural and institutional impediments to the accumulation and structural change needed to initiate rapid and sustained growth. As pointed out in *TDR 1993*, assessing the impact of SAPs on economic performance is a tricky exercise involving a number of methodological difficulties. Nevertheless, experience strongly suggests that the link between adjustment and performance has been weak.

In 1993 the World Bank introduced a four-way classification of SSA countries in order to assess the adjustment experience; it identified 15 countries as a core group of adjusters that accounted for the bulk of Africa's population and income and were thought to have been able to put in place fairly good economic policies and to have introduced some significant institutional changes.[12] However, the subsequent economic performance of this group as a whole and, in particular, their contribution to the current recovery

in SSA appear to have fallen short of expectations. Indeed, of these 15 countries, only three are among what IMF now classifies as "recent strong performers" (table 34). In other words, the large majority of countries that account for much of the recent faster growth in SSA were not among the World Bank "core group of adjusters" five years ago, and most of the countries that were thought to be pursuing relatively sound policies at the time are not among the strong performers today.[13]

Indeed, the rapid growth among some of the "recent strong performers" can largely be explained by some special circumstances that are of a one-off nature and unrelated to SAPs. Angola and Ethiopia certainly benefited greatly from the ending of civil strife, which had seriously disrupted economic activity. In Equatorial Guinea the exploitation of newly discovered oil reserves has been the main factor responsible for recent expansion.

These considerations once again highlight the problem of discontinuity of economic performance in SSA noted above. Since independence, there have always been countries that have performed reasonably well for a few years, but surges of growth have rarely been sustained.

The recent recovery in SSA appears to have been due primarily to increasing utilization of the existing capacity made possible by a relaxation of the foreign-exchange constraint, rather than to new investment. Indeed, evidence suggests that "the investment pause" has not come to a halt and the private investment response to SAPs continues to be weak. For SSA as a whole, the average ratio of private investment to GDP during 1995-1997 was only slightly above the rate achieved during the early 1990s, despite an acceleration of growth.[14] At around 17 per cent of GDP total investment in SSA remains below the average rate not only in the newly industrialized economies of Asia (about one third of GDP) but also in Latin America (slightly above 20 per cent).[15]

According to one view, the problem is not just the level of investment but its distribution. On this view the share of public investment in total investment in Africa is very high compared with other regions, constituting a major impediment to growth, since private investment tends to be much more efficient than public investment.[16] This view, however, not only ignores the mounting evidence regarding the complementarity between public and private investments, but also is misleading when absolute levels of investment are compared. According to a recent study of 53 developing countries, including 10 in SSA, in the 1980s public investment appears to have been generally more productive than private investment. This was explained by a shift of public investment projects to more productive uses as well as by a reduction in the productivity of private investment resulting from insufficient complementary public investment.[17] Moreover, the high share of the public sector in SSA is not due to excessive public investment. Indeed, as the figures in table 35 show, as a proportion of GDP the SSA governments invest less than any other region, in particular the Asian countries. It is also notable that the average share of public investment in the "recent strong performers" during 1990-1996 was greater than in other SSA countries by about one percentage point of GDP.

Table 34

ADJUSTMENT AND PERFORMANCE IN AFRICAN COUNTRIES

Core group of adjusters[a]	*Recent strong performers*[b]
Burundi	Angola
Gambia	Benin
Ghana	Botswana[c]
Guinea	Côte d'Ivoire
Kenya	Equatorial Guinea
Lesotho	Ethiopia
Madagascar	Guinea-Bissau
Malawi	***Lesotho***
Mauritania	Mauritius[c]
Namibia	***Nigeria***
Nigeria	South Africa
Uganda	Togo
United Rep. of Tanzania	***Uganda***
Zambia	
Zimbabwe	

a E.V.K. Jaycox, *Africa: From Stagnation to Recovery* (Washington, D.C.: World Bank, February 1993).
b IMF, *World Economic Outlook*, April 1998 (Washington, D.C.: IMF), Vol. I, table 12.
c In the 1993 grouping by the World Bank Botswana and Mauritius were excluded as outliers.

Table 35

PUBLIC INVESTMENT RATIOS, BY REGION, 1990-1996

(Percentages)

Region	Public investment as a share of	
	Total investment	GDP
Sub-Saharan Africa	28.9	4.8
Western Hemisphere	24.1	4.9
Asia (excluding Japan)	31.1	8.6
NIEs	22.0	6.8

Source: S. Fischer, E. Hernández-Catá and M. S. Khan, "Africa: Is this the turning point?", IMF Paper on Policy Analysis and Assessment 98/6 (Washington, D.C., 1998), table 3.

The need for public investment is much greater in SSA, where human and physical infrastructure is extremely inadequate, than in countries with higher levels of industrialization and development. Moreover, given the rudimentary state of the entrepreneurial class, the public sector may still find it necessary to invest in a number of areas which elsewhere are normally in the domain of the private sector. Certainly, there are serious problems in the allocation and efficiency of public investment in many countries in SSA, the resolution of which could provide significant one-off productivity gains, but there can be little doubt that a public investment rate of 5 per cent of GDP is barely adequate to ensure the improvement in the physical and human infrastructure needed for sustained growth.

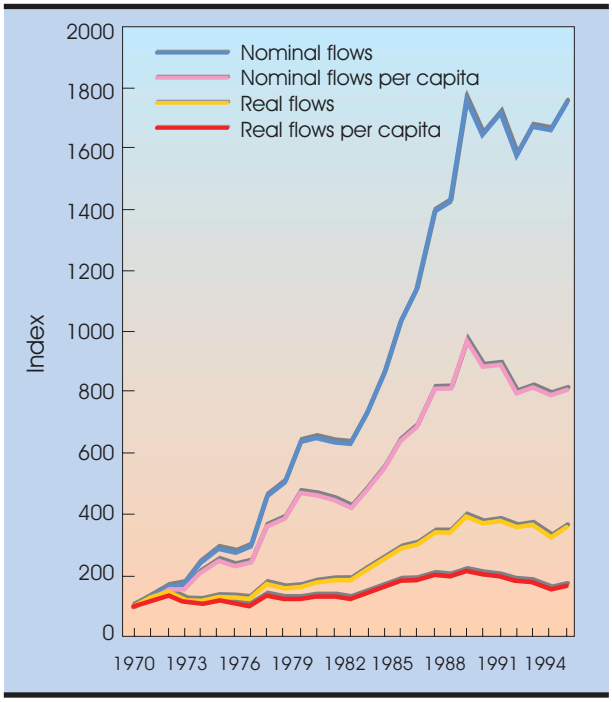
It thus appears that at the current rate of aggregate investment it would be very difficult to accelerate long-term growth in SSA regardless of how efficiently it is allocated and used. Current forecasts by the World Bank for the next 10 years give an average rate of growth of about 4 per cent per annum, i.e. maintenance of the average growth rate of the last three years. Even if this is realized, per capita income in the region would increase, on average, by 1 per cent per annum, so that "the coming decade would only represent the recovery of ground lost over 20 years".[18] But even achieving this performance is far from being assured. Since 1990 ODA has been declining both in real terms (chart 9) and in relation to the GDP of the recipient countries. Moreover, commodity prices have levelled off and turned downwards, a movement which has been accentuated by the weakening of global demand due to the East Asian financial crisis. In these conditions, and given the weak supply response to adjustment policies, even these modest growth projections may prove to be over-optimistic, as they have done in the past.[19]

It is generally agreed that greater policy effort is needed to translate the current recovery into stronger and sustained growth in Africa. There can be little doubt that an important reason for the continuing poor performance of countries undertaking SAPs is slippage in programme implementation. However, programme compliance has not always resulted in strong economic performance, a fact which suggests that there are also serious problems in programme design. In particular, there

Chart 9

FLOWS OF OFFICIAL DEVELOPMENT ASSISTANCE TO NON-OIL EXPORTING COUNTRIES IN SSA, 1970-1996

(Index numbers, 1970 = 100)



Source: World Bank, *Global Development Finance 1997*.
Note: ODA flows exclude technical cooperation grants; real flows are at 1970 import prices.

are reasons to believe that the emphasis on removing price distortions is not necessarily the best way to bring about a strong supply response and growth performance. The following chapters take a closer look at the question of incentives and supply response, seek to identify the main constraints and opportunities in agriculture, industry and trade, and discuss the policies needed to remove the constraints and to realize the opportunities.

There is also a consensus that restoration of economic growth in SSA is unlikely without a solution to the problem of external debt overhang. Indeed, the failure to address the debt problem and to provide adequate external financing is often seen as a major weakness in programme design. While the international community has recognized the need to support greater policy efforts with increased debt relief and net transfer of resources to most SSA countries through the HIPC Initiative, a number of issues remain unresolved. Past *TDRs* discussed many of these issues in detail. What follows provides a brief review, focusing on the link between debt relief and capital accumulation.

E. Improving the prospects: The role of debt relief

Debt overhang describes a situation in which creditors' demand for full debt servicing can reduce the present value of debt servicing in the future by depressing investment and growth. This would damage the interests not only of the debtor countries but also of the creditors. Such a situation could not be rectified by provision of liquidity (new debt) in order to overcome current debt-servicing difficulties. Rather, it calls for a reduction in the stock of debt and debt servicing.

Various debt indicators illustrate the extent and nature of the problem in SSA (table 36). Ninety-three per cent of SSA's external debt is public and publicly guaranteed, and almost 80 per cent of this amount is owed to official creditors, including a substantial and growing part to multilateral financial institutions (chart 10). The debt problem in SSA is therefore essentially one of official debt. Although its external debt is only a small part of the total debt of developing countries, as a proportion of exports and GDP it is the highest of any developing region (table 36). Moreover, unlike in other developing regions, these ratios have exhibited a rising trend since 1988, when creditors first recognized the need to introduce debt reduction as a central element of an international debt strategy dealing with the debt of poor countries.

The relatively low debt service ratio in SSA compared with other regions is not always explained by greater concessionality of the debt. For instance, concessional debt is relatively higher in South Asia, where the debt service ratio is also higher. Rather, it is explained by a continuous growth of arrears, which is perhaps the best indicator of the extent of the debt overhang. Accumulated arrears, on interest and principal payments, reached $64 billion in 1996, amounting to about 27.4 per cent of the total debt. More worrying, two thirds of the increase in debt since 1988 has been due to arrears (table 36).

There is ample evidence of the adverse effects of the debt overhang on investment and growth in Africa.[20] Since the external debt is mainly owed by governments, the debt overhang deters public investment in physical and human infrastructure as well as growth-enhancing current spending on health and education. Also, it creates a problem of policy credibility and considerable uncertainty for private investors, who run the risk that gains from investment could be taxed away to service external debt. This is true not only for domestic investors but also for foreign investors; the latter tend to stay out of countries with serious debt-servicing difficulties. Indeed, it is almost impossible for a country suffering from debt overhang to have access to private capital markets:

> All creditworthiness and ratings analyses on which foreign investors rely include strong negative debt elements. Those running

Table 36

EXTERNAL DEBT INDICATORS FOR DEVELOPING COUNTRIES, 1988 AND 1996, BY REGION

(Percentages)

	Debt/exports		Debt/GNP		Debt service/ exports		Interest and principal arrears as a share of			Share of official debt in total debt
							Total debt		New debt since 1988	
	1988	1996	1988	1996	1988	1996	1988	1996	1996	1996
Sub-Saharan Africa	244.2	236.9	67.7	76.2	20.8	12.4	11.8	27.4	64.8	75.6
North Africa/Middle East	175.4	126.8	41.7	34.0	19.7	12.1	6.8	5.5	0.1	72.4
East Asia	136.7	98.9	33.7	30.8	21.2	12.2	0.5	3.6	5.6	44.5
South Asia	294.6	208.8	28.2	28.3	26.2	23.1	0.0	0.1	0.1	76.3
Latin America	308.0	202.8	56.4	41.4	36.8	30.0	5.2	1.8	-0.1	33.0
All developing countries	175.6	146.2	35.7	37.0	22.0	16.4	5.4	6.1	1.1	50.2

Source: World Bank, *Global Development Finance 1997* (Washington, D.C., 1997).

> portfolio investment funds in Africa or attempting to promote investor interest in HIPC privatizations assess the existence of debt overhang as a key negative influence. Some incentives, such as export-credit guarantees, are directly cut off as a consequence of a debt overhang.[21]

A factor that has played a key role in the persistence of debt overhang in SSA is the short-leash approach adopted by the international community since the start of the debt-servicing difficulties in the early 1980s. While, as repeatedly urged by the UNCTAD secretariat, significant amounts of debt reduction would have been needed to eliminate the debt overhang, to restore growth and to reduce the debt ratios to sustainable levels, in much of the 1980s efforts to deal with the debt problem of low-income countries sought to ensure that debt forgiveness was the exception rather than the norm.[22] This approach started to change with recognition of the need for genuine concessionality in Paris Club reschedulings for poorer countries. The first major step was taken at the Toronto Summit in 1988, where creditor governments recognized the need to reduce the non-concessional official debt owed by low-income countries. However, the debt reduction operations have gone through many incremental steps, from Toronto terms to London terms (or enhanced Toronto terms) to Naples terms and to Lyon terms, as improvements made in each step proved inadequate in dealing with the problem.

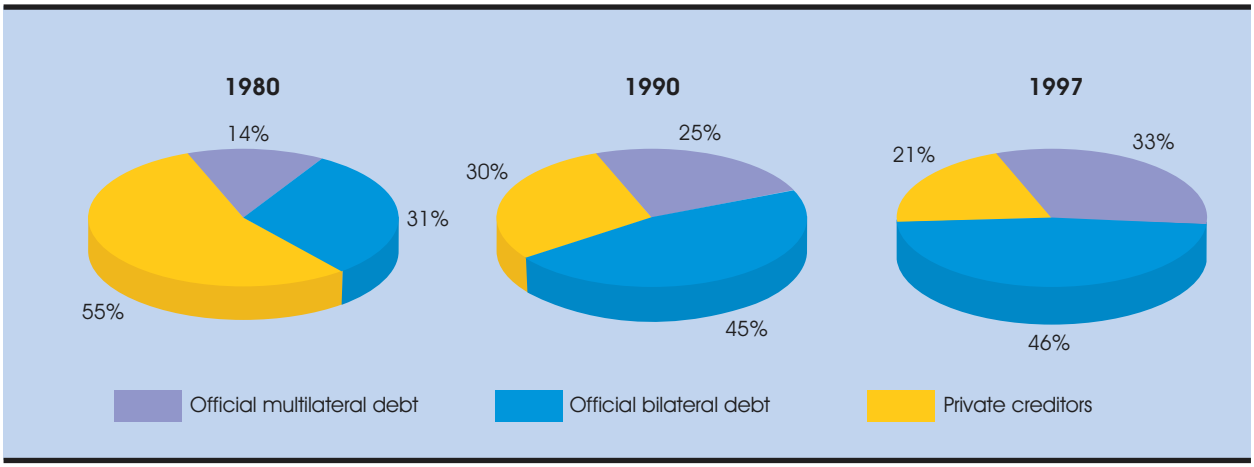
A major shortcoming of these steps was the exclusion of multilateral debt from debt reduction. Multilateral debt accounted for an increasing proportion of the total debt of the poorer countries as a result of the international debt strategy pursued in the 1980s, when lending was increased by the multilateral financial institutions with a view to avoiding a global financial crisis. Moreover, in most cases adjustment policies failed to restore external financial viability:

> Following the initial onset of the developing country debt crisis in the early 1980s, many developing countries borrowed heavily from multilateral sources in order to finance debt servicing to private creditors, thereby shifting the balance of debt from private to public creditors. In addition, many countries borrowed heavily in the context of IMF/WB structural adjustment programmes. The poor performance of countries under these adjustment pro-

Chart 10

COMPOSITION OF PUBLIC AND PUBLICLY GUARANTEED EXTERNAL DEBT OF SUB-SAHARAN AFRICA, 1980, 1990 AND 1997

(Per cent shares)



Source: World Bank, *Global Development Finance 1998, Analysis and Summary Tables* (Washington, D.C., 1998).

grammes ... has left much of the borrowing simply unpayable.[23]

The HIPC Initiative has thus received widespread support in the international community, not only as a comprehensive and coordinated approach, but also as a crucial step in recognizing that losses on bad loans should not be borne by the debtors alone, but shared also by the creditors, particularly in view of the key role that the multilateral financial institutions played in setting the policies in debtor countries. Moreover, the Initiative has been formulated in recognition of the need to reach a sustainable debt position in the context of growth and development.

However, the view is gaining strength in the international community that the HIPC Initiative needs a significant adjustment to become a decisive move to help re-establish the conditions for sustained economic growth. The basic issues relate to eligibility and the adequacy of the debt reduction to be granted, as well as the speed with which countries in need will actually benefit from relief.

There can be little doubt that, since all the debt has to be paid in foreign currency, export earnings are an important determinant of debt-servicing capacity. However, as a very large proportion of debt is owed by the public sector, the debt burden relative to government revenues is at least equally relevant in determining debt-servicing capacity. Even when the economy generates sufficient export earnings and faces no external financing gap, servicing of external sovereign debt could pose serious difficulties. It would necessitate a transfer from the private to the public sector through either cuts in public spending or increases in taxation, both of which might have serious consequences for stability and growth.[24]

Responding to the concern of the countries with high export-GDP ratios and low debt-servicing ratios, the Executive Boards of IMF and the World Bank approved in April 1997 the introduction of an additional sustainability criterion which would allow debt reduction if the debtor country has, *inter alia*, an export-to-GDP ratio of at least 40 per cent and a minimum threshold ratio of fiscal revenue to GDP of 20 per cent.[25] Two countries (Côte d'Ivoire and Guyana) have so far qualified on the basis of this additional criterion.

While, according to this criterion, eligibility will depend on having a minimum fiscal revenue ratio, one of the arguments advanced in favour of debt relief is that it would allow debtor governments to reduce high taxes, which "tend to

undermine growth by introducing serious distortions in the economy, including heightened barriers to trade (via trade taxes), capital flight, tax evasion and reduced work effort".[26] More importantly, while the addition of the fiscal burden criterion has somewhat broadened the range of eligibility and the scope for debt relief, it does not appear to go far enough in restoring the financial viability of the public sector, which holds the key to restoring stability and growth. For instance, a non-eligible country with an export-to-GDP ratio of less than 40 per cent and a debt service ratio of less than 20-25 per cent can still face a considerable fiscal burden, of up to 10 per cent of GDP. The kind of problems this would create is illustrated by the following:

> For example, a well-designed budget might include current expenditures on education (mostly at the primary and secondary level) of some 5 per cent of GDP; public health outlays of some 3 per cent of GDP; costs of public administration of 2 per cent of GDP; and expenses on police and defence of some 3 per cent of GDP. Infrastructure spending is sure to require at least 5 per cent of GDP, even if the government leaves much of the infrastructure finance to the private sector (e.g. for power, telecommunications and ports) and focuses its attention on items (e.g. rural roads) that are much harder to finance through the market. The total outlays in this illustration total 18 per cent of GDP. Evidently, there is virtually no room for debt-servicing, nor for subsidies to households and firms or income transfer programmes other than in health and education. As experience has shown, attempts to collect more than a minimum in external debt servicing result in (a) serious budget deficits; (b) unacceptable cuts in education, public health, or basic infrastructure; or (c) tax rates at levels that jeopardize economic growth.[27]

These considerations suggest that greater attention should be paid to the fiscal burden of debt (e.g. by setting limits to the amount of debt servicing from the budget expressed as a proportion of GDP) in assessing debt sustainability, independently of the degree of export orientation of the economy and the extent to which debt servicing cuts into export earnings.

There are also more fundamental questions raised by the implementation of the HIPC Initiative. They can be illustrated by reference to the considerations set out in Part One, chapter IV above, on the relevance of the principles of bankruptcy codes to international debt workouts. The Initiative is addressed to countries which are unable to service their debts fully. Such a situation corresponds to the notion of insolvency under bankruptcy codes, which enables debtors to benefit from a number of arrangements, including debt standstill, debtor-in-possession financing and debt reduction. Judicial procedures would not permit practices such as requiring debtors to maintain debt servicing and forcing a long delay between the recognition of insolvency and debt reduction. Such procedures would also avoid a situation requiring unanimity among creditors as regards the debt-restructuring plan – a requirement which allows a minority of creditors to block a deal. Moreover, under insolvency procedures, the amount of debt reduction needed and the conditions attached would not be determined by the creditors, and the same principles would apply to all creditors in order to ensure comparability of settlements.

As discussed in Part One, chapter IV, there are serious difficulties in replicating the insolvency procedures for international debt through an international bankruptcy court, not only for sovereign debtors but also for private debtors. Nevertheless, it is possible to establish the key insolvency principles and apply them within the existing international framework. The application of these principles would dictate an immediate write-off of all unpayable debt in SSA, determined on the basis of an independent assessment of debt sustainability.

Experience so far demonstrates that the approach to debt reduction used so far has been inadequate. Not only has it perpetuated aid dependency, but it has also failed to promote "sound policies" and commitment to and ownership of the programmes. Resolving the crisis in SSA requires a bolder approach in order to secure the rapid and adequate debt reduction needed to restore the financial viability of the public sector and economic growth, and in order to ensure that the operation will never have to be repeated. ■

Notes

1 Here, in tracing post-independence performance, 1965 is taken as the cut-off date. Of the British and French colonies, Ghana (1957) and Guinea (1958), respectively, were the first to gain independence. Territories that gained independence after the mid-1960s include Botswana (1966), Mauritius (1968), Guinea-Bissau (1974), Angola (1975), Cape Verde (1975), Mozambique (1975), Sao Tome and Principe (1975) and Zimbabwe (first in 1965, with the Unilateral Declaration of Independence by Southern Rhodesia, and subsequently in 1980, when independence was formally granted by the British Parliament).

2 See J. Dunning, "Changes in the level and structure of international production: The last one hundred years", in M. Cassen (ed.), *The Growth of International Business* (London: Allen and Unwin, 1983), table 5.2. In 1970, FDI was equivalent to 0.52 per cent of GDP in SSA, versus 0.26 per cent in East and South-East Asia, and 0.74 per cent in Latin America and the Caribbean; see UNCTAD, *Foreign Direct Investment in Africa* (United Nations publication, Sales No. E.95.II.A.6), New York and Geneva, 1995, table 18.

3 See B. van Arkadie, "The State and economic change in Africa", in H. J. Chang and R. Rowthorn (eds.), *The Role of the State in Economic Change* (Oxford: Clarendon Press, 1995).

4 In the early 1970s Western Europe was the destination of 55 per cent of African exports, and the origin of 65 per cent of all African imports. In the first half of the 1990s more than 60 per cent of African exports went to Western Europe and about 55 per cent of African imports originated there. The share of intra-African trade in total imports of African countries fell to 3.1 per cent by 1980. It then doubled during the 1980s and had risen to 8.6 per cent by 1995. The issue of intraregional trade is discussed in greater detail in chapter IV below.

5 The issue of commodity diversification is discussed in greater detail in chapter IV.

6 See D. Ben-David and D. Papell, "Slowdowns and meltdowns: Postwar growth evidence from 74 countries", CEPR Discussion Paper No. 1111 (London: Centre for Economic Policy Research, 1995).

7 Moreover, the decline in commodity prices made a major contribution to disinflation in OECD countries; see *TDR 1987,* Part One, chapter II.

8 For a detailed discussion of the fallacy-of-composition problem see *TDR 1993*, Part Two, chapter II, p. 101.

9 See *TDR 1993*, Part Two, chapter II, pp. 97-99.

10 See G. Helleiner, "Trade, aid and relative price changes in sub-Saharan Africa in the 1980s", paper presented at the conference "From Stabilization to Growth in Africa", Marstrand, Sweden, 6-7 September 1992. See also *Adjustment in Africa. Reforms, Results and the Road Ahead*, World Bank Policy Research Paper (New York: Oxford University Press for the World Bank, 1994), p. 29; and for more recent years R. Faruqee and I. Husain, "Adjustment in seven African countries", in I. Husain and R. Faruqee (eds.), *Adjustment in Africa. Lessons from Country Case Studies* (Washington, D.C.: World Bank, 1994).

11 See *TDR 1993*, Part Two, chapter II, pp. 109-110.

12 E. V. K. Jaycox, *Africa: From Stagnation to Recovery* (Washington, D.C.: World Bank, February 1993).

13 This is also confirmed by the results of the World Bank's own assessment of adjustment programmes in Africa. Only one country (Nigeria) classified by IMF as a "recent strong performer" in 1998 was among the six countries which the World Bank had found in 1994 to have made "large improvements in macroeconomic policies"; and another recent strong performer (Uganda) was among those nine countries that had been found to have made "small improvements" *(Adjustment in Africa: Reforms, Results, and the Road Ahead, op. cit.*, pp. 57-59). The listing of Nigeria as a "recent strong performer" is somewhat surprising since GDP growth was, on average, below 3 per cent in 1990-1996 and only slightly above 3 per cent in 1997. Moreover, Nigeria benefited from the strength of oil prices; average prices in 1996 were almost a third higher than two years earlier, but with current trends in oil markets this performance may not be repeated.

14 IMF, *World Economic Outlook*, April 1998 (Washington, D.C.: IMF), table 12.

15 For a discussion of recent savings and investment performance in SSA, see S. Fischer, E. Hernández-Catá and M.S. Khan, "Africa: Is this the turning point?", IMF Paper on Policy Analysis and Assessment 98/6 (Washington, D.C., 1998).

16 *Ibid.*, p. 12 and IMF, *World Economic Outlook,* April 1998, *op. cit.*, p. 72.

17 R. Ram, "Productivity of public and private investment in developing countries: A broad international perspective", *World Development*, Vol.24, No.8, 1996.

18 World Bank, *Global Economic Prospects and the Developing Countries* (Washington D.C.: World Bank, 1997), Appendix I, p. 86.

19 In 1992 the World Bank growth projection for SSA for the 1990s was an average rate of 3.8 per cent per

annum; see *Global Economic Prospects and the Developing Countries* (Washington, D.C.: World Bank, 1992), annex. The actual rate until 1997 was about 2.5 per cent per annum. Thus, to achieve 3.8 per cent for the whole decade, the region would need to grow at a rate of no less than 6 per cent per annum during the rest of the 1990s. But the growth rate now projected for the remainder of the 1990s is in the order of 4 per cent. Even if this growth rate were realized, this would mean some 2.8 per cent growth per annum for the decade as a whole, i.e. one percentage point less than the original World Bank projections. The same considerations are broadly valid for the projections for 1992-2002 in the 1993 issue of *Global Economic Prospects and the Developing Countries* (see table 7.4).

20 For a survey of these studies and the underlying mechanisms see M. Martin, "A multilateral debt facility – global and national", in UNCTAD, *International Monetary and Financial Issues for the 1990s*, Vol. VIII (United Nations publication, Sales No. E.97.II.D.5), New York and Geneva, 1997.

21 *Ibid.*, p. 150.

22 See in particular *TDR 1988*, Part One, chap. IV.

23 J. D. Sachs, "External debt, structural adjustment and economic growth", in UNCTAD, *International Monetary and Financial Issues for the 1990s*, Vol. IX (United Nations publication, Sales No. E.98.II.D.3) New York and Geneva, 1998, p. 53.

24 This is, in effect, similar to the domestic budgetary transfer problem that faced a number of countries in Latin America in the 1980s when the public sector lacked the resources needed to service debt even though the private sector generated adequate foreign exchange earnings to make such payments; see *TDR 1989*, Part One, chapter IV.

25 See *TDR 1997*, box 2.

26 Sachs, *op. cit.,* p. 46. This criterion is indeed a reflection of donor concern that aid reduces tax effort and hence leads to aid dependency. However, if an extra dollar of aid indeed reduces taxation, this would mean that the aid is partly transferred to the private sector. It has been argued that "not only is there no evidence for this effect, but that had it happened it would have been desirable"; see P. Collier, "Aid and economic development in Africa" (Oxford University: Centre for the Study of African Economies, October 1997), mimeo, p. 1.

27 Sachs, *op. cit.*, p. 49. The above does not necessarily imply net negative transfers by the country. As the author points out (p.54, note 1), "overall foreign assistance may exceed 5 per cent of GDP, but much of it will go directly to enterprises and households, and thus will not be available as a source of revenue support for budgetary outlays".

Chapter II

THE ROLE, STRUCTURE AND PERFORMANCE OF AGRICULTURE

A. Introduction

Agriculture is the key sector in many African countries, particularly in low-income countries in SSA. Analysts with very different perspectives agree that the generally weak performance of the sector in the 1970s contributed to the economic crisis which developed in the region at the end of the decade.[1] But there is little consensus about the causes of this weak performance, why it has persisted in many countries despite policy reforms, and what should be done to end it. Promoting agricultural development in Africa has proved to be a complex matter and has given rise to different views on both the role of agriculture in economic development and the tasks which governments should undertake.

Two main issues recur in policy debates, the first being the mix of private incentives and public goods that can best support agricultural development. The second issue is the pattern and processes of resource flows and linkages between agriculture and other sectors of the economy that best promote overall economic development, and what government needs to do to facilitate them.

Agricultural policy reform in Africa has been based on the view that poor performance is due to policies designed to extract resources from farmers in order to promote industrialization and to serve urban interests at the expense of agriculture. The alignment of producer prices to world prices and the fostering of private input and output markets were expected to provide the necessary incentives to farmers to increase output. However, many have argued that "getting the prices right" is not sufficient, because agricultural supply response is constrained by structural factors, including infrastructure, technology and various agrarian institutions such as the gender division of labour and land tenure patterns. There is now increasing agreement on the importance of such non-price constraints on production and productivity growth.[2] But which ones are critical, how they are to be removed, and whether there are trade-offs between policies which support the achievement of price and non-price conditions for agricultural growth are still open questions. Moreover, despite greater understanding in some of these areas, policy is still geared to reducing the fiscal burden of the agricultural sector, and wedded to privatization and market liberalization rather than to pragmatic solutions tailored to the level of development.[3]

The issue of price incentives is embedded within a broader issue relating to intersectoral transfers between agriculture and industry, urban bias, and the contribution of agriculture to the overall growth process. Since the initiation of the reform process, this broader issue has been neglected as the idea that sustained growth in Africa depends on industrialization has fallen out of favour. But this does not mean that the effects of agricultural policy on other sectors, and vice versa, can be ignored. The basic policy problem of all

predominantly agrarian economies, including those in Africa, is how to manage the relations between agriculture and the rest of the economy in a way that promotes agricultural growth and thus enables a structural transformation in which the relative importance of the agricultural sector declines as other sectors, and particularly manufacturing, move onto a dynamic growth path. Thus, policy issues in agriculture need to be addressed in terms of multiple intersectoral linkages which often involve complex policy choices.[4]

The central theme of this and the next chapter is the role of government in promoting agricultural development, focusing in particular on how policy affects incentives and investment. This chapter discusses the role, structure and performance of the agricultural sector in Africa. It starts with the main ways in which agriculture can contribute to economic growth in that region. This is followed by a discussion of its main structural characteristics, including ownership patterns, infrastructure and production structure. Finally, the chapter examines agricultural performance since the 1970s, focusing on total production and food output, exports and productivity growth. It is shown that there have been some improvements in agricultural growth since the mid-1980s. Nevertheless, productivity growth is sluggish, food production still lags behind population growth and the agricultural trade balance continues to deteriorate. The next chapter examines the role of policy in this situation, in particular its impact on incentives, and the influence of structural constraints on investment behaviour and supply response.

B. The role of agriculture in economic growth

Although the economic importance of agriculture has been declining over the last 25 years, the sector still accounts for a large share of GDP and employment in many African countries (table 37). In 16 SSA countries the agricultural sector employs more than two thirds of the labour force and generates more than one third of GDP. In 14 countries more than 80 per cent of the labour force are still in agriculture. Economies in which agriculture contributes less than one third of total GDP and less than two-thirds of the total labour force include the North African and South African Customs Union (SACU) countries, three oil exporters – Congo, Gabon and Nigeria – as well as Cape Verde, Côte d'Ivoire, Mauritania and Mauritius. All the middle-income economies in Africa except Cameroon are in this group. There are only 15 countries in Africa as a whole in which the sector's share in GDP is less than 15 per cent, and in only eight of these (Algeria, Botswana, Cape Verde, Lesotho, Mauritius, South Africa, Swaziland and Tunisia) agriculture absorbs less than 40 per cent of the labour force.

In such predominantly agricultural economies there are two main ways in which output per head can be increased: by shifting employment from agriculture to the industrial sector, where labour productivity is typically higher; and by increasing sectoral labour productivities while maintaining or raising the level of employment. As international comparisons show, there are ample opportunities for enhancing productivity within agriculture in low-income countries. But the scope for sustaining a high rate of productivity growth is much greater in manufacturing. Agriculture is "innately a slow-growing sector"[5], and accelerating agricultural growth normally entails moving from a growth rate of 2-3 per cent to one of 4-6 per cent. By contrast, in manufacturing, because of the greater potential for productivity gains and also because of higher income elasticity of demand, growth rates of 8-10 per cent can be sustained over long periods.

The realization of such growth potentials is an extremely complex process. It depends on an appropriate structure of incentives for private investment in both the agricultural and the industrial sectors, as well as on public investment in physical and social infrastructure. Also, it requires the attainment of key macroeconomic balances: be-

Table 37

AFRICA: CHANGES IN THE SHARE OF AGRICULTURE IN THE LABOUR FORCE AND GDP SINCE 1970, BY REGION

(Percentages)

	Share in			
	Total labour force		GDP	
Region	1970	1990	1970	1995
Low-income countries in:				
West Africa[a]	83.7	75.4	41.5	38.2
East and Southern Africa[b]	80.9	78.5	39.1	35.4
Middle-income countries in:				
West Africa[c]	79.1	67.9	32.2	25.2
East and Southern Africa[d]	59.5	33.4	27.5	7.8
South Africa	31.0	13.5	7.9	4.7
North Africa[e]	49.6	35.4	19.3	14.7
Oil exporters[f]	75.6	55.3	27.3	21.4

Source: UNCTAD secretariat calculations, based on World Bank, *World Development Indicators, 1997* (CD-Rom).
Note: Shares are simple averages of individual country shares.
a Benin, Burkina Faso, Central African Republic, Chad, Gambia, Ghana, Mali, Mauritania, Niger, Sierra Leone, Togo.
b Burundi, Democratic Republic of the Congo, Kenya, Lesotho, Madagascar, Malawi, Rwanda, Somalia, Sudan, Uganda, Zambia, Zimbabwe.
c Côte d'Ivoire, Senegal.
d Botswana, Mauritius, Swaziland.
e Algeria, Egypt, Morocco, Tunisia.
f Cameroon, Congo, Gabon, Nigeria.

tween foreign exchange requirements and foreign exchange availability; between the rate of growth of real wages and the availability of wage goods; between public sector investment needs and non-inflationary means of financing such investment; and broadly between savings and investment. In the early stages of development the growth of agriculture is itself a major component of overall economic growth. But in addition, there are linkages through which agricultural growth can also stimulate growth in other sectors.

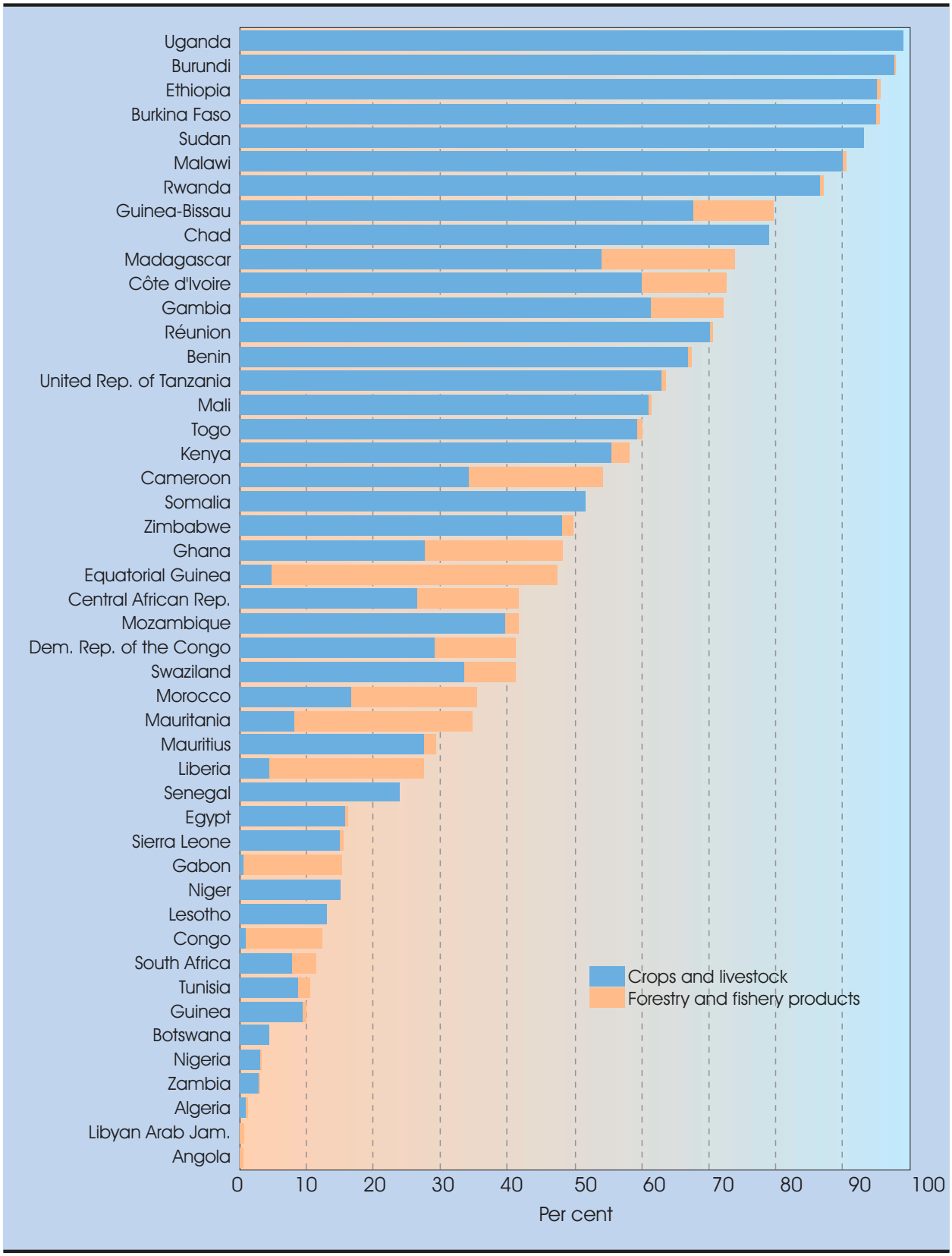
In Africa, overall economic growth depends critically on the performance of agriculture.[6] Firstly, except in a small number of countries with rich mineral resources, significant earnings from tourism or workers' remittances, agriculture is the most important source of foreign exchange earnings, contributing over 50 per cent of total exports in recent years in 20 countries (chart 11). Such earnings are needed to finance the import not only of intermediate and capital goods for local industries, but also of the manufactured consumer goods that must be made available to farmers if incentives to increase output are to have any impact. There is evidence from the early 1980s that a shortage of such incentive goods can create a vicious circle by prompting a reduction in the production of cash crops which in turn deepens the payments crisis, thereby aggravating the shortage of manufactured goods and causing further cutbacks in production.[7]

A second key contribution by agriculture is the provision of food supplies. This is particularly important in view of very high levels of food deprivation in SSA. A number of estimates sug-

Chart 11

SHARE OF AGRICULTURAL PRODUCTS IN TOTAL EXPORTS FROM AFRICAN ECONOMIES, 1995

(Percentages)



Source: UNCTAD secretariat calculations, based on FAO, *FAOSTAT* database.

gest that during 1990-1992 about 43 per cent of the population of SSA – some 215 million people – had inadequate access to food, double the number in 1969-1971.[8] Reducing this deprivation is not only a moral and political priority for governments, but also a critical economic objective since poor nutrition tends to reduce labour productivity.[9] Another reason why food supplies are important is that lower real food prices have important growth-enhancing ramifications throughout the economy, as they allow real wages to rise without impeding accumulation.

Agriculture's third contribution to overall growth is through the supply of raw materials to industry. These forward linkages from agriculture are important because high productivity in agriculture and cheap agricultural raw materials tend to increase profitability and investment in agro-processing industries, thereby enhancing international competitiveness. It has been estimated that between one third and two thirds of manufacturing value added in sub-Saharan Africa depends on agricultural raw materials.[10] For Zimbabwe, one of the economies with a more diversified industrial structure, agriculture provides 40 per cent of all manufacturing inputs. In Kenya, nearly half of micro-enterprises (almost two thirds if forestry and textiles are included) rely directly on agricultural supplies.[11]

Fourthly, being the dominant sector, agriculture can provide, directly or indirectly, resources for public or private investment both within and outside agriculture by generating what is technically known as the "net agricultural surplus", which is simply defined as the total value added in the sector minus the consumption of direct agricultural producers. During the immediate post-colonial period, attempts were made to mobilize the available agricultural surplus of farm households producing export crops through the marketing boards which had been established during the colonial period. Estimates suggest that before the 1980s, export crops contributed from 20 per cent to 40 per cent to government revenue.[12]

Another of agriculture's contributions is the provision of a domestic market for manufacturing. This was historically important for economies which managed to build up a small, inward-looking manufacturing sector. According to a study of seven countries for 1965-1986, "a major cause of manufacturing growth in SSA has been rooted in the establishment of an environment conducive to steady expansive growth outside the sector itself and principally primary-product related".[13] For all except two countries (Côte d'Ivoire and Zambia) the predominant source of growth was increasing domestic demand, which accounted for 54 per cent of manufacturing growth in Botswana, 55 per cent in Cameroon, 69 per cent in Kenya, 76 per cent in Nigeria and 72 per cent in Zimbabwe. As urban incomes grow and manufacturing becomes internationally competitive, the dependence on rural demand is weakened. Nevertheless, as experience shows, including in East Asia, this source of demand is particularly important in the early stages of import substitution when manufacturers rely on the domestic market before they can compete with more efficient producers in world markets.[14] In Africa, too, manufacturing export success has almost invariably been developed on the basis of import-substitution activities.

Lastly, agricultural policy has been used in Africa to promote a pattern of income distribution which is regarded as legitimate and which therefore does not threaten political stability. This is an extremely delicate problem in nation-state building in Africa. Some aspects of agricultural pricing policy, particularly the practice of providing uniform guaranteed prices countrywide, have been part of an implicit social contract designed to redress colonial imbalances and ensure that certain ethnic groups with less fertile land and limited access to markets are not totally excluded.[15]

A major dilemma in agrarian economies is that policies designed to increase the contribution of the agricultural sector to the rest of the economy can impede agricultural growth, thereby failing to attain their original objectives. Thus, attempts to provide fiscal revenues through taxation of agricultural exports may reduce incentives for agricultural producers and cut foreign exchange earnings. Again, policies designed to provide cheap food for the urban population or cheap supplies to industry can reduce agricultural incentives, thereby creating shortages. Similarly, the system of agricultural pricing can be abused to reward political support or punish opposition, or favour urban against rural interests.[16] Experience shows that the countries of SSA have not always been able to strike a balance between such conflicting objectives. This has not only impeded agricultural growth and depressed the living conditions of a large proportion of the population, but also reduced significantly the contribution of agriculture to the rest of the economy.

