DEVELOPMENT ISSUES IN THE CURRENT INTERNATIONAL MONETARY SYSTEM

EDITED BY
DAHLAN SUTALAKSANA

ESSAYS IN HONOUR OF BYANTI KHARMAWAN

Byanti Kharmawan

This book has been specially commissioned by the South East Asian Central Banks Research and Training Centre in memory of the late Byanti Kharmawan, who from 1968 until his death in 1982 was an Executive Director of the International Monetary Fund. Born in Indonesia in 1906, he held a succession of distinguished positions at Bank Indonesia and the Asian Development Bank before joining the IMF. Throughout his career, he dedicated himself to the cause of the developing countries as a whole. Byanti Kharmwan was one of those who believed that the International Monetary System had a crucial role to play in Third World countries. His personal commitment to this belief has greatly advanced the interests of these developing nations and it is in honour of his lifetime endeavours that this volume is dedicated.

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Essays in Honour of Byanti Kharmawan (1906–1982)

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In Memory

BYANTI KHARMAWAN*

(1906–1982)

Biography

Byanti Kharmawan was born in Tegal, Central Java, Indonesia on 1 June 1906. He was educated in Indonesia and the Netherlands, graduating with honours from the Rotterdam School of Economics in 1931. He began his career as civil servant at the Indonesian High Commissioner's Office at the Hague in 1949, before returning to Jakarta to work with the Ministry of Economic Affairs and the Ministry of Finance. He joined Bank Indonesia in 1953 and served as its representative in Europe. In 1961, he was appointed Chief Economic Adviser of Bank Indonesia and was an architect of the 1963 Government's economic stabilization efforts, negotiating credits with the International Monetary Fund, the United States, several European countries and Japan. Prior to his assignment as an Executive Director in the Asian Development Bank in 1966, he was at Columbia University, New York, in 1964, to do research and lecturing. His career in the International Monetary Fund (IMF) began in 1968, when he was nominated as an Executive Director, until his death on 5 October 1982 in Toronto, Canada.

His views

Although Byanti Kharmawan was representing the South East Asian region, Nepal and Fiji on the Board of Executive Directors of the IMF, to his colleagues he was known for his dedication to the cause of the

* Previously bearing the name Khouw Bian Tie.

developing countries as a whole. He believed that for the developing countries the fixed exchange rate system is the best alternative. In J. J. Polak's words, 'Kharmawan was a firm believer in the par value (Bretton Woods) system'.

Byanti Kharmawan's position was clearly articulated in his statements in one of the Board of Executive Directors discussions in the early 1970s on the Smithsonian alternatives:

> 'For years the Fund had been advising them (the developing countries) to create conditions of internal and external stability as prerequisite for a balanced and sustained growth of their economies and as the means of achieving stable exchange rates. In the Fund's philosophy, exchange rate stability and monetary discipline were interlinked.'
>
> 'What, then, were the implications of the interest some developed countries now showed in studying the possibility of introducing flexibility into the exchange rate system? Would the introduction of such flexibility, consciously or unconsciously, lead to the postponement of the measures to be taken in the monetary and fiscal fields.'
>
> 'The authorities of the members that had elected me doubted that this inquiry into exchange rate flexibility was necessary.'[1]

To the South East Asian Central Banks (SEACEN) Research and Training Centre, Byanti Kharmawan was among the first to exercise initiative at establishing this institution both to formalize the co-operation among the voting group members and to enhance their professionalism in central banking. Until his death he was the main supporter among the IMF's officials for co-operation between the IMF and The SEACEN Centre. His dream was to see The SEACEN Centre become an institution capable of serving the needs of the central banks and monetary authorities in the South East Asian region, as he said enthusiastically during the SEACEN Board of Governors Meeting in Colombo in 1981:

> 'I look to the day when The SEACEN Centre would expand itself large enough to run parallel to the BIS (Bank for International Settlements) which serves the central banks in Europe.'[2]

His character

Byanti Kharmawan's tragic death shortly after the IMF Annual Meeting in 1982, when he had been re-elected for the seventh time as an Executive Director in the IMF, shocked his colleagues and left in them a deep sense of loss, much akin to a personal one.

Close friends of Byanti Kharmawan and those who know him personally through all the years of his career have expressed their sentiments about his character in various fashions.

'Byanti Kharmawan had a remarkable grasp and understanding of the technical and administrative issues involved in the operations of the Fund, and an equally remarkable facility of explaining these often complex issues. It was a particular achievement on his part to remain in his office for many years representing our voting group until his sudden death. He gained much respect for his ability and conscientious effort from those associated with him both in the Fund and outside it.'
(*Tun Ismail bin Mohamed Ali*, Chairman of Permodalan Nasional Berhad, Malaysia and former Governor of Bank Negara Malaysia)

'The closeness of our relationship was enhanced because both of us represented groups of developing countries with common problems. I learned a great deal from Byanti during the years when I had the privilege of working with him. He was a man of vast experience, a trenchant mind, and had extraordinarily good sense. He was also extremely kind and invariably understanding of human problems of the people he dealt with. He leaves a big gap and I missed him greatly'.
(*Prof. Alexandre Kafka*, Executive Director, IMF)

'I knew Byanti Kharmawan as a UN diplomat, as a central banker, as an ADB Executive Director, and as a colleague on the Executive Board of the IMF. His personal and intellectual standing among officials of all countries, developing and developed, and of all international organizations, greatly helped the cause of Third World nations. His untimely death in 1982 was a tragic loss not only for his family and his country, but also for the whole developing world.'
(*Dr Benito Legarda*, Economic Counsellor, Philippine Embassy, Washington DC and former Deputy Governor of the Central Bank of the Philippines.

'Through his wise counsel, his perspicacity, his pragmatism, his deep knowledge of the economic and financial world and his sharp mind, Mr Kharmawan exerted a very strong influence over the Fund and its Executive Board. He belonged to that very uncommon kind of men whose abilities are never questioned, and who, by mere character strength and intellectual superiority, succeed in conceiving and winning acceptance for practical and constructive solutions to complex problems. Mr Kharmawan was a true Director of the Fund to the full extent of the word. He indeed held himself

responsible for the promotion and the achievement of the missions of the Fund and, more specifically, of its role with regard to the developing countries.'
(*Mr Jacques de Larosiere*, Governor, Banque de France and former Managing Director of the IMF)

'Mr Kharmawan will be long remembered by his colleagues for his sincerity, warm feelings, and intellectual capacity and for his contribution towards the development and reform of the international monetary system, particularly for the entire developing world. Mr Kharmawan was also a great friend of Burma, and will be fondly remembered as the main architect for initiating and strengthening monetary and technical co-operation between the central banks of Indonesia and Burma.'
(*Mr Maung Maung Hla*, Chairman (Rtd) of the Union of Burma Bank)

'I was always met by his personal warmth and kindness. Mr Kharmawan was liked by all, and especially in the later years, he was generally regarded as the 'eminence grise' of the Fund. While representing most ably a group of developing countries from South East Asia, he never espoused narrow positions favouring a particular group of countries but, on the contrary, sought to advance solutions that would be advantageous to all groups of members of the institution, and indeed to the international monetary system as a whole.'
(*Dr Jacques J. Polak*, former Executive Director of the IMF)

'He was for the interests of developing but he also was realistic. We are not only deprived of his sound and wise counsels but also his dry but witty sense of humour which never failed to brighten up any serious discussion. We had lost someone whom we all completely trusted and respected, who had more than ten years represented our South East Asian Group very effectively in the Fund. Our fond memory of him will remain vivid as long as we live.'
(*Mr Nukul Prachuabmoh*, Chairman of the Board of Directors of Siam Motor Co., Ltd, Thailand and former Governor of Bank of Thailand)

'Mr Byanti Kharmawan, whom I knew when I was in the Board of the International Monetary Fund, was an impressive personality and always worked for strengthening the powers of the Fund for the greater benefit of the developing countries. His forceful, wise and

incisive interventions championing the cause of developing countries as well as the reform of Fund policies were seldom surpassed.'
(*Dr Warnasena Rasaputra*, Governor, Central Bank of Sri Lanka and former Alternate Executive Director of the IMF)

'I will always remember Mr Kharmawan not only as one of the best economists of the world who had a profound knowledge of the monetary issues and problems confronting both the developed and developing world and who contributed significantly to the reform of the world monetary system in the 1970s, but also as one who was an excellent human being, always kind, understanding, affable and charming. He was a gem among men.'
(*Mr Kul Shekhar Sharma*, Chairman of Integrated Development Systems, Nepal and former Governor of Nepal Rastra Bank)

'Byanti Kharmawan is a dear friend and respected colleague of mine who in his lifetime contributed greatly the South East Asia voting group by serving as their Executive Director in the IMF. He understood the issues faced by the central banks of the developing countries and he rarely hesitated to speak out on them at the appropriate moment. He was indeed an excellent representative of the school of monetary professionals who combined enthusiasm for rapid change with the realism to wait for the proper opportunity for taking action.'
(*Dr Arifin M. Siregar*, Minister of Trade and former Governor of Bank Indonesia)