C. Main features of African agriculture

Policies designed for agricultural development and their effects on the overall performance of the economy are circumscribed by certain structural features of African agriculture. These include specific forms of production and a historical legacy of intersectoral dualism between agriculture and non-agriculture. Equally important is the nature of agricultural production, particularly its tradability. These issues are taken up in the following sections.

1. Forms of production

Agrarian production relations and institutions are very diverse in Africa, but in general it is possible to identify three forms of production. The first is "smallholder production", in which work is organized by households around a gender division of labour. Men and women have responsibilities for different crops, or for specific tasks at different stages of production of the same crops, but women, who provide a major part of the labour input, often do not have full control over the product of their labour. Access to land is mediated through indigenous systems of tenure in which membership of the local community is the primary basis for various land-use rights, although there are also land markets for buying and selling user rights, but not outright ownership of parcels of land.[17] Very little of the arable land area is irrigated and thus most producers are subject to the vagaries of the weather.[18] Owing to the dependence on rainfall there is strong seasonality in labour use, particularly in semi-arid areas, where about 70 per cent of labour is expended in a four-month period. In such areas labour shortages in critical periods of planting and harvesting can be particularly acute and coexist with underemployment during the rest of the year.

The second form of production is large-scale capitalist farming. Some farms are foreign-owned plantations, generally export-oriented; some are old colonial settler estates oriented to export or domestic markets; and some are new African estates, often set up by the newly emerging elites. There has been an expansion of this last type in the domestic cereals sector since the mid-1970s, but in some countries such African agribusinesses are also export-oriented.[19]

The third form of production – large-scale state-owned farms – was most strongly developed in the post-colonial period in the few African countries engaged in effecting a transition to socialism (for example, Algeria, Ethiopia, Guinea-Bissau and Mozambique). Following the privatization drive, public ownership of farms is now quite unimportant.

Although smallholder production is the dominant form of production in Africa, it coexists with large-scale capitalist farming. This coexistence has generally not been benign, though it has the potential for positive linkages in forms of contract farming where smallholders act as outgrowers for large agribusinesses. Large settler farms were generally established through measures which sought to reduce the profitability of more efficient smallholder production, constraining competition and ensuring the availability of a workforce. These measures restricted the access of smallholders to land, markets and infrastructure services, which eventually could result in soil erosion, the drying up of wells and exhaustion of pasture.[20]

Today smallholders include both small and medium-sized farm units. Although often described as "subsistence farmers", small units are often enmeshed in product markets, both selling and buying foodstuffs through the year on a seasonal basis and even producing cash crops for export. Larger units produce primarily for sale, hire labour and use manufactured inputs. Farmers in this category, who have variously been called "progressive", "commercial" or even "capitalist" farmers, are responsible for a large proportion of marketed output in many African countries. Those who are mainly involved in export crops are concentrated in areas of relatively high and regular

rainfall where infrastructure is also generally better. The commercially oriented food crop farmers have developed as a result of growing urban demand and with state support, particularly through the integrated rural development programmes of the 1970s which sought to provide seed, fertilizer, pesticides and low-cost credit, and to guarantee market outlets. It is these farmers which form the basis of what is now being described as Africa's maize revolution.[21] They are found in areas closer to major urban centres and with better agro-ecological conditions, but with less favourable rainfall than areas of export crop production.

A significant feature of both small and medium-sized farm units making up the "smallholders" is that an important part of their incomes is derived from non-farm employment in formal or informal activities. This, it is now realized, is widespread throughout Africa (see table 38). Indeed, recent estimates suggest that on average as much as 42 per cent of rural household incomes is derived from non-farm employment, as compared with 40 per cent in Latin America and 32 per cent in Asia.[22] This involves some rural employment, but it often entails the migration of male household members to urban centres. For rich farmers, who occupy the more lucrative niches in the labour market, off-farm earnings provide a source of investment in agriculture, while for the poor they mainly supplement consumption.

Selling labour time to other farmers does not appear to be a major source of earnings for smallholders. This reflects the relative underdevelopment of rural labour markets outside those countries in which capitalist agribusinesses are important. However, evidence suggests that non-monetized labour exchanges are an important form of interaction between rich and poor smallholders.[23] Moreover, the situation is changing, as with rising population densities some farmers are becoming land-poor with use rights over a plot of land not large enough to meet their subsistence needs. A process of concentration of control over different rights in land is occurring as land becomes scarce and commercially valuable. Moreover, some smallholders have become simply "too poor to farm" in the sense that, despite access to land, they cannot mobilize sufficient amounts of labour and other inputs to make a living.[24] Despite these trends, the intensity of landlessness in Africa is still less than in Asia or Latin America. Indeed, in most of rural Africa where indigenous systems of land tenure prevail, it is difficult even to speak of

Table 38

NON-FARM INCOME OF RURAL HOUSEHOLDS IN AFRICA: CASE STUDY EVIDENCE

Country	*Period*	Share of non-farm income in total income *(Per cent)*
Botswana	1974-1975	54
Botswana	1985-1986	77
Burkina Faso (fav.)	1978-1979	22
Burkina Faso (unfav.)	1981-1984	37
Burkina Faso (fav.)	1981-1984	40
Ethiopia (overall)	1989-1990	36
Ethiopia (lowland, fav.)	1989-1990	44
Ethiopia (highland, unfav.)	1989-1990	38
Ethiopia (pastoral)	1989-1990	38
Gambia	1985-1986	23
Kenya (central)	1974-1975	42
Kenya (western)	1987-1989	80
Kenya	1984	52
Lesotho	1976	78
Malawi	1990-1991	34
Mali	1988-1989	59
Mozambique	1991	15
Namibia (fav.)	1992-1993	56
Namibia (unfav.)	1992-1993	93
Niger (fav.)	1989-1990	43
Niger (unfav.)	1989-1990	52
Nigeria (northern)	1974-1975	30
Nigeria (northern)	1966-1967	23
Rwanda	1990	30
Senegal (northern, unfav.)	1988-1989	60
Senegal (central)	1988-1990	24
Senegal (southern)	1988-1990	41
South Africa[a]	1982-1986	75
Sudan	1988	38
United Rep. of Tanzania	1980	25
Zimbabwe	1988-1989	35
Zimbabwe (overall)	1990-1991	38
Zimbabwe (poor)	1990-1991	31

Source: T. Reardon, "Using evidence of household income diversification to inform study of the rural nonfarm labour market in Africa", *World Development*, Vol. 25, No. 5, May 1997.

Note: Non-farm income is income from local non-farm wage employment, local non-farm self-employment and migrants' remittances. The abbreviations "fav." and "unfav." denote favourable and unfavourable agro-climatic zones, respectively.

a Former homelands.

"landlessness" since members of the community have direct or indirect access to community land.[25]

2. Intersectoral dualism

There is a large gap in income per head between the agricultural and non-agricultural sectors in Africa. Value-added per worker in the latter sectors is between 7 and 8 times higher than in agriculture; in Asia and Latin America it is only between 2.5 and 3.5 times higher (table 39).

Table 39

INTERSECTORAL DUALISM: A REGIONAL COMPARISON

	Income ratio[a]			
	1950-1960	*1960-1970*	*1970-1980*	*1980-1990*
Africa	7.05	8.33	8.74	7.79
Asia	1.87	3.37	3.31	3.57
Latin America	2.42	3.00	2.81	2.51
Other	1.88	2.17	2.15	2.25

Source: D. Larson and Y. Mundlak, "On the intersectoral migration of agricultural labour", *Economic Development and Cultural Change*, Vol. 45, No. 2, 1997.

a Ratio of non-agricultural value-added per worker to that in agriculture.

This differential is one of the key indicators of "urban bias"in Africa, but this bias cannot be simply attributed to post-colonial pricing policies.[26] Intersectoral dualism has historical and geographical roots in colonial policies that sought to set up institutional barriers to rural-urban interaction, and in poor agro-ecological conditions. But it is ultimately based on lack of investment in African agriculture and the persistence of low agricultural labour productivity, features which will be examined below.

Intersectoral dualism has important implications for agrarian production relations and structural change. It implies that earnings potentials outside agriculture can be much higher, and it is this differential which, in general terms, underlies the attractiveness to farm households of "straddling" between the agricultural and non-agricultural sectors. Such straddling can have positive effects on agriculture because, as noted, non-farm incomes can provide an important source of farm investment. However, to the extent that off-farm employment opportunities are available, there is continual pressure for productive labour to be diverted from agriculture. Under these conditions, there may be little incentive to adopt high-yielding crop varieties, which can require greater labour inputs. Rather, the types of innovation which are attractive are those which save household labour time and thus enable the diversion of labour from the farm.

The implications of this situation depend on whether there is surplus agricultural labour, i.e. whether the withdrawal of labour will reduce output. In East Asia, at an early stage of industrialization, a combination of widespread surplus labour in agriculture with employment opportunities in the urban economy led to strong dynamic complementarities between agricultural and industrial growth. In such conditions, rapid growth of urban employment can reduce population pressure on land and increase agricultural labour productivity. But where population densities are low, land is not fertile and there are labour shortages in agriculture, the withdrawal of labour can lead to a decline in agricultural output.

The picture in Africa varies from place to place. But a number of astute observers have identified the absence of surplus labour as characteristic of African agriculture in the past, except perhaps in areas concentrating on exports.[27] Moreover, despite high rates of population growth, widespread labour shortages are still identified as a key constraint. Household studies in Southern Africa suggest that "contrary to orthodox thinking, withdrawal of labour from the African countryside tends to result in residual farm work forces which have a lower productive potential than they otherwise would have had".[28] Also, it is estimated that as many as 30 per cent of farm households in Southern Africa are female-headed households with limited productive assets.[29]

3. Export and food crops, and tradability

Whether governments should give priority to export or food crops has been a perennial issue in the debate on agricultural policy in Africa. In the 1970s both African governments and donors laid

emphasis on increasing food production. When export promotion became a central goal of policy reforms in the 1980s, priorities shifted in favour of export crops. It has been argued that the goal of national food self-sufficiency, to which many African governments were committed, was wrong-headed since rising food demand could be met through imports.

Three factors have been increasing the rate of growth of food demand in Africa. The first is the extremely rapid growth of population, which is estimated to have risen from 2.5 per cent per annum in 1960 to 3.2 per cent in the late 1980s. This is the fastest growth rate recorded in human history and contrasts with downward trends both in South Asia, where the rate dropped from 2.5 per cent to 2.1 per cent over the same period, and in Latin America, where it dropped from 2.9 per cent to 2.5 per cent.[30] Second, Africa is experiencing the most rapid rate of urbanization in the world, and it is estimated that the share of the urban population will reach 41 per cent by the year 2000. Third, in view of the prevailing low income levels, improvements in income tend to be spent on food. Estimates show that the overall income elasticity of expenditure on food is close to unity. As income increases, consumption of main staple coarse grains (sorghum, millet and maize) and roots and tubers also rises, but their share in expenditure falls, while for wheat, wheat products and livestock products both the level and the share of expenditure increase with income.

There are a number of difficulties in meeting this rapid growth of food demand through imports, the most important of which is that a major part of staple food in SSA consists of crops which are non-tradable internationally outside Africa. This problem is usually overlooked and agriculture is typically described as a fully tradable sector.[31] However, major domestic food staples over much of Africa, notably cassava, plantain, yams, millet and sorghum in West and Central Africa, and white maize in Southern and East Africa, are not traded internationally outside the region. There is little external demand for them and there are few other international sources of supply.

The extent to which national food demands are met through such non-tradable crops varies from country to country, but traditional food staples are very important in most countries. The major exception is North Africa, where the main source of dietary energy is tradable wheat. Tradable rice is also significant in a few West African countries (Gambia, Liberia and Sierra Leone) and also in Madagascar and (along with wheat) in Mauritius. But non-tradable roots and tubers provide an important part of total dietary energy supply in much of West and Central Africa, making up over 33 per cent of the total in 13 countries (Angola, Benin, Burundi, Congo, Côte d'Ivoire, Democratic Republic of the Congo, Ghana, Mozambique, Nigeria, Rwanda, Togo, Uganda and United Republic of Tanzania). Of the other cereal crops, sorghum and millet are the key staples in some Sahelian countries and also Sudan, while white maize is consumed widely in Africa and is the main staple in East and Southern Africa (table 40). Yellow maize is widely traded internationally and can be substituted in diets for white maize, but it is considered inferior and its consumption is mainly a function of poverty levels. Moreover, transport costs for cereals are high, given current infrastructure and marketing systems, and this means that local prices in the cities of the landlocked countries (Burkina Faso, Chad, Malawi, Mali, Niger, Zambia and Zimbabwe) generally fluctuate in a range discouraging trade outside the region and sometimes even within the region.[32]

Another problem in shifting production to exports and relying on food imports relates to the volatility of export prices and the downward trend in the terms of trade. Indeed, foreign exchange shortages have often limited the ability of SSA countries to import food in adequate quantities, and swings in export earnings have been a major factor in large yearly fluctuations in food consumption.[33]

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There is no simple answer to the choice between food crops and export crops. On the one hand, there is constant upward pressure on food prices because of rising demand. On the other hand, export crops face declining terms of trade and unstable prices. The development of the food sector has implications for poverty, and also has the political dimensions of food security and economic self-reliance. But, more importantly, it is a critical economic issue, with serious implications for overall growth and macroeconomic balances. Indeed, the competitiveness of exports is often conditioned by the factors which influence the domestic supply of and demand for food. In this respect, increasing productivity and food supply is crucial in improving international competitiveness, both in agriculture and in industry, because it helps to keep down wage costs without lowering workers' living standards.[34]

Table 40

SHARE OF MAJOR FOOD GROUPS IN TOTAL DIETARY ENERGY SUPPLY IN AFRICA, BY COUNTRY, 1990-1992

(Percentages)

Country	Roots and tubers	Main cereals			
		Maize	Sorghum and millet	Rice	Wheat
Total Africa	***14.9***	***14.6***	***10.2***	***6.8***	***15.2***
Dem. Rep. of the Congo	**56.2**	9.5	0.7	3.4	1.8
Ghana	**40.7**	15.0	5.4	5.3	4.1
Mozambique	**39.5**	23.5	4.2	4.2	4.1
Benin	**38.2**	20.0	6.8	5.2	3.0
Congo	**38.1**	4.5	0.0	3.8	13.5
Central African Rep.	**36.0**	9.0	3.8	1.9	3.9
Angola	**29.8**	16.1	2.6	6.0	6.5
Togo	**28.8**	22.0	14.0	5.0	6.6
Burundi	**28.4**	12.3	3.7	1.8	2.0
Rwanda	**28.2**	7.0	10.3	0.7	1.1
Uganda	**27.8**	7.8	9.5	0.9	0.4
Côte d'Ivoire	**27.2**	9.3	1.4	21.3	5.2
Nigeria	**26.0**	5.2	22.4	8.8	1.7
Gabon	**21.9**	8.6	0.0	6.9	9.8
Cameroon	**18.0**	14.3	13.0	4.8	6.1
Malawi	3.8	**67.5**	0.7	1.4	0.3
Zambia	9.9	**64.6**	1.3	0.4	4.0
Lesotho	0.7	**56.4**	2.9	0.5	16.4
Zimbabwe	1.6	**41.5**	5.9	0.5	10.9
Kenya	8.0	**40.4**	1.4	2.1	5.8
South Africa	1.7	**32.4**	2.1	3.1	15.9
United Rep. of Tanzania	24.6	**31.8**	4.9	7.0	1.9
Somalia	0.9	**23.5**	15.4	7.6	8.6
Ethiopia	4.2	**18.7**	11.4	0.1	16.1
Namibia	15.6	**16.9**	10.9	0.0	6.0
Botswana	1.5	**16.8**	12.0	2.5	12.6
Niger	3.6	0.3	**65.9**	4.7	3.4
Burkina Faso	0.9	12.3	**56.1**	5.8	1.4
Mali	1.9	8.6	**48.8**	12.7	1.8
Sudan	0.6	1.0	**38.4**	0.7	18.4
Chad	15.2	2.4	**35.3**	4.8	3.2
Madagascar	21.0	3.9	0.0	**48.9**	1.7
Sierra Leone	4.4	1.2	3.8	**45.2**	3.3
Liberia	22.3	0.0	0.0	**42.8**	1.7
Gambia	1.0	3.8	18.3	**38.1**	4.6
Guinea	13.9	3.1	2.7	**33.9**	5.0
Senegal	1.0	5.4	22.6	**27.2**	8.4
Mauritius	1.3	0.4	0.0	**22.5**	21.7
Tunisia	1.4	0.0	0.1	0.3	**52.0**
Algeria	2.2	0.2	0.1	0.4	**50.2**
Morocco	1.9	3.7	0.3	0.4	**44.2**
Libyan Arab Jamahiriya	1.7	0.2	0.0	4.2	**37.9**
Egypt	1.7	17.3	1.1	9.6	**36.4**
Mauritania	0.5	0.6	6.9	17.6	**30.0**
Swaziland	1.4	11.7	0.0	3.6	**26.4**

Source: FAO, *The Sixth World Food Survey* (Rome: FAO, 1996).

D. Trends in agricultural production, trade and productivity

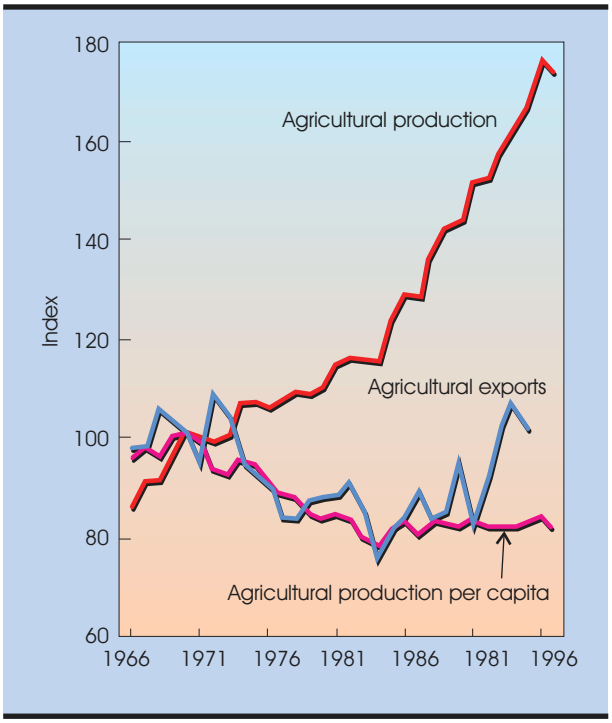
1. Production

As noted in the previous chapter, agricultural growth in Africa has generally been unsatisfactory. FAO statistics, which indicate the volume of agricultural and food output, suggest that this was particularly so in SSA during the 1970s and early 1980s, when output per capita fell. After 1984 agricultural growth accelerated: from 1970 to 1984, total agricultural output rose by 1.2 per cent per annum, and thereafter by 3.1 per cent. However, the recovery only halted the decline in per capita output (chart 12).

Chart 12

VOLUME OF AGRICULTURAL PRODUCTION AND EXPORTS IN SUB-SAHARAN AFRICA, 1966-1997

(1969-1971 = 100)



Source: UNCTAD secretariat calculations, based on FAO, *FAOSTAT* database.

This general trend conceals many differences between countries, regions and commodities. Table 41 compares the growth of agricultural production in the 1970s with growth since 1984. In a sample of 44 countries post-1984 agricultural growth performance was better in 22 and worse in 15 than in the 1970s. Whereas in the 1970s a total of 11 countries had growth rates in excess of 3 per cent, in the post-1984 period there was a total of 13 countries. During the 1970s in six of these 13 countries – Algeria, Chad, Ghana, Nigeria, Togo and Uganda – agricultural growth was less than 1 per cent per annum or negative. All the West African Sahelian countries improved their performance after 1984 compared with the 1970s. In contrast, there is a clear tendency for the countries whose performance worsened to be located in Southern or East Africa.

Overall trends in food production are similar to those for agricultural production. There was some recovery in the rate of growth of output after 1984 for the region as a whole, but again only enough to halt the decline in per capita food production. Regional disaggregation shows that in North Africa a rapid upward trend that had emerged in the mid-1980s was reversed in the early 1990s. In West and Central Africa, the trend since 1984 has been upward but weak, whilst in Southern and East Africa it has been downward (table 42). In the latter regions the downward trend is observed in countries both with and without civil unrest. Table 42 shows that within SSA the growth rate of food production was higher since 1985 than in the 1970s in 18 countries, and of these countries Benin, Burkina Faso, Chad, Ghana, Guinea, Mali, Niger, Nigeria, Togo and Uganda all achieved growth rates higher than 3 per cent per annum.[35]

2. Trade

Focusing on SSA, figures for the volume of agricultural exports indicate a similar post-1984 improvement. The volume of agricultural exports was actually declining from 1972 to 1984, but since

Table 41

COMPARISON OF TRENDS IN AGRICULTURAL PRODUCTION IN AFRICAN COUNTRIES DURING 1970-1980 AND 1985-1996

(Average annual growth of output)

		1970-1980					
		More than 4 per cent	***3-4 per cent***	***2-3 per cent***	***1-2 per cent***	***0-1 per cent***	***Negative***
1985-1996	***More than 4 per cent***			Benin Mali	Burkina Faso Niger	Togo	Ghana Nigeria
	3-4 per cent	Tunisia		*Developing country average*	Egypt Guinea *SSA average*	Algeria Chad	Uganda
	2-3 per cent	Côte d'Ivoire	Gabon Kenya	Central African Republic Guinea-Bissau	Dem. Rep. of the Congo Ethiopia[a] Morocco		Angola Namibia
	1-2 per cent		Malawi Sudan Zambia		Cameroon Congo Madagascar	Lesotho Mauritania Senegal	
	0-1 per cent	Libyan Arab Jam.	United Rep. of Tanzania	South Africa Zimbabwe	Burundi Sierra Leone	Mauritius	Botswana Mozambique
	Negative	Rwanda	Swaziland				Gambia

Source: UNCTAD secretariat calculations, based on FAO, *The State of Food and Agriculture* (Rome: FAO, 1997).
a 1985-1992.

then it has recovered, though with great variability and at a rate slower than that of the growth in the volume of agricultural production (chart 12). An important feature of the agricultural export trends is that during the first half of the 1970s there was actually a steep rise in unit value, which was more marked or more prolonged than in either Latin America or Asia. As a consequence, agricultural export earnings grew rapidly until 1977, even though the volume fell. But from 1977 to 1982 both the unit value and the total value of agricultural exports fell. Because of the continued decline in unit values from 1986 to 1993, a resumption in the growth of export volumes did not result in any increase in agricultural export revenue. However, the situation changed after 1993 owing to a steep increase in the unit value of agricultural exports and a continued rise in export volumes.

As in agricultural production, there have been marked differences in export performance among countries (table 43). In 24 countries out of a sample of 46 the growth in the volume of agricultural exports was higher during the post-1984 period than in the 1970s. In 13 countries the volume of agricultural exports continued to decline.

For individual export crops, it is difficult to identify a clear general pattern. For cotton and coffee, two main traditional agricultural exports,

Table 42

COMPARISON OF TRENDS IN FOOD PRODUCTION IN AFRICAN COUNTRIES DURING 1970-1980 AND 1985-1996

(Average annual growth of output)

		1970-1980					
		More than 4 per cent	***3-4 per cent***	***2-3 per cent***	***1-2 per cent***	***0-1 per cent***	***Negative***
1985-1996	***More than 4 per cent***			Benin	Niger	Burkina Faso	Ghana Nigeria
	3-4 per cent	Côte d'Ivoire Tunisia	*Developing country average*	Egypt	Guinea Mali Morocco *SSA average*	Algeria Chad Togo Uganda	
	2-3 per cent	Sudan	Central African Republic Gabon Kenya	Guinea-Bissau	Cameroon Dem. Rep. of the Congo Ethiopia [a]		
	1-2 per cent		Zambia		Congo Madagascar	Mauritania Mauritius Senegal	Angola Namibia
	0-1 per cent	Libyan Arab Jam. United Rep. of Tanzania	Swaziland	Malawi South Africa	Sierra Leone Lesotho	Burundi	Botswana Mozambique
	Negative		Rwanda		Zimbabwe		Gambia

Source: See table 41.
a 1985-1992.

the export volumes of the largest producers in SSA were about the same in 1995 as in 1970. For cotton, declines in export volumes in the 1970s were reversed during 1981-1989; for coffee there was no clear tendency. The volume of cocoa exports decreased in the 1970s, with an upturn in 1979. In contrast, tea and tobacco, which are of less importance, show an upward trend from 1970 which continued in the 1980s. For all traditional export commodities except tea, the world market share of SSA was lower in 1995 than in 1970.

Agricultural imports have also been growing, in large part on account of cereals. The increase was particularly rapid after 1976. With regard to crops and livestock, the trade performance ratio, i.e. the ratio of the agricultural trade balance (X-M) to total agricultural trade (X+M), fell from 0.51 in 1966-1968 to 0.44 in 1972-1974 and 0.18 in 1979-1981 (table 44). Subsequently, agricultural exports generally rose more slowly than imports. Consequently, net agricultural exports fell in all groups of countries; out of the seven subregions covered in table 44, four registered deficits in agricultural trade during 1993-1995. This worsening of the net agricultural export position of Africa was due to a rapid increase in food imports, exceeding the growth in earnings from export crops.

Table 43

COMPARISON OF TRENDS IN AGRICULTURAL EXPORTS IN AFRICAN COUNTRIES DURING 1970-1980 AND 1985-1996

(Annual average growth of export volume)

		1970-1980					
		More than 4 per cent	*3-4 per cent*	*2-3 per cent*	*1-2 per cent*	*0-1 per cent*	*Negative*
1985-1996	*More than 4 per cent*	Gabon		Sudan		Cameroon	Benin, Burkina Faso, Egypt, Ghana, Guinea-Bissau, Kenya, Libyan Arab Jam.[a], Namibia, Nigeria, Somalia[a], Togo, Uganda, U.R. of Tanzania
	3-4 per cent	Côte d'Ivoire		Zimbabwe			Tunisia
	2-3 per cent						Botswana, Mozambique, Zambia
	1-2 per cent			Chad			Madagascar, Morocco
	0-1 per cent	South Africa		Mali		Mauritius	Central African Republic, Guinea
	Negative			Malawi, Swaziland		Rwanda	Algeria, Angola, Burundi, Congo, D. Rep. of the Congo, Ethiopia[b], Gambia, Lesotho, Liberia[a], Mauritania, Niger, Senegal, Sierra Leone

Source: UNCTAD secretariat calculations, based on data from FAO Statistics Division.

a 1985-1995.

b 1985-1992.

3. *Productivity levels and trends*

Post-1970 trends in land and labour productivity are shown in chart 13, using wheat units as a measure of output. For sub-Saharan Africa as a whole, there was a dramatic decline in labour productivity during 1975-1984. A temporary improvement in the mid-1980s was followed by fluctuating but generally stagnant levels of productivity. On the other hand, output per hectare has continued to grow more or less at a constant rate from the 1970s onwards, with a slight acceleration in the mid-1980s.[36]

Different regional and country performances lie behind these average trends. The main contrast is between West and Central Africa, on the one hand, where an improvement in both yields and labour productivity has taken place since 1983, and the southern, Sudano-Sahel and eastern regions, on the other hand, where labour productivity has

Table 44

AGRICULTURAL TRADE PERFORMANCE, BY REGION, 1966-1995

Region	Ratio of trade balance to total trade in agricultural products[a]			
	1966-1968	1972-1974	1979-1981	1993-1995
Sub-Saharan Africa	0.51	0.44	0.18	0.10
Low-income countries in:				
West Africa[b]	0.34	0.18	0.09	-0.21
East and Southern Africa[c]	0.47	0.43	0.30	0.05
Middle-income countries in:				
West Africa[d]	0.38	0.26	0.13	0.08
East and Southern Africa[e]	0.27	0.31	0.11	-0.10
South Africa	0.42	0.49	0.50	0.09
Oil exporters[f]	0.25	0.08	-0.35	-0.56
North Africa[g]	-0.16	-0.23	-0.64	-0.65

Source: See table 41.

a The balance of the region's trade with agricultural products (X-M) divided by the sum of its agricultural exports and imports (X+M); forestry and fishery products are not included.

b Benin, Burkina Faso, Central African Republic, Chad, Equatorial Guinea, Gambia, Ghana, Guinea, Guinea-Bissau, Liberia, Mali, Mauritania, Niger, Sao Tome and Principe, Sierra Leone, Togo.

c Burundi, Democratic Republic of the Congo, Ethiopia, Kenya, Lesotho, Madagascar, Malawi, Mozambique, Rwanda, Somalia, Sudan, Uganda, United Republic of Tanzania, Zambia, Zimbabwe.

d Côte d'Ivoire, Senegal.

e Botswana, Mauritius, Namibia, Seychelles, Swaziland.

f Angola, Cameroon, Congo, Gabon, Nigeria.

g Algeria, Egypt, Libyan Arab Jamahiriya, Morocco, Tunisia.

either been declining from the mid-1970s onwards or, at best, has remained stagnant. These regions register a much more modest improvement of yields.

Other studies show that the overall growth of total factor productivity in agriculture in 47 African countries was 1.3 per cent per annum between 1961 and 1991. But about one quarter of the countries experienced negative productivity growth, and another quarter positive growth but of less than 1 per cent. Examining countries in different regions and comparing differences in their performance in terms of total factor productivity provides evidence of convergence, in the sense that the countries with the lowest productivity within regional sets have higher rates of productivity growth. But this does not hold for the continent as a whole.[37]

How far are African productivity levels and trends determined by policy choices and how far by natural conditions? It will be useful to start addressing this question by means of a comparative intercontinental investigation of land, labour and capital use and of productivity differentials in agriculture.

The indicators in table 45 show that during the early 1990s average labour and land productivities in cereal production in Africa were much lower than in Asia and Latin America. There is, of course, considerable variation among countries in all regions. But even low-income Asian countries had higher cereal yields per unit of agricultural land than all African countries except Malawi; in some cases the yield differential was as much as one to four. Moreover, yields in Africa are sub-

Chart 13

LAND AND LABOUR PRODUCTIVITY IN SUB-SAHARAN AFRICA, BY REGION, 1969-1994

Source: M. Karshenas, "World agricultural output in wheat equivalent units" (London: School of Oriental and African Studies, 1998), mimeo.

Note: *Output* is measured in wheat equivalent units in 1980 world relative prices. *Land* covers arable land, land under permanent crops, and permanent meadows and pastures. *Labour* refers to the economically active population in agriculture. Regional groupings are as follows: ***Sub-Saharan Africa:*** all of the following; ***West:*** Benin, Côte d'Ivoire, Ghana, Sierra Leone; ***Central:*** Cameroon, Central African Republic, Congo, Democratic Republic of the Congo; ***East:*** Kenya, Madagascar, Uganda; ***Southern:*** Botswana, Lesotho, Malawi, Mozambique, United Republic of Tanzania, Zambia, Zimbabwe; ***Sudano-Sahel:*** Burkina Faso, Chad, Gambia, Mali, Mauritania, Niger, Senegal, Sudan.

Table 45

AGRICULTURAL PRODUCTIVITY AND ITS DETERMINANTS IN AFRICA, ASIA AND LATIN AMERICA, 1994

	Africa	*Asia*[a]	*Latin America*
Cereal yield (kg/hectare)	1 230	2 943	2 477
Cereal output per capita[b] (kg)	159	274	280
Land/labour[c]	5.9	1.3	24.8
Fertilizer/arable land (kg/hectare)[d]	19	126	63
Irrigated area/arable land (per cent)[d]	6.6	33.3	9.2
Tractors/arable land (no./1,000 hectares)[d]	290	804	1 165

Source: UNCTAD secretariat estimates, based on FAO, *Production Yearbook 1995*, and *Fertilizer Yearbook 1995.*

a Including China and Asian economies in transition, excluding Japan.

b Of total population.

c Ratio of the agricultural area (land under temporary and permanent crops and under permanent pasture) to economically active population in agriculture.

d Arable land includes land under temporary and permanent crops.

ject to much greater annual variation than in Asia (see chart 14).

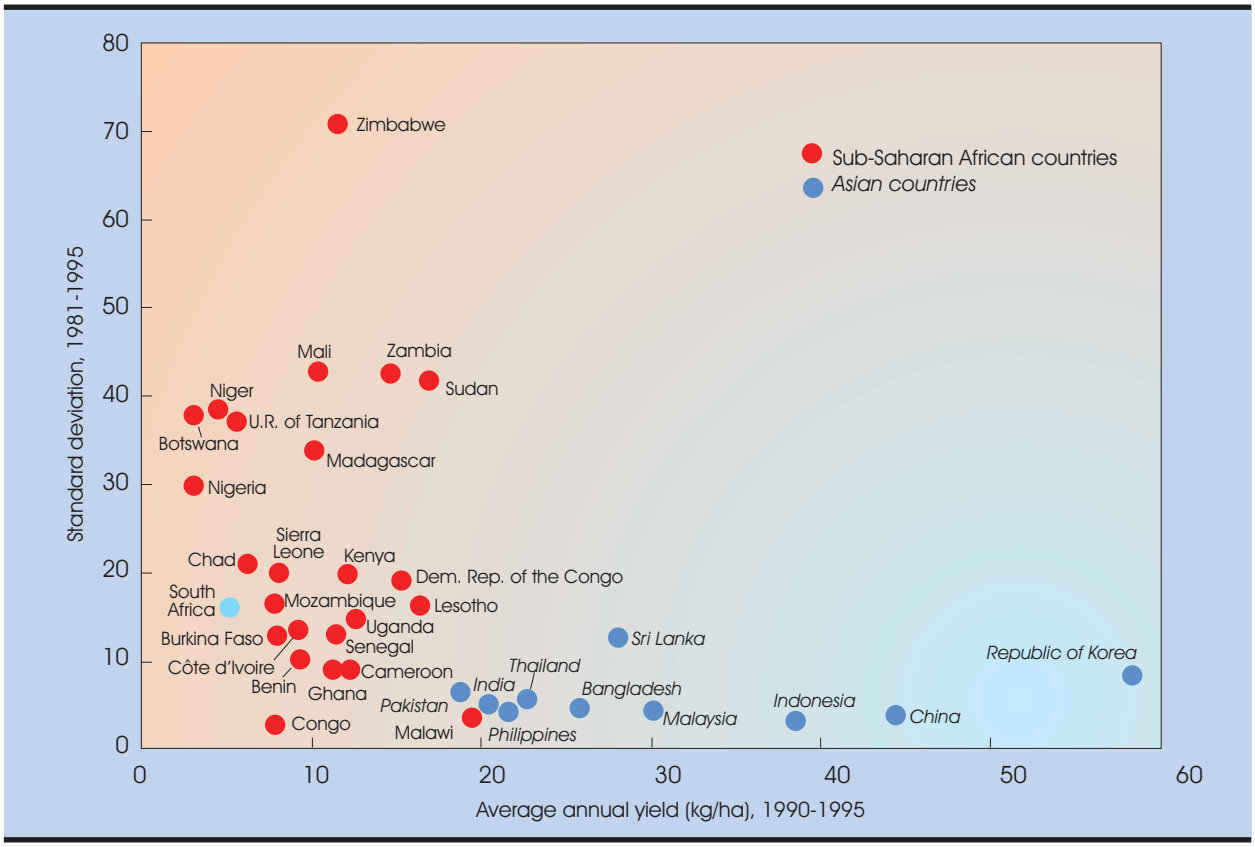
These differences reflect natural and technical endowments of agriculture. Agro-ecological conditions in Africa are difficult. In general terms it is estimated that 46 per cent of the continental land mass is unsuitable for direct rain-fed cultivation because the growing period is too short, in large part because of aridity. Of the land which is suitable for rain-fed cultivation, about half has been classified as marginal in the sense that, for a representative range of crops, yields are only between 20 and 40 per cent of the maximum attainable on the best land. As farmers move on to new areas there is a constant downward pressure on average yields. Also, there is a high risk of drought over 60 per cent of the land area of Africa. In particular, the Sahel, the Horn of Africa and the countries in Southern Africa around the Kalahari desert are characterized by high inter-annual and intra-seasonal rainfall variability. The shift into marginal land is also associated with increasing farming risks. In addition, many African soils are fragile, and inappropriate land use, poor management and lack of inputs can quickly lead to land degradation.[38]

Differing land/labour ratios, which measure the degree to which extensive production methods are used, also affect productivity indicators. Intensive and extensive production methods require different patterns of input use and capitalization. Intensive methods require fertilizers, insecticides, irrigation and improved varieties in order to improve yields per hectare. Extensive methods, on the other hand, allow investment in labour-saving machinery, and therefore tend to increase labour productivity.

Asian and Latin American indicators in table 45 are consistent with these propositions. But for Africa this is only part of the story. The land/labour ratios in Africa are lower than in Latin America but higher than in Asia. Disregarding ecological differences, *ceteris paribus*, the relatively more intensive African agriculture should be expected to achieve higher yields than in Latin America. However, African cereal yields are about one half of those in Latin America, mainly because of undercapitalization. The use of fertilizers and tractors is much more limited and irrigation less widespread in Africa than in other developing regions. Agricultural capital stock per hectare of agricultural land in sub-Saharan Africa in 1988-1992 appears to have been one sixth of the Asian level and less than a quarter of that of Latin America. The scope for economically viable small- and medium-scale irrigation is smaller in Africa and it has been used only to a very limited extent: only 28 per cent of the "irrigable" land is actually irri-

Chart 14

CEREAL YIELDS AND THEIR VARIATION IN SUB-SAHARAN AFRICA AND ASIA



Source: M. Karshenas, "Capital accumulation and agricultural surplus in sub-Saharan Africa and Asia", paper prepared for the UNCTAD project on African Development in a Comparative Perspective (Geneva, 1998), mimeo.

gated in Africa as a whole, and this proportion is less than 10 per cent in Central, East and West Africa.[39]

The undercapitalization of African agriculture is becoming increasingly serious because with rapid population growth land reserves of whatever quality, are being exhausted. This is occurring to different degrees in different parts of Africa. In the Mediterranean and arid North African region there is virtually no remaining land reserve. In Sudano-Sahelian Africa and humid and sub-humid West Africa, there are land reserves which are approximately equal in extent to the area under existing cultivation, but the reserves are of marginal quality and 75 per cent of the land reserve in the Sudano-Sahelian zone is concentrated in one country – Sudan. The main land reserves in Africa are located in humid Central Africa and sub-humid and semi-arid Southern Africa. In both these regions there is unused land considered very or moderately suitable for cultivation (with yields over 40 per cent of the maximum attainable). But a further problem in such regions is infestation by tsetse flies and thus the prevalence of trypanosomiasis.

Projections of land/labour ratios suggest that by 2025 over 50 per cent of SSA will be in high-density conditions similar to those in South Asia.[40] This transition from land abundance to land scarcity has important implications. During the post-colonial era, the overall orientation in Africa has been towards extensive patterns of agriculture. Much of the expansion of production has been effected by bringing in new areas of land rather than by adopting yield-increasing technologies. Thus, for example, between 1961 and 1990, 47 per cent of the increase in cereal output in SSA was due to an increase in cultivated area, whilst 53 per cent was attributable to increasing average yields. In contrast, just 6 per cent and 14 per cent of the increase in East Asia and South Asia, respectively, was attributable to area increases,

whilst the rest was due to higher yields.[41] Already in the 1960s, expansion of cultivated area meant moving on to increasingly marginal land in many countries, something that partly explains the adverse labour productivity trends noted above. But as land reserves are exhausted it becomes necessary to shift from a pattern of agricultural growth based on area expansion to one based on intensification. A shift to more intensive agriculture requires significant investment by farmers and governments; otherwise, there will be strong pressures for a further acceleration of environmental degradation. Such new investment and resource use in favour of intensification involve irrigation as well as the implementation of new technologies (e.g. for the cultivation of high-yielding varieties) and higher levels of input utilization (e.g. fertilizers).

E. Conclusions

Poor agricultural performance in Africa is often portrayed as the outcome of the self-interested policy decisions of urban elites acting against the interests of the majority of farmers. But this view fails to recognize the difficult dilemmas faced by African governments in formulating agricultural policy. These are rooted in the trade-offs between the various important contributions which the agricultural sector makes to the overall growth process in low-income countries. All predominantly agricultural countries face these dilemmas, but they are particularly acute in sub-Saharan Africa for three reasons. First, an important part of agricultural output consists of goods which are non-tradable internationally outside the region. Second, agricultural production takes place in a difficult, risky and fragile natural environment and is seriously undercapitalized, particularly in the context of a transition from land abundance to land scarcity. Third, there is persistent and historically founded intersectoral dualism with very high differentials between output per worker in agriculture and other sectors.

The period since the middle of the last decade has witnessed intense policy efforts to reverse the poor performance during the 1970s. Indeed, in terms of a number of key indicators, including productivity, output and export volumes, the post-1984 period has generally been better than the 1970s and early 1980s. But the improvement has not been sufficient to increase per capita food production and net agricultural exports, or to sustain productivity growth. Moreover, the improvement has been patchy, with many countries faring worse in the later period while a few countries apparently turned their agriculture around. Only a few countries have managed to achieve rates of growth of agricultural value added in excess of 4 per cent. This continued weak performance of agriculture in Africa thus raises the question of the effectiveness of policies in removing impediments to agricultural development, including lack of incentives and structural bottlenecks. The next chapter takes up this question. ■

Notes

1 See, for example, World Bank, *Accelerated Development in Sub-Saharan Africa: An Agenda for Action* (Washington, D.C.: World Bank, 1981) – the so-called Berg Report; and A. Singh and H. Tabatabai, "The world economic crisis and Third World agriculture in the 1980s", chapter 2 in A. Singh and H. Tabatabai (eds.), *Economic Crisis and Third World Agriculture* (Cambridge: Cambridge University Press, 1993).

2 See U.J. Lele, "Agricultural growth, domestic policies, the external environment and assistance to Africa: Lessons of a quarter century", MADIA Discussion Paper 1 (Washington, D.C.: World Bank, 1989.

3 For the latest approach to policy reform see J. Meerman, *Reforming Agriculture: The World Bank Goes to Market* (Washington D.C.: World Bank, 1997). For another view of the current official approach to agriculture and its relationship with earlier donor and African government strategies, see K. Cleaver, *Rural Development Strategies for Poverty Reduction and Environmental Protection in Sub-Saharan Africa* (Washington, D.C.: World Bank, 1997).

4 See C.P.Timmer, "Getting agriculture moving: Do markets provide the right signals?", *Food Policy*, Vol.20, No.5, 1995. The different priorities attached by aid donors and African governments to food and export crop production are just one indication of such policy complexity; see, in particular, OAU, *Lagos Plan of Action for the Implementation of the Monrovia Strategy for the Economic Development of Africa*, Addis Ababa, 1980; and Economic Commission for Africa, *African Alternative Framework to Structural Adjustment Programmes for Socio-Economic Recovery and Transformation (AAF-SAP)* (E/ECA/CM.15/6/Rev.3), Addis Ababa, 1989.

5 J. W. Mellor, *Agriculture on the Road to Industrialization* (Baltimore and London: Johns Hopkins University Press, 1995), p. 5.

6 For agricultural growth linkages in Africa, see S. Block and C.P. Timmer, *Agriculture and Economic Growth in Africa: Progress and Issues*, Agricultural Policy Analysis Project Phase III Research Report No.1016 (Bethesda, Maryland, March 1997).

7 See J.C. Berthélemy and C. Morrisson, *Agricultural Development in Africa and the Supply of Manufactured Goods* (Paris: OECD Development Centre, 1989). For the role of such a vicious circle in an assessment of the breakdown in accumulation in the United Republic of Tanzania at the end of the 1970s, see M. Wuyts, "Accumulation, industrialization and the peasantry: A Reinterpretation of the Tanzanian Experience", *Journal of Peasant Studies*, Vol. 21, No. 2, 1994, pp. 159-193.

8 See FAO, *The Sixth World Food Survey* (Rome: FAO, 1996).

9 It has been estimated that 10-20 per cent of people in poor countries, mostly smallholders in Africa and labourers in South Asia, are too undernourished and unhealthy to work more, even if incentives are provided for them to do so. See World Bank, *Poverty and Hunger: Issues and Options for Food Security in Developing Countries* (Washington, D.C.: World Bank, 1986).

10 See S. Jaffee, "Enhancing agricultural growth through diversification in sub-Saharan Africa", in S. Barghouti, S. Garbus and D. Umali (eds.), *Trends in Agricultural Diversification: Regional Perspectives*, Technical Paper No.180 (Washington, D.C.: World Bank, 1992).

11 Block and Timmer, *op. cit.*

12 R.H. Bates, *Markets and States in Tropical Africa: The Political Basis of Agricultural Policies* (Berkeley: University of California Press, 1981). In some cases, such as Uganda in the 1950s, the contribution was as high as 90 per cent, whilst in others, such as Kenya in the 1960s, it was as low as 10 per cent.

13 R.C. Riddell, *Manufacturing Africa: Performance and Prospects in Seven Countries in Sub-Saharan Africa* (London: James Currey, 1990), pp.34-35.

14 See *TDR 1997*, Part Two, chapter VI, pp. 182-183. For the relationship between import-substitution industrialization and the development of manufactured exports in Africa, see S. Wangwe, *Exporting Africa: Technology, Trade and Industrialization in Sub-Saharan Africa*, UNU/Intech Studies in New Technology (London and New York: Routledge,1995).

15 For the use of agricultural policy as part of an implicit distributional social contract, see T.S. Jayne and S. Jones, "Food marketing and pricing policy in Eastern and Southern Africa: A survey", *World Development*, Vol. 25, No. 9, pp. 1505-1527. For a discussion of the politics of inclusion in Africa see D. Rothschild and W. Foley, "African States and the politics of inclusive coalitions", in D. Rothschild and N. Chazan (eds.), *The Precarious Balance: State and Society in Africa* (Boulder, Colorado: Westview Press, 1988).

16 See Bates, *op. cit.*

17 A penetrating discussion of African land tenure is to be found in H.W.O. Okoth-Ogendo, "Some issues of theory in the study of tenure relations in African agriculture", *Africa*, Vol. 59, No. 1, 1989, pp. 6-12. A balanced account of gender relations is provided by A. Whitehead, "Rural women and food production in sub-Saharan Africa", in J. Dreze and A. Sen (eds.), *The Political Economy of Hunger* (Oxford: Clarendon Press, 1990). See also A. Tibaijuka, "The cost of differential gender roles in African agriculture: A case study of smallholder banana-coffee farms in Kagera Region, Tanzania", *Journal of Agricultural Economics*, Vol. 45, No. 1, 1994.

18 At present only 7.5 per cent of arable land is irrigated, and six countries (Egypt, Madagascar, Morocco, Nigeria, South Africa and Sudan) account for 75 per cent of total irrigated land. See FAO, "Food production and the critical role of water", Technical Background Document No. 7 for the World Food Summit, Rome, 13-17 November 1996.

19 For a discussion of the estate sector in Malawi and Kenya , see U.J. Lele and M. Agarwal, "Smallholder and large-scale agriculture in Africa: Are there tradeoffs between growth and equity?", MADIA Discussion Paper 6 (Washington, D.C.: World Bank, 1989).

20 See K. Deininger and H. Binswanger, "Rent-seeking and the development of large-scale agriculture in Kenya, South Africa, and Zimbabwe", *Economic Development and Cultural Change*, Vol. 43, 1995, pp. 493-522. On contract farming, which has been important in the expansion of non-traditional agricultural exports, see G. Porter and K. Phillips-Howard, "Comparing contracts: An evaluation of

contract farming schemes in Africa", *World Development*, Vol. 25, No. 2, 1997, pp. 227-238.

21 See D. Byerlee and C. K. Eicher, *Africa's Emerging Maize Revolution* (London and Boulder, Colorado: Lynne Rienner, 1997).

22 T. Reardon et al., "The importance and nature of rural nonfarm income in developing countries with policy implications for agriculturalists", in *The State of Food and Agriculture 1998* (Rome: FAO, 1998). These estimates are based on a review of about 100 farm household surveys undertaken from the 1970s to the 1990s.

23 See, for example, M. Mamdani, "Extreme but not exceptional: towards an analysis of the agrarian question in Uganda", *Journal of Peasant Studies*, Vol. 14, No. 2, 1987, pp. 191-225.

24 In Malawi, which has a large population in relation to the area of cultivable land and where the development strategy of the 1970s was founded on African estate production, it was estimated that at the end of the 1980s, 56 per cent of households on customary land (approximately 3.6 million people) were working less than one hectare of land and that their holdings were insufficient to meet their basic food needs. The phrase " too poor to farm" is taken from A. Whitehead, *Poverty in Northern Ghana*, Report to ESCOR (London: Overseas Development Agency, 1986). See also P. Hill, *Rural Hausa: A Village and a Setting* (Cambridge: Cambridge University Press, 1972).

25 For countries such as Kenya, where ownership of land is individually registered, it is possible to speak of the emergence of a landless population, and estimates of rural landless in the early 1980s range from 200,000 to 410,000 households, some 12 per cent of households in some provinces. Women and young men may not have direct access to land under the indigenous communal system, and on this basis it has been estimated, for example, that the number of landless men between the ages of 16 and 30 is 40 per cent in some areas of Zimbabwe. See J. Testerink, "Land relations and conflict in Eastern and Southern Africa", Occasional Paper No.4 (Perth, University of West Australia: Indian Ocean Centre for Peace Studies, 1991).

26 An extended argument regarding the relationship between agrarian conditions and wage rates in Africa and Asia, and their consequences for intersectoral dualism, is to be found in M. Karshenas, "Capital accumulation and agricultural surplus in sub-Saharan Africa and Asia", paper prepared for an UNCTAD project on African Development in a Comparative Perspective (Geneva, 1998), mimeo. For mineral economies, "Dutch disease" phenomena have been identified – see T. A. Oyejide, "Food Policy and the Choice of Trade Regime", and T. B. Tshibaka, "Commentary on the trade regime", in J.W.Mellor, C.L.Delgado, and M.J. Blackie (eds.), *Accelerating Food Production in Sub-Saharan Africa* (Baltimore: Johns Hopkins University Press, 1987).

27 See, in particular, J.W. Mellor, "Determinants of rural poverty: The dynamics of production, technology, and price", chap. 4 in J.W. Mellor and G.M. Desai (eds.), *Agricultural Change and Rural Poverty: Variations on a Theme by Dharm Narain* (Baltimore: Johns Hopkins University Press, 1986). Even W. Arthur Lewis, who first explained how economic development could take place with unlimited supplies of labour, excluded Africa from his discussion of the labour-surplus economy. J. Stiglitz argued that labour was not in surplus in most African economies, but sought to identify various conditions in which the withdrawal of labour did not result in falling output. See "Rural-urban migration, surplus labour, and the relationship between urban and rural wages", *East African Economic Review*, Vol.1, No.2, 1969. S. Berry argued that the labour-surplus model of development was not relevant for Africa, and focused on the absence of automatic reinvestment of profits in the nascent capitalist sector, and on the role of government; see "Economic development with surplus labour: Further complications suggested by contemporary African experience", *Oxford Economic Papers*, Vol. 22, No.2, July 1970, pp.275-287. For a recent assessment of the labour constraint in African agriculture see K. Saito, "Raising the productivity of women farmers in sub-Saharan Africa", World Bank Discussion Papers, Africa Technical Department Series, No.230, 1994, chap. 6.

28 A. Low, *Agricultural Development in Southern Africa: Farm-Household Economics and the Food Crisis* (London: James Currey, 1986), p.188.

29 R. Bush, L. Cliffe and V. Jansen, "The crisis in the reproduction of migrant labour in southern Africa", in P. Lawrence (ed.), *World Recession and the Food Crisis in Africa* (London: James Currey, 1986).

30 The increasing death rates associated with the spread of AIDS lend some uncertainty to population projections. However, it is estimated that the African population will double in the next 20 years if the current trend persists. With a fertility decline of 2.75 per cent a year over the period 1990-2020, the projected increase is from about 500 million in 1990 to 1,100 million in 2020. There are, of course, differences between countries, but one classification of countries according to their population growth rates over the period 1980-2000 indicates that 34 per cent of the 1980 African population were living in countries with very high population growth rates (over 3.5 per cent per year) and only 16 per cent in countries with rates of under 2.5 per cent a year.

31 The importance of the non-tradability of agriculture has, however, been particularly stressed by C.L. Delgado in his "Why domestic food prices matter to growth strategy in semi-open West African economies", *Journal of African Economies*, Vol.1, No.3, 1992, pp. 446-471; and "Agricultural diversification and export promotion in sub-Saharan Africa", *Food Policy*, Vol. 20, No.3, 1995, pp. 225-243. For an analysis of the reasons for non-tradability, see S.C.

Kyle and J. Swinnen, "The theory of contested markets and the degree of tradeability of agricultural commodities: An empirical test in Zaire", *Journal of African Economies*, Vol. 3, No. 1,1994, pp. 93-113.

32 See, for example, Delgado, 1995, *op. cit.*.

33 This has been analysed in C. Kirkpatrick and D. Diakosavva, "Food insecurity and foreign-exchange constraints in sub-Saharan Africa", *Journal of Modern African Studies*, Vol. 23, No. 2, 1985, pp. 239-250.

34 The economic importance of increasing the productivity of food producers is emphasized by O. Aboyade, "Growth strategy and the agricultural sector", in Mellor, Delgado and Blackie (eds.), *op. cit.*, and also by Delgado, 1995, *op. cit*.

35 See S. A. Salih, *Food Security in Africa*, UNU/WIDER World Development Studies, No. 3 (Helsinki, 1995).

36 The use of "wheat units" allows cross-country and inter-temporal comparisons of productivity without reference to prices. For an earlier application of this approach in Africa see S. Block, "The recovery of agricultural productivity in sub-Saharan Africa", *Food Policy*, Vol. 20, No. 5, 1995, pp. 385-405. This study covered the period 1963-1988, and identified a recovery in agricultural productivity in the period 1983-1988, which was particularly marked in West Africa, though not necessarily sustainable. The present results, which are based on a new data set on wheat units, indicate that there was a similar recovery in labour productivity in the mid-1980s and that it has not been sustained.

37 See A. Lusigi and C. Thirtle, "Total factor productivity and the effects of R&D in African agriculture", *Journal of International Development*, Vol. 9, No. 4,1997, pp. 529-538; and A. Lusigi, J. Piesse and C. Thirtle, "Convergence of per capita incomes and agricultural productivity in Africa, *Journal of International Development*, Vol. 10, No. 1, 1998, pp. 105-116.

38 FAO, *African Agriculture: The Next Twenty-Five Years* (Rome: FAO, 1986), annex II: "The land resource base".

39 The estimates of irrigation potential are taken from FAO, 1996, *op. cit.* Aggregate capital stock estimates for 1988-1992 are from FAO, *Investment in Agriculture*, Technical Background Document No.10 for the World Food Summit, Rome, 13-19 November 1996, table 3. They cover investment in land development for arable cropping, planting tree crops, irrigation, building up and housing livestock, and mechanization and farm implements. Expressed in relation to area of agricultural land, they are as follows: sub-Saharan Africa: $157 per hectare; Latin America and the Caribbean: $665 per hectare; and Asia: $913 per hectare.

40 Estimates of land reserves are from FAO, 1986, *op. cit.* Projections of land/labour ratios are those of H. Binswanger and P. Pingali in "Technological priorities for farming in sub-Saharan Africa", *World Bank Economic Research Observer*, Vol. 3, No. 1, 1988, pp. 81-98.

41 Saito, *op. cit*., table 2.3.

Chapter III

AGRICULTURAL POLICIES, PRICES AND PRODUCTION

A. Introduction

Throughout the early post-colonial period in Africa there were two basic approaches to the development of agriculture. The first aimed at "modernizing" smallholder agriculture through the promotion of specialization, standardization and increased use of productivity-enhancing inputs and quality control, particularly by means of integrated rural development projects. The second aimed at channelling resources into highly capitalized indigenous private agribusinesses and state farms. Both these approaches sought to address undercapitalization and structural constraints in African agriculture, but had serious shortcomings in their design and implementation.

At the beginning of the past decade policy reforms were initiated in line with the view that what mattered most for agricultural development were market incentives. It was argued that much of the poor performance of agriculture in SSA was due to excessive taxation of farmers by governments. According to this view, policies designed to extract resources from agriculture in order to promote industrial development and to provide subsidized goods and services to the urban economy undermined agricultural development by reducing the attractiveness of farming:

> African farmers have faced the world's heaviest rates of agricultural taxation ... explicitly through producer price fixing, export taxes, and taxes on agricultural inputs. They were also taxed implicitly through overvalued exchange rates, and through high levels of industrial protection ... The high rates of taxation contributed to sub-Saharan Africa's alarming decline in ... agricultural growth.[1]

Reforms have accordingly aimed at removing distortions in the incentive structure. The initial thrust of reforms was to realign producer prices with world prices through marketing boards and to correct overvalued exchange rates. From the late 1980s onwards there was wider recognition of the importance of structural constraints,[2] but in reality greater attention has been paid to deregulating agricultural markets by dismantling the marketing boards and allowing a greater role for private actors in both product and input markets. Current best practice in agricultural policy is now regarded as including unsubsidized market-determined prices for both inputs and outputs, prices at border parity determined on the basis of "adequate" exchange rates, and economically neutral taxation of agriculture and other sectors. On this view, governments' responsibility is to maintain access to markets, ensure dissemination of information, and provide adequate legal and regulatory frameworks, rather than to intervene in prices.[3]

However, despite intensive reforms over a number of years, the supply response to price liberalization has been much less than expected,

raising several questions about the underlying rationale of the reforms. First, have governments in SSA really taxed agriculture excessively, especially compared with the rest of the developing world? Second, how far have price reforms removed taxation and resulted in greater incentives for farmers? Lastly, are price incentives the only, or even the most important, component of agricultural growth and development?[4] Addressing these questions is essential for greater understanding of the factors affecting agricultural development, including the role of price and non-price incentives, the provision of public goods, and structural and institutional impediments to supply response. That is the purpose of this chapter.

The next section enlarges on the brief analysis of the behaviour of agricultural prices presented in *TDR 1997*, covering a wider range of prices, using a broader sample of countries and products, and making international comparisons.[5] This is followed by a discussion of various factors affecting supply behaviour in SSA, and of the role of public investment in removing structural impediments.

The analysis shows that export crops were not always taxed through price-fixing much more in African than in other major producing countries and that subsequent liberalization of agricultural markets has not always reduced the margin between export prices and producer prices. Secondly, the domestic terms of trade for agriculture in SSA were generally kept above the world terms of trade between agricultural commodities and manufactures. This was partly due to price and subsidy policies in favour of food crops. Since reforms began, agricultural terms of trade and real producer prices have generally performed better in those countries that have continued with interventionist policies in agricultural marketing than in those with more liberal policies.

The behaviour of production and exports noted in the last chapter has been influenced by a number of factors, including the policy reforms. In the context of falling world prices, incentives provided through pricing and exchange rate reforms have been weak. Recovery in production in the mid-1980s coincided with the turnaround in net resource flows (chapter I, chart 7) and the recovery in imports. Increased availability of consumer goods in rural areas in some cases, and pressure to satisfy basic consumption needs in others, appear to have contributed to a positive short-run supply response in some countries. Where devaluations have corrected major exchange rate misalignments, exports recovered, partly because they were diverted into official channels. But adjustment policies have failed to address a number of institutional and structural impediments to increasing agricultural productivity and output. Removing such impediments would have called for increased public investment in agricultural infrastructure and research, but this has not been possible under fiscal retrenchment characteristic of adjustment programmes.

B. Agricultural prices

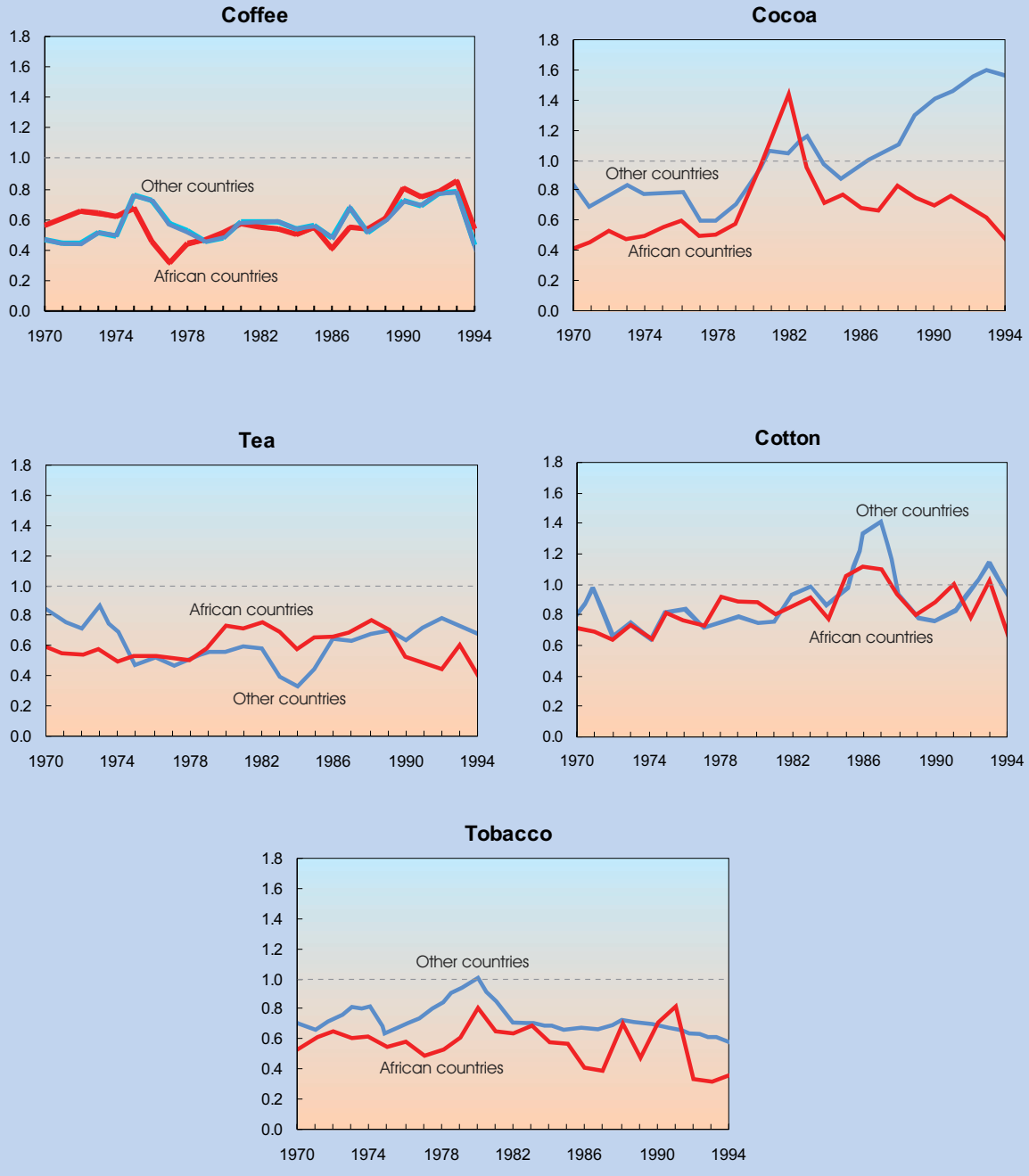
1. Taxation of export crops

One way of addressing the question of "taxation" of agriculture is to examine the margin between export prices (in national currency) and prices received by farmers for major export crops, and to compare the margins between major African and non-African exporters of these crops.[6] Chart 15 presents estimates of the evolution of the ratio of prices received by farmers to border (unit export) prices for coffee, cocoa, tea, cotton and tobacco since 1970. This relative magnitude, which is a non-adjusted nominal protection coefficient (NPC), gives a measure of the rate of surplus extraction from farmers by exporters.

Clearly, the margin between export and producer prices indicates a surplus extraction only when producers and exporters are different entities, and not when producers export directly, as in

Chart 15

RATIO OF PRODUCER PRICES TO BORDER PRICES[a] FOR FIVE MAJOR EXPORT CROPS: COMPARISON BETWEEN AFRICAN AND OTHER DEVELOPING COUNTRIES, 1970-1994



Source: UNCTAD secretariat calculations, based on FAO, *FAOSTAT* database; and IMF, *International Financial Statistics* (tapes).

Note: The country samples are as follows: ***Coffee exporters:*** *African:* Burundi, Cameroon, Côte d'Ivoire, Ethiopia, Guinea, Kenya, Madagascar, Malawi, Rwanda, Uganda, United Republic of Tanzania. *Other:* Colombia, Costa Rica, Guatemala, Indonesia. ***Cocoa exporters:*** *African:* Côte d'Ivoire, Ghana, Guinea, Nigeria. *Other:* Dominican Republic, Ecuador, Malaysia, Indonesia, Papua New Guinea. ***Tea exporters:*** *African:* Burundi, Cameroon, Kenya, Malawi, Rwanda, United Republic of Tanzania, Uganda. *Other:* India, Indonesia, Sri Lanka, Turkey. ***Cotton exporters:*** *African:* Burkina Faso, Burundi, Cameroon, Chad, Mali, Sudan, Uganda, United Republic of Tanzania, Zimbabwe. *Other:* Egypt, India, Pakistan, Paraguay, Syria, Turkey. ***Tobacco exporters:*** *African:* Malawi, Zambia, Zimbabwe. *Other:* India, Indonesia, Republic of Korea, Thailand, Turkey.

a Unit value of exports.

the case of plantation- and TNC-based agribusiness. Moreover, it does not necessarily represent explicit taxation by governments in the sense used in conventional analysis. Such a margin also exists in the case of private traders and exporters. Nevertheless, public marketing boards were the principal exporting agents in Africa until the early 1990s, while similar institutions were less widespread elsewhere. In what follows, however, the term "tax" is used to describe the margin between export and producer prices regardless of the institutional arrangements in the markets for export crops.

It should be noted that this is a crude approximation of the degree of taxation since no allowance is made for marketing and transportation costs and any other value added between the initial (on-farm) and export stages of the marketing chain. However, since domestic transaction costs are generally higher in African countries than in most other developing countries, the observed NPC values may overstate the extent of taxation of farmers in SSA countries compared with other developing countries. Nevertheless, there may also be greater value added between the farm and the export stages among non-African exporters, accounting for part of the margin between the border and producer prices.

The rate of taxation is not independent of the exchange rate. The border price is determined by the nominal exchange rate and dollar prices received by exporters in international markets. A lower exchange rate would thus raise the domestic currency prices received by exporters. If prices paid to farmers remain unchanged, or are raised by less than the rate of devaluation of the currency, the tax rate will rise. Indeed, such behaviour was observed after the post-1986 devaluations in a number of countries in SSA when prices received by farmers declined relative to unit export values. However, even when devaluations lead to a widening of the margin, they tend to raise real producer prices of export crops vis-à-vis non-tradables, thus providing incentives for exports.

It is generally agreed that the currencies of many SSA countries were overvalued during the period from the mid-1970s to the mid-1980s. However, the evidence presented in chart15 does not support the conventional view that African producers have always been more heavily taxed than those in other developing countries through crop pricing policies. Indeed, it suggests that this claim is a gross oversimplification. A commodity-specific comparison of African and non-African exporters presents a much more complex picture:

- For *coffee,* on average the ratio of producer prices to border (unit export) prices does not appear to have been very different between African and non-African producers except during 1975-1977, when the level of taxation in Africa was higher. Producer prices were around 50 per cent of actual border prices in both instances from 1979 to 1988, and then increased sharply before falling back to their previous levels.

- *Cocoa* producers in Africa were always more heavily taxed than in other developing countries, except for a brief interlude in the early 1980s. Producer prices in Africa were on average 55 per cent below actual border prices throughout the 1970s, against 60-80 per cent for their competitors. The situation improved in Africa briefly after 1980, but soon deteriorated significantly when the benefits of devaluations were retained primarily by exporters. Paradoxically, taxation appears to have risen during the reform period in Africa. By contrast, since the late 1980s, prices received by non-African cocoa producers appear to have exceeded the export unit values, which suggests that exports were subsidized.

- For *tea*, taxation was higher in Africa at the beginning and the end of the period under consideration. However, unlike in the case of cocoa, Africa had lower rates of taxation of producers for roughly half of the period covered. During most of the 1980s, African producer prices averaged around 70 per cent of border prices, whereas the ratio was generally below 50 per cent for other developing country producers.

- Taxation of *cotton* appears to have been more moderate and stable than that of tree crops, among both African and non-African producers, and no major difference emerges between the two groups of countries in this respect. The moderate downward trend of the tax rates in the 1980s was reversed subsequently in both groups of countries.

- For *tobacco*, the proportion of border prices received by African producers has consistently been lower than that received by non-African

producers, particularly since the late 1970s. A rising rate of taxation set in after 1980.

Therefore, while in some cases African farmers have indeed faced very heavy taxation compared with other major exportering countries, in other cases they have not.[7] Of the five export crops studied, it is only for cocoa and tobacco that the ratio of producer prices to border prices before the reform process was significantly lower in Africa than in the other major exporters. For coffee and cotton there appears to be no significant difference in the ratio of producer to border prices between African and non-African countries during the pre-reform era. The findings of earlier research – to the effect that the African producers faced higher rates of taxation – were based on a sample of three countries, two of which were major cocoa exporters, and also reflect the adverse effects of exchange rate overvaluation.[8]

Chart 15 also suggests that price reforms in Africa have not always led to lower rates of taxation of export crop producers. Since the mid-1980s, the ratio between producer and export prices has declined for all products considered here except coffee. This implies that the benefits of devaluations during that period accrued to traders more than to farmers. Nevertheless, it should be noted that not all SSA countries in the chart are "reformers". An analysis of price movements differentiating between reformers and non-reformers is contained in subsection 3 below.

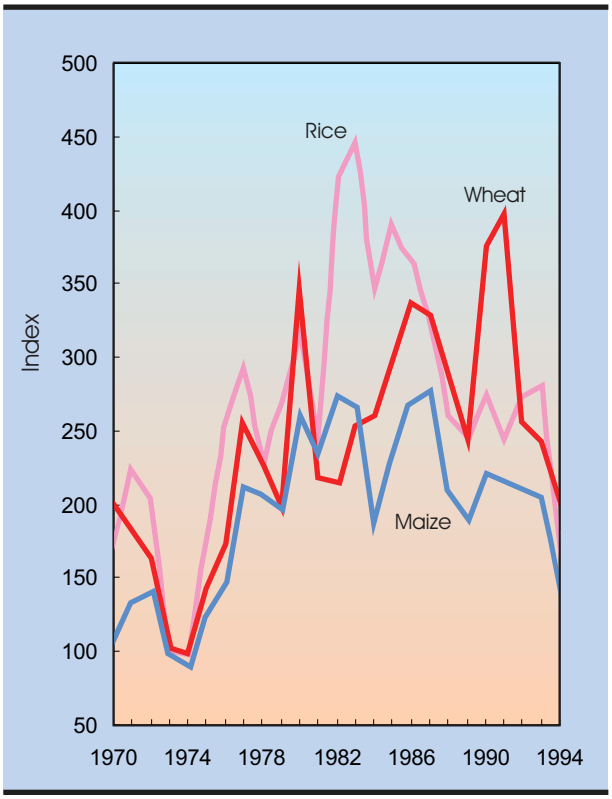
The relevant comparison for traded (importable) food crops such as cereals is between the prices received by farmers and import costs in domestic currency. The latter are determined by world prices and exchange rates, while the former are influenced by pricing and subsidy policies. A positive margin between the prices received by farmers and unit import costs indicates protection of food crop farmers. By raising import costs, devaluations permit reduction of direct price supports of food crops and/or subsidies.

Chart 16 shows the evolution of average ratios of producer prices to world prices (expressed in domestic currencies) for cereals between 1970 and 1994 in a number of countries in SSA. It is apparent that prices received by farmers progressed faster than world prices until the mid-1980s, a fact which indicates high rates of implicit subsidization. Again, market-based reforms and devaluations are possible reasons for the subsequent reversal.

Chart 16

RATIO OF PRODUCER PRICES TO WORLD MARKET PRICES FOR THREE MAJOR CEREALS IN SSA, 1970-1994

(Index numbers, 1973 = 100)



Source: UNCTAD secretariat calculations, based on UNCTAD, *Commodity Price Statistics;* and FAO, *FAOSTAT* database.

Note: Ratios are calculated on the basis of prices received by farmers and world prices expressed in domestic currencies at current exchange rates. Averages are for the following countries: *wheat:* Burundi, Chad, Ethiopia, Kenya, Malawi, Niger, Sudan, Uganda, United Republic of Tanzania, Zambia; *maize:* Burkina Faso, Burundi, Cameroon, Chad, Côte d'Ivoire, Ethiopia, Ghana, Guinea, Kenya, Madagascar, Malawi, Mali, Niger, Nigeria, Senegal, Sudan, Uganda, United Republic of Tanzania, Zambia; *rice:* Burkina Faso, Burundi, Cameroon, Chad, Côte d'Ivoire, Ghana, Guinea, Kenya, Madagascar, Malawi, Mali, Niger, Nigeria, Uganda, United Republic of Tanzania, Zambia.

2. Terms of trade and real producer prices

The analysis above is a simplified version of the conventional approach to the taxation of export crops. It focuses on output prices alone and ignores the prices paid for the products purchased by farmers. It is indeed the prices of output rela-

tive to inputs and to consumer goods purchased by producers that determine the latter's real incomes and consumption, and hence influence their production and investment decisions. The broadest measure of this relative price is the domestic terms of trade of agriculture.

This subsection concentrates on trends in the agricultural terms of trade in SSA for a sample of 20 countries, using two measures. The first refers to agriculture as a whole and is measured as the ratio of the implicit agricultural GDP deflator to the implicit non-agricultural (or manufacturing) GDP deflator. These domestic terms of trade are contrasted with world terms of trade, obtained by deflating the world prices of agricultural products with unit export values of manufactures. The second indicator – real producer prices – refers to specific agricultural products and is measured by the ratio of producers' prices to the domestic consumer price index.[9]

Chart 17 presents trends in agricultural terms of trade in world markets and SSA. There is almost an uninterrupted decline in world terms of trade for agricultural products from 1973 to 1995. Although the decline was somewhat moderate after 1986, and there was an upturn during 1994-1995, the average indices for 1987-1995 were about 60 per cent and 40 per cent below the 1973 levels for "all food" and "raw materials", respectively.

However, the domestic terms of trade of agriculture in SSA show quite different behaviour. After rising during the first half of the 1970s, they remain broadly stable until the early 1990s before rising again; the average index for 1987-1995 is 13 per cent above the 1973 level. Hence, in general, farmers in SSA appear to have been protected from adverse trends in world terms of trade for agricultural commodities.

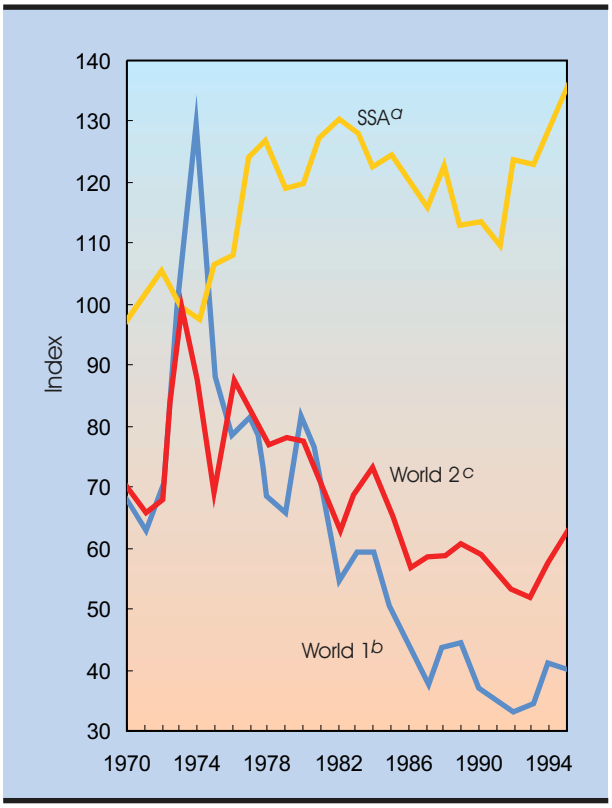
Again, there is a need for caution in interpreting this evidence because of differences between the commodity compositions of the two terms of trade series. This could reduce the reliability of comparisons, particularly when price dynamics are different for different commodities. Indeed, prices of non-tradable food appear to have been an important factor in the better performance of the domestic terms of trade. However, this alone does not account for the large disparity in the movements of agricultural terms of trade between world markets and SSA. The evidence regarding real producer prices suggests that SSA pricing policies, particularly with respect to tradable food crops, played an important role in stabilizing domestic terms of trade for agriculture.

Chart 18 shows trends in real producer prices from 1970 to 1994 for four major export crops

Chart 17

TERMS OF TRADE OF AGRICULTURE: COMPARISON OF SSA AND THE WORLD, 1970-1995

(Index numbers, 1973 = 100)



Source: UNCTAD secretariat calculations, based on UNCTAD, *Commodity Price Statistics;* and World Bank, *World Development Indicators 1997* (CD-Rom).

a Unweighted average of the domestic terms of trade of agriculture for Burkina Faso (except for 1995), Burundi, Cameroon, Côte d'Ivoire, Ghana, Kenya, Madagascar, Malawi, Mali, Nigeria, Senegal and Zambia. The domestic terms of trade of agriculture are measured by the ratios of the implicit sectoral deflator for agriculture to the implicit sectoral deflator for industry.

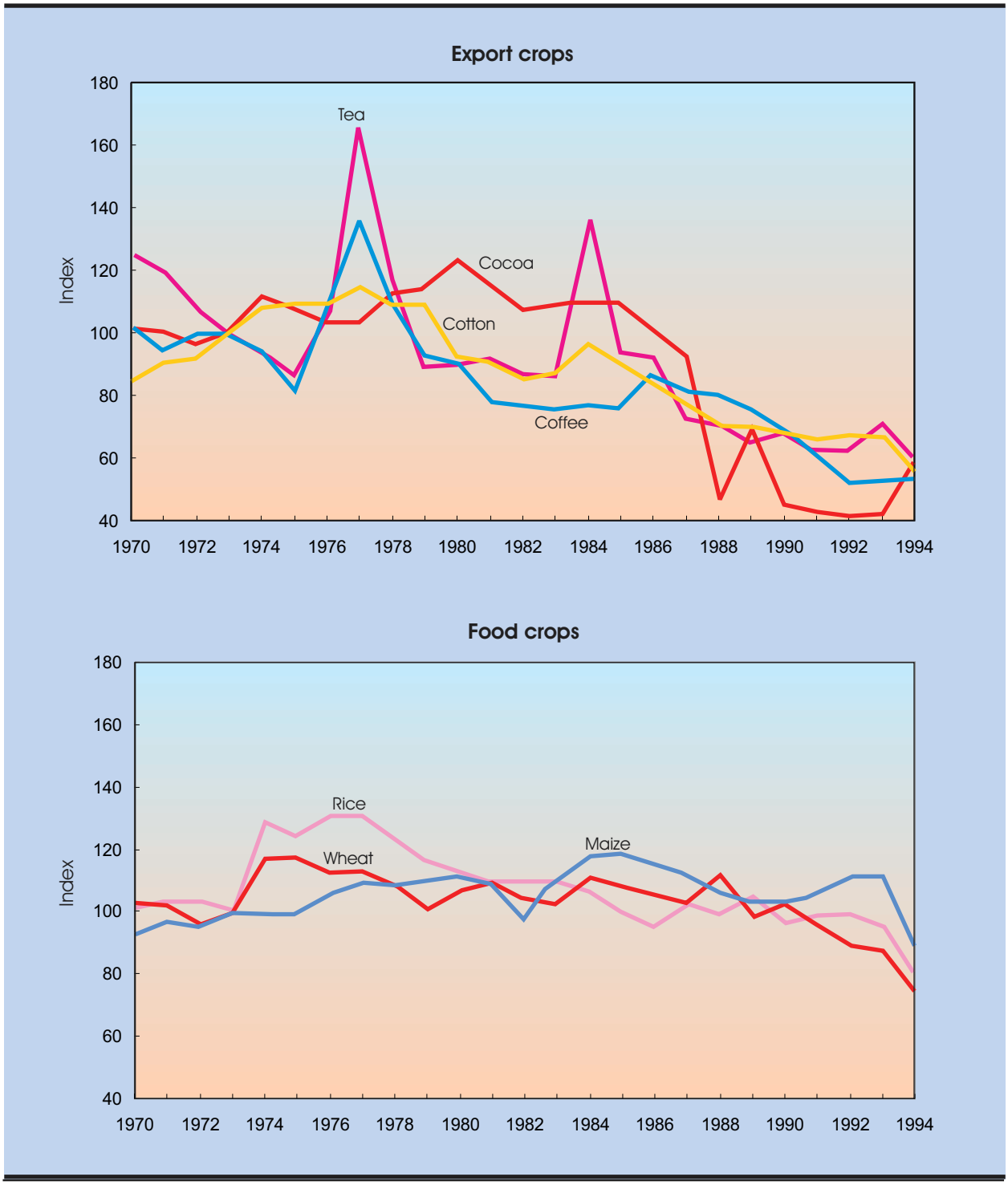
b Ratio of world free market price index for "all food" (tropical beverages, food, vegetable oilseeds and oil) to the unit value index of exports of manufactures from developed market economies.

c Ratio of world free market price index for agricultural raw materials to unit value index of exports of manufactures from developed market economies.

Chart 18

SUB-SAHARAN AFRICA: REAL PRODUCER PRICES FOR SELECTED EXPORT AND FOOD CROPS, 1970-1994

(Index numbers, 1973 = 100)



Source: UNCTAD secretariat calculations, based on FAO, *FAOSTAT* database; and IMF, *International Financial Statistics*.

Note: Real producer prices are nominal prices received by farmers divided by the consumer price index. Data are unweighted averages for the following countries: *cocoa:* Cameroon, Côte d'Ivoire; *coffee:* Burundi, Côte d'Ivoire, Ethiopia, Kenya, Madagascar, United Republic of Tanzania; *cotton:* Burkina Faso, United Republic of Tanzania; *tea:* Burundi, Kenya; *wheat:* Burundi, Ethiopia, Kenya, Niger, Sudan, United Republic of Tanzania, Zambia; *maize:* Burkina Faso, Burundi, Cameroon, Côte d'Ivoire, Ethiopia, Ghana, Kenya, Madagascar, Niger, Nigeria, Senegal, United Republic of Tanzania, Zambia; *rice:* Burkina Faso, Burundi, Cameroon, Côte d'Ivoire, Ghana, Kenya, Madagascar, Niger, Nigeria, United Republic of Tanzania, Zambia.

and three food crops in SSA countries. Overall, the contrast between the sharp deterioration for export crops and a high degree of stability for food crops is striking. Real producer prices of cocoa, coffee, cotton and tea in the early 1990s were 40-50 per cent lower than their average levels during the 1970s. For cereals, real domestic prices in SSA were relatively stable over the same period, with some modest declines after the mid-1980s. A comparison between domestic and international prices shows that while in real terms, domestic prices of export crops generally followed the downward trend in international prices, for cereals those prices were higher and more stable (chart 19).

Movements in domestic terms of trade and real producer prices are influenced by a host of factors, including developments in world markets for agricultural commodities and manufactures, government intervention in national output and/or input markets, and exchange rate policies. Generally, in most African countries government intervention until recently favoured food crops over export crops through price supports and subsidies. This, together with overvalued exchange rates, kept food prices high relative to export crops. With market liberalization, the prices of both food crops and export crops have been linked more closely to world prices, but more so for export crops. Devaluations only partly compensated for the downward trend in real prices of export crops in world markets while, as noted above, at the same time widening the rate of taxation. Consequently, in general, real producer prices for export crops fell throughout the 1980s while those for cereals rose or fell less. These differing trends are shown in chart 20 for changes between the average prices in 1981-1983 and in 1992-1994 for a number of food and export crops in various countries. Nevertheless, despite this broad tendency, there are important differences in the behaviour of real prices of the same food and export crops in different countries, reflecting in large part differences in exchange rate policies and the extent and type of intervention in agricultural product markets.

3. Policy reforms and agricultural prices

The findings discussed above show that despite widespread market-oriented agricultural price reforms, the past ten years have not produced significant improvements in relative prices and terms of trade for agriculture or lowered the rates of taxation of farmers. A more direct way of studying the impact of these reforms is to compare the price movements between "reforming" countries and those that continued with "interventionist" policies. Here, this exercise is carried out for the same set of prices examined above, with countries classified on the basis of their policy regimes as evaluated by the World Bank in its study *Adjustment in Africa* cited above.[10]

Chart 21 shows that since 1984 the overall domestic terms of trade for agriculture have moved much more favourably in the "heavy intervention" countries than in the "light intervention" ones. As of 1993, the former group had achieved an improvement of 24 per cent compared with a 7 per cent decline in the latter.