'Mr Byanti Kharmawan was a remarkable personality. I was often impressed by his constructive and wise interventions. With his experience and insight he gained considerable influence in the Executive Board of the Fund. It was a privilege for us to travel in Indonesia with Byanti Kharmawan and to profit of his knowledge of the country and his wide-ranging and universal interests. His passing away was a personal loss to me.'
(*Dr H. Johannes Witteveen*, Advisor to the Board of Managing Directors, AMRO Bank N.V., Holland and former Managing Director of the IMF)

'His seniority in the Executive Board of the IMF combined with his amazing grasp of detail enabled him to make a significant contribution in all the major decisions that were taken. This was of immense benefit to all member countries in the South East Asian voting group. His eloquent exposition at briefings should be a model for all

to emulate. Above all, I valued him as a kind and sincere friend of Singapore and also personally.'
(*Michael Wong Pakshong*, Senior Adviser to Wearne's Brother Services Pte Ltd, Singapore and former Managing Director of the Monetary Authority of Singapore)

Notes

1. Derived and re-edited from Margaret Garritsen de Vries, 'The International Monetary Fund 1966–71, Volume I: Narrative', IMF, 1976.
2. Derived and re-edited from 'Notes of Meeting of Board of Governors, January 15, 1981, Colombo, Sri Lanka', The SEACEN Centre, 1981.

Contents

Contributors

Michel CAMDESSUS, French, has been the Managing Director of the International Monetary Fund (IMF) since 1987. He graduated from the University of Paris and earned postgraduate degrees in economics at the Institute of Political Studies of Paris and the National School of Administration. His career has been mostly with the French Civil Service since he joined the Treasury of the Ministry of Finance and Economic Policies in 1960. He was the Director of the French Treasury (1982–4) and the Chairman of the Paris Club (1978–84) prior to his appointment as the Deputy Governor in August 1984 and subsequently as the Governor of the Bank of France in November 1984.

Professor Stephen Malcolm GILLIS, American, is the Professor of Public Policy and of Economics, Institute of Policy Sciences and Department of Economics, Duke University (from 1984) and Dean of the Graduate School and Vice-Provost for Academic Affairs (from 1986) of the same university. He obtained his BA (1962) and MA (1963) from the University of Florida and his Ph.D. in 1968 from the University of Illinois. Previously he was the Assistant Professor of Economics, Duke University (1967–9) and gave lectures at the Harvard Law School (1969–71) before he joined the Harvard Institute for International Development (1974–84) as the Institute Fellow and Lecturer in the Economics Department. Professor Gillis has written several articles and books mainly on development economics and fiscal policy.

Dr Ulrich HIEMENZ, German, is the Head of Development Economics Department, Kiel Institute of World Economics, Kiel, West Germany. He acquired his Degree in Economics (Diplom-Volkswirt) in 1969 and obtained his Doctorate in 1972 from the University of Regenburg, Germany. He was teaching in economics at the University of Regenburg (1970–3), before he joined the Kiel Institute from 1973 to 1980. He was the Senior Economist at the Economics Office of the Asian Development Bank (1981–3) before he returned to the Kiel Institute to assume his present position. He has had articles published in various journals.

Professor Alexandre KAFKA, Brazilian, has been Executive Director in the IMF since 1966. Professor Kafka's career is a well blended combination of government and academic posts in the field of international economics. He was Professor of Economics of the University of São Paulo, Brazil (1941–9), and was affiliated with the IMF (1949–51) before he was appointed to become an Executive Director in 1966. In between he served as the Adviser, Superintendency of Money and Credit, Brazil and as Adviser to the United Nations (1956–9) besides his assignment as the Director of the Brazilian Institute of Economics, Getulio Vargas Foundation (1951–63). He was also Professor of Economics in several universities in the USA, namely University of Virginia (1959–61 and 1963–79), its Law School (visiting lecturer, 1980–), and Boston University (visiting Professor of Economics, 1975–7). He has written numerous articles and publications.

Dato' Dr LIN See Yan, Malaysian, has been the Deputy Governor of Bank Negara Malaysia (the Central Bank of Malaysia) since 1983. He joined Bank Negara Malaysia following his graduation, BA (Hons) in Economics, from the University of Malaya in Singapore in 1961. He continued his education at Harvard University, Cambridge, USA where he obtained his MPA and MA in Business and Finance in 1972, and completed his Ph.D. in economics in 1977. He was conferred the title Dato' by the Sultan of Perak in 1985. Dato' Dr Lin has contributed several articles in the field of monetary economics, on theory as well as policies.

Dr Seiji NAYA, American, is currently Director of the Resources System Institute, East-West Center, and concurrently Professor of Economics, University of Hawaii, Honolulu. He holds a Ph.D. from the University of Wisconsin and a BBA from the University of Hawaii. Dr Naya was Chief Economist of the Asian Development Bank in Manila (1980–3); Director, Asian Studies Program, University of Hawaii (1978–80) and Visiting Professor, Thammasat University, Bangkok, Thailand (1972–3 and 1975–6). He was also Faculty Research Fellow at the National Bureau of Economic Research in 1968–9. He was the founding editor of *Asian Development Review* (an Asian Development Bank publication). His research has focused on the international economic problems of Asian countries, and he has written many professional articles and books on the subject.

Pearl Y. IMADA, American, is Research Fellow at the Resources System Institute, East-West Center, Honolulu. She is currently enrolled in the Ph.D. programme in the Department of Economics at the University of Hawaii, Manoa. Her earlier education was at Grinnel College, Grinnel, Iowa (BA in Economics major, 1977) and Hitotsubashi University, Department of Economics, Tokyo (MA, 1982). She began her teaching

career in 1982 as a Teaching Assistant at the University of Hawaii, Manoa. Ms Imada has written several articles related to development issues in Asia.

Dr Jacques J. POLAK, although born and educated in the Netherlands and still a Netherlands citizen, pursued his entire career outside of the Netherlands and has resided in the United States since 1940. Prior to his recent assignment as Senior Advisor (1987) to the Development Centre, OECD and consultant to the World Bank, he was an Executive Director in the IMF (1981–6), which he joined in 1947. Previously his service was dedicated mostly to the League of Nations and the United Nations (1937–46). Dr Polak, who was educated at the University of Amsterdam (MA, 1936; Ph.D., 1937), has also taught as professorial lecturer at the Johns Hopkins University (1949–50), the George Washington University (1950–5) and the Johns Hopkins University School for Advanced International Studies (1987–) and has published several books on economics and various articles in economic journals.

Dr Arifin M. SIREGAR, Indonesian, was the Governor of Bank Indonesia prior to his appointment as Minister of Trade in 1988. He graduated from the Netherlands School of Economics, Rotterdam in 1956 and continued his education at the University of Munster, West Germany, where he received his Masters Degree in 1958 and his Ph.D. in Economics (Magna Cum Laude) in 1960. Previously he joined the United Nations in New York (1961–3) and in Beirut (1963–5). He later joined the International Monetary Fund (1965–71) prior to his appointment as the Managing Director of Bank Indonesia in 1971. Dr Siregar has several publications and articles in various journals to his credit.

Dr U Tun WAI, a Burmese national, is currently a Distinguished Fellow in International Banking and Finance at the Institute of South East Asian Studies in Singapore, following his retirement as the Deputy Director of the International Monetary Fund Institute in 1987, the position he held for 14 years. Educated at the Universities of Rangoon, Burma (IA, 1941), Bombay, India (BA, 1944), and Yale, USA (MA, 1945; Ph.D., 1949), he has had a long and distinguished career. After serving as Head of the Economics Department of the University of Rangoon 1948–9, he worked in various capacities at the United Nations Economic Commission for Asia and the Far East from 1949 to 1955 and at the IMF from 1955 to 1987. His broad experience at the IMF included serving as the editor of *International Financial Statistics*. Dr U Tun Wai is well known for his economic articles in learned journals and has published several books in development economics.

Foreword

I am honoured to have been given the opportunity to write a few words of introduction to this festschrift in memory of a distinguished gentleman, economist and international civil servant. Mr Byanti Kharmawan, friend and colleague to many in all parts of the world, was all of these and more during a remarkable career that spanned half of this century until his death at the age of 76 in 1982.

The events of Mr Kharmawan's life were not cast in a single mould. The rich mix of contributions in this volume mirrors Mr Kharmawan's intense involvement in all the big economic questions facing the developing countries. This was an area where Mr Kharmawan brought his intellect, experience and diplomacy to bear upon an increasingly wider stage. In his native Indonesia, during the 1960s, Mr Kharmawan was a key player in developing both his country's economic stabilization efforts and an approach to the balance of payments that laid the foundation for Indonesia's subsequent economic progress. After these successes, at an age when most men would gradually move toward retirement, Mr Kharmawan did just the opposite. He moved on to the international stage, first representing a wide group of Asian countries at the Asian Development Bank, and then at the International Monetary Fund where his interests broadened well beyond the countries he represented. Along the way he helped found The SEACEN Centre that is now sponsoring this volume.

Mr Kharmawan's 14-year stay at the Fund, right until the time of his death, was remarkable in many ways. At the Fund's Executive Board, he is remembered as the man who always asked the probing questions, whose influence of fund policies far transcended the boundaries of his constituency and whose statesman-like skills helped guide the Executive Board toward workable compromises affecting countries all over the world. In many ways he was the conscience of the Executive Board, acutely aware of the social and political contexts in which economic policies have to be formulated and implemented. At the time of his death in 1982, his colleagues at the Fund noted that he was a man who 'strove not simply to defend limited interests, but always kept broad interests to the fore'.

In this volume of essays, Mr Kharmawan is being remembered for his contributions to the world of economic and public affairs. But there was more to his world than the economic questions he helped answer. He took pride in his academic and business achievements claiming that these pursuits helped keep him in touch with the real world. Less known perhaps, but equally important to the man, were his wide linguistic and literary interests that served him as a journalist and inspired him to speak in many languages and write on subjects as diverse as Dutch poetry and Indonesian nationalist movements. Never far from thinking about deeper philosophical issues, he also developed a special understanding of world religions.

The papers in this volume will serve Mr Kharmawan's memory well. They bear upon the major economic issues facing the developing world – how to mobilize additional resources and how to use these resources in the most effective way to stimulate the higher levels of growth on which depend the hopes of hundreds of millions of people for a better life.

In the Fund, which was Mr Kharmawan's principal arena for the last decade and a half of his life, we are also debating these issues as we consider how imaginatively the international system can contribute to the strengthening of a growth momentum. As part of an international effort, the Fund has sought to marshal concessional resources that will be available with relatively long maturities to help the Fund's poorest members in their courageous efforts to strengthen their economies through structural adjustment. As we proceed to support these efforts through this new structural adjustment facility, we must constantly search for other initiatives that would also contribute to durable growth.

The success of internationally co-ordinated financial efforts such as these, however, ultimately depends upon the policies of governments in both industrial and developing countries. In the increasingly interdependent global economy in which we live, there can be no durable gains for anyone unless there are gains for all. This is the message of economic co-operation that Mr Kharmawan helped develop and which finds increasing acceptance everywhere today. I am happy that some of the important Asian experiences are reported in this volume – they certainly have implications and lessons for policy-makers in other countries and regions as well. I commend SEACEN's initiative in bringing out this volume of essays that will further illuminate and extend this debate even as they pay homage to one key participant.

Michel Camdessus

Editorial Preface

In the 1980s the world's concern over the problems faced by the developing countries has been growing. Some developing countries are worried over the increasing income gap they are experiencing relative to the industrial countries, and others are distressed at their fast growing debt burden.

A majority of developing countries have drawn wide international attention largely because of their failure in trying to build up their economies. Why should this happen after decades of search for guidance in theoretical doctrines and after the implementation of an enormous number of experiments to solve the problem of development? What went wrong?

One possible explanation pointed to the possibility that the role of the international environment has not been properly treated in the previous analyses of development. Some economists have argued that the major responsibility for progress is in the hands of the developing countries themselves. However, the facts showed that these countries alone could not posssibly solve the problem. Development depends fundamentally both on their own economic policies and on the international environment. Economists like Williamson and Gabin furthermore argued that 'developing countries for some years suffered from unsatisfactory functioning of the international monetary system'.[1]

Since its establishment, the International Monetary Fund (IMF) has been very active in rescuing the developing countries from the damaging effects of international economic crises. The World Bank and its group have also extended tremendous amounts of funds to promote economic growth in these countries. In recent years, both institutions have remarkably increased their contributions to support the developing economies. The IMF's Enhanced Structural Adjustment Facility (ESAF) and The World Bank's General Capital Increase (GCI) are concrete examples of the increased efforts adopted by these leading institutions.[2]

These facts raise more questions to be answered. Is there any positive role for the international monetary system to play in the development process of the developing countries? Or, how can devel-

oping countries derive strength from the present international monetary system?

Byanti Kharmawan was one of those who believed that the international monetary system is a critical element to the developing countries in accomplishing their objectives. It is in his honour that The SEACEN Centre publishes this collection of essays on the 'Development Issues in the Current International Monetary System', a theme that reflects his lifetime endeavour.

This volume assembles the thoughts of a number of prominent writers in the field of international monetary affairs and economic development which should give its readers comprehensive and integrated views in approaching the issues.

'The VAT in Developing Countries: Taxation of Financial Services', by Professor S. Malcolm Gillis, reflects the author's endeavour to search for an alternative in improving the tax base of developing countries, by promoting the value added tax (VAT) system to the service sector, a viable target.

Dr Ulrich Hiemenz's paper, 'On the Inter-relation between Trade and Growth in Developing Countries', presents his theoretical and empirical observations on the inter-relation between trade and growth.

In 'The International Debt Problem: Do We Need a New Debt Strategy?', Professor Alexandre Kafka discusses the present strategies to solve the problems of debt-ridden developing countries and some suggestions to refine them.

Dr Lin See Yan, in 'The Flow of Funds for National Development: Savings, Investment and the Mobilization of Domestic Resources in Malaysia', focuses on the Malaysian evidence using the flow of funds approach.

The article on 'Economic Performance of Asian Developing Countries' by Professor Seiji Naya and Ms Pearl Imada tries to analyse the evidence gained from Asian developing countries and to apply it generally to the developing countries.

Dr Jacques J. Polak's article on 'The Choice of an Exchange Rate Regime' is concerned with the options faced by the policy makers of the developing countries in foreign exchange rate policy.

'Monetary Policy in Developing Countries', by Dr Arifin M. Siregar uses the Indonesian case to describe a typical formulation of monetary policy in a developing country and special problems encountered by its monetary authority.

The final contribution by Dr U Tun Wai, discusses 'The Role of Developing Countries in the International Monetary System'. In this article, the author presents empirical tests of the economic positions of the developing countries in the world economy, and discusses the role of these countries in the present international monetary policy which is centred around the IMF.

Each of the contributions in this volume is self-contained and unique. The reader can capture the message of the author in each article. Nevertheless, the reader may gain comprehensive insights by absorbing all the interwoven issues presented in each essay in order to arrive at a clear view of the role of the international monetary system in the development process.

Dahlan M. Sutalaksana *15 March 1988*

Notes

1. John Williamson and Michael Gabin, 'International Monetary Issues in 1985', in UNCTAD's *Compendium of Selected Studies on International Monetary and Financial Issues for the Developing Countries*, New York: United Nations, 1987, pp. 1–32.

   Williamson and Gabin also argued that it would be wrong to blame all the world's economic troubles on the international monetary system. Nevertheless, it is a fact that misfortunes have resulted from policies that the major countries have chosen to pursue in the context of the present international monetary system.

2. Michel Camdessus in his remarks in the *23rd Conference of the Governors of South East Asian Central Banks* in Singapore on 20 January 1988, reported the support enjoyed by the IMF for its campaign to assist the developing countries; and as reported by the Associated Press in the *Asian Wall Street Journal* on 22 February 1988, the Board of Executive Directors of the World Bank has reached an agreement on a $74.8 billion general capital increase, to be subscribed by member countries until 30 September 1993. World Bank president Barber Conable was also reported as saying that he hoped the member governments would act with 'urgency' to ratify the agreement so that the Bank could step up its lending to Third World nations.

Acknowledgements

In 1985, Dato' Dr Lin See Yan, Deputy Governor of Bank Negara Malaysia, suggested the idea of a publication in honour of the late Mr Byanti Kharmawan, one of the notable supporters in the establishment of The SEACEN Centre. Subsequently, the Centre formulated a proposal and submitted it to the Fifth Meeting of the Board of Governors in Baguio City, Philippines, in early 1986 for their approval.

The SEACEN Centre has been encouraged by the enthusiastic response of the prominent writers from developed as well as developing countries, who have contributed to the present publication. Most of the contributors knew Mr Byanti Kharmawan in person, and others knew him by name. The Centre wishes to express its appreciation for their invaluable contributions which reflect the spirit of international co-operation.

The SEACEN Centre also wishes to acknowledge its indebtedness to Dr Rachmat Saleh, the former Governor and Dr Arifin M. Siregar, the Minister of Trade and former Governor of Bank Indonesia, for their encouragement and assistance in its efforts to publish this commemorative volume; and to Mrs Moedijah B. Kharmawan for the contribution of her husband's memorable photograph.