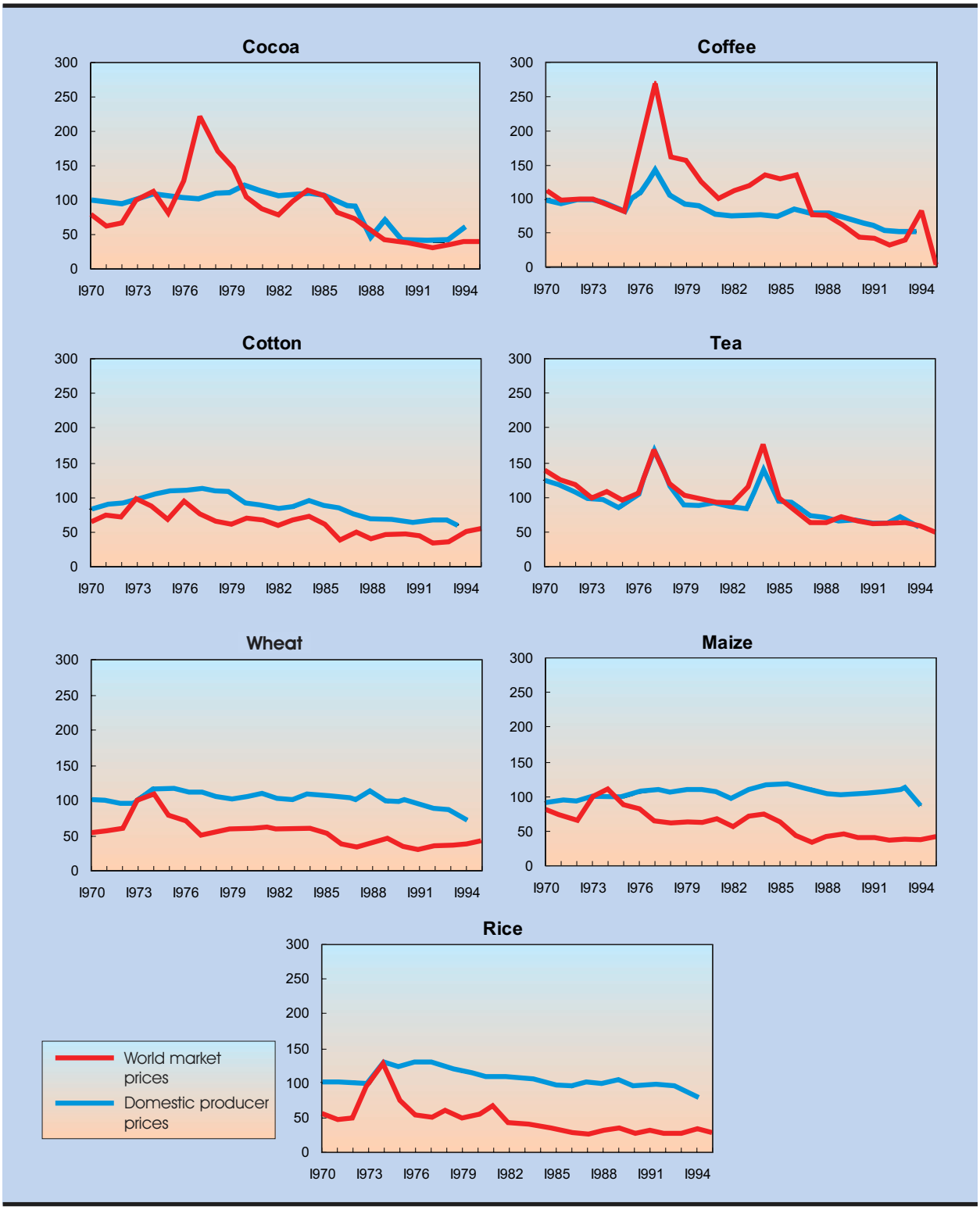
The impact of policy regimes on real producer prices is examined here by classifying major African producers of cocoa, coffee, cotton, tea and cereals into groups with "continued interventionist", "continued liberal" and "newly liberalized" policy regimes vis-à-vis agricultural markets as defined by the World Bank. For export crops, with the exception of coffee until 1992, real producer prices have performed better since 1984 in those countries which have continued with interventionist policies in the markets for the specified commodities than in those with more liberal policy regimes (chart 22). This is consistent with the findings reported in the World Bank study,[11] which show that in those countries which had continued with centralized producer pricing, there was an increase of 4.8 per cent in the domestic real producer prices for export crops, whereas there was a fall of 18.8 per cent in countries which had shifted from centralized pricing to indicative pricing or total deregulation. For food crops, it appears that farmers in countries with a high degree of intervention in agricultural markets enjoyed significantly better relative prices than the average, particularly during more recent years.

The picture is much the same regarding the taxation of export crops, as measured by the ratio of prices received by farmers to border prices (chart 23). In countries with ongoing or newly liberalized marketing arrangements this ratio fell faster or rose much less rapidly than in countries with continued government intervention, with once again the single exception of cocoa. The impact of the policy regime on relative movements between import and producer prices of cereals is more ambiguous.

Chart 19

REAL WORLD MARKET PRICES AND REAL PRODUCER PRICES IN AFRICA FOR SELECTED PRIMARY COMMODITIES, 1970-1995

(Index numbers, 1973 = 100)



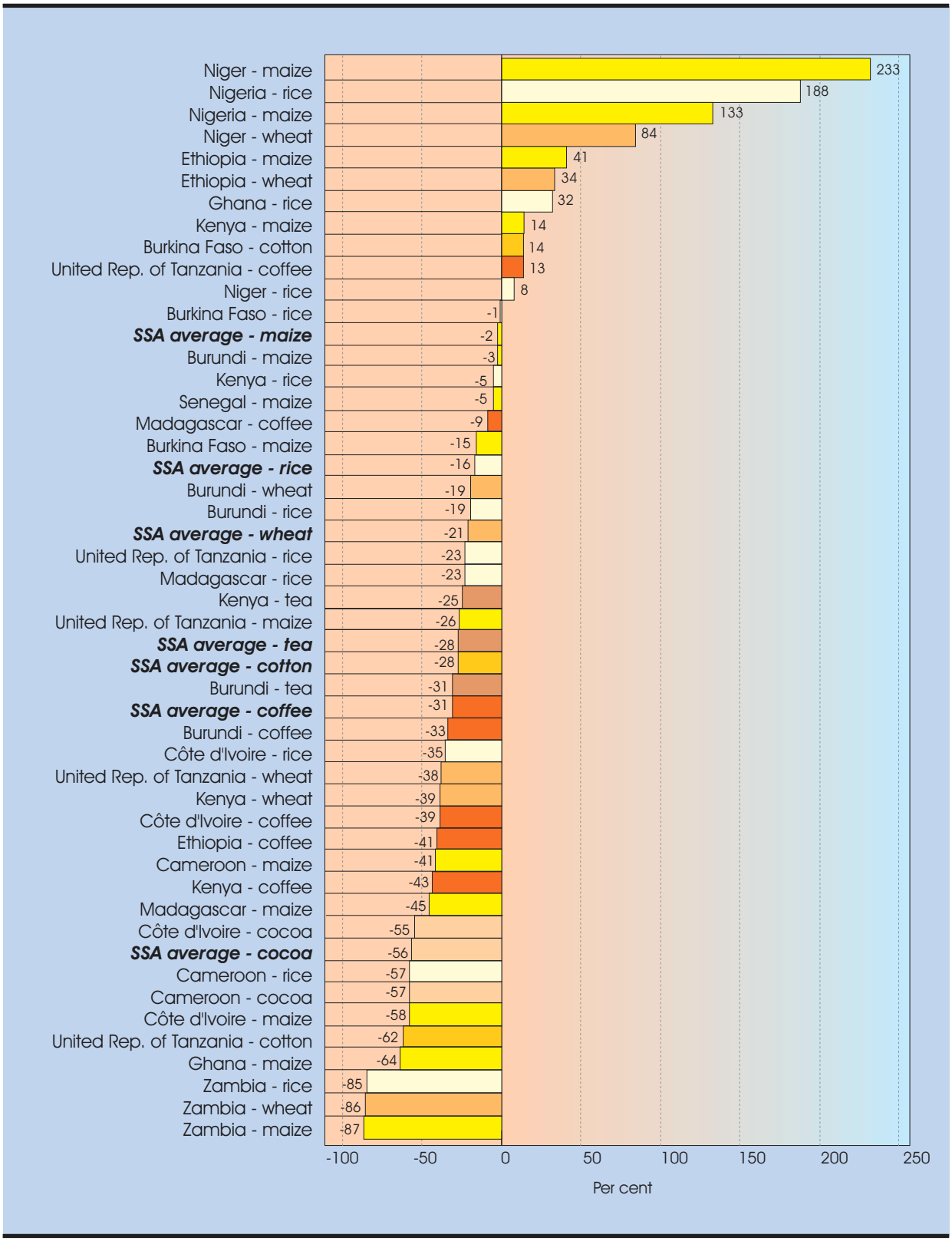
Source: UNCTAD secretariat calculations, based on UNCTAD, *Commodity Price Statistics* (tapes); FAO, *FAOSTAT*; and IMF, *International Financial Statistics* (tapes).

Note: Real world market prices are nominal prices deflated by the unit value index of exports of manufactures from developed market economies. Real producer prices are nominal prices received by farmers deflated by the consumer price index. Averages of real producer prices relate to the countries specified in chart 18.

Chart 20

CHANGE IN REAL PRODUCER PRICES OF MAJOR EXPORT AND FOOD CROPS IN SELECTED SUB-SAHARAN AFRICAN COUNTRIES BETWEEN 1981-1983 AND 1992-1994

(Percentages)

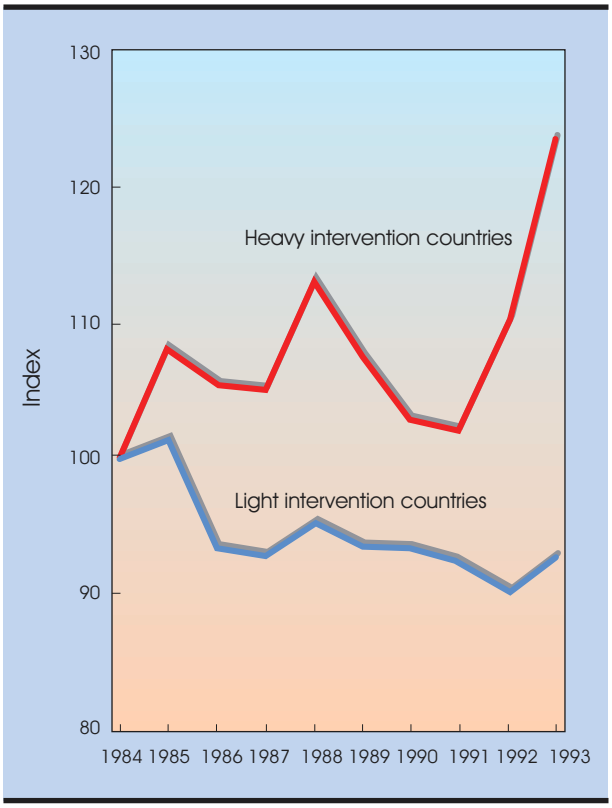


Source: UNCTAD secretariat calculations, based on data from FAO, *FAOSTAT* database; and IMF, *International Financial Statistics*.

Chart 21

DOMESTIC TERMS OF TRADE OF AGRICULTURE AND POLICY ORIENTATION OF SSA COUNTRIES BY COUNTRY GROUPING, 1984-1993

(Index numbers, 1984 = 100)



Source: UNCTAD calculations, based on World Bank, *World Development Indicators 1997* (CD-Rom).

Note: Data are unweighted averages of countries classified according to their degree of market intervention (see text). Heavy intervention countries are Burkina Faso, Cameroon, Côte d'Ivoire, Ghana, Kenya, Madagascar, Senegal, United Republic of Tanzania and Zambia; light intervention countries are Burundi, Chad, Malawi, Mali, Nigeria, Rwanda and Uganda. The domestic terms of trade of agriculture are measured as the ratio of the implicit sectoral deflator for agriculture to that for manufacturing or industry.

4. Implications

The findings of the foregoing subsections are cause for concern. First of all, they suggest that the assumptions about agricultural pricing policies in the 1970s which underlie the subsequent reforms are not entirely valid. It is true that the African governments which depended on export crops allowed their currencies to appreciate in the 1970s, and this was a handicap for African agriculture. However, while producers of certain export crops indeed faced heavy taxation, the margins between export prices and producer prices were not always higher for African than for non-African producers. Nor is it true that the entire agricultural sector was always subject to falling real prices, either for food crops or for export crops.[12]

The findings also suggest that the pricing reforms of the 1980s and the market liberalization and privatization of the 1990s have generally been associated with falling real producer prices for export crops. The domestic terms of trade have apparently turned against farmers more in those countries which have sought to link domestic and world prices. The shift from public to private marketing agents has not increased the proportion of export prices passed on to producers.

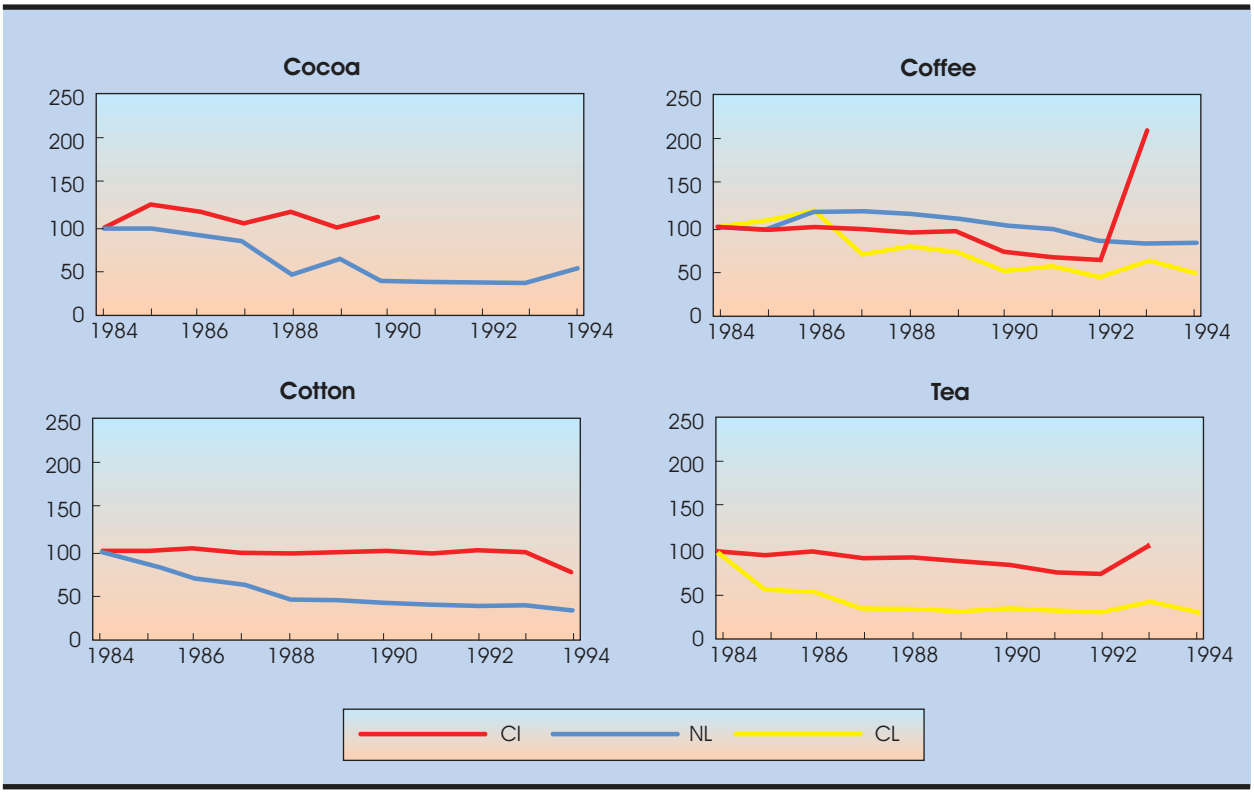
Local studies of prices of specific commodities can no doubt refine the general features identified here. However, the dynamics of agricultural price formation and the problems facing reformers and export crop farmers cannot be properly understood in the national context alone. When world prices and real producer prices for agricultural commodities are rising, there is scope for surplus extraction without undermining incentives and production. When international prices and real producer prices for agricultural commodities are falling, it would be difficult for public marketing agencies to impose an additional squeeze on farmers through forward market linkages, i.e. by higher margins between border and producer prices. In a sense, low taxation may have been an inevitable response to adverse global conditions.

Competition among traders should limit the scope of surplus extraction from farmers. In particular, the lifting of institutional restrictions on marketing can benefit farmers in more accessible and high population density areas. However, whether liberalization is an appropriate approach to agricultural development in a situation of missing and imperfect markets, adverse global conditions and poor infrastructure is very questionable. One close observer of African agriculture has argued that "donor emphasis on precipitating market liberalization in the short run may well set back the cause of market development".[13] Policies formulated without paying attention to the characteristics of domestic market structures and constraints and global conditions court failure.

Chart 22

REAL PRODUCER PRICES FOR SELECTED COMMODITIES, AND POLICY ORIENTATION OF SSA COUNTRIES BY COUNTRY GROUPING, 1984-1994

(Index numbers, 1984 = 100)



Source: UNCTAD secretariat calculations, based on FAO, *FAOSTAT* database; and IMF, *International Financial Statistics* (tapes).

Note: Real producer prices are nominal prices received by farmers deflated by the consumer price index. Countries are classified according to their degree and history of market intervention (see text). The country groupings are: NL = newly liberalized; CI = continued intervention; CL = continued liberalization. Averages are unweighted and include the following countries: *Cocoa:* CI: Ghana; NL: Cameroon, Côte d'Ivoire. *Coffee:* CI: Rwanda; CL: Kenya; NL: Burundi, Côte d'Ivoire, Madagascar, United Republic of Tanzania. *Cotton:* CI: Burkina Faso; NL: United Republic of Tanzania. *Tea:* CI: Burundi, Rwanda; CL: Kenya.

C. Agricultural supply behaviour: Sources and constraints

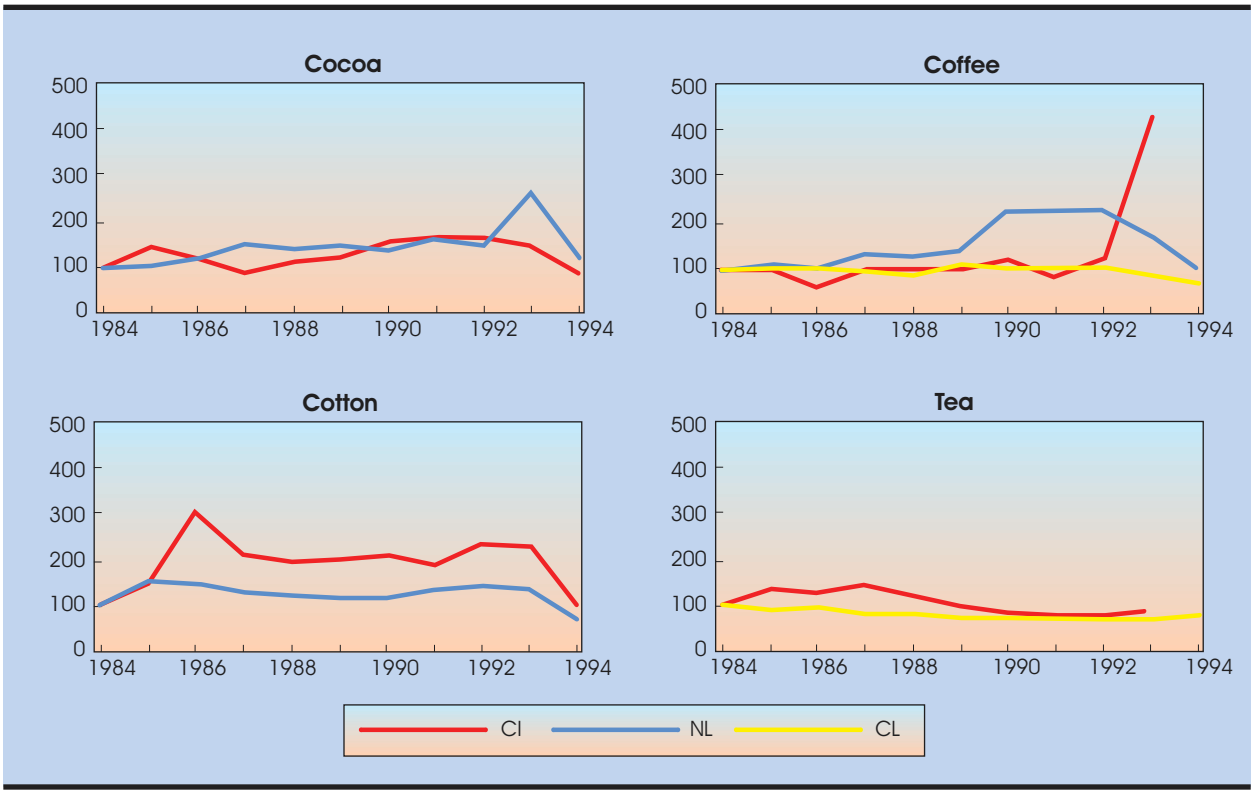
The response of agricultural production to price incentives depends on a host of structural and institutional factors influencing productivity and profitability. Empirical analyses generally suggest that the aggregate supply response of producers to price incentives is weaker in low-income countries, and show that:

> ... the magnitude of supply response to economic reforms depends on the degree to which the agricultural economy is developed. Adequate rural infrastructure (irrigation, roads and transport, power, telecommunications), credit, market information, recurrent inputs, research, extension and farmer education and health are necessary for agricultural development. If these are seriously deficient, even getting the prices right in an ideal enabling environment will not suffice to develop agriculture.[14]

Chart 23

RATIO OF PRODUCER PRICES TO BORDER PRICES[a] FOR SELECTED COMMODITIES, AND POLICY ORIENTATION OF SSA COUNTRIES BY COUNTRY GROUPING, 1984-1994

(Index numbers, 1984 = 100)



Source: See chart 22.
Note: See chart 22. The country grouping is as in that chart, with the addition of Uganda (coffee, NL), Chad and Mali (cotton in both cases NL).
a Export unit value.

In SSA weak supply response to price incentives used to be attributed to a lack of motivation and the allegedly perverse economic rationality of African farmers, particularly smallholders. These colonial stereotypes have been swept away by research which has shown that African producers have the same keen sense of costs and returns as farmers throughout the world.[15] But at the same time, it has become increasingly evident that structural and institutional constraints are particularly tight for African producers.[16] These constraints include inadequate basic infrastructure; missing or imperfect markets for output, land, labour and credit; supply problems for agricultural inputs and basic consumer goods purchased by farmers; lack of appropriate technological packages; gender relations; and high levels of risk.

1. Short-run supply response

The way in which these constraints work can best be understood by isolating the main agricultural supply processes. In the short run, aggregate supply response to price incentives can occur through three basic processes. First, idle land and labour can be brought into use, leading to an expansion in output through a "vent for surplus" mechanism.[17] Second, price incentives may lead to efficiency gains resulting from reallocation of resources and changes in the output mix. Third, intensification of production can occur through the application of more variable inputs and through greater care and attention at all stages of the production cycle. Different factors enhance or constrain the efficacy of each of these processes.

(a) "Vent for surplus"

Production may be expanded when farm households make a greater effort and bring idle land into use in response to price incentives or greater availability of incentive goods. This mechanism is of historical importance in Africa, and has been widely used to explain the initial surge in newly introduced export crops – coffee, cotton, cocoa, groundnuts and palm nuts – which occurred with the first wave of globalization at the turn of this century. It is likely that part of the short-run supply response to policy reforms was due to "vent for surplus" effects. There was a widespread tendency among commercially oriented smallholders in a number of SSA countries in the early 1980s to reduce their marketed output because of the unavailability of such consumer goods as soap, textiles, matches, tea, coffee, sugar, cooking oil, tinned milk, fish, cement, metal roof sheeting, radios and bicycles, due to foreign exchange shortages and the collapse of the domestic manufacturing industry. The negative effects of such shortages on recorded market output have been extensively studied in Ghana, Madagascar, Mozambique and the United Republic of Tanzania.[18] When trade liberalization, import expansion, reform of the exchange rate policy and the dismantling of price controls made incentive goods less scarce in rural areas, productive capacity was brought back into use.

However, there are limits to such expansion. First, it is a one-off response. As a World Bank report on the United Republic of Tanzania remarked, agricultural growth during 1983-1990 was "a one-time phenomenon associated with a return to a market-clearing situation in the rural economy that cannot be expected to sustain growth in the 1990s".[19] Secondly, there may not always be unutilized resources. In both high and low population density countries, the land tenure system means that there are pockets of high-density settlement alongside low-density areas where the entry of outsiders into the local community can be limited or fraught with social problems. Even where there are community land resources available, poorer farmers simply cannot farm extra land because they cannot mobilize the necessary complementary inputs. High levels of poverty mean that "farmers in most of SSA cannot afford to keep either their labour or land idle even at very unattractive prices".[20] Nevertheless, because part of their basic consumption needs are market-mediated, falling real producer prices can cause already hard-working farmers to work even longer hours simply to sustain minimal subsistence. For the richer farmers, what is important is the thinness of rural markets for wage labour, which makes it difficult to hire extra labour.

An important part of the total labour in agriculture is provided by women, and time allocation studies show a strong gender dimension to household labour constraints. Women, who are responsible for directly productive agricultural work as well as for maintaining the household and reproduction, have heavy work burdens. This situation is not simply due to cultural norms, but is closely associated with lack of infrastructure and transport means, with much time being spent in fetching water and firewood, and carrying goods.[21] Also, both men and women are affected by morbidity (sickness), which reduces production and productivity; and evidence shows that the distance of the rural population from health facilities reduces their use and leads to increases in the number of days lost through illness.[22] When there has been a switch from food crops to export crops, inadequate nutrition can constrain supply response. As a World Bank report on Malawi observed, the "nutritional implications of extensive switching of production away from non-tradable food crops into export crops have impeded adjustment".[23]

(b) Output mix adjustment

Three main factors influence the ability of farmers to achieve efficiency gains through a reallocation of resources. The first is the level of capitalization of farm operations. In semi-arid Africa the key element for farmers is animal traction (oxen or a donkey with a plough), which allows households not only to cultivate more land and enhance yields, but also to have greater flexibility in reorienting production. Micro-analysis of recent supply behaviour in Burkina Faso shows that farm households responded positively to increases in the prices of cotton and maize, two key cash crops. By contrast, increased prices for these crops led to a decrease in aggregate supply for farmers limited to hoe cultivation, because cotton and maize demand more labour than millet and sorghum.[24]

The second factor, which limits changes in output mix, is the commitment of households to meet part of their subsistence needs through their own production. This behaviour results from the fact that the rural food markets are thin, food prices in rural markets are highly volatile, and there are large margins between rural producer

prices and consumer prices. The opportunity cost of export crop production is thus the retail price of food in rural markets. As a consequence, poor farmers tend to grow food crops with low risks and low returns. It makes economic sense to meet household food needs through one's own production, even though shifting to export crops appears to be more rational. Evidence shows that "consumer prices for staple food must fall by 5-30 per cent to stimulate cash cropping incentives in most grain deficit areas of Zimbabwe".[25]

The third factor is gender relationships, which can reduce the flexibility of household units to reallocate resources. The rigidity of the gender division of labour in Africa is now perhaps overaccentuated, but it is certainly true that asymmetries in the provision of household labour and the control of income from specific crops and plots of land significantly reduce flexibility. A typical example is the adoption of rice production in northern Cameroon, where income from rice sales is controlled by men. It has been shown that many women preferred to work on subsistence crops even though returns from rice cultivation were higher.[26]

(c) Agricultural intensification

Another form of response to price incentives – agricultural intensification – can either be labour-based or involve both additional labour and other variable inputs such as organic and chemical fertilizer on a given unit of land. The observation that the transition from extensive slash-and-burn production methods to intensive farming techniques occurs with rising population density has led to the suggestion that intensification is constrained by low population density and the consequent lack of inducement to intensify production. But although this process of intensification promoted by high population density may be relevant in a subsistence economy, in most current African conditions sustainable intensification requires additional capital and hence depends on assessment of profitability and risk, as well as on the availability of credit, skills and appropriate intensification packages. All of the latter can be influenced by policy and, whether market-driven or state-administered, are characterized by gender biases.

An important trend which has been observed in many African countries during the policy reform is the decline in the use of purchased inputs, particularly fertilizers. Firstly, input prices have risen sharply with the removal of subsidies;[27] and secondly, fertilizer distribution systems have broken down as private traders have not adequately replaced marketing boards, particularly in supplying farmers in need of small quantities of fertilizer in remote areas. Once again infrastructure is a key constraint. There are also problems related to credit markets. The marketing boards had offered an institutional response to the problem of missing private credit markets. As they had a legal monopsony over marketed output, they could provide seasonal inputs on credit against the potential crop as collateral. Through the interlocking of input supply and output marketing a larger number of small farmers had access to both inputs and working capital. With privatization, this system of seasonal credit has broken down.[28]

These factors have had adverse consequences so far for the maize revolution which was developing in East and Southern Africa. In the 1980s major increases in food grain production were achieved in Kenya, Zambia and Zimbabwe through pricing and market support policies which encouraged farmers to adopt hybrid maize seed, resulting from decades of agricultural research, and to increase fertilizer use. Policies included the expansion of marketing board buying stations in smallholder areas, expansion of state credit disbursed to smallholders, and subsidies on inputs. In the 1990s, however, this approach came to be regarded as fiscally unsustainable. With the dismantling of state marketing services, reduced availability of credit and rising real fertilizer prices, yields and production per capita stagnated, even when allowance is made for the adverse effects of drought. Remoter areas of large, low population density countries can be particularly affected by the policy change. The transition from pan-territorial to market pricing has reduced grain prices received by smallholders in the more remote grain-surplus areas in the United Republic of Tanzania and Zambia. In Madagascar food market liberalization has been associated with an increase in price volatility and greater regional and seasonal price dispersions.[29]

In high-density areas, declining use of purchased inputs raises questions about the sustainability of intensification. Evidence from the Senegalese groundnut basin, for example, shows that with the abolition of fertilizer subsidies and the increasingly difficult access to fertilizer credit, aggregate annual use of fertilizer has declined from a high

of 80,000 tons in the mid-1970s to a range of 20-30,000 tons during the 1980s and 1990s. Farmers have compensated by increasing the seed per hectare, a solution that may make sense in the short term, given prevailing prices of groundnuts and fertilizer, but that will have adverse ecological consequences over the longer term.[30]

2. Investment and productivity growth

Both the removal of various structural obstacles to agricultural supply response and long-run trends in productivity and output depend on the pace of investment and technological progress. In predominantly agricultural economies, the net agricultural surplus (i.e. the agricultural value-added minus agricultural producers' total consumption) is the major source of funding for investment both within agriculture and outside. In extreme conditions where productivity is very low, the value-added of the sector is barely sufficient to meet the basic subsistence and simple reproduction needs of agricultural producers, and there may even be insufficient surplus to maintain the natural resource base. Because of the undercapitalization of African agriculture, many African farmers are in this low-productivity, hand-to-mouth situation. In such situations there can be no agricultural growth without an external injection of resources to increase productivity.

Greater understanding of how more successful African farmers have been able to create an agricultural surplus, and of what they do with that surplus, is vital to successful agricultural policies in Africa. There is unfortunately a general lack of knowledge of private farm investment behaviour, and the general omission of this issue in policy analysis which underpins agricultural reforms has been highlighted in a recent report by the World Bank Operations Evaluation Department with regard to its own agricultural sector studies:

> There is no analysis of the constraints on private sector investment in any of the reports. Nevertheless all the reports stress the need to develop an effective enabling environment that would help to induce private investment. Unlike the old public production paradigm, the new market friendly policy line depends on private investment to achieve rapid growth, in agriculture as in other sectors. In many countries, achieving the needed rate of private investment in agriculture is a problem the Bank has not addressed in its sector work on agriculture.[31]

Smallholder farm investment is primarily founded on the surplus generated by both on-farm and off-farm activities. The absence of individual rights to land has meant that few farm households have collateral for loans from formal banking institutions. Private traders provide seasonal credit, tying their loans to purchase of crops, but this usually entails high implicit rates of interest and is likely to be avoided unless a farmer is desperate and seeking a "hungry season" loan to guarantee the survival of the household.[32] Small farmers in the past had access to credit provided by marketing boards or special directed credit agencies, but with the implementation of reforms these sources started to disappear. What is more, special directed credit arrangements, which were an important component of donor lending, particularly by the World Bank, have been replaced by liberalized financial intermediation and market-based interest rates. The previous arrangements did not reach the poorest smallholders for whom they were often designed. However, available evidence on financial liberalization suggests that these reforms have also been unable to increase the volume of savings or access to credit in rural areas except by those who can offer collateral.[33]

Under these conditions non-farm income has become an even more important source for on-farm investment, directly or as collateral. How non-farm earnings derived from the public and private sector wage bill can propel agrarian capital accumulation has been shown historically for Kenya.[34] But where urban unemployment is on the increase, such opportunities are diminishing. Moreover, whether non-farm income is reinvested in agriculture depends on a delicate balance of incentives and capital requirements. These are affected by the physical and economic environment, including infrastructure and market structures, the scale and timing of non-farm income flows in relation to farm investment needs, and intra-household distribution and control of both non-farm and on-farm incomes. The persistence of a high degree of intersectoral dualism, which is rooted in low agricultural productivity, has been only marginally affected by agricultural price reforms.[35]

An important tendency observed in Africa amongst successful farmers is the diversification of their portfolios, using net incomes from farm-

ing to invest in trade and urban real estate, or in their children's education, rather than for expansion of agricultural production. This behaviour reflects both the relative profitability and the riskiness of investment in different sectors. Diversification of activities in different sectors results from high levels of risks associated with each of them, while shifting resources out of agriculture reflects the higher risks of agricultural operations based on climate, markets and public policy. Moreover, market price risks of agricultural activity appear to have increased as a result of deregulation of crop markets.[36]

How customary land tenure arrangements affect incentives for private farm investment is a critical issue. According to one view, since tenure insecurity undermines investment incentives and diverts resources into unproductive litigation costs, land registration and freehold titles are necessary in order to unleash agricultural investment. However, other analyses of the effects of such land reforms indicate that "in the absence of profitable technological options, registration will have little effect on investment and productivity in agriculture"[37] and suggest that investments to improve land are actually increased under the indigenous tenure system because they can increase security of use rights. This debate is still open, but it is certain that the tenure system does affect the operation of rural labour and capital markets, and one legacy of the multiplication of land rights which occurred in the colonial period is that agricultural surplus and entrepreneurial energies are deployed to build up access to, and command over, land and labour resources rather than to increase their productivity.[38]

The profitability of private investment in agriculture depends on public investment in infrastructure. This includes institutional support for specific crops (see box 6), as well as location-specific investments in safe water, electricity, health and education facilities, and also transport. The rural transport bottleneck is a particularly important constraint on private farm investment because it reduces real returns and is also a source of product market imperfections. The density of rural roads in Africa is very low, particularly when compared with Asia.[39] Moreover, many of the roads are in a poor state of repair because of lack of proper maintenance, motorized transport services are often in short supply and expensive, and there is a dearth of non-motorized off-road transport equipment, which is particularly important for delivering produce to the first point of sale. The experience of the Northern Guinea Savanna of Nigeria, a country where the rural road network expanded by 45 per cent between 1985 and 1992, shows how rural road investment can, in association with the discovery of locally adapted hybrid varieties of maize and demonstration effects of rural development projects, facilitate expansion of food production.[40]

Because of lack of data, it is not always possible to gauge how public expenditure supporting farm investment has developed under adjustment programmes. However, in many SSA countries, much of public investment expenditure in agriculture was externally financed, often in the form of integrated rural development projects, but such expenditure has been declining. From available evidence it appears that the proportion of government expenditure going to agriculture has remained under 10 per cent of total expenditure on average.[41] This is a better indicator of urban bias in Africa than agricultural pricing policy.

The rate of technological change in agriculture depends ultimately on agricultural research. Most of the problems with that research, pointed out a decade ago, are still unsolved: costs of R&D in Africa are higher than elsewhere, owing in part to the fact that programmes are still largely foreign-funded, and the small size of countries and research stations, dispersion and high staff turnover impede the attainment of a "critical mass". As a result, with the notable exception of maize, "most of SSA now offers smallholders no dramatic, immediately applicable new technology that might (with adequate price incentives) safely and substantially increase the profitability of food farming over large areas. While this is so, the elasticity of total farm output to currently recommended policy changes, including price changes, can seldom be very large".[42] These observations are probably as true to a large extent now as they were ten years ago. Evidence for 19 countries in SSA shows that real agricultural expenditures, which had been growing rapidly in the 1960s and moderately in the 1970s, ceased to grow in the 1980s and early 1990s. In 1991, the research expenditure in these countries was 0.7 per cent of agricultural GDP. However, estimates of the returns to investment in maize research indicate high annual rates of return, usually in excess of 40 per cent.[43]

Box 6

PRICE AND NON-PRICE FACTORS IN COTTON DEVELOPMENT IN SSA

A comparative analysis of cotton production and exports in SSA was carried out in the late 1980s for Cameroon, Kenya, Malawi, Nigeria, Senegal and the United Republic of Tanzania.[1] It illustrated the role of price and non-price factors in agricultural development, starting from the observation that there had been a clear tendency since the early 1970s for francophone African countries to perform better in cotton production and exports than anglophone countries (with the exception of Zimbabwe).

In two countries (Nigeria and the United Republic of Tanzania) price factors were found to have played a major role in determining the volume of cotton production. In both countries abnormally low relative prices of tradables favoured the production of food crops. The Dutch-disease-induced increase in labour cost in Nigeria and the dearth of consumer goods in the United Republic of Tanzania acted as further disincentives for the production of agricultural exportables.

However, apart from these extreme cases, differences in cotton production performance could not be explained by differences in the evolution of real producer prices. Rather, and particularly in the more successful countries (Cameroon and Senegal), non-price factors (including research, credit and subsidized inputs) explained most of the production increase. In Senegal, they more than compensated for the negative effect of declining producer prices.

The analysis also found that much of the difference in performance amongst the sample countries was due to institutional factors. In general, francophone countries appeared to benefit from better coordination between upstream and downstream agents in the cotton industry, thanks to the presence of the Compagnie Française pour le Développement des Fibres Textiles (CFDT). The CFDT improved vertical integration in the countries where it operated, and provided positive inputs in terms of professionalism, know-how and experience with technological, market and finance conditions.

As a result of this key institutional difference, a distinct high-input/high-yield technological pattern prevailed in cotton production in the francophone countries, while the anglophone ones were stuck in a low-input/low-yield pattern. Despite the relative success of the former, the CFDT-inspired approach was not immune to criticism, because it led to high production and administrative costs and to an excessive and even monopolistic focus on cotton. In the anglophone countries, on the other hand, lack of technological progress was making cotton cultivation increasingly unattractive, except as a diversification and risk-minimization strategy.

The main conclusion of the analysis was that, notwithstanding the relevance of macroeconomic and sectoral pricing policies, institutional factors had been paramount in explaining inter-country differences in cotton production growth. The unsatisfactory performance of cotton in an otherwise relatively successful economy such as Kenya underlined the importance of crop- and sector-specific institutional arrangements, often rooted in part in the colonial legacy of the various countries. The political influence of cotton producers was also important. Future priorities for cotton development were identified as follows: to strengthen research and extension systems; to eliminate input supply and finance bottlenecks; and to build institutions, including through regional cooperation and coordination.

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[1] U. J. Lele, N. van de Walle and M. Gbetibouo, "Cotton in Africa: An analysis of differences in performance", MADIA Discussion Paper No. 7 (Washington, D.C.: World Bank, 1989).

D. Adjustment policies and agricultural performance

As noted in the previous chapter, agricultural production grew so slowly in the 1970s and early 1980s that output per capita was falling. For many countries, there was also a dip in agricultural export volumes. In the mid-1980s, output picked up and the downward trend in exports was reversed, but despite these improvements, agricultural production per capita has stagnated and export volumes have not yet recovered to their 1970 levels in most countries.

How these trends are related to various policies pursued under structural adjustment programmes introduced in the 1980s is difficult to ascertain since these programmes combine three elements (financing, policy design and implementation). While the reduction of agricultural taxation through output pricing and market deregulation has been at the centre of adjustment policies, the reforms have also involved a wider range of measures which have affected not only output prices, but also a host of other elements such as: prices and the availability of agricultural inputs, incentive goods and rural credit; the quantity and quality of rural transport infrastructure and transport means; the quality and costs of health and education services for farmers; agricultural research and extension systems; opportunities for and remuneration of off-farm employment; and the level of food demand. The performance of African agriculture reflects the influence of this package of measures, as well as of the external financing associated with adjustment programmes, on incentives and structural constraints on agricultural production, investment and productivity growth.

Agricultural performance is also affected by the weather, changes in international prices and external demand. It is notable that the acceleration in the growth of agricultural output and the recovery of export volumes in the mid-1980s coincided with a reversal in the downward trend in net resource transfers, in large part on account of substantial increases in ODA (see chapter I, chart 7). This was also associated with a shift from declining to rising import volumes.

As already discussed, reforms have not always succeeded in altering price structures as intended. They have often failed to reduce the taxation of export crops or to improve the agricultural terms of trade and real producer prices. Moreover, reforms have not effectively tackled key structural constraints which impede the acceleration of agricultural growth in many countries. It has been suggested that "SSA suffers from structural handicaps that are impossible to remove or reduce through the standard policy reform programs".[44] There are indications that some ingredients of reforms have actually aggravated constraints on the growth of smallholder production. Major exceptions to this situation are those countries where, in the past, attempts were being made to foster domestic capitalist agribusinesses or state farms. In such cases, important restrictions on smallholder choices and access to resources were removed. But elsewhere access to inputs and credit has not improved because input subsidies and public agricultural services (input provision, product distribution, credit and extension) have been reduced, and the private sector has not adequately taken over these functions. Moreover "the decline in donor support to rural development projects and integrated commodity projects was accompanied by a decline in investment in rural health, education and infrastructure facilities",[45] the more so because governments have been unwilling or unable to provide the operation and maintenance funds required to sustain investment. The decline in external aid to sub-Saharan African agriculture was very steep during 1987-1994, when it dropped from $4,609 million to $1,322 million (at constant 1990 prices).[46]

The upturn in agricultural production and export volumes reflects greater utilization of existing resources rather than an acceleration of investment and productivity growth. Production and export expansion in the mid-1980s coincided with a recovery in external resource flows and imports. Exchange rate adjustments and trade liberalization also appear to have contributed by shifting the incentives towards exports and reducing shortages of incentive goods in the countryside. Moreover, given the declines in real producer prices and per capita incomes, it is possible that there has been a more intensive utilization of household labour.[47]

Currency depreciations can be expected to cause a shift from food crops to export crops since many food crops are not tradable. Again, incentives for food production vis-à-vis export crops are weakened by the removal of subsidies and by depressed food demand due to contractionary monetary and fiscal policies. However, higher food import costs associated with devaluations at the same time encourage consumers to substitute local food for imports. The effects of devaluations on output mix between export and food crops for domestic consumption thus depend on the degree of tradability of food crops and reliance on food imports. It appears that where a currency was grossly overvalued and parallel currency markets were pervasive, exports either declined or were diverted into unofficial channels. In such cases, exchange rate adjustments supported by export promotion measures have achieved positive results in spite of the downward trend in real producer prices.[48]

Table 46 compares post-1984 trends in total agricultural production, export volume and food production with average growth rates in the 1970s for three groups of countries defined according to the degree of compliance with adjustment programmes. These groups are not defined simply on the basis of pricing policies, but of their overall compliance with conditionality with regard to macroeconomic policy (fiscal deficit reduction, public expenditure levels, exchange rates, etc.), of their public sector management (including civil service reform, public expenditure reform and public enterprise restructuring and privatization), and of their private sector development (including financial sector reform, trade policy reform, regulatory environment, and pricing and incentives).[49] Three generalizations can be made from the table:

- First, it is apparent that for all groups of countries, the most significant change is in the volume of agricultural exports. This reflects the partial recovery from the dip of the 1970s and early 1980s and the return of exports to official marketing channels. However, the improvement in export performance is actually weakest for the good compliers.