This note of appreciation would not be complete if it did not include in it Dr J. E. Ismael, Executive Director of the IMF and Mr Khong Kim Nyoon, his Adviser, for their valuable comments and assistance in the preparation of this publication.

The SEACEN Centre congratulates Mr Dahlan M. Sutalaksana, its Assistant Director for Research, for a work well done in organizing and editing this publication. Credit is also due to Ms Karen How, who has worked on the manuscripts and the correspondence; to Mr Baharuddin M. Dali, the Centre's Chief Librarian, who has skilfully assisted in the editing tasks; and to Dr U Tun Wai, an old acquaintance of the Centre, who has given valuable advice and helpful comments on this publication.

The SEACEN Centre wishes to acknowledge the positive support and assistance provided by its member central banks and monetary authorities in making this publication possible.

Last but not least, the Centre also wishes to acknowledge its appreciation to the World Bank (IBRD) and Matthew Bender & Co., Inc., for their permission to publish articles under their copyrights.

Dr Vicente B. Valdepenas, Jr
Director, The SEACEN Centre

Kuala Lumpur, Malaysia
April 1988

The VAT in Developing Countries: Taxation of Financial Services*

S. MALCOLM GILLIS

Introduction

Financial institutions have presented vexing problems in both the design and administration of income taxes.[1] Many nations are now encountering significant difficulties in applying value added taxes to financial institutions. Value added is clearly present in financial transactions, no less so than for transactions involving goods and other services. This does not necessarily imply that value added in finance is easily taxed nor that all financial services should be taxed under a value added tax (VAT). After 25 years of experience with value added taxation in Europe, it is now clear that truly satisfactory solutions to problems of taxing financial institutions under this tax have yet to be devised, much less implemented. The European experience with taxation of financial institutions under the VAT certainly does not furnish an abundance of positive lessons for developing countries considering adoption of a VAT. This is unfortunate, since inappropriate choices in applying VAT to financial services in such countries may impede the orderly development of their financial sectors. In turn, this outcome would tend to slow the process of growth and development, by hampering not only the emergence of efficient financial intermediation activities, but also efforts for mobilizing domestic capital resources as well as the capacity of the financial system to transform and distribute risk.

* This paper is the amended version of 'The VAT and financial services' prepared by the author for the Conference on Value Added Taxation in Developing Countries sponsored by The World Bank in 1987.

This paper will attempt to identify workable options for the VAT treatment of financial institutions in developing nations. A workable option is defined as one that is as consistent as possible with neutrality in the tax treatment of financial institutions, but which is also both administratively feasible and which does not place needless barriers in the way of orderly development of the overall financial system.

This paper is concerned primarily with designs of options for the type of VAT that extends through the retail sector. Moreover, it focuses only on the treatment of financial services under a consumption-type VAT, imposed on the destination principle, collected by the tax-credit method.[2] Restriction of the scope of the paper in this way is justified in a subsequent section on 'Possible options for VAT treatment of financial services'.

Financial sectors in developing countries

It was not until the mid-1960s that analysts and policy makers began widely to recognize the role of the financial system in the processes of growth and development in developing countries. Economists such as Shaw (1973) and McKinnon (1973) had by 1980 clearly established the importance of 'deep' finance[3] in mobilization of domestic resources, promotion of employment, growth and diversification of risks in both rural and urban settings. Successful financial reforms in Korea, Taiwan, Colombia, Brazil, Indonesia and a host of other countries tended strongly to support the 'financial deepening' thesis. It is now widely appreciated that policies, including tax policies, that lead to 'shallow' finance (a shrinkage in the real size of the financial system) are inimical to growth and development.

Differences in financial structure as between different developing countries are at least as great as differences in levels of income among these countries. Therefore, generalizations about financial structure in such nations are difficult to defend. Nevertheless, some commonalities may be cited.

In virtually all developing countries, the financial system consists of a remarkable variety of interconnected financial institutions, both formal (organized) and informal (unorganized). In very low-income nations, or in countries with long histories of strong inflation, the size of the unorganized financial sector may equal or exceed that of the organized sector. Except in Liberia and a few Francophone African countries, a central bank lies at the core of the financial system. But in all developing countries, the commercial banking system (public and privately owned) is not only the most visible, but the most critical component of the organized financial system. Commercial banks are

virtually everywhere the principal recipients of financial savings and the primary sources of domestic credit to the private sector. Development of other elements of the organized financial sector, including investment banks, savings bank and the non-bank financial intermediaries, is vitally dependent upon a well-functioning commercial banking sector. Non-bank financial intermediaries include life insurance companies, casualty insurance firms, reinsurance agencies and pension funds.

Co-existing with the more modern organized financial sector is the so-called 'unorganized' sector that in some countries antedates the organized sector by several centuries. This sector includes pawnshops, local money lenders, trade credit, co-operative credit and other informal arrangements involving the borrowing and lending of money, including intra-family transfers. Taxes, whether income or value added taxes, typically do not apply to the unorganized sector, whether by design or by default. This of course does not mean that the unorganized financial sector will be unaffected by taxes imposed on the organized sector.

In some countries, particularly in Latin America and East Asia, the organized financial system has been a major vehicle for mobilization of domestic savings. In other countries, and especially in Africa, the organized financial system has remained small and poorly developed, contributing little to resource mobilization or to the pooling of risks across the economy. (See, for example, Gillis *et al.*, 1983, chapter 3.) A major consideration in the design and implementation of the VAT in all developing countries is that of insuring that the tax does not jeopardize either of these vital functions of the financial system.

Comparative treatment of financial services under the VAT: developed and developing countries

The base of a consumption-type value added tax extends to – and is intended to be confined to – all personal consumption spending, including all services of a consumption nature. Failure to tax any consumption item, whether goods or services, favours the excluded services relative to taxed items. Nevertheless certain services, including some types of financial services, may be legitimately excluded for the VAT base because of administrative reasons, or because they do not represent consumption. Full inclusion of financial services in the VAT base has not proven practicable in VAT countries, for both reasons. Two methods have been utilized in attempts to free financial institutions from obligation to pay VAT: ordinary exemption and zero-rating. Firms prefer the latter to the former. As explained by Shoup (1987) the exemption method frees a firm from paying tax on sales of exempt items (services), but it does not free the item (services) from tax since the firm may still

pay VAT on its purchases. Zero-rating, however, achieves both. This is possible because there is a zero-rate of tax applied on sales and then a refund of any VAT paid on purchases.

European Community

After nearly two decades of experience with VAT in most European Community (EC) countries, satisfactory methods for full taxation of financial services have yet to be developed. Rather, practical problems in including banking services in the base of the VAT have led all EC countries to exempt, rather than zero rate, the 'core' activities of banks. No EC country attempts to apply VAT to such intermediation activities as loans, deposits or security transactions (Price-Waterhouse, 1979). Six out of nine EC countries do, however, apply VAT to several so-called 'secondary' activities of banks, including rentals of safe deposit boxes, printing of cheques and foreign exchange transactions. However, EC countries such as Germany do zero-rate banking services when these are 'exported' to countries outside the EC (International Bureau of Documentation, 1982, p. 53). Britain, however, zero-rates all financial services supplied to persons outside the UK (Price-Waterhouse, 1979).

While a portion of services supplied by banks is included within the VAT net, the entirety of services provided by insurance companies is non-taxable to the customers of such firms. Specifically, all EC countries have exempted all insurance services.

It is noteworthy that although EC countries do not generally attempt to apply VAT to financial services, many do impose other forms of indirect taxes on such services. In particular, all EC countries have special levies on insurance, sometimes expressed as a percentage of the premium, sometimes as a percentage of the value of the policy. In certain cases these taxes are substantial. In the mid-1980s, taxes on life insurance premiums were 4.8 per cent and 4.4 per cent in France and Belgium, respectively, and 6 per cent on several types of insurance in the Netherlands (Gillis, 1984).

Other countries

Israel has been the only country to attempt to apply VAT to a wide variety of financial services. However, the VAT imposed on financial institutions in Israel was unusual in that it was not of the 'subtraction method' tax-credit type. Under this common method of imposing VAT tax liability is computed by subtracting taxes paid on purchases from taxes due on sales. Israel, however, imposed a special 'addition' type of VAT on the financial sector.[4] A 12 per cent VAT rate applied to the sum of payrolls and profits of financial institutions.[5] No offsets were allowed for ordinary VAT paid by financial firms on their purchases, nor could

customers of banking firms credit the 'special' VAT against the ordinary VAT due on their sales.

The special VAT on financial institutions proved unworkable and unpopular. Firms using banking and insurance services, for example, could not utilize the special VAT as a credit against taxes due on their sales, and financial institutions could not use ordinary VAT paid on their purchases as a credit against the special VAT applied to their supply of financial services. In response to complaints from both groups, the government abolished the addition type of VAT on financial institutions in 1981, replacing it with a separate tax of identical coverage, but completely divorced from the VAT. Since the 1981 tax on financial institutions is not labelled a VAT, it is quite clearly non-creditable.

The principal lesson from the Israeli experience seems to be that efforts to apply an addition method VAT to financial services while other sectors employ the subtraction method leads to complications with tax-credit offsets. The solution adopted in Israel was to ignore the credit problem through enactment of special taxes on financial institutions, as in Europe.

The VAT treatment of financial institutions in New Zealand has been the topic of extended debate, as that country moved toward implementation of the VAT (called the Goods and Services Tax, or GST in New Zealand), in October 1986.

The Ministry of Finance originally proposed that most financial services (including all life insurance premiums) be exempt from the GST. Fire and general insurance as well as reinsurance services were, however, to be fully taxed. Firms in the financial sector that would be affected by exemption reacted strongly, primarily on grounds that exemption without credit would seriously complicate the GST compliance tasks for a large number of registered persons.[6] There were also concerns that exemption of financial institutions would endanger their international competitiveness, even with zero-rating of exports of financial services, as proposed by the government. And zero-rating of financial services was seen as complicating compliance with the tax (Advisory Panel on Goods and Services Tax (GST), 1985, p. 4), not to mention tax administration.

The Government's Special Advisory Panel, which included experts from the financial sector, proposed instead that the VAT be fully applied to all financial services except certain insurance. For insurance, the Panel endorsed the Government's proposal for full taxation of premiums for fire and general insurance policies, as well as reinsurance. The Panel however, also strongly recommended full taxation of premiums for 'pure life insurance' (both term and whole life policies), and exemption of that portion of any whole life premiums that involve a savings element for the policy-holder (Advisory Panel on GST, 1985, pp. 19–20).

Further, in the event that full taxation of financial services proved unacceptable to the Government, the Advisory Panel recommended

zero-rating instead of exemption (Advisory Panel on GST, 1985, p. 17). The Government subsequently rejected the Panel's recommendations on the VAT treatment of financial institutions, and announced in August 1985 that it would proceed with its original proposals virtually intact: exemption of all financial services save fire and general insurance and re-insurance (Douglas, 1985). Exports of all financial services, including both exempt life insurance services and taxable non-life insurance, were, however, to be zero-rated under the GST (Government of New Zealand, 1985).

Developing countries that have employed the retail form of the consumption VAT have in general opted for the EC treatment of financial services. The Korean VAT provided exemption, not zero-rating, to all insurance services and to financial services generally. However, in Korea as in Europe, services rendered outside the country are zero-rated (Republic of Korea, 1978, pp. 19–21). Latin American VAT countries also tend to follow the EC pattern. Both Argentina and Brazil exempt all financial services from VAT. Brazil, like most European countries also employs special taxes on financial institutions, called the 'Imposto Sobre Operacoes Financeiras (IDF)'. Chile, however, taxes general insurance under the VAT, but not life insurance companies, and exempts the 'core' activities of banks.

Generic issues in the application of VAT to financial institutions

VAT choice criteria and the financial sector

Developing countries contemplating adoption of the VAT face a large array of possible forms of the tax from which to choose (Shoup, 1969, 1987). Nevertheless, the scope of this paper is largely confined to discussion of issues in the taxation of financial services under one particular type of VAT: the EC type tax extended through the retail level, imposed upon consumption only, collected through the tax-credit method and levied on the basis of the destination principle. Restriction of the scope of the discussion in this way is justified for three reasons.

First, major issues in the tax treatment of financial services ordinarily do not arise, or are unimportant, under pre-retail types of VAT such as those employed in Indonesia after 1984 and in Colombia before that date. This is particularly true in the case of consumer banking services, life insurance services and pension funds, less so in the case of casualty insurance. For example, under a VAT extended only through the manufacturers' level, these institutions would not be defined as taxable 'manufacturers'. In any case, the fact that no component of interest paid to banks is subject to VAT is immaterial where registered firms are concerned: interest is an element of value added by manufacturing firms.

(See below: 'Possible options for VAT treatment of financial services'.) Furthermore, to the extent that purchases of life insurance services do represent consumption, this service is rendered essentially to final consumers and is therefore best seen as a 'retail' activity. Exclusion of casualty insurance services from a pre-retail VAT does give rise to problems, since in developing countries a high proportion of these services tend to be rendered to taxable manufacturing firms, if the Indonesian experience is typical. But this is merely one of the unavoidable costs of operating a pre-retail VAT. On balance, there are few good reasons for including financial institutions in the base of a pre-retail VAT.

Second, the discussion is limited to the EC 'consumption' type of VAT because this has been overwhelmingly the VAT of choice for the 25 or so developing countries that now operate a VAT, and because there are good economic and administrative reasons for that choice.

Third, other alternative methods for imposing VAT, including the 'addition' method, have never been successfully implemented by any central government anywhere, and the lone attempt in Israel to apply a special 'addition' VAT to financial institutions was finally abandoned after five years of disappointing experience.

Neutral tax treatment of financial services under a VAT and its conditions

There is no reason to presume that neutrality should be the overriding goal of tax policy. Governments may and often do make deliberate departures from neutral tax treatment of certain sectors of the economy, including the financial sector, in order to achieve other policy goals. Departures from neutrality, however, may involve costs, not only in terms of economic efficiency, but in administrative and equity terms as well. It is therefore essential that the conditions for neutrality be portrayed as clearly as possible in order to make these costs as transparent as possible, so that policy makers can weigh them against presumed gains from non-neutrality, including possible efficiency gains.

'Neutral' taxes are not necessarily 'efficient' taxes or 'optimal' taxes.[7] A neutral tax is defined as one that does not lead to material changes in the structure of private incentives that would prevail in the absence of the tax. While not nearly as intellectually satisfying a guide to tax policy as 'optimal taxation', neutral taxation is to be preferred as a benchmark until such time as analysts are able to identify optimal departures from neutrality in real world policy settings, and until such time as administrative capacities are equal to the task of operating necessarily complicated optimal tax structures. In both developed and developing countries that time will not likely arrive before the twenty-first century.[8]

Achievement of the aims of consumption taxation requires taxation of all personal consumption expenditure. Neutrality under a consumption-type VAT will be interpreted to require uniform taxation of all current personal consumption expenditure.[9] It should go without saying that any divergences from neutrality thus defined would be gladly accepted by most decision-makers in developing countries, whenever these divergences can be shown to satisfy the goals of optimal taxation at acceptable costs of tax administration and compliance.

Having established that neutrality in taxation is a less-than-hallowed concept and that optimality in taxation is less-than-practical, under existing technology and institutions, we may now proceed.

Neutral treatment in applying VAT to the financial sector involves four principal features:

1. Neutral treatment of financial services relative to other taxable goods and services.
2. Neutral treatment as between all types of financial institutions.
3. Neutral treatment between firms that specialize in financial services (banks, insurance companies) and other firms that do not specialize in finance but which offer financial services complementary to the principal activities (trade credit offered by wholesale houses and manufacturers, factoring and leasing firms, etc.).
4. Neutral treatment between domestic and foreign suppliers of financial services and, particularly, avoidance of unintended discrimination against maturing (infant industry) domestic financial institutions.

As discussed below, full neutrality thus defined is, at least at the present time, not feasible under any administerable VAT.

Difficulties in achieving neutrality

The principal sources of difficulty in achieving neutral treatment of financial services under a tax-credit consumption type VAT are of three principal types. First, problems in defining the value of taxable financial services. Second, problems due to substitutability between different types of financial assets and services and, third, implications of 'openness' of the domestic economy, particularly when capital is mobile internationally.

Defining financial services

This problem has two facets: identifying the service element in financial payments by and to financial institutions and isolating the consumption element in financial services thus identified.

Identifying the service element in financial payments
The taxable component of most non-financial services may be defined easily: the value of legal, advertising and barber services is measured by gross sales value. Value added in such services is defined as gross sales minus purchases from other firms. But the gross value of payments from and to financial institutions is generally not a good measure of the monetary value of the service rendered. Further, the service component of many payments for financial services is rarely identified as a separate, free-standing charge to customers.

1. *Banking* Consider first the case of banks. We focus here on the 'core' activity of banks: financial intermediation. Determination of the value of 'secondary' financial services is not at issue here. For so-called secondary services, such as safe deposit box rentals, the value of the service is the account of rental paid. For other secondary services, such as 'free' checking accounts, ascertaining value of the service is more difficult.

For banks, the value of loan repayments is not a measure of the value of the service to the borrower; the repayment consists both of nominal interest paid by the buyer and amortization of principal. Amortization must clearly be excluded in determining the value of the service. But what about interest paid by borrowers? Does this measure the value of the service provided by the lender, quite apart from the fact that (when inflation is anticipated) nominal interest rates are inclusive of inflation? Interest charged by banks must cover not only the costs of deposits, but also the gross margins of banks. Interest paid on deposits is clearly investment income to the recipient, not a component of 'services' provided to borrowers. The service element in bank lending then is the gross margin of the bank: this consists of intermediation costs plus profits associated with financial intermediation. This is a small fraction of total debt service, even in developing countries.