- Second, there is little difference between the groups in terms of improvements they achieved in growth rates of total agricultural and total food production. However, this result changes when low population density countries (which are not found amongst the good compliers) are excluded. There is a clear tendency for the aggregate agricultural growth rates to be lower in the post-1985 period than in the 1970s in these countries.[50] When the sample is limited to high and medium population density countries, weak and poor compliers have a better overall performance in terms of agricultural growth.

- Third, there is a major divide between Southern and East African countries, on the one hand, and West and Central African countries on the other. In the former, the growth of agricultural output is lower in the post-1984 period than in the 1970s in both good and poor compliers, but it is markedly lower in the good compliers. For West and Central Africa it is faster in all cases, but particularly so in the good compliers. Also, in Southern and East Africa, the recovery of agricultural exports appears to be associated with a decline in the rate of growth of food production. Although drought may be part of the reason, the decline also reflects, as noted above, the immediate impact of the dismantling of the state-centred approach to expanding food grain production.

As with all exercises of this type, these results must be interpreted with caution. However, they do not provide much support to the idea that adjustment programmes have generally brought a better policy mix for tackling incentives and structural and institutional constraints across Africa.

Table 46

AGRICULTURAL PERFORMANCE AND COMPLIANCE WITH ADJUSTMENT PROGRAMMES IN SSA

	Average annual volume increase					
	Agricultural production		Agricultural exports		Food production	
	1970-1980	1985-1995	1970-1980	1985-1995	1970-1980	1985-1995
Country group	*(Per cent)*					
Country with good compliance	1.0	2.2	-2.0	1.0	1.0	1.9
West and Central Africa[a]	0.0	3.0	-2.8	1.7	-0.0	2.6
Southern and Eastern Africa[b]	2.6	1.0	-0.7	-0.2	2.5	0.9
Country with weak compliance	1.6	2.7	-3.3	3.4	1.7	2.6
	(0.9)	*(3.2)*	*(-3.4)*	*(3.7)*	*(1.0)*	*(2.9)*
West and Central Africa[c]	1.8	3.4	-1.4	2.8	1.8	3.3
Southern and Eastern Africa[d]	1.4	1.4	-6.5	4.4	1.6	1.4
Country with poor compliance	1.8	2.6	-4.9	2.3	1.9	2.7
	(1.2)	*(3.7)*	*(-4.0)*	*(4.8)*	*(1.0)*	*(3.4)*
West and Central Africa[e]	1.6	3.0	-5.8	3.5	1.7	3.1
Southern and Eastern Africa[f]	2.2	2.0	-3.4	0.4	2.1	1.9

Source: UNCTAD secretariat calculations, based on FAO, *FAOSTAT* database. The classification of countries is that of World Bank, *Adjustment Lending in Sub-Saharan Africa: An Update,* Report No. 16594 (Washington, D.C., May 1997).

Note: Group averages are unweighted. Those shown in brackets exclude low population density countries (see text), asterisked below.

a Benin, Gambia, Ghana, Mali, Mauritania.
b Malawi, Mauritius, United Republic of Tanzania.
c Burkina Faso, Guinea, Côte d'Ivoire*, Niger, Togo, Guinea-Bissau*, Senegal.
d Uganda, Madagascar*, Zambia*, Zimbabwe.
e Central African Republic*, Congo*, Gabon*, Nigeria, Cameroon*.
f Kenya, Burundi, Democratic Republic of the Congo*.

E. Conclusions

Comparative analysis shows that a particularly effective agricultural development strategy in the early stages of development is a two-sided approach in which the State taxes agriculture, but at the same time counterbalances this resource outflow by making adequate investment in basic infrastructure for agricultural production, and helping to introduce a stream of innovations needed to enhance productivity and profitability of private investment. This pattern has been identified as the main characteristic of East Asian agricultural development.[51]

In Africa too, before the agricultural marketing reforms, public policy aimed at a two-sided approach. But, as in the case of import-substitution

strategy in industry, there were serious problems of policy design and implementation. Many governments sought to raise revenue by taxing export crops without ploughing part of the money back into the sector to increase productivity. Instead, they concentrated on the promotion of food crop production, often subsidizing marginal areas through pan-territorial price support. A significant proportion of public expenditure in agriculture went into financial subsidies, particularly for inputs (e.g. fertilizers), credit and marketing, rather than into infrastructure investment and agricultural research to enhance agrarian capital formation and productivity growth. More important, a large share of revenues obtained from export crops went into urban consumption.

The success of market-based agricultural development in Africa requires on-farm private investment. This can occur only through a policy which increases the profitability of investment and lowers risks by providing a stable environment and removing technical and financial constraints on the capacity and willingness to invest. Agricultural reforms have not succeeded in this respect. They have sought to improve profitability through action on one side of the equation, namely through higher output prices. But in practice, because they have been implemented in the context of imperfect private markets and falling international commodity prices, they have failed to reverse the downward trend in real producer prices. The bias of agricultural policy reforms in favour of export production has also ignored the fact that for many farmers it is lower food prices and improved food distribution systems that would encourage them to grow high-value crops.

Farmers have also been squeezed because key production and marketing costs – the other side of the profitability equation – have risen rapidly: prices of fertilizers and transport costs have soared with devaluations and removal of subsidies. Lower wages have not been much help because hired labour generally accounts for less than 20 per cent of the total labour force. The dismantling of marketing boards has increased price risks, adding to the uncertainties of rain-fed agriculture. The interlocking marketing systems centred on marketing boards which provided inputs and credit have been only partially replaced by private sector arrangements.

Analysis of supply behaviour has identified many institutional and structural constraints. Some of these, such as low population density and agro-climatic conditions, are legacies of geography and history, and out of reach of policy, at least in the short to medium term. Some, notably the gender division of labour and control of resources, can be quite intractable and give rise to complex policy decisions. But other structural constraints can be reduced through public investment in agricultural research and infrastructure, and through measures designed to increase farmers' skills, access to finance and capacity to invest. The importance of tackling these policy-based constraints is now well established by analysis and empirical evidence. Reorienting development policy in this direction will require a shift from an approach based on ideology to one governed by pragmatism. ■

Notes

1 *Adjustment in Africa* (Washington, D.C.: World Bank, 1994), p. 76. For an earlier formulation of this view see *Accelerated Development in Sub-Saharan Africa: An Agenda for Action* (Washington, D.C.: World Bank, 1982) and *World Development Report 1986* (Washington, D.C.: World Bank, 1986).

2 See, in particular, H. Binswanger, "The policy response of agriculture", in *Proceedings of the World Bank Annual Conference on Development Economics* (Washington, D.C.: World Bank, 1989), pp. 231-258, together with comments by A. Braverman and A. Valdes and the floor discussion of the paper, pp. 259-271.

3 See J. Meerman, *Reforming Agriculture: The World Bank Goes to Market*, World Bank Operations Evaluation Department Study (Washington, D.C.: World Bank, 1997), p. 70.

4 These are indeed old questions raised as part of the criticism of the reform process described as "pricist", i.e. something that proceeds "as if correct pricing

policy – for farm inputs, outputs, and foreign exchange – were (a) readily definable and attainable, (b) in general best approached by reducing state involvement in agricultural markets, (c) at least the most important component in, probably in most cases necessary and sufficient for, rapid and equitable agricultural growth" (M. Lipton, "Limits of price policy for agriculture: Which way for the World Bank?", *Development Policy Review*, Vol. 5, 1987, p. 201).

5 Part of the empirical results discussed in this section are from K. Boratav, "Movements in relative prices in sub-Saharan Africa" (Geneva: UNCTAD, 1998), mimeo. Detailed information on the methodology and the data used can be obtained from the UNCTAD secretariat.

6 For some of the more complex ways of making cross-country comparisons of agricultural taxation and problems associated with them, see M. J. Westlake, "The measurement of agricultural price distortion in developing countries", *Journal of Development Studies*, Vol. 23, 1987; D. Byerlee and M. L. Morris, "Calculating levels of protection: Is it always appropriate to use world reference prices based on current trading status?, *World Development*, Vol. 21, No. 5, 1993; and M. Karshenas, "Dynamic economies and the critique of urban bias", *Journal of Peasant Studies*, Vol. 24, No. 1/2, 1996.

7 The conventional claim of excessive taxation of agriculture in Africa has been questioned by J. G. Beynon, "Pricism v. structuralism in sub-Saharan African agriculture", *Journal of Agricultural Economics*, Vol. 40, No. 1.

8 See A.O. Krueger, M. Schiff and A. Valdes (eds.), *The Political Economy of Agricultural Pricing Policy,* Vol. 4*, A Synthesis of the Economics in Developing Countries* (Baltimore: Johns Hopkins University Press for the World Bank, 1991-1992).

9 Both indicators have shortcomings which warrant caution in their interpretation. When GDP deflators at market prices rather than factor costs are used in estimating the overall terms of trade of agriculture, there may be inter-temporal inconsistencies in the measure of relative agricultural prices. For instance, a country may have dismantled its marketing boards and introduced explicit taxes on agricultural exports. Under those circumstances the market price measure of the agricultural GDP deflator can show an increase without any change in the prices received by producers. The estimates of real producer prices use FAO producer prices, but once again caution is needed in interpreting the data. Past FAO price series for SSA refer mostly to official prices paid by marketing boards to farmers, or to government support prices. When prices in parallel markets are higher, the official prices underestimate the prices actually received by farmers. By contrast, after liberalization, reported prices usually refer to average prices received by farmers. This may result in an overestimation of the effect of liberalization on producer prices.

10 Chart 21 classifies countries into those with "heavy" and "light" intervention using an overall score of 15 in table A13 of *Adjustment in Africa* as the break-point, whilst charts 2.3.7.B and C use crop-specific information in table A9 of that study to classify countries as "continued interventionist", "continued liberal" or "newly liberalized". For other recent classifications see *Adjustment Lending in Sub-Saharan Africa: An Update*, Operations Evaluation Department Report No. 16594 (Washington, D.C.: World Bank, 1997); and K. Cleaver, *Rural Development Strategies for Poverty Reduction and Environmental Protection in Sub-Saharan Africa* (Washington, D.C.: World Bank, 1997); the latter uses a qualitative rating based on recent World Bank evaluations. To examine how different classifications can affect results, table 1 of the latter study has been taken as a check-list of the country classifications used in this section for comparing the terms of trade of agriculture under different policy regimes. The listing in that study produces three countries which fall into the market-oriented group in the present chapter (Malawi, Mali and Uganda) and three countries (Cameroon, Madagascar and Senegal) which fall into the "interventionist" category. With 1984 as the base year, the average agricultural terms of trade of the market-oriented group decline to 93 in 1995 (1984=100), whereas those of the interventionist group rise to 136.

11 Tables A.9 and A.18.

12 This conclusion was reached earlier by D. Ghai and L. Smith, "Food price policy and equity", in J. W. Mellor, C. L. Delgado and M. J. Blackie (eds.), *Accelerating Food Production in Sub-Saharan Africa* (Baltimore and London: Johns Hopkins University Press, 1987), pp. 284-285. Also, it has been shown in a study of East Africa that the heavy subsidization of food crops after 1973 meant that in most countries there was no net taxation of agriculture; see U. J. Lele and L. Meyers, "Growth and structural change in East Africa: Domestic policies, agricultural performance and World Bank assistance 1963-86", MADIA Discussion Paper No. 3 (Washington, D.C.: World Bank, 1989).

13 U. J. Lele, "Comparative advantage and structural transformation: A review of Africa's economic development experience", in G. Ranis and T. P. Schultz (eds.), *The State of Development Economics: Progress and Perspectives* (Oxford and New York: Basil Blackwell, 1988), p. 204.

14 Meerman, *op. cit.*

15 Results of studies of the supply response of individual export crops to changes in the real prices of those crops indicate that for annual crops (cotton and tobacco) short-run supply elasticities generally range from 0.2 to 0.7. For tree crops (coffee, cocoa and tea), the range is lower – from 0.1 to 0.3. Long-run elasticities are generally higher, but usually less than unity; see G. Helleiner, "Smallholder decision making: Tropical African evidence", in L. G. Reynolds

(ed.), *Agriculture in Development Theory* (New Haven and London: Yale University Press, 1975); and N. Mamingi, "How prices and macroeconomic policies affect agricultural supply and the environment", World Bank Policy Research Working Paper No. 1645 (Washington, D.C.: World Bank, 1998).

16 Surprisingly, in view of its importance to the adjustment process, there is little research into the aggregate supply response of agriculture to real output prices in Africa. The main multi-country empirical study (M. E. Bond, "Agricultural supply response to prices in sub-Saharan Africa", IMF Staff Papers, Vol. 30, 1983, pp. 703-726) is now 15 years old. For a set of nine SSA countries, Bond found that price elasticity was low and only significant in two countries – Kenya and Ghana. The estimates correspond to those for other low-income countries and suggest that a 10 per cent increase in real crop prices will elicit only a 1 or 2 per cent increase in aggregate agricultural output in the short run.

17 "Vent for surplus" is a generic term for models of trade and growth that involve the exploitation of resources which had previously been unused because they had no economic value.

18 J. C. Berthélemy and C. Morrisson, *Agricultural Development in Africa and the Supply of Manufactured Goods* (Paris: OECD Development Centre, 1989); and D. Bevan, P. Collier and J. W. Gunning, *Peasants and Governments: An Economic Analysis* (Oxford: Clarendon Press, 1989).

19 World Bank, *Tanzania Economic Report: Towards Sustainable Development in the 1990s*, Report No. 9352-TA (Washington, D.C.: World Bank, 1991), quoted in L. Putterman, "Economic reform and smallholder agriculture in Tanzania: A discussion of recent market liberalization, road rehabilitation, and technology dissemination efforts", *World Development*, Vol. 23, No. 2, 1995, p. 315.

20 O. M. Ogbu and M. Gbetibouo, "Agricultural supply response in sub-Saharan Africa: A critical review of the literature", *African Development Review*, Vol. 2, No. 2, 1990, p. 90.

21 On the time that women spend in transport activities in rural areas, see D. F. Bryceson and J. Howe, *African Rural Households and Transport: Reducing the Burden on Women*? (Delft, Netherlands: International Institute for Hydraulic and Environmental Engineering, 1992); and I. Barwell, "Transport and the village: Findings from African village-level travel and transport surveys and related studies", World Bank Discussion Paper No. 344, Africa Region Series (Washington, D.C.: World Bank, 1996).

22 See Bevan, Collier and Gunning, *op. cit.,* especially chapters 13-15.

23 World Bank, "Report and Recommendation of the President of the International Development Association to the Executive Directors on a proposed credit of SDR 52.6 million (US $70 million equivalent) to the Republic of Malawi for an agricultural sector adjustment programme", Report No. P-5189-MAI (Washington, D.C.: World Bank, 1990), quoted (p. 869) in J. Harrigan, "Modelling the impact of World Bank policy-based lending: The case of Malawi's agricultural sector", *Journal of Development Studies*, Vol. 33, No. 6, 1997, pp. 848-873.

24 K. Savagodo, T. Reardon and K. Pietola, "Mechanization and agricultural supply response in the Sahel: A farm-level profit function analysis", *Journal of African Economies*, Vol. 6, No. 3, pp. 336-377.

25 T. S. Jayne, "Do high food marketing costs constrain cash crop production? Evidence from Zimbabwe", *Economic Development and Cultural Change*, Vol. 42, No. 2, 1994, p. 399. See also A. De Janvry, M. Fafchamps and E. Sadoulet, "Peasant household behaviour with missing markets: Some paradoxes explained", *Economic Journal*, Vol. 101, 1991, pp. 1400-1417.

26 C. Jones, "Intra-household bargaining in response to the introduction of new crops: A case study from North Cameroon", in J. L. Moock (ed.), *Understanding Africa's Rural Households and Farming Systems* (Boulder, Colorado: Westview Press, 1986).

27 Fertilizer costs in Africa are inherently high because of high transport cost, lack of competition in distribution systems and absence of economies of scale in procurement. International comparisons show the following median nitrogen fertilizer-maize price ratios: Asia (1980-1992): 2.7; Latin America (1980-1992): 3.8; Kenya (1980-1995): 7.3; Zimbabwe (1980-1994): 6.4; and Côte d'Ivoire (1980-1992): 5.4; see P. W. Heisey and W. Mwangi, "Fertiliser use and maize production", in D. Byerlee and C. K. Eicher (eds.), *Africa's Emerging Maize Revolution* (Boulder, Colorado, and London: Lynne Rienner, 1997), table 13.3. These ratios have been exacerbated by the failure to reduce import barriers; see D. Gisselquist, "Import barriers for agricultural inputs", UNDP-World Bank Expansion Program, Occasional Paper No. 10 (Washington, D.C.: World Bank, 1994).

28 See C. Poulton, A. Dorward and J. Kydd, "The revival of smallholder cash crops in Africa: Public and private roles in the provision of finance", *Journal of International Development*, Vol. 10, No. 1, 1998, pp. 85-104.

29 T. S. Jayne and S. Jones, "Food marketing and pricing policy in Eastern and Southern Africa: A survey", *World Development*, Vol. 25, No. 9, 1997, pp. 1505-1527; and C. B. Barrett, "Liberalization and food price distributions: ARCH-M evidence from Madagascar", *Food Policy*, Vol. 22, No. 2, 1997, pp. 155-173.

30 V. Kelly, B. Diagana, M. Gaye, T. Reardon and M. Sene, "Have structural adjustment programs compromised efforts to intensify sustainable African agricultural production: Empirical evidence from Senegal", paper presented to the Meeting of the International Association of Agricultural Economists, Sacramento, California, August 1997. See also T. Reardon et al., "Promoting sustainable intensification and productivity growth in Sahel agriculture

after macroeconomic reform", *Food Policy*, Vol. 22, No. 4, 1997, pp. 317-327.

31 Meerman, *op. cit*., p. 156.

32 For a full discussion of rural financial markets in least developed countries, including policy implications, see UNCTAD, *The Least Developed Countries 1997 Report* (United Nations publication, Sales No. E.97.II.D.6), New York and Geneva, 1997.

33 See B. M. Desai and J. W. Mellor, "Institutional finance for agricultural development: An analytical survey of critical issues", *Food Policy Review*, No. 1, 1993; W. G. Donovan, "Agriculture and economic reform in sub-Saharan Africa", AFTES Working Paper No. 18, 1996, chapter 8; M. K. Nissanke, "Financing, enterprise development and export diversification in sub-Saharan Africa" (Geneva: UNCTAD, 1998), mimeo; P. Mosley, "Micro-macro linkages in financial markets: The impact of financial liberalization on access to rural credit in four African countries", paper presented to the meeting of the UNU/WIDER Project on Impact of Liberalization on Key Markets in Sub-Saharan Africa, Addis Ababa, March 1998.

34 G. Kitching, *Class and Economic Change in Kenya* (New Haven: Yale University Press, 1980). See also T. Reardon, E. Crawford and V. Kelly, "Links between non-farm income and farm investment in African households: Adding the capital market perspective", *American Journal of Agricultural Economics*, Vol. 76, No. 5, 1994, pp. 1172-1176.

35 For a detailed discussion of trends in the ratio of value-added per worker in agriculture and non-agriculture during the reform period, see M. Karshenas, "Capital accumulation and agricultural surplus in Africa and Asia", paper prepared for the UNCTAD project on African Development from a Comparative Perspective (Geneva: UNCTAD, 1998), mimeo.

36 See Barrett, *op. cit.*

37 R. Barrow and M. Roth, "Land tenure and investment in African agriculture", *Journal of Modern African Studies,* Vol. 28, No. 2, 1990, p. 296.

38 For overviews of the debate, see H.W.O. Okoth-Ogendo, "Agrarian reform in sub-Saharan Africa: An assessment of State responses to the African agrarian crisis and their implications for agricultural development", in T.J. Bassett and D.E. Crummey (eds.), *Land in African Agrarian Systems* (Madison, Wisconsin: Wisconsin University Press, 1993); J.-P. Platteau, "The evolutionary theory of land rights as applied to sub-Saharan Africa: A critical assessment", *Development and Change*, Vol. 27, 1996, pp. 29-86; E. Sjaanstad and D.W. Bromley, "Indigenous land rights in sub-Saharan Africa: Appropriation, security and investment demand", *World Development*, Vol. 25, No. 4, 1997, pp. 549-562. On the view that diversity of claims leads to inappropriate deployment of surplus, see S. Berry, "No condition is permanent" (Madison, Wisconsin: University of Wisconsin, 1993), mimeo.

39 In the early 1990s, for example, a group of 18 countries in the humid and sub-humid tropics had only 63 kilometres of rural roads per 1,000 square kilometres. Taking account of population density difference, this was less than one sixth of the level in India in 1950; see D.S.C. Spencer, "Infrastructure and technology constraints to agricultural development in the humid and subhumid Tropics of Africa", Environment and Production Technology Division Discussion Paper No. 3 (Washington, D.C.: International Food Policy Research Institute, 1994).

40 J. Smith et al., "The role of technology in agricultural intensification: The evolution of maize production in the Northern Guinea Savanna of Nigeria", *Economic Development and Cultural Change*, Vol. 42, No. 3, 1994, pp. 537-554.

41 M. Gallagher, "Government spending in Africa: A retrospective of the 1980s", *Journal of African Economies*, Vol. 3, No. 1, 1994.

42 M. Lipton, "The place of agricultural research in the development of sub-Saharan Africa", *World Development*, Vol. 16, No. 10, 1988, p. 1231. Thirtle et al. found empirical evidence in favour of the need for critical mass, showing that large countries appear to fare better than small ones, possibly because of the existence of scale economies in R&D (C. Thirtle, D. Hadley and R. Townsend, "Policy-induced innovation in sub-Saharan African agriculture: A multilateral Malmqvist productivity approach", *Development Policy Review*, Vol. 13, 1995, pp. 323-348). If this finding were confirmed, it could contribute to explaining the good performance of Nigeria's domestic-market-oriented agriculture.

43 For an analysis of agricultural research expenditures, see P. Pardey, J. Roseboom and N. M. Beintema, "Investments in African agricultural research", *World Development*, Vol. 25, No. 3, 1997, pp. 409-423. Estimates of rates of return to maize research are from D. Byerlee and D. Jewell, "The technological foundation of the revolution", in Byerlee and Eicher (eds.), *op. cit.*

44 Y. Hayami and J.-P. Platteau, "Resource endowments and agricultural development: Africa vs. Asia", paper prepared for the IEA Round Table Conference on "The Institutional Foundation of Economic Development in East Asia", Tokyo, 16-19 December 1996, p. 34.

45 Cleaver, *op. cit.,* p. 23.

46 FAO, *Investment in Agriculture: Evolution and Prospects* (Rome: FAO, 1996), table 8.

47 A number of researchers have pointed to cases of positive supply response of peasant farmers to declining producer prices and the rising costs of inputs, which has taken the form of more intensive use of household labour and compression of household consumption. Empirical evidence is provided for Brazil (F. Contre and I. Goldin, "L'agriculture en période d'ajustement au Brésil", *Revue Tiers-Monde*, Vol. XXXII/12, April-June 1991), for Turkey (K. Boratav, "Inter-class and intra-class relations of distribution under structural adjustment: Turkey during the 1980s", in T. Aricanli and D. Rodrik (eds.), *The*

Political Economy of Turkey, (Basingstoke, UK: Macmillan, 1990)), and for the United States during the Depression years (H. Friedmann, "World market, State and family farm: Social bases of household production in the era of wage labor", *Comparative Studies in Society and History*, Vol. 20, No. 4, 1978). Such behaviour could help explain post-1985 productivity improvements in Africa in conditions of adverse price movements.

48 Recent research on 13 sub-Saharan African countries in the 1980s which compares export responses to currency depreciations in situations with different parallel currency premiums shows that "official depreciations which were preceded by relatively large exchange misalignment and were accompanied by a reduction in the latter, as proxied by the currency premium, exerted roughly twice as much positive effect on real exports as other official depreciations" (Z. Yiheyis, "Export adjustment to currency depreciation in the presence of parallel markets for foreign exchange: The experience of selected sub-Saharan African countries in the 1980s", *Journal of Development Studies*, Vol. 34, No. 1, 1997, pp. 111-130).

49 World Bank, *Adjustment Lending in Sub-Saharan Africa: An Update*, Operations Evaluation Department Report No. 16594 (Washington, D.C.: World Bank, 1997). In the present analysis, the following countries are excluded from the sample because of the effects of social unrest: Chad, Mozambique, Rwanda, Sierra Leone and Sudan, and also Sao Tome and Principe.

50 When countries are classified in terms of high, medium and low population densities, according to the classification of H. Binswanger and P. Pingali ("Technological priorities for farming in sub-Saharan Africa", *World Bank Economic Research Observer*, Vol. 3, No. 1, 1988), which takes account of agro-climatic potential, it is apparent that agricultural growth rates declined or were stagnant between the 1970s and the post-1985 period in 8 out of 10 low-density countries, 4 out of 11 medium-density countries and 3 out of 11 high-density countries.

51 J. Teranishi, "Sectoral resource transfer, conflict and macro-stability in economic development: A comparative analysis", in M. Aoki, H. K. Kim and M. Okuno-Fujiwara (eds.), *The Role of Government in East Asian Development: A Comparative Institutional Analysis* (Oxford: Clarendon Press, 1997).

Chapter IV

TRADE, ACCUMULATION AND INDUSTRY

A. Introduction

The major challenge facing a large number of low-income, predominantly agrarian economies in Africa is how to break out of the vicious circle of low productivity and heavy dependence on a small number of primary commodities. The challenge is a long-standing one. Efforts in most countries in the years following independence tended to concentrate heavily on developing import-substituting industries in order to increase productivity and diversify the production structure. Today the emphasis has shifted to improving export performance. It has been increasingly recognized that, given the limited size of domestic markets and the dependence on the import of intermediate and capital goods, expanding export capacity and increasing international competitiveness are vital for rapid growth and development.

Meeting this challenge requires a higher level of investment and establishing a virtuous link between trade and capital accumulation. The pattern of investment is a crucial determinant of such a link. It is evident that the competitive advantage of most economies in SSA lies in the exploitation of natural resources through diversification and increased processing of resource-based products. However, although it reduces risks, diversification as such does not ensure strong and sustained growth. The challenge is to identify, support and expand activities in areas where value-added is greater, productivity growth is faster and demand elasticities in world markets are higher.

For economies at higher levels of development, particularly with better endowments in physical and human capital, improving productivity and international competitiveness depends very much on the rehabilitation of industry, particularly as regards labour-intensive products. Many of the existing manufacturing industries in Africa were established in the context of the import-substitution strategies pursued in the post-colonial era. Much of their capacity is unviable because of rapid shifts over the past decade in the global and national policy environment and changes in some of the key parameters affecting their competitiveness. The lack of a positive response to such shifts reflects, to a great extent, the failure of these industries to advance beyond the infant industry stage and their continued dependence for survival on protection and on provision of foreign exchange earned by the primary sector or secured through foreign aid. Restructuring such industries into efficient and competitive units calls for substantial investment in both physical and human capital.

A strong and sustainable investment recovery is thus a necessary condition for more outward-oriented development strategies in Africa. Linking trade to the process of capital accumulation will mean that policies are based neither simply on a drive for greater openness, nor on "picking winners", but on widening as much as possible the choice of investment opportunities across the spectrum of more dynamic sectors.

The following section analyses the level and composition of Africa's trade. The analysis shows that Africa's marginalization in world trade is a reflection of its inability to sustain a rapid growth

rate. This is followed by an examination of the region's endowments in human and physical capital and natural resources, which suggests that its export potential lies in the primary sector, even though there are unexploited opportunities in manufacturing in some countries. The subsequent section focuses on accumulation and export growth, emphasizing the opportunities for diversification and processing in the primary sector to promote non-traditional exports, and drawing on the experience of successful countries in East Asia and elsewhere. This is followed (in section D) by a brief analysis of the structure and performance of African industry and the potential for manufactured exports. The final section examines the market opportunities for exports from Africa both to the advanced industrial countries and through intraregional trade.

B. Main features of African trade

1. Level of trade

An indication of the marginal status of SSA in the world economy is the very low absolute level of its exports and its decreasing share in world trade during the past four decades, a trend which has worsened markedly since 1970. In 1995, the value of total merchandise exports from SSA, including South Africa, was $73 billion (of which South Africa alone accounted for $28 billion), which is close to the figure for Malaysia ($74 billion) but considerably less than that for the Republic of Korea ($125 billion). As table 47 shows, the trend in exports from SSA is in sharp contrast to that not only of the fast-growing East Asian NIEs, but also to that of most other developing regions. The consequence has been import compression, and, given the reliance of SSA countries on imported capital and intermediate goods, weak productivity and output growth, which adversely affect exports.

In some accounts the resistance of African policy makers to open trade regimes is advanced as an explanation of the poor overall economic performance of the continent,[1] and on this basis the conclusion is drawn that countries in SSA need to rapidly liberalize trade as the surest way of correcting the price distortions and misallocation of resources which have held back economic growth.

But do the economies of SSA indeed trade too little, given their levels of per capita income, population size and geographical characteristics? Generally, the share of trade in GDP tends to be high in small countries because the limitations of the domestic market lead to production structures that are more specialized than in larger countries. Since higher income levels are often associated with larger imports of both primary products and manufactures, a commensurate increase in exports is needed if a country is to avoid balance-of-payments problems; hence, richer countries tend to trade more. Higher transport and transaction costs associated with a number of geographical features such as distance from the world's leading traders, the extent of common borders, weak infrastructure and land-locked status tend to reduce both the competitiveness of a country's products on export markets and the opportunity costs of producing a product at home rather than importing it. The regression results reported in table 48, taking into account these factors, suggest that the ratio of trade to GDP in countries of both sub-Saharan Africa and North Africa is very much in line with their population size and per capita income. Countries in Latin America and the Caribbean on average trade less than expected, while the East Asian NIEs trade more.[2]

It thus appears that the comparatively small share of SSA countries in world trade is primarily a reflection of their small share in global output. Slow growth in traded-goods sectors explains why SSA as a whole experienced a decline in the share of exports in GDP over the past two decades in a period of rapidly growing world trade, starting from a ratio which was similar to that of the East Asian NIEs in the 1970s. It follows that the SSA

Table 47

SHARES OF DEVELOPING ECONOMIES IN WORLD EXPORTS AND IMPORTS, BY REGION, 1950-1995

(Percentages)

	1950	1960	1970	1980	1985	1990	1995
				Exports			
All developing economies	33.0	23.9	18.9	29.0	25.2	23.7	27.7
America	12.1	7.7	5.5	5.4	5.6	4.2	4.4
Africa	5.3	4.2	4.1	4.6	3.2	2.3	1.5
Sub-Saharan Africa	3.3	2.9	2.4	2.5	1.7	1.2	0.8
Asia	15.2	11.5	8.5	18.4	15.8	16.7	21.4
First-tier NIEs[a]	2.8	1.6	2.0	3.8	5.8	7.7	10.4
				Imports			
All developing economies	28.9	25.2	18.8	24.0	23.2	22.2	29.1
America	10.0	7.5	5.7	5.9	4.2	3.6	4.8
Africa	5.7	5.1	3.4	3.7	2.8	2.1	1.7
Sub-Saharan Africa	3.1	3.0	2.3	2.2	1.5	1.1	0.9
Asia	12.6	11.8	8.5	13.4	15.4	15.8	22.0
First-tier NIEs[a]	3.0	2.2	2.7	4.3	5.3	7.5	10.8

Source: UNCTAD, *Handbook of International Trade and Development Statistics, 1997*.
a Hong Kong, China; Republic of Korea; Singapore; and Taiwan Province of China.

countries need to focus on growth-enhancing policies, rather than concentrate on trade liberalization. It is unlikely that a liberal trading regime will by itself generate a greater volume of trade unless it is accompanied by a faster rate of economic growth. An extensive econometric literature on the determinants of economic growth has been unable to confirm an independent role for openness.[3] Moreover, an examination of recent experience in East Asia as well as of specific liberalization episodes in the advanced industrial economies fails to show any direct causal link between openness and faster growth.[4]

2. Export composition and resource endowment

At least two statistical problems hamper the discussion of SSA's export structure: the unreliability of trade statistics for many countries and the arbitrary classification in those statistics of products such as non-monetary gold, uncut precious stones and some natural-resource-based chemicals, which are very important export items for a number of SSA countries, as manufactured exports.[5] Table 49 compares a number of alternative estimates regarding the share of manufactures in SSA countries' exports. Whilst the estimates differ significantly, they all confirm the general impression that manufactures, on average, account for a small share of total exports, but that there is also much variation among countries. Even on the broadest definition, manufactures account for under 15 per cent of total exports in close to two thirds of countries in SSA; on a narrower definition, the proportion is less than 10 per cent in three quarters of the countries and under 5 per cent in half. By contrast, and on most accounts, the share in Mauritius is close to 70 per cent, in South Africa

Table 48

AFRICAN TRADE IN THE 1980s IN COMPARISON: SOME REGRESSION RESULTS

(Dependent variable: Sum of ratios of exports and imports to GDP, 1980-1989 average)

	Sub-Saharan Africa dummy	North Africa dummy	NIEs[a] dummy	Latin America dummy	OECD dummy	Log (Population)	Log (Per capita income)	Log (Distance)	Gravity component of openness	Constant	R-squared	Number of observations
(1)	-3.5	0.4	27.9	-12.1	-5.5	-8.2	6.3			130.7	0.57	110
	(-0.6)	*(0.1)*	*(3.7)*	*(-2.7)*	*(-1.0)*	*(-8.3)*	*(2.6)*			*(4.2)*		
(2)	-2.6	-6.9	26.8	-17.2	-15.3	-8.6	8.0	-8.8		143.3	0.62	83
	(-0.4)	*(-0.8)*	*(3.7)*	*(-3.5)*	*(-2.2)*	*(-6.9)*	*(2.7)*	*(-1.8)*		*(4.1)*		
(3)	-12.1	-6.9	29.7	-16.6	-3.3	-9.8		-7.6		224.3	0.58	87
	(-2.6)	*(-0.8)*	*(4.0)*	*(-3.4)*	*(-0.6)*	*(-8.2)*		*(-1.5)*		*(11.6)*		
(4)	-4.9	-0.7	26.0	-4.6	1.5				0.8	30.4	0.45	116
	(-1.1)	*(-0.1)*	*(3.1)*	*(-0.9)*	*(0.3)*				*(8.8)*	*(7.1)*		

Source: Trade and population data from UNCTAD database; GDP data from Penn World Tables, version 5.6 (http://www.nber.org/pwt56.html); "distance" from R. Barro and J.-W. Lee, "Data set for a panel of 138 countries", 1994 (http://www.nber.org/pub/barro.lee); "gravity component of openness" from J. A. Frankel and D. Romer, "Trade and growth: An empirical investigation", NBER Working Paper No. 5476 (Cambridge, Mass.: National Bureau of Economic Research, 1996).

Note: t-statistics are shown in brackets. Dummy variables for the five country groupings are used to see whether Africa trades less than would be expected taking into account structural characteristics. The analysis was done for 1980-1989 because the availability of purchasing-power-parity-adjusted per capita GDP data is seriously constrained for earlier and more recent years. However, doing the analysis for the periods 1980-1992 and 1964-1992 on the basis of a reduced data set does not change the basic pattern of the results.

a Indonesia, Malaysia, Republic of Korea, Taiwan Province of China and Thailand; Singapore and Hong Kong, China, have not been taken into consideration because their very large share of trade in GDP makes them statistical outliers.

and Zimbabwe around 30 per cent, and in Kenya, Senegal and Sierra Leone around 20 per cent.[6]

The composition of African exports reflects in large part the underlying structural features of African economies, in particular their endowments in labour, human and physical capital, and natural resources. Indeed, it is generally agreed that differences in factor endowments are an important factor accounting for differences among countries in export structure. Moreover, it is recognized that there are strong complementarities between these factors, particularly between human and physical capital, which limit the possibilities of changing production and export structures. However, these factor endowments and their interrelationships are not permanently fixed. In particular, in a process of development the accumulation of capital and skills, and related changes in technological conditions, allow an economy not only to alter its growth path but also to deepen its integration into the world economy. Consequently, it is also necessary to consider the time horizon and the pace of accumulation and development when examining comparative export structures and performance.

Given that most manufacturing activities require a much higher input of capital and skill per worker than of land per worker, countries with a relatively high ratio of capital and skill per worker can be expected to export mainly manufactures, while those with a low ratio of skill per worker and a relatively high ratio of land per worker can be expected to export mainly primary products. SSA's export structure indeed corresponds to this pattern.[7] Among seven regional groupings SSA has been consistently the least skill-abundant, as measured by the number of average years of

Table 49

ALTERNATIVE ESTIMATES OF THE SHARE OF MANUFACTURES IN TOTAL MERCHANDISE EXPORTS OF AFRICAN COUNTRIES

(Percentages)

Country	UNCTAD	World Bank	Owens and Wood	Wood and Mayer	Amjadi, Reincke and Yeats	IDC[a]
	1990	1990 or 1989	1989	1989-1991	1990 or latest year available	1989-1991
Angola	6.3	0.1	..	0.3	1.0	4.8
Benin	12.4	..	26.9	4.5	3.4	..
Botswana	..	..	..	..	..	9.0
Burkina Faso	11.0	..	9.9	7.2	11.0	..
Burundi	2.0	2.0	8.7	4.0	2.0	..
Cameroon	8.4	8.5	24.7	8.2	15.2	..
Cape Verde	45.1	12.3	2.4	35.0	12.3	..
Central African Republic	48.2	48.2	29.9	2.2	48.2	..
Chad	12.7	9.0	3.8	4.7	9.0	..
Comoros	42.2	26.6	..	13.4	26.6	..
Congo	12.5	12.5	2.3	4.4	6.6	..
Côte d'Ivoire	16.8	16.8	12.3	5.7	16.8	..
Dem. Rep. of the Congo	16.6	16.6	8.7	5.1	16.6	..
Djibouti	..	7.8	11.1	57.2	7.8	..
Equatorial Guinea	..	..	..	8.9	4.0	..
Ethiopia	5.3	5.3	3.9	4.1	5.3	..
Gabon	3.4	3.4	4.8	4.0	3.4	..
Gambia	25.9	25.9	..	0.6	25.9	..
Ghana	13.4	13.4	..	3.2	13.4	..
Guinea	..	..	..	0.7	0.5	..
Guinea-Bissau	..	..	..	4.6	4.9	..
Kenya	17.3	17.3	24.2	21.1	17.3	..
Liberia	30.9	30.9	0.6	22.4	0.1	..
Madagascar	15.2	15.2	9.7	14.2	15.2	..
Malawi	4.8	4.8	8.9	4.9	4.8	9.2
Mali	1.6	1.6	2.7	0.6	6.8	..
Mauritania	0.5	0.5	6.7	0.8	0.5	..
Mauritius	68.1	68.1	26.9	61.2	68.1	64.9
Mozambique	..	17.5	..	46.4	17.5	28.4
Namibia	..	..	..	..	..	9.6
Niger	55.5	..	4.3	1.7	2.0	..
Nigeria	2.1	2.1	0.7	0.9	2.1	..
Rwanda	4.7	4.7	..	0.8	4.7	..
Senegal	22.5	22.5	21.9	13.5	22.5	..
Sierra Leone	26.1	26.1	24.3	2.6	26.1	..
Somalia	1.1	1.1	1.9	5.0	1.1	..
South Africa	34.4	34.4	28.7	28.6	34.4	28.6
Sudan	1.0	1.0	1.1	4.8	1.0	..
Swaziland	..	..	..	..	..	13.4
Togo	9.1	9.1	6.9	8.5	9.1	..
Uganda	1.1	1.1	..	0.8	1.1	..
United Rep. of Tanzania	17.5	11.8	3.6	9.9	11.8	17.8
Zambia	7.5	11.2	1.9	4.0	11.2	3.9
Zimbabwe	30.9	30.9	25.7	34.4	30.9	32.1

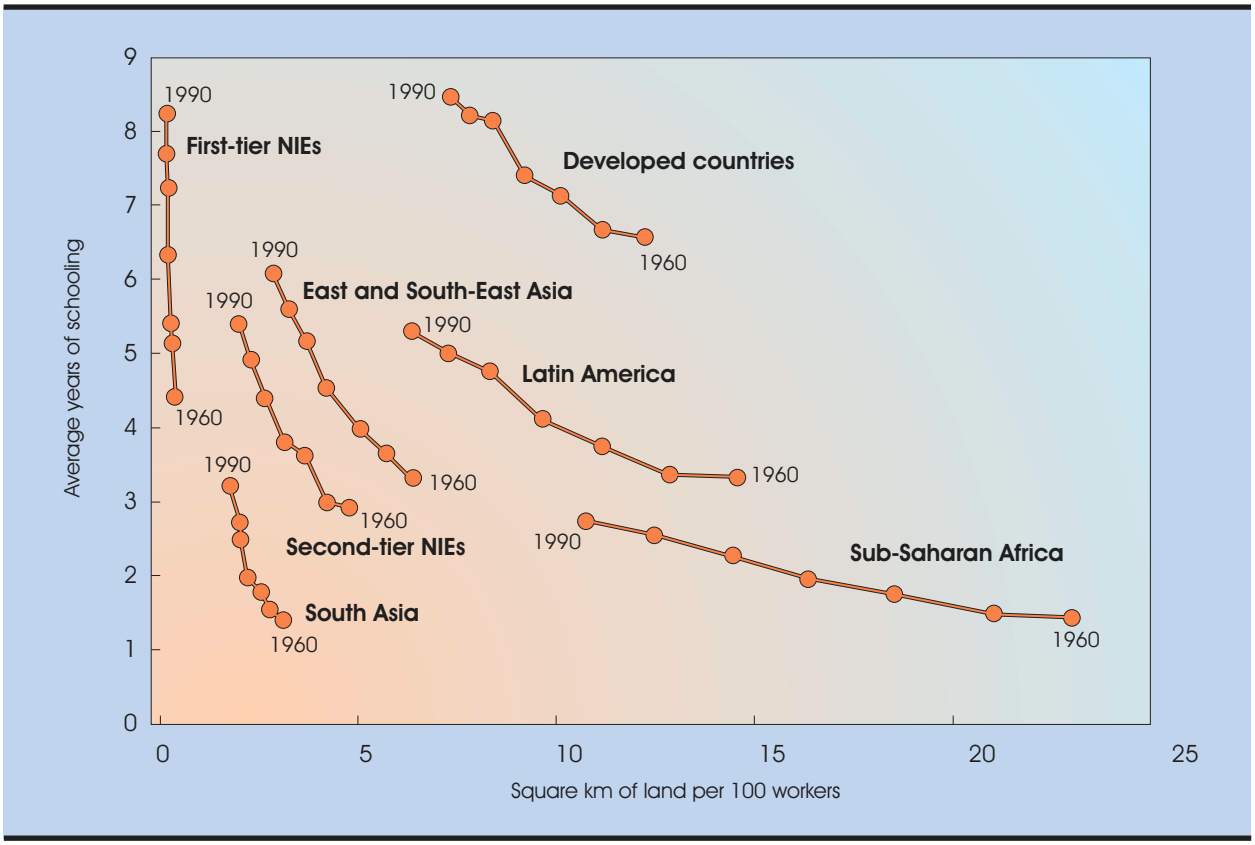
Source: UNCTAD, *Handbook of International Trade and Development Statistics, 1994;* World Bank, *World Development Indicators, 1997* (CD-Rom); T. Owens and A. Wood, "Export-oriented industrialisation through primary processing?", *World Development*, Vol. 25, No. 9, 1997, based on UNIDO data; A. Wood and J. Mayer, "Africa's export structure in comparative perspective" (Geneva: UNCTAD, 1998), mimeo; A. Amjadi, U. Reincke and A. Yeats, "Did external barriers cause the marginalization of sub-Saharan Africa in world trade?", World Bank Policy Research Working Paper No. 1586 (Washington, D.C.: World Bank, 1996).

a Industrial Development Corporation of South Africa.