For loans to business firms registered for VAT, the entire discussion is largely irrelevant. Interest expenses of registered firms are part of their value added, and this value added is taxed at the level of the firm. It would therefore be inappropriate to tax any component of interest received by banks from registered firms.

Therefore, the VAT base for banking services would, at most, be the gross margins of banks in their lending to households and non-registered firms.

2. *Insurance* Neither the value nor the value added in insurance services is measured by the gross premium paid by policy-holders. We examine first the case of casualty (accident) insurance. Consider a very simplified insurance arrangement under which ten people cover their risks of accidents by each paying a 'premium' of $100 into a common

pool. Administering this pool costs $50, net of any interest earnings on the pool. The arrangement provides that a total of $950 will be paid to the first one of the ten who suffers an accident. It is clear that neither the premiums nor the payment of the claim represent value of the service. Rather both are transfers of money. The value of the service in this case is the cost of administering the pool: the cost of getting the money to the victim, where it is most needed. The 'loading charge', or net premium is $50. The loading charge is merely the excess of gross premiums over and above accounts required to cover losses (pay claims). The 'loading charge' for each policy-holder is $5.00. The value of the service to each is also $5.00. Had the pool paid out only $900 instead of $950 to the victim, the loading charge would now include both expenses and profit of the pool. The value of the service would then be $10 per policy-holder. This is also the value added by the insurance activity.[10]

The case of life insurance is only slightly more complicated. Services under pure term life insurance policies are analogous to that in the simple illustration for casualty insurance. But for whole life policies, part of the premium represents an addition to savings of the policy-owner. The value of the insurance service is clearly again the loading charge of the company, which consist mostly, but not wholly of wages and salaries. In both cases (casualty and life insurance), however, it is clear that value added is present in the supply of the service. The existence of value added in an activity, however, does not necessarily imply that it can be easily taxed.

Identifying the consumption element in financial services

We have seen that, in principle, the service element in financial transactions can be defined. And taxation of financial services rendered to business firms registered for VAT involves no problems *per se*, since any VAT paid by them on purchases becomes a credit against taxes due on sales. Services rendered to households, however, do present problems. A consumption VAT is meant to be confined to personal consumption. It is not altogether clear that household outlays for all types of financial services represents 'consumption'.

1. *Banking* Establishing that there is both value added and an identifiable service element in bank lending to households (the gross margin of banks) does not imply that all such services are consumption in nature. Services involved in mortgage lending to households may be viewed as having both a consumption and an investment element. What proportion of the service should be taxed as consumption? The appropriate answer probably lies somewhere between zero and 100 per cent, depending upon one's point of view. It should be noted however, that any purchase of an investment good by a non-registered entity, including

households, carries with it a value added tax burden. If the VAT rate were 10 per cent, then if a household, for example, buys a lathe to make furniture for the home, the price paid for the lathe will include a 10 per cent VAT element.

2. *Insurance* Classification of insurance services into consumption and investment presents vexing problems not resolved in this paper.

Purchase of insurance contract by a household might be viewed as 'consumption': the household could be viewed as 'consuming' reduced variance in future income. But there are other considerations that argue in favour of treating at least some insurance services not as consumption, but as investment.

(a) *Term life insurance* Under ordinary term life insurance, a policy is purchased to cover risks of death over a specified period, say five years. The premium is fixed for the whole period, and there is no build-up of savings; the policies have no cash value to the policy-holder. Although term life insurance policies are not nearly so widespread in developing countries as in say, the US or Canada, the cost advantages of term relative to 'whole' life will not likely go long overlooked in developing countries.

A purchase of a term-life insurance contract involves essentially a transfer of wealth from the policy-holder to the beneficiary. Payment of the premium by the policy-holder reduces the lifetime consumption of goods and other services for the policy-holder and increases the lifetime consumption possibilities of the beneficiary; the increased consumption of the latter would be taxed under the VAT. It would seem, then, that inclusion of this service in the base of the VAT would amount to double taxation.

(b) *Ordinary whole life insurance* Like term insurance, 'whole life' insurance provides pure insurance protection. But unlike pure term insurance, 'whole life' also provides investment income to the policy-holder. The yearly increase in the cash value of this income adds to the net worth of the policy-holder; it cannot then, be defined as consumption.

(c) *Casualty insurance* In most developing nations, it is likely that most casualty insurance contracts are purchased by businesses, not households. However, forward-looking tax policy should take into account the possibility that household purchase of casualty insurance may eventually be as widespread in developing countries as in industrial countries.

Taxation of casualty insurance services to business firms presents no major problems except as noted below. Again, taxes

paid on purchases may be credited against taxes due on sales. Households are again the source of difficulty. One could argue that casualty losses do not reduce households' VAT liability, since casualty losses reduce net worth rather than consumption. That being the case, it might be argued that net premiums (loading charges) paid by householders for casualty insurance should be taxable under a VAT.

However, it should be recognized that for casualty losses on such household assets as cars or other consumer durables, restoration of the asset would result in spending that would be taxable under the VAT (the same would apply to housing if the VAT base included housing). Would this then mean that taxation of net premiums for casualty insurance coverage would constitute double taxation? This question is not resolved in this paper.

Substitutability of financial assets and competitiveness in financial markets

Where there is not a high degree of substitutability between financial assets, and where competition between different types of institutions is weak, there may be justification in aiming only at rough justice in the design of VAT policy towards financial institutions. In such circumstances, the fact that application of VAT (or exemption from VAT) provides a small competitive disadvantage to one segment or one asset in the financial system (say, insurance companies, savings banks) will not result in major shifts in financial resources away from the disfavoured segment, and towards favoured segments.

In developing countries with 'shallow' financial systems (and which are relatively closed economies), we would expect to find a less well-developed financial sector than in countries with 'deep' financial systems. A limited range of financial assets and limited competition among financial institutions are hallmarks of shallow finance. Non-neutral treatment of different types of financial services will not *per se* cause much additional damage in such circumstances.

But in developing countries with 'deep' financial systems, we ordinarily expect to find a richer variety of financial assets, more types of financial institutions and greater competition among them for savings. Where different financial assets are reasonably close substitutes, and where competitiveness prevails, even a small arbitrary tax advantage to one type of asset may cause major shifts of funds into that asset, and into the institutions that specialize in offering them. For example, life insurance services may be easily taxed when the industry is highly concentrated (as in Indonesia), but if pension funds and investment management companies faced slightly more favourable VAT treatment, large flows of resources may be drawn from life insurance companies. If

banking in developing countries in particular becomes more and more open and competitive, then to the extent that assets can be more easily tailor-made by different types of institutions to fit the needs of the public, the problem may become more serious.

Openness and international capital mobility

Nature of the problem

The difficulty of attaining even rough neutrality of treatment of financial institutions under the VAT increases with the degree of openness of the domestic financial sector and with the international mobility of capital.

With open capital markets and international capital mobility, inappropriate tax treatment of financial services under a VAT may induce movements of capital out of the taxing country.[11] It also may reduce the ability of maturing (infant-industry) financial institutions in developing countries to compete with foreign banks and insurers, particularly in their own domestic markets. In such circumstances, even a relatively small amount of additional VAT burden could result in some disadvantages for domestic banks and insurance companies competing with foreign financial institutions in the domestic market, even if exports of financial services are zero-rated. This is because although under the destination principle, imports of financial services are nominally subject to VAT, such imports are not easily detected, let alone taxed, in any country.[12]

The major concern for most developing countries then is not whether inappropriate application of VAT will hinder the ability of maturing financial institutions in these countries to compete in external markets, although this possibility would be a source of concern for such higher-income nations as Singapore, Hong Kong, Malaysia and Korea in the very near future, and perhaps for Brazil, Argentina and Colombia in the more distant future. For middle-income developing countries, such as Indonesia, that are not likely soon to become international financial centres, the major concern should be the possibility that inappropriate VAT treatment of financial institutions will provide a competitive edge, however small, for foreign banks and insurers over struggling domestic financial firms.

Evidence on openness and mobility

To the extent that economies in developing countries are closed, and to the extent that international mobility of capital is slight, developing countries considering adoption of a VAT may safely ignore the possible implications of VAT for both competitiveness of domestic financial institutions and for capital flows.

Indeed, capital controls, both explicit and implicit, do abound in the world economy and particularly in developing countries. Explicit controls are defined as restrictions on inward and outward movements of foreign exchange, usually in the form of limitations on purchase of foreign exchange by residents for purposes of international trade policy. Implicit capital controls include laws and regulations unrelated to trade policy which nevertheless limit the domestic holding of use of assets denominated in foreign exchange. Kimbrough and Greenwood (1986) find that explicit controls on the international movement of capital existed in 72 per cent of IMF member countries throughout the entire five-year period 1978–82 (inclusive), while only 19 per cent of IMF members had no explicit capital controls at all during that period. Furthermore, even in countries that use no explicit capital controls, implicit controls may hinder international mobility of capital.[13]

These observations would seem to suggest that the international mobility of capital may be limited. There are, however, other considerations that lead to quite different conclusions. First, the fact that explicit (and implicit) controls on capital are widespread, particularly in such developing countries as India, Pakistan and Ghana, is not any indication that the controls are effective in limiting international mobility of capital.[14] In any case, presumptions that capital controls are administered with anything close to 100 per cent effectiveness lack any significant empirical support. Second, there is a small but growing body of empirical evidence that suggests a fairly high degree of international mobility of capital countries, as attested by the work of Harberger (1980), Summers (1985) and Hartman (1983).[15] Third, not all developing countries utilize explicit capital controls. Indonesia, for example, has not utilized explicit foreign exchange controls of any kind since 1970.

Fourth, even the presence of implicit controls does not necessarily restrict the ability of foreign financial institutions to operate in domestic markets. For example, foreign firms wrote 75 per cent of all non-life insurance issued in Canada in 1980 and 25 per cent of life insurance (Shearer *et al.*, 1984, p. 229). Foreign insurance firms have gained a major share of the total insurance business in Indonesia in spite of laws forbidding foreign equity ownership in insurance, and in spite of ostensibly tight limitations on foreign participation in reinsurance. And although foreign banks are required by law to limit their operations to the capital city of Jakarta, this restriction did not prevent the Jakarta branches of American banks from becoming very major profit centres of the worldwide operations of the parents in 1971–81.

In sum, it appears unwise for any developing country to frame VAT policy toward financial services under the assumption that the effects of the tax on international capital flows and domestic competitiveness of financial institutions can be safely ignored.

Possible options for VAT treatment of financial services

General issues

Like their counterparts in Europe and New Zealand, developing country tax authorities face three principal options for the VAT treatment of financial services.

1. Full taxation, with VAT credits on inputs.
2. Exemptions, with no credits.
3. Zero-rating, also known as exemption with full credits.

The complexities involved in achieving neutral treatment of financial services when all are subject to VAT has led all EC countries, New Zealand, Korea and most Latin American nations to adopt option 2: exemptions. This choice has been dictated by expediency. Exemption violates all four conditions for neutrality outlined in the section 'Comparative treatment of financial services under the VAT'. No country has gone so far as to zero-rate all financial services, largely because of fear of revenue loss. Virtually all VAT countries, however, do zero-rate the export of financial services.[16]

In what follows, banking and insurance issues will be discussed separately. Although common problems affect VAT design toward both, the nature of several other difficulties calls for separate discussion.

Banking services

Full taxation option

In only one country has there been strong sentiment for application of VAT to the full price of 'core' banking services.[17] The Government's Advisory Panel on GST (1985, pp. 6–9) in New Zealand proposed this option, which was rejected by the government.

The merits of full application of VAT to financial services (when these are properly defined) are not inconsiderable. First, full taxation generally involves greater VAT revenues than other alternatives. Further, this option would best satisfy all four neutrality conditions. When financial services are appropriately defined, full taxation preserves neutrality between financial services and other goods and services, between different types of financial institutions, between the latter and non-specialized providers of financial services and between domestic and foreign suppliers of financial services (assuming zero-rating of the latter). Indeed, the 'full taxation' approach was favoured strongly in New Zealand over the 'exemption' approach by some financial institutions and retailers (Advisory Panel on GST, 1985, p. 7).

Other considerations suggest the need for great caution in applying the 'full taxation' approach. First, taxation of interest paid by registered firms to banks is both unnecessary and anomalous under a retail type tax-credit VAT. Value added of firms is defined as the difference between receipts from the sale of goods and services minus purchases of other goods and services from other firms. Interest enters in the calculation neither as minuend nor subtrahend. Rather, interest paid by registered firms to banks is a constituent of the remainder; it is actually part of the value added of firms, and is taxed at that level.

Full taxation of banking services provided to non-registered firms and to households might, however, be advisable on both neutrality and revenue grounds. But this approach also encounters problems. First, if transactions with non-registered firms and households were the only taxable transactions for banks, the latter would have to distinguish carefully between transactions of this type and those with firms registered for VAT. This could result in significant compliance difficulties, particularly since non-registered firms tend to be a higher proportion of total firms in developing countries than in industrial countries (Due, 1984). Also, except in the unimaginable situation where households and non-registered firms were made responsible for withholding VAT on their 'sales' to banks (deposits in interest-bearing accounts), banks would have to be required to collect and remit VAT on both their 'purchases' (deposits) and their 'sales' (interest-bearing loans), a requirement that would be at the least unusual for a VAT. In addition, taxation of bank loans to households and non-registered firms would create incentives for financial disintermediation: persons would be faced with incentives to borrow from sources other than banks and financial institutions (US Treasury, 1984, Vol. III, p. 51; Advisory Panel on GST, 1985, pp. 9–10).

Further, the 'full taxation' approach, even when confined to transactions between banks on the one hand and households and non-registered firms on the other, involves transitional problems not encountered under either the exemption or the zero-rating options. Application of VAT to all loans to these groups would cause banks to suffer windfall losses on existing loans and would also involve enormous compliance difficulties (Advisory Panel on GST, 1985, p. 29). Either intricate phasing-in provisions would be necessary, or the VAT would have to be limited only to financial contracts consummated after the effective date of the tax.

Finally, there is the issue of first defining the value of financial services and then deciding which definable services are to be considered as consumption. The nominal interest rate, we have seen, is not a good measure of the value of banking services provided in loans, particularly since a portion of the nominal rate reflects compensation for inflation risks assumed by banks. The value of the service provided by lenders is, arguably, measured by the costs of transferring funds from savers to investors: the costs of financial intermediation. In the US, these costs,

measured roughly by commercial bank 'spreads', may be as low as 1–1.5 per cent of the amount of bank loans, but are at least twice that high in most developing countries (Gillis *et al.*, 1983, p. 362). In any case, the value of the service rendered will ordinarily be a small fraction of the nominal interest rate.

Exemption option

Exemption of banking services is fraught with problems. Exemption means only that the sales of the exempted service are not subject to tax; firms supplying exempted services, however, pay tax on their purchases. Banking services provided to registered business firms are exempt (as opposed to zero-rated), value added at the exempt banking stage is recaptured, for tax purposes, in sales at the registered business stage because there are no VAT credits to applied from 'purchases' from financial institutions. If this were the only effect of exempting banking, few problems would arise. But in addition, the registered business firms bear (under usual forward shifting assumptions) the tax paid by the exempt banks on their purchases. Thus, when a registered non-financial business firm sells to a final consumer, VAT is due on the sales, unreduced by any credits arising from application of VAT to banking services. As a result, final sales of products sold by firms utilizing exempt banking services will be taxed more heavily than if banks were fully taxed.

The amount of VAT not allowed as credits under the exemption option may be considerable. Brannon (1986) estimates that in the US financial sector, for example, purchases from other firms are as much as 20–30 per cent of value added ('loading'). Therefore, if financial institutions were exempt from VAT, they would still bear 20–30 per cent of the full VAT because they would receive no credits (refunds) on their taxable purchases from other firms.

Exemption involves other non-neutralities as well as administrative compliance difficulties. First, exemption would likely place domestic banks at some relative disadvantage *vis-à-vis* offshore banks, even if exports of financial services were zero-rated. Banks from other VAT countries of course benefit from zero-rating of their offshore activity and the US does not yet have a VAT. Therefore, in the domestic market, the services of home banks would appear less attractive to borrowers, given the difficulty of applying VAT to imports of all financial services which may be easily concealed.

Second, exemption provides financial institutions with incentives to produce intermediate goods themselves (in-house computing, printing and advisory services) rather than purchasing these inputs from specialized firms, with consequent loss in efficiency.

Administrative problems abound in the exemption option. First, exemption tends to create complicated apportionment problems for

firms supplying both taxable goods and services and exempt financial services. Any VAT paid on inputs would have to be apportioned to insure that such firms do not claim credit for taxes paid on inputs used in the provision of exempt banking services.

Second, as noted by the Advisory Panel on GST (1985, pp. 4–5) in New Zealand exemption makes the VAT highly vulnerable to sophisticated tax evasion devices. With exemption of domestic transactions and the usual zero-rating of export transactions, customers of financial institutions would quickly discover how to secure non-taxable financial services from offshore affiliates of domestic banks. For example, a bank in a developing country using the exemption option for domestic banking services could first lend to an offshore affiliate. This would be deemed a zero-rated export transaction. The offshore affiliate would then lend to the developing country customer. With domestic financial services exempt, tax would not apply on the transaction, and refunds would have been paid on all input taxes of the domestic bank that lent to the offshore affiliate. These and similar types of offshore arrangements are not uncommon even in non-VAT countries in South East Asia and the Caribbean. A VAT with financial services exempt would enhance the attractiveness of such practices, thereby substantially reducing any revenue that otherwise would be gained by the exemption option (relative to zero-rating).