Chart 24

SCHOOLING AND LAND AVAILABILITY IN DIFFERENT GROUPS OF COUNTRIES, 1960-1990, AT FIVE-YEAR INTERVALS

(Years of schooling and land per worker)



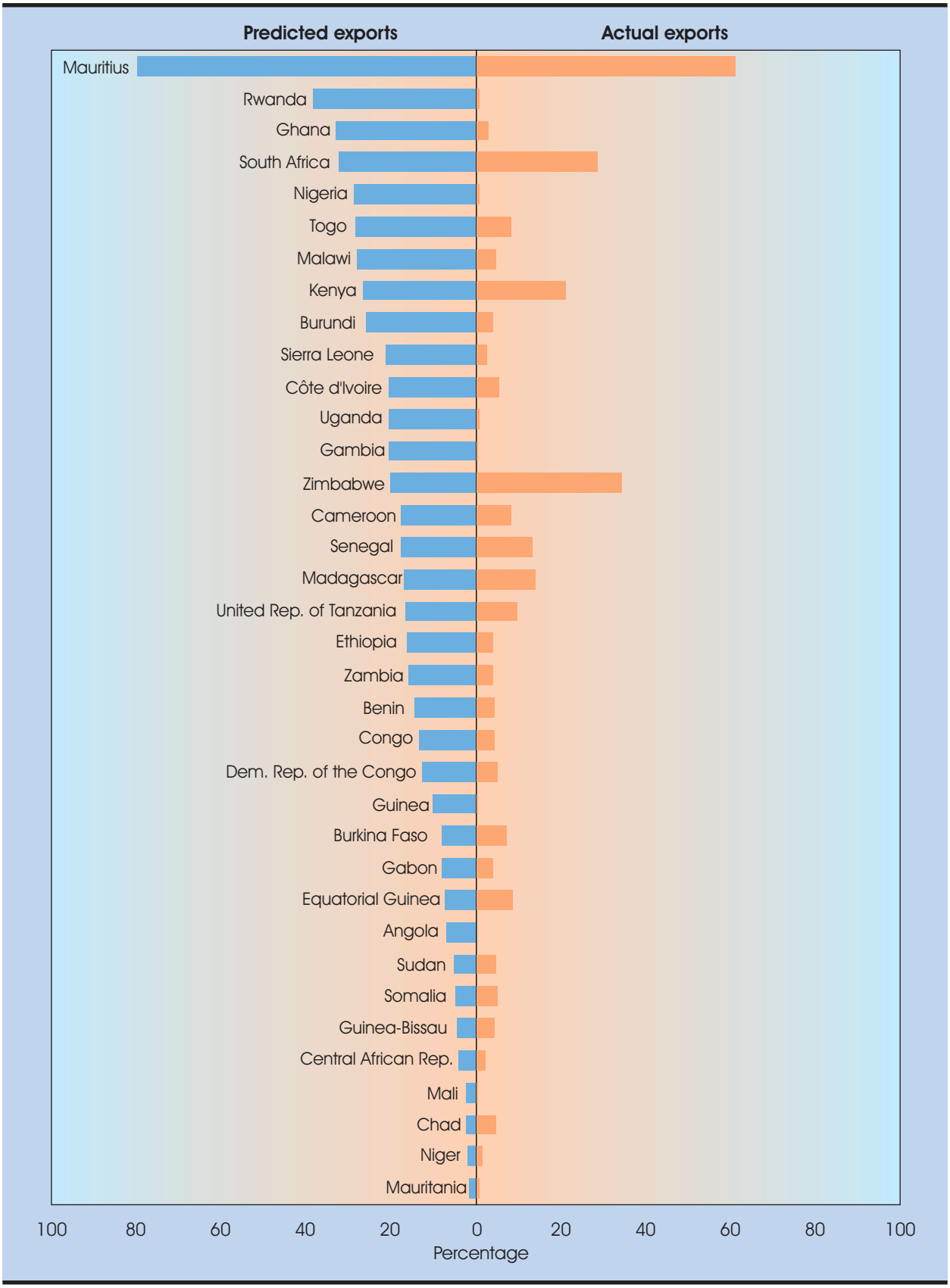
Source: R. Barro and J.-W. Lee, "International data on education" (Cambridge, Mass.: Harvard University), mimeo; and World Bank, *World Development Indicators, 1997* (CD-Rom).
Note: Data are for total land area ("land") and population over age 15 ("workers").

schooling (see chart 24). Its current resource structure is roughly the same as that of Latin America in the 1960s, and its skill-per-worker (but not its land-per-worker) endowment resembles that of the second-tier East Asian NIEs three decades ago. While the endowment structure of SSA is consistent with its low manufacturing to primary exports ratio, that ratio is actually lower than expected in comparison with other regions.

Arguments based on regional averages neglect the internal diversity of SSA. Human and, in particular, natural resources are widely dispersed among these countries. In chart 25 the actual manufactured export shares for SSA countries and South Africa are compared with the shares predicted on the basis of their relative resource endowments. Only one country in SSA – Mauritius – is predicted to be a manufacturing specialist, whilst a large majority of countries are predicted to have a manufactured export share below 20 per cent. The chart indicates, moreover, that the actual share of manufactures is lower than the predicted share for 29 of the 36 countries, equal to the predicted one in four countries, and higher in only three. The negative discrepancies exceed 10 percentage points in 17 countries and 20 percentage points in nine. It thus appears that most SSA countries export fewer manufactures relative to primary products than would be predicted from their resource endowments; this implies that they have some scope to increase the share of manufactures even without further accumulation of human and physical capital.

Chart 25

ACTUAL AND PREDICTED SHARES OF MANUFACTURES IN TOTAL EXPORTS OF AFRICAN COUNTRIES, 1990



Source: A. Wood and J. Mayer, "Africa's export structure in comparative perspective" (Geneva: UNCTAD, 1998), mimeo.

While the discrepancy between actual and predicted shares of manufactured exports may to some extent result from data errors, the evidence of untapped manufacturing export opportunities may also reflect a high degree of underutilization of human and physical capital. This means that manufactured exports may be increased without reducing primary production and exports, and thus be associated with a rise in total export earnings if conditions for greater efficiency and competitiveness can be secured.

The conventional analysis lays stress on inadequate infrastructure, inappropriate economic policies and unfavourable geography in explaining SSA's weak performance. However, the results of an analysis of the correlations for SSA countries of the discrepancies in actual and predicted manufactured export shares with variables which proxy these factors show that lack of openness, the most commonly cited measure of inappropriate policies in conventional analysis, does not provide a significant explanation. By contrast, levels of infrastructure development and the misalignment of exchange rates appear to be much more important.

Much of the unrealized potential in manufactured exports is concentrated in about a dozen countries, while in some two dozen others there is little or no immediate potential. Moreover, even where the potential exists, geographical conditions are likely to be a constraining factor, so that the possibilities of increasing the manufactured export share through improvements in policies and infrastructure may be overstated. Examples are some mineral-rich economies such as Ghana, Nigeria and Sierra Leone, as well as small land-locked countries such as Burundi, Malawi, Rwanda, Swaziland and Uganda, where high transport costs are less of an obstacle to increasing primary exports than manufactured exports, which latter depend heavily on imported inputs.

3. Diversification in the primary sector

Given SSA's resource endowments, the low share of manufactures and the high share of primary goods in its exports are not surprising. Another important aspect of SSA's export structure is that these primary exports are often concentrated on a limited number of traditional products. Consequently, SSA economies are more vulnerable to natural disasters and more exposed to adverse price movements and instability in export earnings than others. Also, they suffer more than other countries from the low price elasticity of demand for many agricultural products.[8]

Export dynamism and diversification away from primary commodities into new products with more favourable price and productivity prospects are often associated with an increasing share of manufactures in a country's export basket. However, this is too narrow an approach, particularly for countries in SSA. In the first place, emphasis solely on rapid diversification into manufactures can prejudice policy efforts aimed at maximizing the rents which arise from effective exploitation of natural resources in the initial stages of development. If properly used for investment in physical and human capital, these rents can provide a strong development stimulus. Moreover, with heightened global competition and the ability of transnational corporations to allocate different stages of production to different countries, some labour-intensive manufactures, such as apparel and computer chips, have begun to exhibit the kind of unfavourable price dynamics previously associated with primary commodities. Indeed, as discussed in *TDR 1996* (Part Two, chapter III), SSA may be particularly vulnerable to unfavourable price movements in these low-skill manufacturing activities. Finally, even though in general primary production has a smaller impact on development than manufacturing, it involves a range of activities of widely differing technological sophistication, and skill and capital intensity. Diversification into more sophisticated agricultural products can consequently provide more dynamic growth effects.

In assessing the scope for diversification within the primary sector, a distinction can be made between processed and unprocessed primary products. Although it is again difficult to avoid classification problems, processed primary products can be defined as those which are identified as manufactures in industrial and employment statistics but as primary products in trade statistics. Such goods are produced in factories but use large inputs of raw materials; they include canned food, cigarettes, paper and aluminium ingots. Processed and unprocessed primary products can be further broken down into agricultural products and minerals, metals and fuels, with a further subdivision of agricultural products into static and dynamic ones. The group of dynamic agricultural products includes items whose income elasticity of

Table 50

SHARES OF DIFFERENT CLASSES OF PRIMARY PRODUCTS IN TOTAL EXPORTS, BY REGION, 1990

(Percentages)

Region	Processed commodities			Unprocessed commodities		
	Minerals, metals and fuels	Dynamic agricultural products	Static agricultural products	Minerals, metals and fuels	Dynamic agricultural products	Static agricultural products
Sub-Saharan Africa	5.9	1.8	4.2	24.9	12.9	39.4
Middle East and North Africa	11.1	1.5	1.1	50.5	4.8	1.8
Latin America	12.3	3.5	4.9	18.5	13.6	19.0
South Asia	0.8	0.3	4.5	1.9	13.3	12.7
East and South-East Asia	3.2	3.6	5.0	13.0	6.0	9.2
First-tier NIEs	5.2	0.8	1.4	0.1	3.5	0.5
Second-tier NIEs	2.6	7.4	6.0	19.8	5.0	8.9
Developed countries	4.2	3.3	6.1	6.0	6.0	3.9

Source: See chart 25.
Note: For the distinction between static and dynamic agricultural products, see text.

demand is greater than unity and much higher than that of traditional agricultural products.[9]

Table 50 shows that agricultural products account for almost 60 per cent of SSA's exports, with nearly 40 per cent of all exports being unprocessed static products. It also shows that the share of processed exports of minerals, metals and fuels is comparable to that in other developing regions. However, processed copper from the Democratic Republic of the Congo and Zambia accounts for the bulk of these exports, and if those two countries are excluded the share is reduced considerably.

C. Accumulation and export growth

While manufactures could make a significant contribution to the growth of total exports in a small number of African countries, most countries will inevitably have to continue to rely on an expansion of natural-resource-based production. This expansion may be achieved in two ways: by increasing productivity and output in traditional products and regaining market shares; and by diversifying into more dynamic, processed primary products. Since attaining these objectives depends on technological change and creation of additional productive capacity, and hence on new investment, a sustainable growth process requires mutually reinforcing dynamic interactions between capital accumulation and exports, resulting in structural changes in the pattern of production and exports.

This dynamic is quite well known and is described in some detail in previous *TDRs* in relation to the evolution of the East Asian NIEs. In the earliest stage, when exports consist largely of primary commodities, the challenge is to maximize the rents and foreign exchange from the exploitation of natural resources, which calls for considerable investment in the primary sector, including public investment. Rising output in the primary sector then allows a surplus to be generated for investment to establish resource-based industries. As the scope for accelerating development through productivity improvement and diversification in the primary sector is exploited, sustaining growth will require a gradual shift to the production and export of manufactured goods, starting with technologically less demanding ones, and then gradually upgrading into more sophisticated products and industries.

Such a process is characterized by rising exports, savings and investment, both in absolute terms and as a share of GDP. Initial constraints on domestic resource mobilization mean that an important part of domestic investment will need to be financed by capital inflows. In this respect FDI can be one important means not only of reducing the resource gap, but also of creating employment and increasing output and exports of natural-resource-based industries. But the precise nature of its contribution will depend on how the increased current revenue and foreign exchange earnings are utilized. Over time, the resource gap should narrow as exports and domestic savings begin to grow faster than investment with the emergence of a strong national entrepreneurial class that is more inclined to reinvest profits.

Such a pattern has characterized the export-investment nexus in East Asian NIEs ever since their initial stages of development. Similar dynamic patterns have not been present in Africa, except in Mauritius and, to a lesser extent, Botswana, Egypt and Morocco (see table 51). Indeed, Mauritius provides an example of how a surplus generated in a traditional primary sector as a result of productivity gains can help to shift resources quickly into manufactured output and exports. At independence in 1968 Mauritius was still essentially a monoculture economy, dependent upon sugar exports for its foreign exchange. However, the accumulation of sugar profits saw the emergence of a local entrepreneurial class, and once the limits of import-substitution industrialization had been reached, government efforts to diversify into textile exports found a ready source of domestic savings which could be used to strengthen private and public investment in support of a more export-oriented industrial drive. In some cases sugar plantation owners themselves went directly into textile production and exports, while in others profits from sugar exports were channelled into investments in textiles through the domestic financial system.[10]

1. Expansion of traditional exports

As discussed in the previous chapters, agro-ecological conditions are difficult in many parts of SSA. However, undercapitalization is certainly a major factor in low productivity compared with other regions. Improvements in irrigation, fertilizer use and seed varieties could increase productivity and output considerably in much of SSA and at the same time make agricultural products more competitive in world markets. It is also important to note that tropical climatic conditions, seen by some as a major constraint on growth in SSA, have not prevented rapid growth in other developing regions, most notably South-East Asia.

More important, there is a large unexploited potential in minerals in some African countries. As a result of intensive exploration and prospecting, estimates of SSA's mineral reserves have been raised considerably over the past few years. Of the known world reserves, Southern Africa alone has nearly 90 per cent of platinum group metals, 85 per cent of chromium, 75 per cent of manganese and 50 per cent of gold.[11] Given the currently low level of exports in some countries, successful exploitation of mineral reserves could lead to a rapid and very substantial increase in export earnings. However, unless the physical infrastructure is improved significantly, the scope for expanding mineral exports will be limited mainly to high-value products and to countries with long coastlines.

While some minerals can be exploited by medium-sized companies with comparatively modest sunk costs, the exploitation of other minerals often requires substantial initial investments. Many existing state enterprises in the mining sector, which have traditionally involved high-cost and low-productivity operations, are unable to make these investments without major restructuring. It thus seems almost certain that FDI, whether through wholly owned operations or through joint

Table 51

GROSS NATIONAL SAVINGS, GROSS DOMESTIC INVESTMENT AND EXPORTS IN AFRICA

(Percentages of GDP)

	1968-1970			1975-1978			1986-1989			1990-1993		
Country	*Savings*	*Investment*	*Exports*	*Savings*	*Investment*	*Exports*	*Savings*	*Investment*	*Exports*	*Savings*	*Investment*	*Exports*
Benin	..	..	..	13.0	17.3	22.1	6.3	12.7	26.8	6.6	14.2	22.7
Botswana	..	..	..	8.0	35.7	42.5	34.3	24.8	71.8	31.9	36.7	66.7
Burkina Faso	..	..	..	18.1	23.2	8.7	19.8	21.0	10.4	20.9	21.4	11.6
Cameroon	..	..	..	16.1	25.4	23.6	17.5	22.3	19.3	13.4	16.1	19.4
Central African Republic	4.7	17.8	27.4	9.9	12.0	24.6	..	..	..	..	..	..
Chad	13.0	18.0	21.1	15.7	20.1	22.2	6.0	9.0	20.5	-2.3	8.8	17.1
Côte d'Ivoire	21.2	20.1	37.6	20.7	26.5	39.5	6.1	13.9	33.9	-3.0	7.6	30.6
Ethiopia	10.8	12.9	10.4	7.3	9.0	12.3	7.9	13.0	8.7	7.1	9.8	6.9
Gabon	..	..	..	54.4	58.5	51.7	20.8	35.5	40.9	25.7	23.6	47.6
Gambia	..	..	..	2.8	18.5	36.8	18.7	18.4	52.6	24.9	20.4	60.8
Ghana	8.7	12.5	20.5	7.5	8.2	11.3	6.2	11.6	17.7	4.9	14.5	17.3
Kenya	17.8	21.4	29.6	18.0	23.8	31.6	16.4	24.1	22.9	15.6	19.4	30.6
Liberia	..	..	..	29.9	31.9	55.4	..	..	..	..	..	..
Madagascar	..	..	..	5.4	8.5	16.2	11.2	11.9	16.1	4.9	11.9	16.2
Malawi	1.7	20.4	23.9	18.0	31.0	27.9	5.4	17.8	22.8	1.0	17.0	21.0
Mali	..	..	..	11.5	16.0	12.1	9.2	21.3	16.4	14.3	22.2	16.4
Mauritania	23.5	23.9	39.3	17.3	36.8	36.0	15.5	26.1	51.7	9.0	20.6	43.7
Mauritius	13.0	11.9	40.8	23.0	29.7	49.2	27.6	28.2	63.7	28.0	29.9	61.6
Niger	..	..	..	12.2	18.6	21.1	16.5	14.0	20.0	6.9	7.1	15.3
Nigeria	6.7	13.6	9.5	23.7	28.3	20.5	14.0	17.1	27.3	..	..	..
Rwanda	..	..	..	17.8	14.9	13.4	10.7	14.9	8.1	6.9	11.0	5.9
Senegal	5.5	13.6	24.3	11.7	17.3	37.1	0.5	12.0	25.0	2.9	13.2	23.9
Sierra Leone	11.2	14.4	30.3	3.6	12.5	24.7	1.1	9.7	15.9	-0.2	13.6	26.7
Togo	..	..	..	31.8	36.1	49.6	11.7	24.7	42.1	4.0	14.9	29.9
Uganda	13.5	13.5	22.5	5.1	6.7	10.3	2.9	10.8	8.0	2.8	15.1	7.6
Zambia	37.6	26.6	55.3	14.8	29.4	38.1	1.4	12.6	32.4	1.8	11.1	27.3
South Africa	24.6	28.5	23.9	24.4	26.2	30.4	22.7	19.9	29.0	16.5	15.7	24.0
Algeria	30.9	32.5	22.8	36.9	47.3	30.0	27.2	29.7	15.4	28.5	29.9	24.6
Egypt	8.8	13.2	13.9	18.4	30.5	21.8	10.0	22.4	20.9	19.3	19.0	29.5
Morocco	12.6	15.3	18.1	15.9	28.3	18.2	21.8	22.2	23.9	21.1	22.8	25.5
Tunisia	17.6	21.9	21.6	24.4	30.2	30.2	21.9	23.5	38.4	21.0	27.8	41.1

Source: UNCTAD secretariat calculations, based on World Bank, *World Tables* (tapes).

ventures, will play an increasingly important role in this sector in most African countries. Africa is home to some successful mining firms, including the world's largest mining company. But the export potential of this sector will continue to be determined by complementary public sector investments in infrastructure.

An expansion of mineral production will not by itself provide the missing economic linkages needed for a strong and sustained process of economic growth. Rather, it could offer an important source of foreign exchange earnings and government revenues which could be used to accelerate capital formation and structural change in other parts of the economy. This requires better management of the mineral sector than was often exercised in the past, when traditional concerns about ownership and control of extraction, processing and marketing activities dominated policy-making, as well as an effective macroeconomic response in order to avoid possible "Dutch disease" problems.

Botswana is a good example of a country with an effective mineral-led growth strategy and one of the highest growth rates in the world economy over the past three decades. The share of the mining sector in Botswana in GDP rose from zero in 1966 to close to 50 per cent in 1986 and currently stands at a little under 40 per cent. This development has been very closely tied to the exploitation of diamonds, which dominated foreign exchange earnings and are a major source of government revenues. Exploitation of diamonds has been carried out by a single large TNC, which, like the Government of Botswana, has a 50 per cent stake in the diamond mines. The key elements of Botswana's success have been the successful negotiation of contracts with transnational producers and the prudent management of mineral revenues, including their use for public investments in physical and human capital. Also, policy makers have avoided the urban bias common to many economies in Africa, and have channelled resources to improving agricultural growth and productivity. However, despite these achievements, serious doubts about its heavy dependence on a single commodity remain, and in recent years Botswana has tried to diversify the range of activities linked to the exploitation of diamonds as well as its range of primary exports.

A crucial question is to what extent attempts to expand traditional exports may encounter a fallacy-of-composition problem, leading to falls in prices and even in export earnings. Experience shows that such a possibility cannot be ruled out, particularly for the main export crops of the region.[12] However, rapid growth in the resource-poor Asian countries, including China and India, can alter the demand conditions for all sorts of primary products, including traditional agricultural commodities and minerals. Nevertheless, expansion in traditional products would require a careful assessment of potential costs and benefits, particularly if it needed substantial investment. Moreover, problems associated with shifts from food crops to export crops, discussed in chapter II, would also need to be kept in mind.

2. Non-traditional exports

The case in favour of processing and diversification into non-traditional exports is well established. They should help improve the stability of export earnings and reduce the risks of investment.[13] Perhaps, and most significantly, they hold out the possibility of establishing activities which offer greater potential for deepening a country's technological base and skills profile, and of entering markets with a comparatively high income elasticity of demand.

However, the link between diversification into new primary products and overall export performance is not a simple one. While diversification may stabilize export earnings, it does not as such help establish a dynamic investment-export nexus. It has to encompass products with greater supply and demand potentials, and be accompanied by policies designed to translate increased incomes into faster capital accumulation. Moreover, new products may require considerably higher levels of capital and skill which may be more productively employed in the traditional sector in generating export earnings.

Again, processing does not always add value to primary products. When the technology is old and inefficient, it may be more rational to export the primary product without processing it; this appears to be the case, for example, regarding cashew nut exports in some Southern African countries. Sometimes inefficient processing can put domestic industries producing final consumer goods at a disadvantage in international markets if such industries are forced to purchase processed materials from high-cost domestic firms. That

appears to be true of some consumer durable industries in Southern Africa, where metal sheets supplied by domestic producers cost much more than if obtained in world markets.[14]

Thus, not all economies with diversified production and export structures achieve a rapid rate of accumulation and income growth. Indeed, according to one study for the period 1970-1985, for nine of the 11 countries which diversified into new products, real export earnings actually declined or remained stagnant. Of the eight countries which experienced growth in real export earnings during this period, only two did so on the basis of a diversified export profile.[15]

As discussed earlier, there are some agricultural products which have a dynamic potential because of their high unit value and high income elasticity of demand. Successful diversification into such products generally requires introduction of new technologies, efficient management and marketing techniques. If these are put in place, positive linkages may be created with domestic industry in the food, beverages and tobacco sectors. Such linkages are likely to favour a greater export orientation, as well as the emergence of domestic firms processing agricultural commodities that are large enough to compete in international markets. The need to establish such firms is essential if a strong profit-investment-export nexus is to emerge in SSA.

East Asian experience holds some useful lessons in diversification and processing based on the primary sector. Unlike the first-tier East Asian NIEs, three economies of South-East Asia (Indonesia, Malaysia and Thailand) were able to exploit a rich natural-resource base which provided considerable scope for accelerated growth through diversification and increased processing of resource-based products. Between 1967 and 1975 the share of primary exports in total non-oil exports of these three countries fell, but the average in 1975 was still over 87 per cent. Moreover, the share of some key primary commodities rose during this period: in Indonesia the share of non-food primary products rose from 70 per cent to 73 per cent; in Thailand the share of food exports rose from 55 per cent to 64 per cent of total exports; and in Malaysia a more pronounced drop in the share of primary exports during this period coincided with a successful diversification into palm-oil and cocoa processing as well as into rubber, wood and paper products. In Thailand, too, there was diversification into food exports such as fish products, as well as into wood and paper products and non-metallic mineral products. In Indonesia, where diversification has been slower, there was a move into timber and from the mid-1970s into wood and paper products. Nevertheless, in 1985 more than two thirds of these countries' non-oil exports were accounted for by primary and resource-based industries with a low skill, capital and technology content, and for Indonesia alone the proportion was over 85 per cent.[16]

Even traditional products such as timber can offer considerable potential for diversifying into more processed products and into simple manufactures. In Indonesia, plywood exports grew significantly during the 1980s following the country's move into wood and paper products in the 1970s. Malaysia has also significantly increased its processed timber exports, particularly plywood and furniture.[17] Such processing is particularly relevant for countries such as Cameroon, Gabon and Ghana, which have already moved successfully into timber exports.

Attracting FDI offers possible advantages in these early stages of diversification, given the ready access of affiliates to capital, technology and marketing networks of the parent TNC. However, successful diversification experiences in these dynamic agricultural sectors suggest that public sector support and domestic investment are an equally crucial ingredient. For example, the great expansion of Chile's exports of non-traditional and dynamic agricultural goods such as fruit, forestry and wine products since the mid-1980s has been premised on a strong recovery in domestic private investment. However, it is difficult to imagine that this private investment would have materialized without earlier public investment in agricultural and forestry education, research and infrastructure development. Foreign direct investment has been an important source of new marketing channels and technology, which has been adapted by domestic producers.[18]

A similar experience characterizes the strong performance of South-East Asian agro-exporters.[19] Malaysia's highly successful development of dynamic agricultural exports such as palm oil, as well as of processed exports in the cocoa and rubber sectors, has been based on the emergence of comparatively large production units and strong policy support, particularly for product-specific research (see box 7).

Box 7

THE PALM OIL INDUSTRY IN MALAYSIA

The emergence and the rapid growth of export-oriented palm oil production and processing have been a remarkable factor in Malaysia's economic development.[1] In less than 20 years the palm oil refining industry, which had a capacity of less than 40,000 tons of crude oil feedstock in the early 1970s, grew into a large export-oriented industry. Today it processes 99 per cent of the domestic crude palm oil and crude palm kernel oil, i.e. 8 to 9 million tons per year. This is an estimated 60 per cent share of world refined palm oil products (or 70 per cent of their world trade) and about 10 per cent of world oils and fats (or 25 per cent of their world trade).

The Government encouraged diversification into palm oil in response to sharp fluctuations in rubber prices in the 1950s and declining rubber prices in the 1960s, as well as in anticipation of the inevitable exhaustion of tin deposits. Diversification into palm oil was favoured by a number of factors, including the growing international demand for palm oil, Malaysia's favourable factor endowment regarding both physical resources (climate, topography and plantation infrastructure) and human resources (plantation management and agro-economic expertise), and the lower labour intensity of palm oil production, compared with rubber production; this last factor became more important with the increasing shortage of labour on estate plantations.

Research efforts supported by both the Government and the private sector have been an important element in the success of the palm oil industry. In 1979, the Government established the Palm Oil Research Institute of Malaysia (PORIM) with a view to expanding the current consumption of palm oil products, finding new uses, improving production efficiency and product quality, and promoting the marketability of palm oil products. PORIM has two notable features: it has been funded mainly by the industry itself through a levy on production, and a joint committee of industry and government representatives has been in charge of deciding its research programme. These features have ensured both the continuous availability of research funding and the responsiveness of research to the needs of producers.

The Government has actively encouraged downstream processing and refining of palm oil, with a view to building a resource-based industrial sector. Crucial in this effort has been the policy to partially exempt processed palm oil products from export duties, depending on the degree of processing. The ensuing massive investment in processing capacity led to intense competition among refiners, which forced them to enhance their industrial and technological capabilities rapidly. As a result, within a decade Malaysia was able not only to reach the world technological frontier in palm oil refining, but even to push back this frontier.

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[1] For a more detailed account of the role of government policies in the development of the Malaysian palm oil industry see M. Jelani and B.M. Malek, "Support policies for the Malaysian palm oil industry", paper presented at the FEDEPALMA International Conference, Barranquilla, Colombia, 2-9 June 1995; K.S. Jomo and M. Rock, "Economic diversification and primary commodity processing in the second-tier South-East Asian newly industrializing countries", UNCTAD Discussion Paper No. 136 (Geneva, 1998); and UNCTAD, "Analysis of national experiences in horizontal and vertical diversification, including the possibilities for crop substitution: Malaysia" (UNCTAD/COM/73, 1995).

A number of SSA countries have also diversified into dynamic agricultural exports during the 1980s and 1990s, although absolute export earnings are, in most cases, still small (table 52). Kenya, the United Republic of Tanzania and Zimbabwe have successfully developed horticultural exports, and other countries, such as the Gambia, are beginning to develop export capacity in these products. Apart from a number of small exporters that have been able to establish business connections overseas through family ties, foreign firms with easy access to production inputs and marketing networks have often been dominant in these cases.

The provision of high-yielding varieties and other commercially applicable results of agricultural research is likely to be an important element in SSA's strategy to increase productivity in agri-

Table 52

EXPORTS OF DYNAMIC AGRICULTURAL PRODUCTS[a] FROM SELECTED REGIONS AND COUNTRIES, 1980-1994

(Millions of dollars)

Region/country	*1980*	*1985*	*1990*	*1992*	*1994*
Africa	2 540	2 290	3 477	3 522	3 853
Sub-Saharan Africa	1 524	1 403	1 878	1 877	2 050
of which:					
Cameroon	25	12	58	74	97
Côte d'Ivoire	298	272	319	335	366
Kenya	79	79	125	142	153
Senegal	198	238	400	280	212
Zimbabwe	44	42	37	34	62
Egypt	131	168	159	206	158
Tunisia	138	146	311	310	352
Memo items:					
All developing countries	29 023	32 819	52 873	59 419	71 247
Brazil	3 965	4 997	5 636	5 793	7 244
Chile	585	887	1 840	2 322	2 406
Malaysia	1 724	2 237	2 551	3 178	4 488

Source: UNCTAD database.

a Meat and meat products; dairy products; fish and fish products; fresh and processed fruit, vegetables and nuts; feedstuffs; oilseeds; vegetable and animal oils; and spices.

culture and to further shift exports towards dynamic agricultural products. However, as noted in the last chapter, research expenditure in SSA stopped growing in the late 1970s and has been considerably lower than elsewhere. Donor support for agricultural research has increased and somewhat compensated for declining government funding, but it is unlikely that such high levels of donor funding will continue indefinitely.[20] Strengthening African agricultural research needs to take into account the high degree of location specificity of agricultural technology which has made technology transfer from developed countries to SSA difficult. It is encouraging to note, however, that many SSA countries have recently strengthened their cooperation in agricultural research and that a number of regional projects have been implemented.[21]

D. Industry and competitiveness

While in many African economies there is considerable scope for increasing productivity in the primary sector, in the longer run a more determined shift towards promoting manufacturing production and exports will be required in order to maintain rapid productivity growth. So far, industrial performance has generally been poor, and in SSA only a few countries are currently able to move more strongly into labour-intensive manufacturing exports. On the other hand, some countries in Southern and North Africa are already close to the limits of the initial expansion of manu-

facturing that can be achieved on the basis of abundant labour alone and increasingly require upgrading of skills and technology for further manufacturing growth.

1. The structure and performance of industry

Available data indicate that the manufacturing share in the GDP of Africa (excluding South Africa) is low even by the standards of other developing regions. In 1995, it was only 11.5 per cent compared with 21 per cent for Latin America and 24 per cent for South and East Asia. Africa's share in that year in the manufacturing value-added (MVA) of all developing countries was only 5.5 per cent, a decline from the already low level of around 6.9 per cent in the mid-1980s.[22] Moreover, in absolute terms MVA grew only slightly in SSA between 1980 and 1990 and has even fallen since then, in sharp contrast to developing countries elsewhere.

As a result, the absolute gap in manufacturing output between SSA and the rest of the world has increased significantly over the past 20 years. In the early 1990s, the MVA of all SSA countries was at about the level of Indonesia and Turkey, while it had been three times that of Indonesia in 1970. As regards the distribution in Africa, there is, as already noted, a wide dispersion among countries. South Africa accounts for about the same MVA as all SSA countries combined, among which Cameroon, Côte d'Ivoire, Kenya, Nigeria and Zimbabwe have the greatest manufacturing activity. In per capita terms, only Mauritius and South Africa have established a strong manufacturing base comparable to that of middle-income countries such as Turkey (chart 26). A number of North African economies, in particular Morocco and Tunisia, also compare favourably with successful second-tier East Asian NIEs, such as Indonesia. However, an examination of trends in per capita manufacturing output shows that while there were 14 countries in SSA with per capita manufacturing comparable to and in many cases considerably higher than that in Indonesia in 1980, all (for which data are available) had been overtaken by 1995.

Most countries in SSA have not reached the threshold level of manufacturing which could help them break out of the vicious circle restricting entry into foreign markets; output is mainly for their domestic markets. This situation contrasts with that of East Asia, where support and protection given to these industries were made conditional upon successful export performance from the very early stages of their establishment. Consequently, manufacturing industries in Africa have not been exposed to market discipline through exports, and in addition they have failed to benefit from the scale advantages needed to compete internationally. These factors have, in turn, further restricted the development of such industries to small and sluggish domestic markets, perpetuating high costs and giving rise to inefficiencies and low levels of productivity.

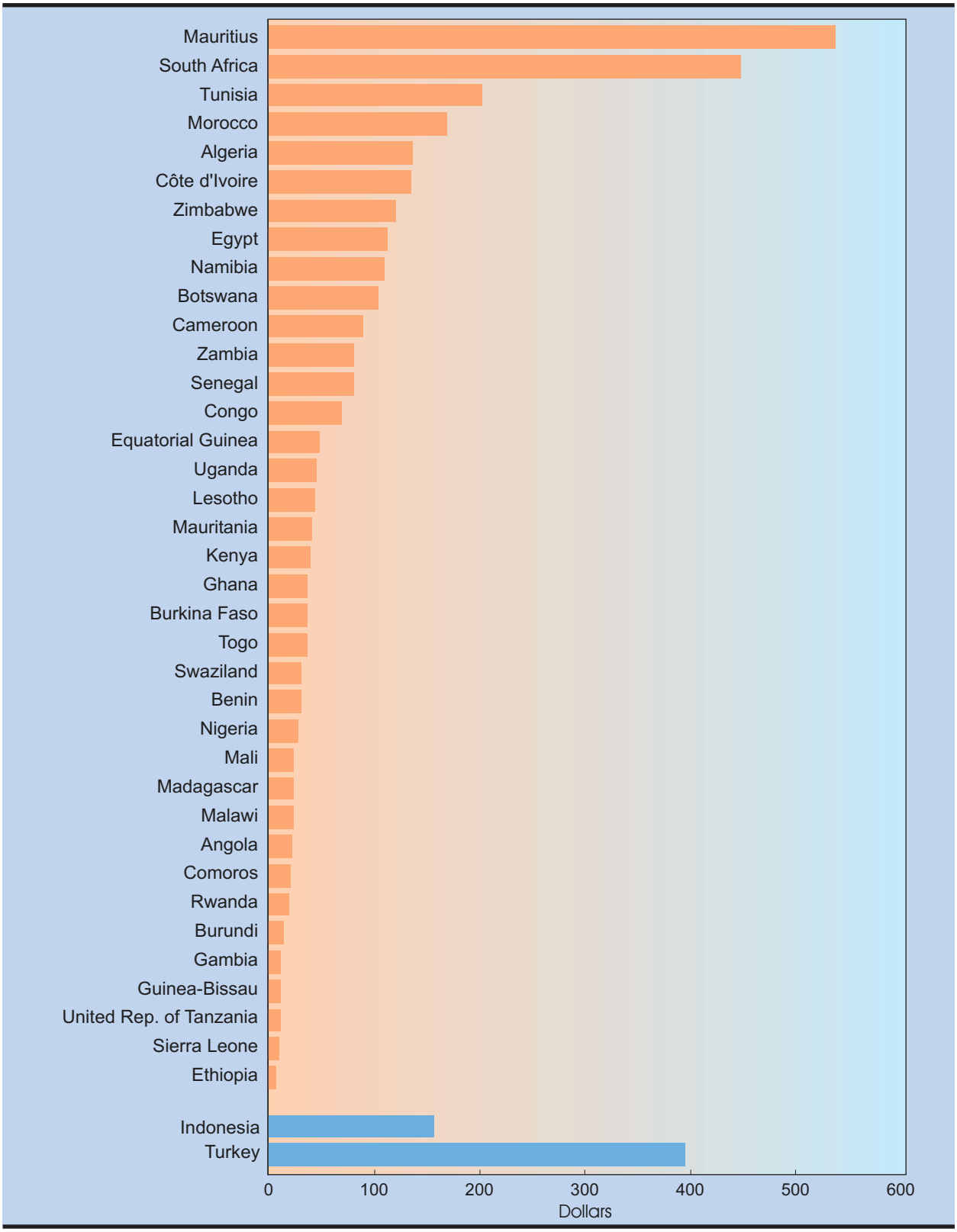
The food industry appears to dominate manufacturing in the non-mineral African economies, while the group of other manufactures, which includes petroleum and metals, accounts for a substantial share in the other countries (see table 53). The importance of the food, beverage and tobacco sectors in manufacturing and the small share of manufactures in total exports confirm the importance of the domestic market in the development of manufacturing in SSA. By contrast, the share of manufacturing activities which are most likely to provide strong developmental effects is very small.

This situation, in part, reflects mistaken policy choices in the first stages of industrialization. The principal role assigned to manufacturing in SSA countries even prior to independence was to produce non-durable consumer goods for the domestic market in an attempt to replace imports. This first attempt at changing the structure of domestic production did not in most cases require sophisticated government interventions to alleviate the market coordination failures which often characterize modern industrial activities. Moreover, since transportation costs were typically high in SSA, such goods could be cost-competitive with imports even when domestic production costs were high by international standards. However, in most cases, this strategy failed to strike the kind of balance between domestic and export-oriented activities which is needed in order to improve the balance-of-payments situation and promote industrialization. This lack of balance was reflected in the virtual absence of efforts to promote manufactured exports, and, together with high costs, it dampened any ambitions that manufacturers might have had to penetrate and secure a sure foothold in export markets.[23]

Chart 26

MANUFACTURING VALUE-ADDED PER CAPITA IN SUB-SAHARAN AFRICA, SOUTH AFRICA, INDONESIA AND TURKEY, 1995

(In constant 1987 dollars)



Source: World Bank, *World Development Indicators, 1997* (CD-Rom).

Note: Data for Benin, Burkina Faso, Equatorial Guinea and Namibia are for 1994, and those for Côte d'Ivoire and Zimbabwe are for 1993.

Table 53

SHARES OF SELECTED PRODUCT GROUPS IN TOTAL MANUFACTURING VALUE-ADDED IN AFRICA, BY COUNTRY, 1970 AND 1993

(Percentages)

	Food, beverages and tobacco		*Textiles and clothing*		*Machinery and transport equipment*		*Chemicals*		*Other manufactures*[a]	
Country	*1970*	*1993*	*1970*	*1993*	*1970*	*1993*	*1970*	*1993*	*1970*	*1993*
Algeria	32	13	20	14	9	15	4	5	35	54
Burkina Faso	69	..	9	..	2	..	1	..	19	..
Cameroon	50	26	15	12	4	1	3	8	27	54
Congo	65	..	4	..	1	..	..	..	29	..
Côte d'Ivoire	27	35	16	11	10	7	..	..	47	47
Egypt	17	21	35	13	9	13	12	13	27	40
Gabon	37	..	7	..	6	..	6	..	44	..
Ghana	34	36	16	5	4	2	4	10	41	47
Kenya	33	42	9	9	16	10	9	9	33	30
Libyan Arab Jam.	64	..	5	..	0	..	12	..	20	..
Madagascar	36	..	28	..	6	..	7	..	23	..
Malawi	51	..	17	..	3	..	10	..	20	..
Mali	36	..	40	..	4	..	..	..	20	..
Mauritius	75	..	6	..	5	..	3	..	12	..
Mozambique	51	..	13	..	5	..	3	..	28	..
Rwanda	86	..	..	..	3	..	2	..	8	..
Senegal	51	58	19	2	2	3	6	14	..	23
Sierra Leone	..	69	..	1	..	..	..	..	..	30
Somalia	88	..	6	..	..	..	1	..	6	..
South Africa	15	16	13	8	17	18	10	10	45	48
Sudan	39	..	34	..	3	..	5	..	19	..
Swaziland	37	..	2	..	..	..	..	..	60	..
Tunisia	29	..	18	..	4	..	13	..	36	..
U. R. of Tanzania	36	..	28	..	5	..	4	..	26	..
Zambia	49	..	9	..	5	..	10	..	27	..
Zimbabwe	24	33	16	16	9	6	11	4	40	41

Source: World Bank, *World Development Indicators, 1997* (CD-Rom).

a Wood and related products, paper and related products, petroleum and related products, basic metals and mineral products, fabricated metal products, and professional goods and miscellaneous manufactured articles.

2. *The competitiveness of manufacturing exports*

As noted earlier, there is potential for expanding manufactured exports in a small number of countries in SSA. However, the question arises whether current manufacturing structures lend themselves to a more export-oriented development path. In the absence of selective export promotion policies, competitiveness depends on the behaviour of real wages, on productivity growth and on the real exchange rate. A comparison of unit labour costs in African countries and some potential competitors in a number of manufacturing sectors in 1995 shows that in most cases costs

Table 54

UNIT LABOUR COSTS IN SELECTED COUNTRIES AND INDUSTRIES, 1980 AND 1995

(Ratios to the United States level)

	Textiles		Clothing		Transport equipment		Footwear	
Country	1980	1995	1980	1995	1980	1995	1980	1995
Ghana	0.79	1.05	0.53	..	0.84	..	5.26	..
Kenya	0.97	1.61	1.07	0.65	1.57	2.25	0.43	1.13
Madagascar	0.75	0.49	0.59	1.24	0.73	1.28	0.77	0.59
Mauritius	0.67	0.96	1.08	1.53	1.02	1.28	0.81	0.57
United Rep. of Tanzania	0.90	..	0.87	..	0.64	..	1.23	..
Zimbabwe	0.71	0.69	1.07	1.30	1.01	0.98	1.02	0.97
South Africa	1.01	1.45	1.45	1.88	1.23	1.35	1.22	1.48
Egypt	1.28	1.45	1.15	1.02	1.55	1.48	1.50	0.30
Morocco	1.16	1.33	1.45	1.64	1.33	1.24	1.46	..
Tunisia	1.37	..	1.24	..	0.95	..	1.15	..
Bangladesh	1.04	1.81	0.77[a]	0.87	0.73	0.35	0.49	0.71
Indonesia	0.58	0.32	1.14	0.95	0.40	1.46	0.45	0.85
India	1.16	1.09	1.19	0.46	1.25	1.46	1.65	0.60
Republic of Korea	0.74	0.81	0.79	0.91	0.76	0.80	1.01	1.03
Turkey	0.69	0.42	0.71	0.39	0.98	0.63	1.06	0.60

Source: UNCTAD secretariat calculations, based on UNIDO, *Handbook of Industrial Statistics, 1988*, and *International Yearbook of Industrial Statistics*, various issues.

a 1983.

in Africa were much higher than in competing countries such as Bangladesh, India and Indonesia (table 54). Moreover, in general, unit labour costs in Africa actually increased after 1980 relative to those in competing countries, even though in many cases real wages stagnated or even declined.[24] On the other hand, some African economies with relatively high wages, such as Mauritius, Morocco and South Africa, have been among the region's most successful exporters of goods such as textiles, clothing and footwear. Strong productivity growth in these economies has been a key ingredient of their export success.

A more comprehensive competitiveness indicator, taking into account exchange rate, wage and productivity movements, is presented for selected African countries in table 55. From the early 1980s to the mid-1990s, the aggregate competitiveness indicator improved for some of these countries, and for Egypt quite spectacularly. However, it appears that this was largely due to a combination of currency depreciation and significant cuts in real wages; investment has actually fallen significantly. In a number of countries strong productivity and investment growth has been offset by currency appreciation or rapidly rising wage costs. The pattern of strong investment and productivity growth, combined with moderate growth in real wages and relatively stable currencies – a pattern found in India, Indonesia and Turkey – still appears to be absent from Africa.

Many African firms which have moved successfully into exports in areas such as textiles and clothing have done so because substantial investment in new equipment and quality control facilities has made it possible to build links with foreign dis-

Table 55

COMPETITIVENESS INDICATORS FOR MANUFACTURES IN SELECTED COUNTRIES, 1995

(Index numbers, 1985 = 100)

	(1)	(2)	(3)	(4)	(5)	(6)
					Memo items	
Country/region	Real exchange rate[a]	Real wage costs in manufacturing[b]	Labour productivity[c] in manufacturing	Aggregate competitiveness indicator[d]	Employment in manufacturing	Investment[e]
Ghana[f]	250.8	259.1	187.5	181.4	128.2	105.2
Kenya[g]	85.2	76.3	69.6	77.7	108.4	93.2
Mauritius[h]	84.5	165.5	165.6	84.5	150.4	108.3
Zimbabwe[i]	143.7	81.1	82.7	146.5	90.2	103.5
South Africa[f]	66.9	105.7	118.0	74.7	94.3	95.2
Egypt[f]	180.2	63.5	121.3	344.2	116.0	90.3
Morocco	78.3	101.6	144.3	111.1	167.2	92.9
Indonesia	140.5	155.8	182.0	164.1	248.6	111.6
India[f]	169.8	116.1	167.2	244.6	119.0	100.6
Republic of Korea	71.3	248.3	283.4	81.4	119.6	107.5
Turkey[h]	121.5	181.2	237.8	159.4	110.6	105.1

Source: Exchange rate and price data from IMF, *International Financial Statistics Yearbook 1997;* investment and GDP data from World Bank, *World Development Indicators, 1997* (CD-Rom); all other data from UNIDO, *International Yearbook of Industrial Statistics*, various issues.

a Price-deflated bilateral exchange rate with the dollar; an index number higher than 100 indicates a real depreciation of the local currency since 1985.

b Nominal wage costs deflated by the index of wholesale prices, where available, otherwise by that of consumer prices.

c Real value-added per worker.

d Calculated by multiplying the ratio of value-added per worker in manufacturing (column 3) to real wage costs in manufacturing (column 2) by the real exchange rate (column 1).

e Index of the ratio of gross domestic investment to GDP.

f 1985-1993.

g 1991-1995.

h 1985-1994.

i 1994 (1989 = 100) except for investment/GDP, which is for 1993 (1989 = 100).

tributors.[25] Effective marketing is closely tied to product quality and reliability even for labour-intensive products, and investment in human and physical capital is often a prerequisite for establishing a reputation as a reliable trading partner. Successful African manufacturing firms have invested in marketing either in-house or through links with marketing services, and in some countries public institutions have been particularly important through organizing trade fairs and handling trade formalities. Where foreign marketing firms have been used extensively there does not appear to have been, except in Mauritius, the transfer of capabilities that was typical of the East Asian experience.

The experience of the second-tier NIEs in South-East Asia is again instructive for SSA. As in the case of their north-eastern neighbours a decade or more earlier, a decisive element in the shift of these economies to labour-intensive manufactured exports was the combination of private and public investment with supportive trade and industry policies.[26] Manufacturing became the leading economic sector, in terms of share of GDP,

in the late 1970s in Thailand and in the early 1980s in Malaysia, but in Indonesia not until the early 1990s. In all these countries manufacturing was built up through a fairly prolonged period of import-substitution industrialization (ISI), which helped to build local capabilities in light and resource-based manufacturing. As in SSA, food, beverages and tobacco were the dominant sectors in MVA in these countries. However, a more diversified manufacturing structure emerged under ISI than has been the case in most SSA countries, and these sectors subsequently formed an important part of the exporting capacity of countries in South-East Asia, often through the close involvement of foreign firms, particularly in labour-intensive clothing and electronics sectors.[27] In all three countries a number of resource-intensive sectors emerged under ISI, which subsequently acquired export capacities, including jewellery, food processing and wood-based products.

E. The markets for African exports

For developing countries, success in entering the expanding areas of international trade holds the key to sustaining growth based on successful export performance. Such trade is not always confined to products with high income elasticities. International trade can expand for different reasons and with vastly different implications for the longer-term growth of national economies. Liberalization in fairly sluggish but large markets and in products with moderate or even low income elasticities can offer ample export opportunities for small developing countries, particularly in OECD markets, where expansion of trade is associated not so much with rapid growth as with shifting competitive positions. However, only a handful of developing countries have so far been able to penetrate and increase their shares in expanding areas of trade in these highly competitive markets.

The potential for increasing manufactured exports, particularly at the lower end of the skill spectrum, is also considerable not only to advanced economies but also to the NIEs, where rapid economic growth and industrial upgrading have opened up new market opportunities for less developed countries. Moreover, the possibilities for greater trade with other developing countries, and particularly intraregional trade, also need careful consideration in the creation of more export-oriented manufacturing sectors in SSA. Intraregional trade can provide an initial step in the acquisition of the necessary skill and know-how before the challenges are met in the more demanding markets of advanced economies.

1. OECD markets

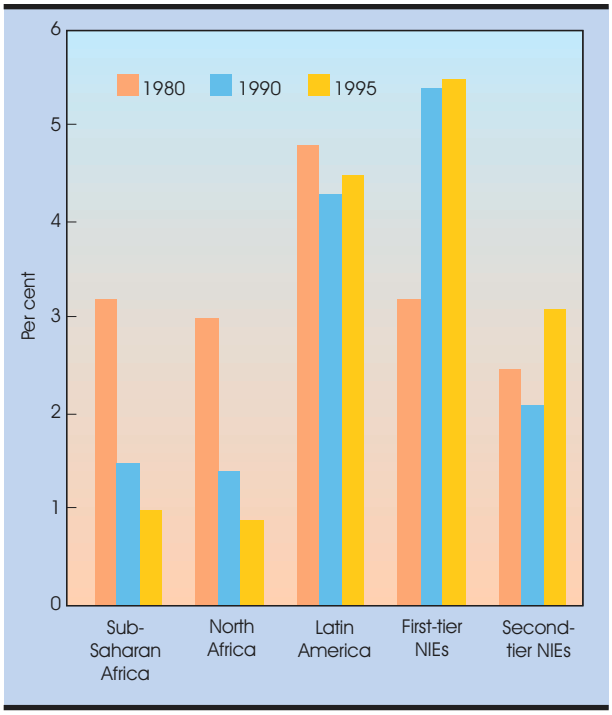
African countries have been much less successful in the markets of advanced industrial economies than most other developing countries over the last decade. The shares of both SSA and North Africa in total OECD imports have dropped significantly since the beginning of the last decade (chart 27). From 1980 to 1995 the share in both cases declined from more than 3 per cent to around 1 per cent, whereas the share of the first-tier East Asian NIEs rose from 3.5 per cent to 5.8 per cent, and that of Latin America was relatively stable at around 5.0 per cent. Moreover, SSA had a share similar to that of the second-tier East Asian NIEs in 1980, whereas the share of the latter group of countries had risen to three times that of SSA by 1995.

A more detailed analysis, based on data from ECLAC's Comparative Analysis of Nations (CAN) system, permits a classification of exports by their dynamic market position in OECD markets.[28] As explained in detail in *TDR 1996*, a dynamic/competitive position materializes when a country increases its share in the market for a dynamic product, defined as one for which trade is growing faster than the average for all products; such a product is called a "rising star". Similarly, an undynamic/competitive position is one where a country's share is rising in the market for a product for which trade is growing more slowly than the average for all products; such a product is called

Chart 27

SHARES OF SELECTED REGIONS IN TOTAL IMPORTS OF OECD COUNTRIES, 1980, 1990 AND 1995

(Percentages)



Source: OECD, *Monthly Statistics of Foreign Trade*, various issues.

Note: First-tier NIEs are Hong Kong, China; Republic of Korea; Singapore; and Taiwan Province of China. Second-tier NIEs are Indonesia, Malaysia and Thailand.

a "declining star". The corresponding positions where a country is becoming uncompetitive are called "lost opportunities" (trade for the product is growing above average) and "setbacks" (trade for the product is growing below average).

A country should strive to have a large number of rising stars, i.e. aim at increasing the share of dynamic products in its total exports. This has been the basis of the success of many East Asian economies. Having an increasing share of its exports in the lost-opportunities category means that while these dynamic products have secured a higher share in the country's export basket, the country itself has lost market shares for these products. An increasing share of declining stars in a country's export basket means that these products have become more important in the country's exports, indicating that the country itself has become more competitive in these sectors, but that the sectors' evolution in world trade is below average. Even though such a position has positive aspects from the point of view of competitiveness and may increase exports, a growing share of these stagnant products in a country's export basket will not improve the economy's dynamic potential over the medium term. A number of Latin American countries are in this position.[29]

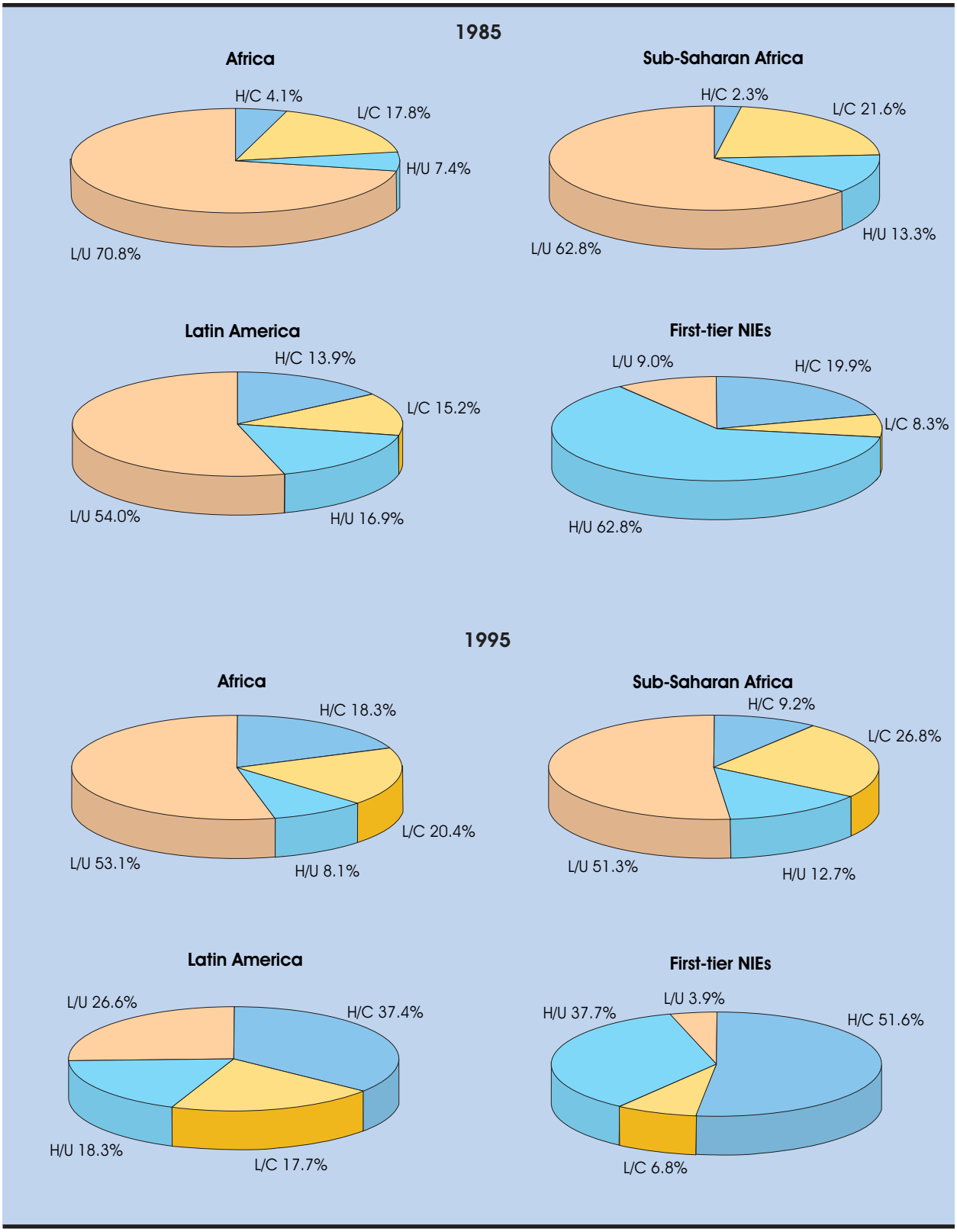
A comparison of the evolution between 1985 and 1995 of the shares for the four product categories in total exports of four developing regions shows that both Africa as a whole and SSA have increased the share of rising stars in their export baskets (chart 28). Moreover, they have by and large kept constant the share of the other group of dynamic products (lost opportunities). However, the share of these products in Africa's exports is far smaller than in the other regions; they account for about one fourth of the total for the whole of Africa and about one fifth for SSA, compared with more than half for Latin America and about 90 per cent for the East Asian tigers. In general, Africa, and in particular SSA, export a relatively high proportion of products for which growth is not above average.

2. Opportunities for intraregional trade

At various times during the past three decades, SSA countries have, with varying degrees of determination, made efforts towards regional integration. Increased regional trade and investment indeed offer a means of overcoming the constraints on individual countries related to their small size and of breaking away from their traditional export structure. Moreover, the regional context is useful for learning to adapt to the pressures of international integration, particularly the challenges of increased global competition. For manufacturing sectors which are traditionally oriented towards the domestic market and internationally uncompetitive, increased regional trade and investment can be a first step towards closer integration with the world economy. It would allow enterprises to gain experience in competing in foreign markets and dealing with customs and other trade-related regulations; hence, they would gradually enhance their capacity to export to more demanding global markets. Moreover, certain types of exports in such areas as agricultural machinery and other farm implements can often capture a

Chart 28

DYNAMISM AND COMPETITIVENESS OF EXPORTS FROM SELECTED DEVELOPING REGIONS, 1985 AND 1995



Source: ECLAC, Comparative Analysis of Nations database.
Note: H/C: highly dynamic/competitive position (rising market share for highly dynamic products);
L/C: less dynamic/competitive position (rising market share for less dynamic products);
H/U: highly dynamic/uncompetitive position (falling market share for highly dynamic products);
L/U: less dynamic/uncompetitive position (falling market share for less dynamic products).

wider regional market because they have to suit local climatic and physical conditions. In learning to adapt to these conditions firms can also build up innovative capacities which can subsequently be used to enhance their competitiveness in other markets.[30] Similar considerations can apply to labour-intensive products such as textiles and clothing, jewellery products and wood products, where design can provide regional niche markets.

A regional pattern of industrialization involving a progressively deeper regional division of labour where trade and investment flows link developing countries at different levels of development has been an important part of successful growth stories in East Asia. Replicating this kind of experience is an attractive prospect for SSA. But greater intraregional trade can also have benefits globally. The immediate impact of additional exports from one SSA country to another may be a reduction in the share and level of imports from developed countries, i.e. trade diversion. However, given that the increased exports are likely to lead to faster economic growth, imports from developed countries can over time also grow faster, thereby making up for the initial loss. Hence, ultimately, increased intraregional trade among developing countries can have a global trade-generating effect.

Table 56 suggests that between 1988 and 1996 most SSA countries shifted their exports away from industrialized countries, and that intra-African trade expanded considerably, while the opposite occurred in North African countries.[31] For example, in 1996 five countries – Côte d'Ivoire, Kenya, Malawi, Senegal and Zimbabwe – exported more than 20 per cent of their products to Africa, while in 1988 only three of them did so. However, this increased intra-African trade is dominated by only a few countries: Côte d'Ivoire, Ghana, Kenya, Nigeria and Zimbabwe account for about two thirds of all SSA exports to other countries in the region, including South Africa. Moreover, the increase has been due to a small number of primary commodities. Petroleum alone accounts for one third of the increase, with cotton, live animals, maize and cocoa accounting for another 18 per cent. The small share of regionally traded manufactures is confined to products with a large natural-resource content, such as cement, aluminium, iron plate and sheet, and woven cotton fabrics.[32]

Intraregional trade in SSA in 1996 amounted to about $9.5 billion (equivalent to about 8.6 per cent of the region's total exports), a level which is often considered too low for enhancing welfare and growth. It reflects the comparatively low level of SSA trade overall, but also the relatively high cost of regional trade, which is determined by, in addition to excessive transport costs, political barriers to trade and factors influencing the general business environment such as ethno-linguistic fragmentation and political instability.

What, then, is the potential for greater intra-SSA trade? It may be quantitatively assessed by the value of goods which are currently imported from the rest of the world but for which at least one SSA country is successfully exporting to the rest of the world to a significant extent. Trade between the Southern African Customs Union (SACU), which comprises Botswana, Lesotho, Namibia, South Africa and Swaziland, and the non-SACU members of the Southern African Development Community (SADC) Angola, Malawi, Mauritius, Mozambique, the United Republic of Tanzania, Zambia and Zimbabwe (hereinafter SADC-7), has greater potential for expansion than trade among other SSA countries.[33] This is because of the substantially greater differences in per capita GDP[34] and in current production and export structures between the two groups of countries.

Given the overlap in the product composition of exports by non-SACU members of SADC to the rest of the world with SACU's imports from the rest of the world, there is an untapped potential for trade between the two groups. Apart from petroleum, where the overlap is greatest, this potential mainly concerns primary products (including meat, tropical beverages, cotton, diamonds and non-ferrous metals) and a few resource-intensive basic manufactures (such as cotton yarn, cement and some types of woven fabrics); for other manufactures the potential is limited (table 57).

A trade potential identified in this way can, however, only be a rough estimate because it is based on actual trade flows rather than on their determinants. Therefore, supply capabilities in the potential exporting countries and market access conditions in the potential importing countries have also to be taken into account. For example, the current subregional trade pattern in Southern Africa has been strongly influenced by the asymmetrical pace of trade liberalization. Most SADC-7 countries, specifically Angola, Malawi, Mozambique, Zambia and Zimbabwe, have implemented substantial trade liberalization

Table 56

THE DESTINATION OF AFRICAN EXPORTS, 1988 AND 1996

(Millions of dollars and percentages)

Exports from	Year	Total exports ($ million)	Per cent share in African exports					
			Industrial countries	Developing countries	Africa	Developing Asia	Middle East	Latin America
Africa	**1988**	**64 300**	**67.6**	**16.2**	**6.2**	**4.5**	**1.4**	**1.6**
	1996	**110 900**	**64.7**	**26.0**	**10.1**	**9.1**	**1.9**	**2.8**
Cameroon	1988	1 582	85.0	13.9	11.4	0.6	0.1	0.4
	1996	2 222	83.9	16.1	9.2	5.7	0.2	0.1
Côte d'Ivoire	1988	2 780	65.3	31.0	21.7	3.2	..	0.4
	1996	4 996	65.4	33.8	23.3	3.5	0.5	2.2
Gabon	1988	1 207	78.9	20.6	5.0	3.4	1.5	9.2
	1996	2 850	85.4	14.2	2.9	6.5	0.3	3.3
Ghana	1988	874	79.5	15.9	2.0	3.2	1.0	3.3
	1996	1 704	68.2	26.6	15.8	7.3	0.7	0.1
Kenya	1988	1 073	60.0	34.8	24.6	6.1	3.5	0.1
	1996	2 203	46.3	48.3	32.1	9.0	6.5	0.1
Malawi	1988	280	77.9	19.2	18.0	..	..	..
	1996	494	55.0	38.0	23.6	4.3	2.2	1.0
Mauritius	1988	1 001	93.9	6.0	3.5	2.0	0.5	..
	1996	1 573	87.7	9.8	6.7	2.5	..	0.1
Nigeria	1988	6 884	88.1	11.5	6.5	0.5	0.1	4.2
	1996	14 836	79.9	20.1	8.5	7.5	..	3.7
Senegal	1988	591	59.1	34.1	18.7	14.4	0.1	0.1
	1996	806	43.3	46.8	22.1	20.2	2.3	2.0
Uganda	1988	323	89.5	9.6	0.5	6.7	11.5	..
	1996	559	82.1	17.9	2.4	2.8	1.9	0.1
Zambia	1988	871	72.0	28.0	6.2	15.2	5.5	..
	1996	1 000	41.3	58.7	13.9	33.8	9.8	..
Zimbabwe	1988	1 396	58.8	40.6	29.9	5.8	1.7	0.6
	1996	2 343	46.9	53.0	38.4	8.1	2.4	0.4
South Africa	1988	21 830	42.8	12.0	4.4	5.2	0.7	0.7
	1996	35 682	43.3	30.5	12.5	12.9	1.7	2.2
Egypt	1988	2 120	50.4	44.9	3.5	8.2	15.6	0.3
	1996	5 239	51.9	46.3	2.0	6.6	15.9	..
Morocco	1988	3 464	70.2	29.4	2.5	11.9	7.0	2.2
	1996	6 973	81.2	18.8	3.0	7.3	..	2.2
Tunisia	1988	2 393	76.8	20.3	4.0	6.7	4.9	0.3
	1996	5 519	82.4	14.4	3.1	3.3	5.7	0.6

Source: IMF, *Direction of Trade Statistics Yearbook*, various issues.

Table 57

ACTUAL AND POTENTIAL SADC-7 EXPORTS TO SACU, 1995

(Millions of dollars)

Product	*Actual SACU imports from SADC-7*	*Potential SACU imports from SADC-7*	*Current main SADC-7 exporters*
Petroleum (SITC 33)	0.2	2 775	Angola
Non-ferrous metals (SITC 68)	9.3	325	Zambia, Zimbabwe
Cement and diamonds (SITC 66)	15.0	264	Angola, Mauritius, Zimbabwe, United Republic of Tanzania
Iron and steel (SITC 67)	5.0	225	Zimbabwe
Cotton (SITC 26)	35.7	191	United Republic of Tanzania, Zimbabwe, Mozambique
Cotton yarn and textile fabrics (SITC 65)	20.7	158	Mauritius, Zambia, Zimbabwe
Clothing and accessories (SITC 84)	27.9	139	Mauritius, Zimbabwe, Malawi, United Republic of Tanzania
Cocoa, coffee, spices, tea (SITC 07)	11.3	117	United Republic of Tanzania, Malawi, Zimbabwe
Meat (SITC 01)	4.1	97	Zimbabwe
Memo item:			
All products	402.2	8 822	

Source: F. von Kirchbach and H. Roelofsen, "Trade in the Southern African Development Community: What is the potential for increasing exports to the Republic of South Africa?" (Geneva: International Trade Centre UNCTAD/WTO, 1997), mimeo.

Note: Trade potential is calculated as the overlap between SADC-7 exports to the world and SACU imports from the world.

programmes during the past 10 years, thus effectively opening their markets to South Africa and the rest of the world, while South Africa appears to have adopted a more gradual approach. Although more recently there has been some improvement in the access of, for example, Zimbabwean textiles, clothing and agricultural products to the SACU market, a further levelling of the current regional asymmetries regarding market access would probably be needed in order to increase the scope for SADC-7 exports to SACU.

International competitiveness and supply capacities also affect intraregional trade potential. For example, to the extent that SADC-7 exporters to the EU are supported by preferential market access conditions under the Lomé Convention, it is not clear whether these exporters could compete on an equal footing with SACU's imports from elsewhere, or whether they would be competitive only if SACU granted them preferential conditions similar to those granted by the EU. Moreover, SADC-7 would need to create sufficient supply capacities so that increased exports to SACU would lead to trade creation rather than simply replace its exports to the EU.

If conditions regarding the competitiveness and supply capability of SADC-7 exporters are fulfilled, increased intraregional trade in Southern Africa could help reduce regional trade

imbalances in the context of growing exports and imports for all the countries concerned. Given that South Africa runs large trade surpluses with SADC-7 countries, the increased exports by the latter to SACU will reduce bilateral imbalances. However, since a growing share of imports by SADC-7 countries now comes from South Africa, greater export earnings by those countries will also translate into increased sales by South Africa to neighbouring countries. In this sense, intraregional trade involving initially a diversion of SACU imports from advanced countries to SADC-7 can be trade-generating for all the parties concerned.

These prospects for increased intra-SSA trade are not independent of the wider efforts to accelerate accumulation and restore sustained growth. However, even small increases in intraregional trade help develop new export capacity which can generate a virtuous circle of regional growth dynamics by easing the balance-of-payments constraints on imports and providing learning effects which will eventually make African exporters more competitive globally. However, it is likely that trade within SSA will initially be confined to subregions centred on comparatively more advanced countries such as South Africa, Kenya and perhaps Côte d'Ivoire, while the prospects for enhanced trade among these subregions will evolve more slowly alongside improvements in transportation and communication facilities. ■

Notes

1 See, for example, D. Dollar, "Outward-oriented developing economies really do grow more rapidly: Evidence from 95 LDCs, 1976-1985", *Economic Development and Cultural Change*, Vol. 40, 1992, pp. 523-544; and J.D. Sachs and A.M. Warner, "Sources of slow growth in African economies", *Journal of African Economies*, Vol. 6, 1997, pp. 335-376.

2 For similar results see D. Rodrik, "Trade policy and economic performance in sub-Saharan Africa", NBER Working Paper No. 6562 (Cambridge, Mass.: National Bureau of Economic Research, 1998).

3 In their "Economic reform and the process of global integration" (*Brookings Papers on Economic Activity*, No. 1, 1995) Sachs and Warner have offered the most cogent version of the "open economies converge" thesis. In commenting on this work, Stanley Fischer noted that: "The strength of the Sachs-Warner results is surprising, given that the question that is being looked at, that of the influence of openness on growth, has been extensively studied before ... It is particularly surprising that this paper reaches stronger conclusions than the World Bank's famous 1987 *World Development Report*, which was so roundly criticized for overreaching" (*Ibid.*, pp. 103-104). More sophisticated versions of the "open economies converge" thesis now stress a package of market-liberalizing and macroeconomic disciplining policies. The empirical evidence in support of this approach is stronger – though still far from conclusive – than for the simpler versions, but is very much contingent upon the level of income and development achieved by countries. See P. Mosley, "Globalization, economic policy and convergence", in UNCTAD, *International Monetary and Financial Issues for the 1990s*, Vol. X (United Nations publication, forthcoming).

4 For further discussion of these and related points regarding the links between trade policies and economic growth, see *TDR 1997*, Part Two, chapter II. section E, and R. Rowthorn and R. Kozul-Wright, "Globalization and economic convergence: An assessment", UNCTAD Discussion Paper No. 131 (Geneva, February 1998).

5 An additional problem is that disaggregated export data become available only after much delay, which is why tables 49 and 50 refer to 1990 data (three-year averages for 1989-1991). More recent data available for a few SSA countries suggest that the share of different product categories in total merchandise exports has not changed significantly since then.

6 Some trade statistics reveal a relatively high share of manufactures for the Central African Republic, Sierra Leone and Zambia, but this is because gold and uncut diamonds are counted as manufactures. Similarly, Niger's large share, on the basis of data in the UNCTAD *Handbook of International Trade and Development Statistics*, is due to the classification of uranium exports as manufactures.

7 The empirical analysis in this section draws on A. Wood and J. Mayer, "Africa's export structure in comparative perspective" (Geneva: UNCTAD, 1998), mimeo. The interpretation of the results here may, however, be somewhat different from that of the authors.

8 See T. Akiyama and D.F. Larson, "The adding-up problem: Strategies for primary commodity exporters in sub-Saharan Africa", World Bank Policy Research Working Paper No. 1245 (Washington, D.C.: World Bank, 1994).

9 This group includes meat and meat products, dairy products, fish and fish products, fruit, vegetables, nuts, spices and vegetable oils. For further discussion of this product classification, see Wood and Mayer, *op. cit*.

10 For a discussion of the Mauritian experience see L. Darga, "A comparative analysis of the accumulation process and capital mobilisation in Mauritius, Tanzania and Zimbabwe", paper prepared for an UNCTAD project on African Development in a Comparative Perspective (Geneva, 1998), mimeo; and T. Meisenhelder, "The developmental state in Mauritius", *Journal of Modern African Studies*, Vol. 35, No. 2, June 1997. As discussed in these papers, some special conditions - in particular, favourable access to the EU market - helped accelerate growth in Mauritius. However, only through effective policies was Mauritius able to make full use of these opportunities.

11 Data contained in a recent report by the United States Bureau of Mines, as cited in "Survey of African Mining", *Financial Times*, 15 September 1997. Known reserves are not, of course, the same as profitable production opportunities; whether it is worthwhile to invest in exploiting such reserves will depend on the actual costs of exploitation and the future world market prices of the respective commodities.

12 For a discussion of this experience see *TDR 1993*, Part Two, chapter II, section C.

13 For a discussion of the definition of non-traditional exports and its relation to diversification see G. Frazer and G. Helleiner, "Non-traditional exports and export diversification: Alternative definitions and methodologies", paper prepared for the WIDER Project on Growth, External Sector and the Role of Non-Traditional Exports in Sub-Saharan Africa, Helsinki, May 1997.

14 High costs may also be a feature of the early stages of infant industries which are promoted in the context of a longer-term development strategy. In this case it is necessary to avoid a situation in which domestic firms receiving inputs from these industries have to bear the difference between world market prices and the higher cost of domestic supplies. This can be achieved through the provision of temporary price or cost subsidies.

15 See P. Svedberg, "The export performance of sub-Saharan Africa", in J. Frimpong-Ansah, S.M. Ravi Kanbur and P. Svedberg (eds.), *Trade and Development in Sub-Saharan Africa* (Manchester: Manchester University Press, 1990).

16 This category includes food products, other primary commodities, wood and paper products, and non-metallic mineral products. See *TDR 1996*, Part Two, chapter II, section C.

17 See UNCTAD, "Analysis of national experiences in horizontal and vertical diversification, including the possibilities for crop substitution: Malaysia" (UNCTAD/COM/73), 1995, and *TDR 1996*, Part Two, annex to chapter II.

18 M. Agosin, "Export performance in Chile", paper prepared for the WIDER Project on Growth, External Sector and the Role of Non-Traditional Exports in Sub-Saharan Africa, Helsinki, May 1997.

19 K.S. Jomo and M. Rock, "Economic diversification and primary commodity processing in the second-tier South-East Asian newly industrialized countries", UNCTAD Discussion Paper No. 136 (Geneva, 1998).

20 See P. Pardey, J. Roseboom and N. Beintema, "Investments in African agricultural research", *World Development*, Vol. 25, No. 3, 1997, pp. 409-423.

21 See, for example, A. Taylor et al., "Strengthening national agricultural research systems in the humid and sub-humid zones of West and Central Africa", World Bank Technical Paper No. 318 (Washington, D.C.: World Bank, 1996).

22 UNIDO, *International Yearbook of Industrial Statistics 1998*, table 1.3.

23 R.C. Riddell, "Manufacturing Africa. Reflections from the case-studies", in R.C. Riddell with P. Coughlin, C. Harvey, I. Karmiloff, S. Lewis Jr., J. Sharpley and C. Stevens, *Manufacturing Africa* (London: Overseas Development Institute and James Currey; and Portsmouth, New Hampshire: Heinemann, 1990), p. 36; and L. Mytelka and T. Tesfachew, "The role of policy in promoting learning during the early industrialization: Lessons for African countries", paper prepared for the UNCTAD Workshop on Economic Development and Regional Dynamics in Africa, Mauritius, December 1997.

24 From 1975-1979 to 1987-1991 manufacturing real wages in Zimbabwe, Mauritius, Kenya and the United Republic of Tanzania declined by 32 per cent, 37 per cent, 40 per cent and 83 per cent, respectively; see ILO, *World Employment Report 1996/97* (Geneva: ILO, 1997).

25 See S. Wangwe, "Conditions under which African manufacturing industries in sub-Saharan Africa have been able to break into export markets", paper presented at the UNCTAD Workshop on Economic Development and Regional Dynamics in Africa, Mauritius, December 1997.

26 See *TDR 1996*, Part Two, chapter II, section C.

27 See R. Rasiah, "The export manufacturing experience of Indonesia, Malaysia and Thailand: Lessons for Africa", UNCTAD Discussion Paper No. 137 (Geneva, 1998).

28 See also E. Rodriguez, "Export diversification by region", paper prepared for the WIDER Project on Growth, External Sector and the Role of Non-Traditional Exports in Sub-Saharan Africa, Helsinki, 1998.

29 For further discussion see *TDR 1996*, Part Two, chapter II, section D.

30 See Wangwe, *op. cit*.

31 It could be argued that this increase in recorded intra-SSA trade is misleading because the incentives to circumvent official trade channels have greatly diminished with trade and exchange-rate reform. However, even where unrecorded trade flows are large, they have usually concerned goods imported from outside SSA or goods of domestic origin but destined for export outside SSA. Hence, such goods would in any case not qualify as true intraregional trade.

32 A. Yeats, "Problems and prospects for African regional trade arrangements: Some empirical evidence" (Washington, D.C.: World Bank, 1997), mimeo, p. 40.

33 This analysis draws on F. von Kirchbach and H. Roelofsen, "Trade in the Southern African Development Community: What is the potential for increasing exports to the Republic of South Africa?" (Geneva: International Trade Centre UNCTAD/WTO, 1997), mimeo. The Democratic Republic of the Congo and Seychelles are also non-SACU members of SADC, but they joined SADC only in 1997, so that their trade data could not be taken into account.

34 Countries with similar living standards are likely to engage in enhanced bilateral trade only if they have a significant level of industrial production and hence trade in specific intermediate goods and production inputs, as well as in brand-name finished goods.

Chapter V

POLICY CHALLENGES AND INSTITUTIONAL REFORM

A. Introduction

Any long-run improvement in living standards in Africa can be achieved only through a sustained rise in productivity. Increasing investment is a prerequisite, if not a guarantee, of rapid productivity growth, because the latter requires the use of more productive technologies and higher skill levels, which are usually embodied in, or closely related to, new plant and equipment. Furthermore, strong complementarities between public investment and private investment mean that these should rise together if the fast and continuous pace of economic growth which has so far eluded the majority of countries in SSA is to be achieved.

In most countries, higher investment will be closely linked to an export-oriented development strategy and a shift in the structure of output and employment from agriculture to industry. As noted in chapter IV, resource endowments limit this investment-export nexus in the early stages of development. However, these endowments are themselves transformed with a successful take-off into sustained economic growth. Also, faster economic growth makes possible closer integration into the world economy, ensuring that international factors reinforce the domestic determinants of the growth process. The possibility of growth impulses being transmitted to neighbouring countries through trade and investment links can often give a strong regional dimension to that process.

Clearly, Africa needs structural reform and adjustment in order to overcome many of the impediments to capital accumulation and economic growth. In the view of some observers, such impediments result primarily from government interventions in economic activity; new investment opportunities should ensue quickly if such practices are abandoned and the logic of price reform dictated by global markets is accepted. The analysis in the last four chapters has raised serious doubts about such expectations. Liberalization and privatization, even to the extent that they are desirable, can hardly exhaust policy options in Africa. Policies need to be based on greater realism, in recognition of the fact that economic activity is undertaken by fallible economic agents in both the private and the public spheres, that markets and other institutions needed for the efficient functioning of a market economy are missing or highly imperfect, and that initial weaknesses and asymmetries in supply capabilities are as likely to be reinforced as removed by closer integration into world markets.

B. Policy options

1. Elements of a pro-investment climate

Present conditions in SSA do not preclude a take-off into rapid and sustained economic growth (see box 8). At the same time, it is far from certain that the recent recovery constitutes a turning point, given the generally weak investment performance and the failure to increase the level and diversify the structure of exports. Raising investment from its currently depressed levels thus assumes particular importance.

Policy intervention of various kinds can play a key role by setting the general conditions for a fast pace of capital accumulation and correcting specific market failures impeding it. Such intervention should, however, be founded upon the recognition that in market-based systems capital accumulation is closely linked to the consolidation of private property rights and the emergence of a strong domestic entrepreneurial class willing to commit its resources to investment rather than personal consumption.[1] The combination of public and private initiatives needed to stimulate rapid economic growth is perhaps best illustrated by the East Asian NIEs. However, a similar picture can be found in Latin American countries such as Chile, as well as in better-performing African economies such as Mauritius, Morocco and Tunisia.

The tissue of a modern entrepreneurial class is very thin in most African countries. To some extent, this may reflect the suspicion with which governments viewed modern and large-scale enterprises in their countries because they were owned or managed either by persons belonging to ethnic minorities or by nationals of the former colonial power. This reaction, however, was common to many other post-colonial experiences. Rather, stalled growth across much of SSA is linked to the failure of the State to gradually cede its initial economic power to a nascent independent entrepreneurial class which could assume the lead role in a dynamic accumulation process.

A more rapid pace of capital accumulation depends, *inter alia*, on the availability of resources for both the public and the private sector, as well as on incentives for private investment. As discussed in chapter I, rapid and substantial debt relief for a number of countries in SSA could provide a significant boost to public investment while at the same time increasing the availability of foreign exchange needed for imports of capital goods. As for the mobilization of domestic resources, experience suggests that it is much easier to increase savings from a growing level of income than from a stagnant one. Consequently, to the extent that output and income could be increased by greater and better utilization of existing resources, they could provide a basis for higher rates of domestic savings and investment. Such an opportunity appears to exist particularly in countries which have recently achieved significant increases in output and income.

Improvements in economic conditions need to be accompanied by policies designed to encourage savings and investment. While interest rate policies have an uncertain, and even perverse, influence on savings, fiscal, trade and credit policies can play crucial roles in creating conditions that favour saving over consumption. In countries with a developed corporate sector, a range of fiscal instruments can be used to encourage retention and reinvestment of profits, including tax exemptions and special depreciation allowances applied on a general level or targeted at specific industries. Again, measures such as controls on luxury imports, restricted access to consumer credit and public appeals to wealth holders to show self-restraint can provide incentives to increase the savings ratio.[2]

However, the principal policy challenge in many countries is to create a pro-investment climate so as to raise productivity levels and initiate the necessary structural changes. There is a consensus that political stability, a good legal structure and effective contract enforcement are needed in order to ensure rising levels of private investment. A stable macroeconomic climate is also desirable, although actual rates of inflation, and the size of the budget and current account deficits consistent

Box 8

INITIAL CONDITIONS AND ECONOMIC TAKE-OFF

Modern growth theory emphasizes the path dependence of economic development. It has been argued that because of the weakness of its initial economic and social conditions, a sustained acceleration of growth in SSA is precluded. Moreover, the relative success of countries in other developing regions over the past three decades may pose greater obstacles to rapid growth in SSA than were faced by previous generations of latecomers to development.

In point of fact, present economic conditions in SSA are not uniformly less favourable than were conditions in the East Asian countries on the eve of their take-off into sustained growth. As the table shows, the conditions are similar in many respects to those in East Asia in the mid-1960s, and in some respects they are better than those in South-East Asia in the mid-1970s, when the countries in that region launched into two decades of very fast economic growth and structural change.

MAJOR ECONOMIC AND SOCIAL INDICATORS FOR THE REPUBLIC OF KOREA, THE SECOND-TIER NIEs AND SUB-SAHARAN AFRICA

	Republic of Korea	*Second-tier NIEs* [a]	*Sub-Saharan Africa*
	1960	1975	1995
GDP per capita *(at constant 1987 dollars)*	768	692	598
Agricultural value-added *(per cent of GDP)*	36.7	28.3	29.2
Manufacturing value-added *(per cent of GDP)*	13.8	15.1	11.4
Gross domestic savings *(per cent of GDP)*	11.6 [b]	24.6	7.6
Gross domestic investment *(per cent of GDP)*	13.0 [b]	25.2	19.9
Exports of goods and services *(per cent of GDP)*	3.3	28.4	33.4
Urban population *(per cent of total population)*	27.7	24.1	34.3
Primary school enrolment *(per cent gross)*	103.0 [c]	86.7	75.0
Secondary school enrolment *(per cent gross)*	42.0 [c]	29.3	27.0
Telephones in use per 1,000 inhabitants	4.4	7.8 [c]	9.5 [d]
Life expectancy at birth *(years)*	53	55	52

Source: UNCTAD secretariat calculations, based on *World Development Indicators 1998*, The World Bank, Washington, D.C., 1998.
Note: Figures for regions are mean values.
a Indonesia, Malaysia, Thailand.
b 1962.
c 1970.
d 1988.

In two important respects, however, present conditions in SSA do not match those in East Asia prior to the latter's growth take-off. First, the physical and social infrastructure, particularly the education base, is generally poorer. Secondly, to judge from the levels of savings and investment the accumulation process is much weaker. However, changes in these conditions can be quite rapid. Both the Republic of Korea and Taiwan Province of China, for example, made great strides in the 1950s in raising the level of basic education, often from a lower starting point than some countries in SSA. In the 1960s, and again from quite modest levels, a shift of resources to higher levels of education and training further enhanced the human capital stock in those countries.[1] In communication and transport infrastructure, too, the push in these countries came after 1970. Similarly, during the 1950s gross national savings were less than 4 per cent of GDP in the Republic of Korea and less than 10 per cent in Taiwan Province of China. In both countries they rose rapidly in the 1960s, more than doubling by the end of the decade, and exceeding 30 per cent by the early 1980s.

[1] Although the second-tier East Asian NIEs began with comparable, and in some cases considerably better educational and infrastructural starting points than the first-tier NIEs, their subsequent growth was slower. Indeed, one of the slower growing East Asian economies over the past three decades – the Philippines – began with one of the best educational endowments.

with high rates of investment, fall within a fairly wide band.[3] Furthermore, it is generally agreed that abrupt policy shifts should be avoided so as to allow investors to take a long view.

But it is also important to ensure that markets do not generate impulses that undermine incentives and opportunities for investment. In this respect, it is a matter for concern that some recent policy reforms which are aimed at correcting price distortions and improving allocative efficiency in SSA may have damaging consequences for both private and public investment. This is true particularly of financial liberalization, but also of some trade liberalization measures (see subsection 3 below).

(a) Avoiding financial instability

The conditions that gave rise to rapid financial liberalization in many countries in Africa, as in developing countries elsewhere, are quite familiar.[4] Generally, it was introduced as a reaction to excessive and often misguided government intervention in the financial sector, including public ownership of banks and controls over interest rates and credit allocation, which often resulted in negative real deposit and lending rates and preferential treatment for public entities. Initially, reform efforts were directed towards improving government intervention, such as lifting interest rate ceilings above inflation, phasing out directed credit allocation and reducing public sector deficit financing from the banking system, but they were soon abandoned in favour of market-determined interest rates and privatization and deregulation of the banking system. Simultaneously, there has been a shift in public sector deficit financing to private markets through the issue of bills and bonds. This was thought to bring about not only greater price stability but also better fiscal discipline, as well as a shift to indirect control in the conduct of monetary policy, and hence give a greater role to market forces.

It is generally agreed that a number of conditions have to be satisfied for orderly and successful financial liberalization. First, a relatively high degree of price stability is needed in order to avoid sharp increases in interest rates. Second, the government budget should be brought under control in order to prevent a public sector debt spiral of high interest rates, deficits and debt, which could necessitate large cuts in primary spending to avoid debt explosion. Third, there should be relatively well developed, sound financial institutions that would give depth to markets and ensure healthy competition. Fourth, it is important to ensure that the corporate sector is not highly vulnerable to increases in interest rates. Finally, effective prudential regulations and strict bank supervision should be put in place in order to reduce the likelihood of financial instability.

Many of these conditions were not satisfied before the implementation of financial liberalization in SSA. Consequently, the experience with such reforms has been rather disappointing.[5] First of all, because fiscal adjustment was slower than expected, the switch to bond financing has led to very high and variable real interest rates since the market for government debt turned out to be very thin, consisting of only a few banks. This has resulted in a rapid accumulation of domestic debt and fiscal instability. High intermediation costs and large amounts of non-performing loans carried by the recently privatized and/or deregulated banks are another reason for high interest rates. Finally, although a large number of locally incorporated commercial banks have been established, their low level of capitalization, combined with weak prudential regulations and poor lending practices has caused banking crises in several countries. In Kenya, for example, 14 commercial banks and non-bank financial institutions failed in 1993 alone, compared with three in 1984-1988.[6]

The combination of high interest rates and increased financial instability has placed a considerable burden on the private sector even where the rates were technically efficient and competitive. Increased debt charges on profits, together with the higher cost of finance, have discouraged private investment. Public investment has been equally hit by rising interest payments on domestic debt, since it is often easier to shift the burden onto capital than current spending.

While there should be no illusions about the difficulty of reforming the financial sector in SSA, there is little reason in principle to assume that the institutions developed in East Asia to mobilize domestic savings, or the measures of financial restraint employed there, are incompatible with existing conditions in many countries.[7] Given the difficulties associated with ensuring the depth and soundness of financial markets and institutions, it might prove wiser to move towards administered interest rates while making every effort to avoid the kind of problems encountered in the past. This

could also help to check the accumulation of domestic debt and fiscal instability. Under a regime of measured financial restraint, policymakers not only have greater leverage on capital accumulation, but also assume the important role of a risk-sharing partner at a critical stage of economic development.[8] Although strict government control of credit allocation is neither a necessary nor a desirable feature of financial restraint, institutional arrangements, including development banks, are still needed to channel credits to agricultural smallholders and small and medium-sized industrial enterprises.[9]

The liberalization of foreign trade and foreign-exchange markets has taken a course similar to that of domestic liberalization. Initially, exchange rates remained regulated and currency devaluation was the most frequently and intensively used tool in adjustment programmes in SSA. But subsequently many countries moved towards market-determined exchange rates and current account convertibility. As a result, the extensive restrictions on access to foreign exchange for current account transactions, which were the norm during the early 1980s in the vast majority of SSA countries, no longer exist: as of September 1997 more than 30 countries had formally subscribed to the Article VIII obligations of the IMF and by 1996 foreign exchange markets had been unified and the previously often substantial black market premium on foreign exchange had been eliminated in all SSA countries except Burundi, Ethiopia, Liberia and Nigeria.[10]

Again, the markets for foreign exchange have proved to be very thin, resulting in excessive volatility. Exchange rate instability has been further exacerbated by arrangements that have resulted in de facto liberalization of the capital account. As part of their foreign exchange reform, many countries have introduced "own-funds" import schemes, under which no questions are asked about the source of finance for imports, as well as foreign exchange bureaux. The bureaux system was in principle designed for all current account transactions, while some control over capital movements would be retained; it was assumed that the source of funds for the bureaux system would be unrecorded exports and workers' remittances. However, owing to inadequate monitoring and supervision of bureaux transactions, this system has also been used for a wide range of capital transactions, resulting in a de facto liberalization of the capital account. Currently enforced recording procedures do not allow a clear separation to be made between current and capital transactions which go through the bureaux system, but it has been estimated that the scale of capital flows to SSA countries in relation to the size of the latter's economies is comparable to that in other regions if the unrecorded flows from the bureaux system are taken into account.[11]

Available evidence for a number of countries in SSA suggests that private capital flows have been an important cause of increased exchange rate instability. For instance, during the first half of the 1990s Kenya and Uganda experienced sharp appreciations when private transfers and access to short-term credits increased markedly. Zambia experienced a depreciation of the real effective exchange rate in 1991, followed by an appreciation in 1992 and 1993 and another depreciation in 1994. South Africa has experienced similar fluctuations.[12]

Establishing an investment-export nexus in SSA depends to an important extent on the maintenance of stable and competitive real exchange rates. There was certainly a need to move towards more realistic and flexible exchange rates from the earlier regimes of rigid and overvalued rates. Indeed, evidence cited in chapter III suggests that devaluations assisted some African agricultural exporters in achieving competitiveness. However, again, the pendulum appears to have swung too far, giving rise to instability. An appropriate management of exchange rates requires, *inter alia*, the kind of regulation and control of capital flows discussed in Part One, chapter IV, above.

(b) Curbing capital flight

The available, albeit limited, evidence on capital flight suggests that SSA is one of the regions most affected. For example, it has been estimated that 70 per cent of privately owned wealth (excluding land) was held abroad in 1992, and that Africa's private capital stock would be about three times higher than it currently is if that wealth had simply been retained at home.[13] Assets of such a magnitude could make a crucial contribution to Africa's economic take-off if they could be mobilized for productive investment.

It is often held that overvalued exchange rates, the absence of profitable investment opportunities and economic and political instability were the main reasons for capital flight in SSA. It is not clear,

however, whether the expatriation of these assets was motivated by a simple economic calculus of risk and return. More likely, much of it appears to have originated from the illicit diversion of public funds rather than to have been constituted by business incomes seeking economic stability or high yields abroad. To that extent, market confidence and policy credibility considerations probably play a minor role in decisions about where the money is invested. A change in the banking regulations of those developed countries where these funds tend to be invested would probably be a more effective measure towards their repatriation.

Nevertheless, consideration of risk and return are not irrelevant. The appropriate policy response is not to ease restrictions on capital account transactions, which would be inappropriate for most countries in SSA, but to pursue measures which can lock domestic investors into a growth take-off in a relatively secure environment. Greater political stability, effective property rights, investment incentives and stable exchange rates are needed to prevent further capital flight from aborting faster growth in SSA.[14]

However, capital flight is not exclusively a financial problem. The emigration of highly skilled individuals ("brain drain") has contributed to a shortage of skilled personnel and qualified workers in SSA, depriving its economies of a crucial and desperately needed factor for growth and development. It is estimated, for example, that 60,000 doctors, engineers and university staff left Africa during 1985-1990 and that as many as 20,000 a year have left since 1990.[15]

It is difficult to determine cause and effect between the supply of a skilled labour force and private investment. The fact that the level of investment flows from developed to developing countries is less than would be expected from economic theory has been explained by some authors in terms of the absence of an appropriately skilled labour force in developing countries.[16] However, new investment increases the demand for skilled workers and hence provides incentives for individuals to invest more in their education and to stay in their own country. Hence, policies conducive to private investment are also a crucial element of a strategy for skill accumulation, including the return of skilled workers from abroad.

An equally effective measure that could reduce the pull factor and facilitate the return of skilled workers to Africa is their greater use in operations in the region by international financial institutions (IFIs) and aid agencies. This could have other benefits as well. For instance, it has been argued, in relation to development research, that:

> IFI professionals cost much more than professionals living in their native developing countries and having similar qualifications; moreover, these professionals in developing countries also have the comparative advantage of knowledge with respect to domestic institutions and idiosyncracies ... For example if the equivalent of 50 per cent of the resources used in Washington to finance 1,000 World Bank economists were used in 100 developing countries to finance 1,000 graduate domestic economists (on average 10 per country), the policy reform advice and development research would be greatly improved; there would also be spillovers and domestic externalities increasing local research and development. At the same time, there would be an important saving of resources in Washington D.C. World Bank expenditures.[17]

(c) Using foreign direct investment

Africa needs to attract private capital with a long-term commitment to the region. Foreign direct investment can make a growing and positive contribution to the extent that it brings productive assets to complement domestic resources and improves linkages with overseas markets. Many SSA governments have, over the past decade, made concerted efforts to attract FDI by liberalizing their investment laws, including easing restrictions on entry and on profit remittances and strengthening protection of intellectual property, as well as by offering generous fiscal incentives.[18] However, the flow of FDI to Africa continues to be minimal, a situation which reflects the weak growth performance of the region. Whether in search of markets or cost advantages, FDI is attracted by success.

Nevertheless, FDI can be attracted in some sectors, the most important of which is probably mining although in many cases it will require improving public infrastructure. More stable legislative and contractual arrangements have helped to reduce the risk in mining projects with long gestation periods and could encourage TNCs to establish more processing facilities in such areas as petroleum.[19]

The availability of unskilled labour and a strong raw material base should also prove attractive to international agribusiness, particularly where technological requirements are not too demanding. Moreover, the strong backward and forward linkages associated with these activities make such investments particularly attractive. As noted in chapter IV, a number of countries in Latin America and South-East Asia have struck a balance between private and public sector investment, and between domestic and foreign producers, that has allowed a rapid expansion of non-traditional agricultural exports. Some countries in SSA have also been successful in this regard. Tourism is another sector which could be quickly and effectively developed in cooperation with TNCs, particularly through the use of management contracts and licensing arrangements.

To the extent that countries are ready to begin exporting manufactures, closer links with international firms will be desirable. However, securing the right kind of FDI and making a judicious choice of instruments for technology transfer and marketing become even more important at this stage in terms of indigenous capacity-building and long-term productivity growth. While there are obvious advantages which a foreign affiliate can bring to a production location, TNCs are generally attracted by a strong growth performance rather than leading the process of growth, and too much should not be expected from export-oriented manufacturing FDI in most countries in SSA.[20] Moreover, the strategy pursued by some African countries – immediately following independence – of reliance on FDI, external advisers, expatriate technical personnel and turnkey operations, with the aim of leapfrogging the initial stages of industrialization, prevented the development of important domestic production linkages.[21] In any case, FDI in manufacturing, where international competition is more intense, is perhaps even more cautious than in other sectors. In this respect, closer regional links could be particularly useful in bringing FDI to some countries neighbouring South Africa.

The policy challenge for countries with considerable foreign investment in mining and agriculture is how to capture an important part of the rents from the exploitation of natural resources, and also to avoid the "Dutch disease" problem that may be associated with an expansion of exports of the latter, as well as to invest efficiently in non-traditional export sectors the financial resources thus generated (see chapter IV). Establishing linkages with local suppliers and securing technology spillovers become more important objectives for activities in the secondary sector. It is essential to remember that TNCs are driven by their own narrow objectives which are different from, and potentially at odds with, the host countries' objectives of building up local capacities and a strong domestic supply base. Moreover, even a successful policy of attracting FDI must be vigilant as regards TNCs' rapidly exiting from cost-sensitive sectors when domestic wages start rising or lower-cost locations begin to emerge.[22]

2. Agricultural policies

A central objective of agricultural development policy is to promote private farm investment and sustainable productivity growth amongst smallholders. This objective is founded on two premises. First, strategies which focus exclusively on promoting capitalist agribusinesses have often not had the desired economic or social results. Second, the key problem facing smallholders is undercapitalization. Without assets they cannot generate a surplus for investment, and are forced to adopt risk-minimizing behaviour which tends to reduce output and productivity; furthermore, agricultural intensification is likely to promote land degradation.

However, throwing more money at the problem is not likely to do much good if priorities are not carefully selected. Past agricultural development projects channelled resources into areas with limited productivity potentials, and often with multiple objectives. Agricultural growth may be better promoted by focusing policies and targeting resources on areas with the highest productive potential and high population density. Also, their effectiveness should not be undermined, as it was in the past, by gender biases in the provision of agricultural services.

The analysis in the previous chapters strongly suggests that an exclusive emphasis on either export crops or food crops needs to be avoided. The desirable mix has been elusive, in part because policies have been overburdened with the goals of poverty reduction and self-reliance. Certainly, in most countries in SSA agricultural exports need to expand, particularly in those without mineral resources and immediate opportunities for manufactured exports. However, it should be borne in

mind that higher productivity in food production and lower prices can make a significant contribution to export expansion by reducing wage costs. This can be particularly important where much of domestic food consumption is in commodities which are non-tradable outside the region.

The profitability of agricultural production and investment depends on a host of factors, including input and output prices, productivity and transaction costs. Concentrating on producer prices alone does not always bring about higher production and investment when other factors influencing costs are unfavourable. Leaving these to markets does not always generate the right incentives for farmers. Moreover, even where incentives are generated, supply response does not always follow if there are legal, financial and technical constraints on the capacity to invest and produce.

Experience elsewhere, particularly among the most successful NIEs in East and South-East Asia, suggests that it is possible to achieve high rates of agricultural growth even when farmers are taxed, but only if the overall configuration of factors that determine profitability stimulates investment and production. One important factor is the large amount of public investment needed to raise productivity and reduce transaction costs. Again, the way in which agriculture is taxed impinges directly on incentives. Elsewhere, for example, land taxes had the effect of promoting, rather than discouraging, productivity growth, and the relevance of such schemes to Africa can be explored. But what may be more important immediately is the reform of local government to ensure that local taxes are collected fairly and efficiently and used for local development purposes. Progress in this area can be rapid.[23]

The low productivity of African agriculture, when combined with declining and volatile world prices, creates a vicious circle. When world prices decline, private investment in agriculture is increasingly unattractive; but without investment, productivity will remain low. This situation arises partly because governments in the past may not have made the best use of gaining from commodity booms, devoting revenues to other purposes rather than supporting agricultural productivity growth through investment. But today's problems cannot be solved by simply passing the world prices to producers. It is essential to increase public investment in agriculture and there may also be a case for treating certain crops at certain times as "infant industries" by implementing sector-specific supply-side policies. Such policies would seek to reduce costs through measures designed to improve the technological capacities of farmers, achieve economies of scale and specialization, and encourage market development. In this regard, much experience has been acquired in Africa for certain export crops, such as tea in Kenya and cotton in francophone West Africa, and also for food crops, such as maize in Zimbabwe.

The disappointing past performance of many marketing boards and *caisses de stabilisation* (which often date from colonial times) does not imply that the original reasons for their establishment no longer hold; these reasons included the desire to improve marketing channels, guarantee minimum prices, and (in the case of the latter) stabilize prices and provide other services connected to agricultural development. They have failed for other reasons, notably on account of inefficiencies in their operation and of political interference. The recent wave of privatization and liberalization in Africa has reduced the role of these boards and *caisses*, but has failed to solve the major problems confronting farmers. These entities were established to counter real weaknesses due to the lack of marketing arrangements for both inputs and products, the unavailability of credit and storage, and the absence of competition; and, despite their deficiencies, they did provide a measure of price stability for farmers, ensure quality control, serve as a focal point for forward sales, and negotiate international financing at attractive rates. In consequence the reduced role of these institutions in some African countries has left commodity trade in disarray and farmers much more exposed to volatility in world commodity markets.

These problems can be avoided by actions which include adaptation of official rules and regulations to ensure that modern techniques for commodity trade, financing and risk management are available to the private sector,[24] stimulating local banks to play a more active role in these areas, strengthening farmers' associations, better dissemination of information, promoting organized markets in certain cases, and the provision to both farmers and traders of risk-management services. The private sector and competitive markets can help in meeting many of these needs but the possible scope of their role is limited. Modern techniques to hedge against price instability are beyond the individual means of most African farm-

ers and traders and, owing to their imperfections, domestic capital markets provide little opportunity for consumption smoothing over time. Moreover, competitive markets are lacking in many areas of African commodity trade, and the private sector is likely to be unwilling or unable to provide much of the other infrastructure required for such trade. Thus government action remains indispensable in areas such as market development (which is not an automatic process but requires public-sector support), financing and risk management, and the provision of other services and infrastructure; and under many of these headings an important role can be played by reformed and depoliticized marketing boards and *caisses*. Indeed, in present circumstances there is a strong case for institutional pluralism in which marketing boards and *caisses* are part of a landscape that also includes private organizations, parastatals and cooperatives.

Land reform is also a key policy issue in SSA. Customary land tenure arrangements can hamper the development of rural labour and capital markets and divert entrepreneurial energies towards gaining access to local resources rather than improving productivity. They are characterized by significant gender and generational biases which undermine incentives for key social groups. On the other hand, individual titling will not lead to increased private farm investment unless other constraints are also removed. Critical in this regard are the dissemination of locally adapted technologies for increasing productivity, and the provision of special credit facilities and institutions. Greater availability of, and higher remuneration from rural non-farm employment opportunities also play an important role because income from these activities increases the surplus available for investment in agriculture and can provide a buffer against risk.

3. Trade policies

Unquestionably, in the past many countries in SSA raised their levels of protection to excessive levels. The absence of competitive pressures eventually precluded higher productivity and improvements in managerial and technological capabilities, and prevented the graduation of infant industries to a higher level of maturity because it protected inefficiency and created windfall profits for those with privileged access to import licences.

In most countries quantitative restrictions on imports have been eliminated and replaced by tariffs, and tariff structures have already been drastically compressed and their scale reduced over the past decade or so. However, there have also been cases of policy reversal in this area, partly as a result of the impact of tariff reductions on budget revenues, and partly because economic costs exceeded gains.

However, although import-substitution policies have proved unsuccessful in much of SSA, rapid and comprehensive import liberalization is not the only, or the most desirable, alternative. A gradual approach is warranted, in part because little is known about the link between trade policies and productivity growth.[25] But perhaps more significantly, an extensive examination of trade liberalization experiences suggests that strong prior export expansion is critical for sustaining any moves towards greater openness to imports, and that it is wrong to see export expansion and import substitution as mutually exclusive strategies. The case for infant industry protection and industrial policies to promote learning and develop managerial and other capabilities in domestic firms is no less relevant in SSA today than it has been for all successful late developers over the past century.[26]

A trade regime designed to promote investment and exports should have a number of basic features. First, it should allow exporters to have easy and reliable access to inputs at world prices. Second, it should facilitate investment. Third, it should discourage luxury consumption. Finally, it should protect domestic producers against damaging competition. From this point of view, the trade policy reforms adopted in SSA are not always satisfactory.

While attainment of the above objectives requires selective liberalization and differentiated tariff structures, reform in Africa, as elsewhere in the developing world, has been governed by a desire to attain a relatively uniform tariff structure with low tariff rates in the belief that this minimizes distortions while generating budget revenues. However, this approach has often resulted in the taxation of exporters. Efforts to establish duty drawback schemes have not generally succeeded in according duty-free status to exporters for their imported inputs. An alternative would be to exempt all key inputs from import duties while raising the tariffs on others. This would be a rational option particularly in coun-

tries lacking domestic industries that provide inputs to other sectors. Furthermore, value-added taxes could be used, where necessary, to discriminate against uses of such inputs for domestic consumption as well as to make up for revenue losses. Such a scheme could also be effectively applied to capital goods imports, since most countries lack domestic capital goods industries. However, import charges on capital goods continue to be comparatively high in many countries in Africa, and this appears to be a reason for the lower than expected investment response to import liberalization.

Regarding the evidence on tariff structures across countries and product categories in the most recent year available, several features are noteworthy.[27] Imports of machinery and equipment are in general subject to lower charges than other manufactures. However, consumption goods are to be found in both groups. With regard to the structure of charges within the group of machinery and equipment imports, the evidence suggests that the North African countries (with the exception of Tunisia) and South Africa, i.e. the relatively more industrialized African countries, have significantly lower charges on machinery than on transportation equipment. This feature is most striking when compared with the structure of charges in Côte d'Ivoire and, to a lesser extent, Kenya, Madagascar and Malawi (a country where this feature was much more pronounced at the end of the 1980s), which is relatively favourable to imports of transportation equipment compared with imports of machinery. To the extent that this tariff structure is a reflection of a comparatively favourable treatment of imports of luxury consumer goods (such as expensive passenger cars) relative to those of production facilities which are required in industry, it would appear to be particularly inappropriate.[28]

An accurate description of the trade regimes in Africa is complicated by various exemptions such as those for public purchases and in the use of donor aid. In some countries, export retention schemes have allowed exporters to use their proceeds to import not only duty-free intermediate goods but also consumer goods. These, together with large-scale smuggling and reduction in tariffs on consumer goods, have created serious difficulties for local firms in competing with imports. One recent study of Zambia has noted that basic consumer goods industries such as textiles and leather and wood and furniture products have been hit hardest by trade liberalization; under normal circumstances, those industries are likely to form the basis of a more export-oriented industrial base.[29]

Phased and differentiated import liberalization needs to be complemented by an efficient system of export promotion through fiscal, credit and other incentives. State assistance with market information and export penetration strategies, trade banks, insurance mechanisms for exporters, and the rationale for export taxes and direct subsidies all need to be examined carefully in this context. Export-processing zones, widely used in East Asia, might provide a context in which to experiment with many of these policy initiatives.[30] However, in all cases, support must be time-bound and linked to technological and skill development, productivity growth, the emergence of complementary supply industries and scale considerations, as well as to explicit export targets. More sophisticated technology and training policies will be needed, particularly once initial resource advantages have been fully exploited, in order to address the small base of managerial and technological capabilities in SSA, and to facilitate the switch to new and more dynamic areas of competitiveness.

C. Constraints of the new trading regime

It is increasingly argued that the adoption by developing countries of selective strategies may no longer be possible because the intensification of multilateral trade disciplines and the extension of their scope as a result of the Uruguay Round prohibit the use of some key policy tools to promote exports and protect infant industries. It is pointed out in particular that the WTO regime has reduced the scope for using measures such as trade-related subsidies and imposing conditions

on FDI, and for practices such as lax enforcement of intellectual property rights; all these were integral parts of the East Asian development strategy.

Certainly, the more generalized protection which provided a backdrop for targeted policies in East Asia is no longer possible. It may also be true that the new trading regime will reduce the scope for policy manoeuvre for those developing countries that wish to pursue a strategy involving vigorous infant industry protection and export subsidies. Tighter constraints may in particular arise from the Agreement on Trade-Related Investment Measures (TRIMs) and the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs). However, although the Uruguay Round has clearly imposed greater discipline, it has also improved security of market access for exports from developing countries. This represents an improvement on the conditions faced by many East Asian NIEs.[31]

With respect to infant industry protection, to the extent that tariff rates remain unbound or bound at ceilings above currently applied rates, they can be increased to protect infant industries. The Agreement on Subsidies and Countervailing Measures perhaps contains the most meaningful provisions on differential and more favourable treatment for poorer countries, some of which are not subject to any precise time limits. For example, the least developed countries and 20 other countries with GDP per capita of less than $1,000 are exempt from the prohibition on export subsidies so long as they remain in these categories and certain thresholds, based on shares of world markets for products benefiting from export subsidies, are not reached. These exemptions cover most countries in SSA.

Thus, while the WTO multilateral agreements have reduced the scope of some policy options, selective strategies can still be applied. The main constraint would seem to be the necessity for such strategies (particularly those which involve negotiations with developed countries or TNCs) to respect the specific time frame laid down in the different agreements. In this context, both formal and informal government-business links, which played such an important role in East Asia's success, are likely to be of growing importance. As discussed in the next section, measures to strengthen government-industry partnerships deserve closer attention. Also, technical assistance should place more emphasis on informing countries in SSA of the full extent of these possibilities, and incorporating them into larger development strategies.

Furthermore, it should be noted that there are many policy measures that remain outside the scope of WTO obligations. Many of the policies identified earlier with a dynamic investment climate can still be so designed as to be permissible under the new trading rules. These include general fiscal concessions to corporations, the provision of subsidized R&D, measures to promote corporate savings and investment, and differential taxes (VAT and excise tax) on domestic consumption and production. Since these policies can have considerable influence on promoting technological upgrading and international competitiveness, their importance cannot be emphasized too strongly.

Arguably, slow growth in the North and the persistence there of high tariffs and subsidies in some agricultural and food-based products, together with the erosion of preference margins for African countries, are greater obstacles to raising export levels and entering some non-traditional lines of export.[32] Action is needed by OECD countries to improve access for African exporters of both traditional agricultural products and processed raw materials; this would also help to improve market knowledge and marketing skills that will be needed for such products as textiles.

D. The institutional hiatus and reform

Social divisions, particularly those linked to ethnic differences, have often been cited as an important reason for low investment and slow growth in SSA because they have given rise to excessive rent-seeking behaviour, political instability and poor public services. Certainly, a number of countries in SSA suffer from civil strife or external conflicts, and some still lack some of the basic

social and political conditions for initiating sustained growth. However, social conflict and division are not an intrinsically African problem, but rather are linked to the debilitating effects of poverty, growing inequality and heightened factional competition in situations of severe economic decline.[33] As discussed at length in last year's *TDR*, political and social instability tend to be greater where social stratification and inequalities are associated with widespread poverty. This can threaten to generate a vicious circle whereby political instability and social unrest give rise to greater uncertainty, lower investment and slower growth, which in turn lead to greater poverty and further instability.[34]

Global comparisons show that, contrary to a widespread perception, even though SSA has the largest number of politicized communal groups, it experiences less economic and political discrimination than most other regions, thanks in large part to efforts by many post-independence States to build multi-ethnic political coalitions.[35] These efforts, however, have not been without large economic costs. Redistributive measures based on the politics of inclusion have in many cases reduced microeconomic efficiency and dissipated investment funds, and at worst have generated a system of spoils for the wealthy and well-connected. But it does not follow that ethnic multiplicity is necessarily an impediment to growth. A number of successful East Asian NIEs, for example, have faced serious ethnic tensions in the course of their development, which were once seen as obstacles to growth. The experience of Malaysia illustrates how it is possible to manage ethnic divisions whilst nevertheless accelerating growth.

There is a widespread belief that countries in SSA still lack much of the basic institutional infrastructure to manage complex economic policies. However, healthy scepticism about excessive claims regarding what policymakers can achieve needs to be distinguished from simple prejudice against public action in general, and myths about African managerial capacities in particular.[36] There is little doubt that the economic stagnation of the 1980s, the accompanying fiscal crisis of the State and the ideological shift away from public activities have all seriously weakened governments in SSA, and in particular have eroded state managerial capacities, thus making it difficult to pursue certain types of policy. But the warning of an ill-fated marriage between complex policies and unsophisticated States in SSA is a false one. On the one hand, it ignores those successful experiences which evolved out of a period of deep economic and political crisis, and often on a weak bureaucratic base.[37] On the other hand, whilst the policy rhetoric of the past decade has denied the existence of the requisite state capacity in SSA to pursue demanding national development strategies, the alternative has called for a daunting combination of closer links with the world economy through trade and financial liberalization, stabilizing the economy, downsizing state agencies and privatizing public assets, financial deepening, fiscal discipline, good governance, democratization and the creation of an "enabling environment" for the private sector. Often, the recommendation has been to pursue all reforms simultaneously and at a fast pace.

A take-off to growth requires that governments pursue general policies aimed at raising the level of investment, together with a more limited number of selective interventions in certain key import-substitution and export-oriented industries which contribute to the accumulation of capabilities and know-how. In SSA, as earlier in the second-tier NIEs, these policies will need to target resource-based activities and some simpler labour-intensive manufactures. There is little reason, *a priori*, to deny that engagement in a limited number of policies during the initial stages of export promotion in SSA will allow governments to learn how to design sectoral policies, to find out what incentives are effective and for what purpose, and to learn about the loopholes that a policy that looks good on paper may have in practice. More sophisticated policies needed for promoting the next generation of industries can build on these experiences.

After a decade or more of reform in SSA premised on the assumption that government failures are far worse than market failures, the need for a different emphasis is now increasingly recognized, stressing the complementarity between the State and the market and promotion of the developmental State. The latter term was coined to describe the set of government institutions which aim to promote entrepreneurship, profits and capital accumulation without compromising a wider set of development objectives beyond those narrowly prescribed by business interests. Certainly, in SSA, this requires capacity building in the public and private sectors; also, it is necessary to avoid the capture of state agencies by special interest

groups. However, a developmental State will also seek to fill gaps and repair failures across a range of institutions in SSA.

This is a daunting task, and any comprehensive agenda of institutional reform can emerge only at the country level, where ownership of the reforms can be ensured and the chances of success thereby enhanced.[38] However, in the light of the policy suggestions discussed above, two closely related sets of reforms can now be considered by many countries in SSA: the creation of a competent and independent state bureaucracy, and the building of closer ties between such a bureaucracy and the emerging private sector.

The need to restore an effective policymaking machinery depends in part on recovering the bureaucratic momentum which was present in many countries in SSA in the early post-independence years but was subsequently lost. According to one recent study:

> In many countries in sub-Saharan Africa, the civil service has sharply deteriorated in almost every way since the 1970s ... Beginning in the 1980s, a succession of fiscal stabilization programs has reduced government employment in Africa to the lowest level of any developing region. Thus although additional downsizing may be necessary, most do not need to shrink the workforce but to overhaul the entire civil service system.[39]

This overhaul will have various dimensions. First of all, the core of the bureaucracy needs to be strongly insulated from political pressures. Total insulation is neither possible nor desirable (as it could make the bureaucracy unresponsive to an important source of change), but if the bureaucracy is unduly subject to the pressures of day-to-day politics, it will be less able to devise and modify policies in the light of its own experience, and is more likely to become overburdened with multiple objectives, many of which will be short-term in nature.

A second feature involves the degree of personnel continuity in the civil service. Policymaking cannot be embodied only in organizational structure and rules. Much will depend on the accumulated knowledge of civil servants, and it is necessary to find ways to maximize the application of such knowledge. A career structure is needed that rewards ability in a manner competitive with the private sector. Remuneration may not need to be equivalent to the private sector, but there must be a combination of salaries, job satisfaction, perquisites, security and prestige that ensures that public sector managers match those in the private sector.[40]

Thirdly, it is absolutely indispensable that the core bureaucrats have substantial learning capabilities if policies are to be improved over time.[41]

Reforms of the civil service need not advance on all fronts simultaneously. Indeed, in the light of their recent history an excessively ambitious reform package is unlikely to succeed in SSA. In East Asia elements of the bureaucratic structure retained old-fashioned practices even as key ministries were undergoing significant reform. Thus, whilst confronting vested interests, disrupting established repertoires and changing prevailing norms are always difficult, the emergence of a few centres of excellence can make a considerable difference.

Given a capable, internally coherent state bureaucracy, the next challenge is to connect bureaucrats and entrepreneurs, a challenge that should be pursued on at least two different levels. On the most general level, governments need to diffuse a sense of shared commitment to a collective project of national development. The essential complement to this broad ideological commitment is a more concrete set of ties that enable specific agencies and enterprises to construct joint projects at the sectoral level.[42]

Cooperating with the private sector does not mean taking it for granted that local business groups will behave like Schumpeterian entrepreneurs. Instead, an approach combining engagement and support with scepticism and pressure is needed, in order to transform the character of private corporate elites. Specifically, policies of rent creation and discipline are called for so as to better manage profits and investment. However, the danger must be avoided of rents becoming more permanent, which in the long run would weaken entrepreneurship and hamper productivity growth, a feature which has been all too common in SSA. There are two possible solutions. The first is to establish policy mechanisms and institutions to ensure that creating the initial rents is essentially a "priming" exercise and that the support and protection are eventually withdrawn as the industry matures. The second is to impose performance

criteria, in particular by using the discipline of the international market through, for example, export targets – a process sometimes described as establishing "contests".[43] In this way, infant industries promoted through state-created rents are expected to eventually prove themselves by the standards of the international market, to have their import protection gradually removed and/or to be pushed by the government to start exporting at a relatively earlier stage of development.

Behind any successful management of rents lies a much deeper process of building a robust network of government and business institutions consistent with strategic development goals. This will involve creating a series of formal and informal links with the entrepreneurial classes to assist in the design, implementation and coordination of policy measures. Such links can be established through sector-specific agencies within existing bureaucracies or the creation of specialized institutions. Deliberation councils are perhaps the archetypal forum for private entrepreneurs to filter policy proposals. But other organizational tools can serve a similar purpose, including task forces led and managed by the private sector, and major conferences bringing together business leaders, academics and government technocrats.[44] Such arrangements cannot be artificially imposed on countries in SSA and should, in any case, begin modestly. However, there are already some successful examples, such as in Ghana and Mauritius, which suggest that efforts in this direction can provide a fruitful avenue for building trust between the State and private actors.[45] ■

Notes

1 For further discussion see *TDR 1997*, Part Two, chapter V.

2 For further discussion of such measures see *TDR 1997*, Part Two, chapter VI.

3 For a useful discussion of what is known about those limits, see J. Stiglitz, "More instruments and broader goals: Moving toward the post-Washington Consensus", The 1998 WIDER Annual Lecture, Helsinki, January 1998.

4 These issues are discussed at greater length in *TDR 1991*, Part Two, chapter III.

5 For a discussion of these issues, see M. Nissanke, "Financing enterprise development and export diversification in sub-Saharan Africa" (Geneva: UNCTAD, 1998), mimeo; and N. Lipumba, "Liberalisation of foreign exchange and financial markets: What have we learned?" (Helsinki: WIDER, 1998), mimeo. For evidence on financial market liberalization in Uganda see L. A. Kasekende and M. Atingi-Ego, "Impact of liberalisation on key markets in sub-Saharan Africa: The case of Uganda" (Kampala: Bank of Uganda, 1998), mimeo.

6 See N. S. Ndung'u and R. W. Ngugi, "Impact of liberalisation on key markets in sub-Saharan Africa: The Kenyan case" (University of Nairobi, 1998), mimeo.

7 See J. Stiglitz and M. Uy, "Financial markets, public policy, and the East Asian miracle", *World Bank Research Observer*, Vol. 11, August 1996.

8 See T. Hellman et al., "Financial restraint: Toward a new paradigm", in M. Aoki et al. (eds.), *The Role of Government in East Asian Economic Development* (Oxford: Clarendon Press, 1997); and M. Nissanke and E. Aryeetey, "Comparative institutional analysis: Sub-Saharan Africa and East Asia", paper prepared for the African Economic Research Consortium (AERC) Conference on Comparative African and East Asian Development Experience, Johannesburg, November 1997 (mimeo).

9 See N. Lipumba, "Structural adjustment policies and economic performance of African countries", in UNCTAD, *International Monetary and Financial Issues for the 1990s,* Vol. V (United Nations publication, Sales No. E.95.II.D.3), New York and Geneva, 1995.

10 For the evolution of exchange rate arrangements in SSA see IMF, *Exchange Rate Arrangements and Exchange Restrictions* (Washington, D.C.: IMF), various issues. See also Lipumba, *op. cit.*

11 See L. A. Kasekende, D. Kitabire and M. Martin, "Capital inflows and macroeconomic policy in sub-Saharan Africa", in UNCTAD, *International Monetary and Financial Issues for the 1990s*, Vol. VIII (United Nations publication, Sales No. E.97.II.D.5), New York and Geneva, 1997.

12 *Ibid.*, p. 71. For a discussion of these issues see, for example, P. K. Asea and C. M. Reinhart, "Le prix de l'argent: How (not) to deal with capital inflows",

Journal of African Economies, AERC Supplement, Vol. 5, 1996, pp. 231-271.

13 P. Collier and J. Gunning, "Explaining African economic performance" (Oxford University: Centre for the Study of African Economies, 1997), mimeo, p. 3.

14 See Lipumba, *op. cit*.

15 H. Körner, "The 'brain drain' from developing countries: An enduring problem", *Intereconomics*, Vol. 33, No. 1, 1998, p. 27.

16 R. Lucas, "Why doesn't capital flow from rich to poor countries", *American Economic Review*, Vol. 80, 1990, pp. 92-96.

17 P. Meller, "The role of international financial institutions: A Latin American perspective", in G. Helleiner (ed.), *The International Monetary and Financial System* (London: Macmillan, 1996), p. 268.

18 See UNCTAD, *Foreign Direct Investment in Africa* (United Nations publication, Sales No. E.95.II.A.6), New York and Geneva, 1995.

19 See M. Odle, "Foreign investment opportunities in Africa", paper prepared for the International Conference on Reviving Private Investment in Africa: Partnerships for Growth and Development, Accra, Ghana, June 1996.

20 See R. Rasiah, "The export manufacturing experience of Indonesia, Malaysia and Thailand: Lessons for Africa", Discussion Paper No. 137 (Geneva, 1998).

21 L.K. Mytelka and T. Tesfachew, "The role of policy in promoting enterprise learning during early industrialization: Lessons for African countries", paper presented at the UNCTAD Workshop on Economic Development and Regional Dynamics in Africa: Lessons from the East Asian Experience, Mauritius, 4-5 December 1997.

22 On the role of FDI in East Asia and the policy lessons see *TDR 1996*.

23 For a clear argument in support of local government reform, see M. Mamdani, *Citizen and Subject: Contemporary Africa and the Legacy of Late Colonialism* (Princeton, N.J.: Princeton University Press, 1996).

24 See UNCTAD, "National institution building to facilitate access to risk management markets for small producers and traders" (TD/B/CN.1/GE.1/2), Geneva, 1 August 1994.

25 Stiglitz, *op. cit*., p. 16.

26 See *TDR 1994*, Part Three, chapter I; G. Helleiner, *Trade Policy and Industrialization in Turbulent Times* (London: Routledge, 1994); T. Biggs and P. Srivastava, "Structural aspects of manufacturing in sub-Saharan Africa: Findings from a seven country enterprise survey", World Bank Discussion Paper No. 348 (Washington, D.C.: World Bank, 1996); and S. Lall, "Trade policies for development: A policy prescription for Africa", *Development Policy Review*, Vol. 11, 1993.

27 See UNCTAD, *Directory of Import Regimes* (United Nations publication, Sales No. E.94.II.D.6), New York, 1994; and UNCTAD, TRAINS [Trade Analysis and Information System], CD-Rom (Geneva: UNCTAD, 1998).

28 It is interesting to note in this context that, according to the Uganda Investment Authority, cars currently account for 16 per cent of Uganda's imports compared with only 8 per cent for machinery (*Le Monde*, 3 March 1998).

29 See H. Tokeshi, "Trade reform in Zambia", Informal Discussion Paper 1, World Bank Macroeconomic Unit for Southern Africa (Washington, D.C.: World Bank, 1997).

30 For a useful discussion see P. Harrold et al., "Practical lessons for Africa from East Asia in industrial and trade policies", World Bank Discussion Paper No. 310 (Washington, D.C.: World Bank, 1996).

31 Japan faced discriminatory quantitative restrictions for many years after joining GATT, as many countries invoked the non-application clause against it. Other East Asian countries faced a series of non-tariff barriers, including voluntary export restraints in textiles and clothing and other sectors, as well as the threat of countervailing duties applied without the "injury test" by the United States (until the acceptance of the Tokyo Round Code).

32 According to the UNDP *Human Development Report 1997*, industrial countries spent $182 billion on agricultural subsidies, equivalent to 65 per cent of African GDP. See also UNCTAD, *International Trade Liberalization Measures and Implications for Export Diversification in Africa*, forthcoming, December 1998.

33 See UNCTAD, *The Least Developed Countries, 1997 Report* (United Nations publication, Sales No. E.97.II.D.6), New York and Geneva, 1997, Part III.

34 See *TDR 1997*, Part Two, chapter V.

35 See T. R. Gurr, *Minorities at Risk: A Global View of Ethnopolitical Conflicts* (Washington, D.C.: United States Institute of Peace Press, 1993).

36 On myths about African States, see T. Mkandawire, "Thinking the impossible? Developmental States in Africa" (Geneva: UNCTAD, 1998), mimeo; and for a general review of the social science literature on the African State, see C. Gore, "Social exclusion and Africa south of the Sahara: A review of the literature", International Institute for Labour Studies Discussion Paper 62, Geneva, 1994, chapter 5. A useful antidote to excessive pessimism about African development management is D. K. Leonard, *African Successes: Four Public Managers of Kenyan Rural Development* (Berkeley and London: University of California Press, 1991).

37 East Asian bureaucracies were often accused, by outside observers, of harbouring conservative practices and of being unable to organize their economic development. It is instructive to recall that until the 1960s, for example, the Republic of Korea sent its bureaucrats to Pakistan for training in economic policymaking.

38 See I. Elbadawi and G. Helleiner, "African development in the context of the new world trade and financial regimes: The role of the WTO and its rela-

tionship to the World Bank and the IMF", paper for the AERC project on Africa and the New World Trading System, Nairobi, April 1998.

39 S. Schiaro-Campo, "Reforming the civil service", *Finance and Development*, Vol. 33, No. 3, 1996, p.10.

40 East Asian experience points to a diversity of options aimed at producing parity. See J. Campos and H. Root, *The Key to the Asian Miracle: Making Shared Growth Credible* (Washington, D.C.: Brookings Institution, 1996).

41 The Republic of Korea attempted a much wider reform of the civil service and relied more on dedicated career bureaucrats, whereas Taiwan Province of China was more willing to identify special career tracks and recruit external people in mid-career using the Taiwan National University and successful completion of graduate training abroad as selection tools. Singapore is different again: potential recruits are identified in secondary schools and given government scholarships for higher education in return for a commitment to enter the civil service; see P. Evans, "Transferable lessons? Re-examining the institutional prerequisites of East Asian economic policies", *Journal of Development Studies*, Vol. 34, No. 6, August 1998.

42 It is worth noting that in East Asia these connections did not spring into place fully developed. Indeed, according to one recent assessment, "the evolution of government-business ties in East Asia has been even more convoluted and counter-intuitive than the evolution of the bureaucracy itself"; see Evans, *op. cit.*, p. 74.

43 See World Bank, *The East Asian Miracle: Economic Growth and Public Policy* (New York: Oxford University Press, 1993).

44 See Campos and Root, *op. cit.*

45 Harrold et al., *op. cit*.

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