Zero-rating option

There are two principal disadvantages of zero-rating of banking services. The first, and most obvious, is the revenues that would thereby be foregone. We first compare revenue loss from zero-rating with that associated with exemption. Suppose that taxable purchases from other firms are as high as 20–30 per cent of value added by banks (as in the US). In a middle-income country, such as Indonesia, where value added in the financial sector (banking plus insurance) is 7 per cent of GDP (World Bank, 1984), revenues under exemption of all financial services would account to no more than 0.02 per cent of GDP, at a VAT rate of 10 per cent. Zero-rating then, would involve, at most, a revenue loss of 0.02 per cent of GDP, assuming 100 per cent collection efficiency under the exemption option. And actual revenues under the exemption option would likely be considerably smaller, because of the availability of offshore tax avoidance devices.

Revenues from a fully collected, perfectly administered, 10 per cent VAT on financial institutions would be about 0.7 per cent of GDP for a country such as Indonesia. This is not a trivial number, but then again the assumption of perfect administration overstates actual revenue potential. In countries with relatively large financial sectors, however, the revenue consequences of zero-rating could be quite significant. For the

US, Brannon (1986) estimates this loss at 9 per cent of the yield of a hypothetical broad-based VAT.

The main problem involved in zero-rating is administrative in nature. Many developing countries' tax systems are not well geared to operation of rebate structures, whether for zero-rating of financial services or for exports. But inasmuch as a rebate system will have to be devised and operated for exports, in any case, the incremental costs of applying zero-rating to financial services should not be too great, particularly given the relatively small number of financial firms involved in most developing countries.

Insurance services

Choices regarding the tax treatment of insurance services are somewhat clear-cut compared to banking.

Full taxation option

Full taxation of insurance services involves certain administrative and conceptual difficulties, but may still be advisable for some types of insurance. This is particularly true for non-life insurance services, provided primarily in developing countries to registered business firms. Taxation of these services under a VAT would give rise to credits for firms purchasing insurance. By itself, this presents no major problems.

There remains the issue, discussed earlier, of defining the value of insurance services in general and deciding which types of insurance services rendered to households are properly classifiable as consumption. Clearly the full value of the premium is not the appropriate measure of the value of the service. The best measure of this value is the net premium, or the 'loading' charge. But it is not entirely clear that purchase of life insurance services represents consumption that should be taxable under a VAT. This issue, however, cannot be resolved here.

Taxation of insurance services, however these services are measured, does involve some risks, because of the openness of the sector and because of the apparent mobility of international capital. Exports of insurance services, if any, would of course be zero-rated. If it is clear that imports of insurance services can be fully taxed on the same basis as that applicable to domestic insurance services, then taxation of insurance premiums will not result in any significant competitive disadvantages for domestic firms. It is not, however, altogether obvious that imports of insurance services can be easily detected, let alone taxed.

Exemption option

Exemption of insurance services would give rise to the same types of problems with uncredited VAT on inputs as in banking. And, particularly

with regard to the ability of domestic insurance firms to compete in the domestic market with foreign firms, full taxation is preferable to exemption.

Zero-rating option

Zero-rating again involves the disadvantage of revenue loss. But given the small present size of the insurance sector in most developing countries (e.g. less than 2 per cent of GDP in Indonesia), the loss would not be large. Zero-rating also involves some additional administrative demands, including that of providing rebates to insurance firms which, however, are not numerous in most developing countries. Finally, zero-rating would favour somewhat the purchase of insurance services relative to taxed goods and services.

Conclusions

Apart from administrative considerations, the best VAT option is likely to be that of zero-rating. This option violates only one of the conditions for neutrality, whereas exemption violates all four. In addition, zero-rating of exports of financial services will be required in any case, in order to implement the destination principle. If a rebate structure is required for this purpose, and to accommodate new and rapidly growing firms, provision of rebates to the relatively small number of firms in the financial sector should not engender significant complications.

Also, the revenue consequences of zero-rating of financial services are not likely to be consequential in most developing countries considering an EC type of VAT, whereas this is not the case in Canada, the US or Europe.

Moreover, the administrative and definitional problems involved in both the full taxation and the exemption options appear to be at least as formidable in the developing country context as in industrial countries. Zero-rating is not, however, without its own administrative problems, but these are by no means insurmountable.

Finally, zero-rating is also most supportive of financial deepening in developing countries, an important consideration in countries where the financial sector is expected to shoulder a substantial share of the task of resource mobilization.

Complete exemption of all financial services is arguably the most unsatisfactory solution of all the developing countries, on almost all counts. Full taxation of all services is at least tolerable, provided the value of taxable services can be appropriately defined and provided there is some assurance that imports of financial services will be effectively taxed. Neither proviso is likely to be satisfied in the developing country context.

If zero-rating of all financial services is, however, deemed impossible on administrative grounds then consideration might be given to the following alternative scheme:

1. Full taxation of all non-life insurance, on grounds that these are provided primarily to registered firms (in the developing country setting). VAT paid on such services would be fully creditable against taxes due on sales of registered firms.
2. Zero-rating of bank transactions with registered firms, on grounds that full taxation of such activity is unnecessary under a VAT since interest expenses constitute a part of value added of taxable firms.
3. Exemption, rather than zero-rating, of the value of life insurance services on grounds that these services are provided primarily to individuals, and that exemption is not likely to erode significantly the ability of life insurance firms to compete with foreign firms, provided that net, not gross, premiums are taxed.
4. Exemption of banking services provided to households and non-registered firms, on administrative and compliance grounds.

This last alternative is not in any sense preferred; it merely represents the maximum concessions that could be made to expediency, consistent with openness, financial deepening and administrative constraints.

Finally, this paper has examined issues in application of VAT to financial services in isolation from several other questions of VAT design. But resolution of these 'other' issues may have an important bearing on the advisability of selecting one or another option for the tax treatment of financial services. For example, if all housing services are included in the base of a VAT, zero-rating of all intermediation costs in mortgage lending to households may not only be justified, but required for neutral treatment of housing. But, as is much more likely, VAT coverage of housing services is deficient because of practical difficulties in taxing imputed rent in owner-occupied housing (Conrad, 1986), exemption or full taxation of mortgage interest may be indicated as one means of redressing VAT discrimination in favour of consumption of housing services.

Notes

1. Complex questions are involved in the tax treatment of reserves for bad debts of banks, foreign exchange gains and losses of banks, reserves of insurance companies, the taxation of income from reserves of pension funds, the relative tax treatment of mutual relative to stockholder owned insurance companies, and limiting the scope for transfer pricing by banks through such devices as related party loans. See, for example, Aaron (1984).
2. For a clear discussion of the features of a consumption type VAT of the tax-credit type, imposed on the destination principle, see Shoup (1987).

3. The term deep finance, or financial deepening, is usually attributed to Shaw (1973). Financial deepening refers to growth in the real size of the financial system, as measured, for example, by the ratio of liquid assets to GNP. The essence of deep finance is avoidance of sharply negative real rates of interest.
4. See Shoup (1987) for a full description of the 'subtraction' and 'addition' methods of imposing VAT.
5. *The special 'addition type'* VAT applied to a broad variety of financial institutions, including not only banks and insurance companies, but companies or cooperative societies receiving money on current account and withdrawable by cheque, and 'any class of persons as determined by the Minister of Finance'. Shamus Diagnun, 'Basis on which banking and insurance might be brought within the scope of VAT', unpublished, Washington, DC, 1984.
6. Exemption of financial services increases compliance difficulties because many firms in New Zealand provide both goods and financial services. For such firms, exemption of financial services would require difficult apportionment problems for VAT paid on inputs, particularly for those who extend credit as part of a normal sale. (Advisory Panel on Goods and Service Tax, 1985, pp. 4, 5).
7. An *efficient* tax system is one that involves a minimum amount of deadweight loss (excess burden) for raising the required amount of revenue. An *optimal* tax system pursues both equity and efficiency goals; optimal tax analysis focuses on the trade-off between equity objectives and the deadweight efficiency costs of raising a given amount of revenue. In general, either an efficient tax system or an optimal VAT system would involve different rates of tax on different goods, with tax rates inversely proportional to their demand elasticities. Quite clearly, neither a neutral tax structure, and in particular a uniform structure of tax rates, clearly satisfies the requirements for efficient or optimal taxation. However, the informational and administrative requirements for imposing a set of optimal taxes across any economy are, under present technology, so great as to preclude its practical application. For a thorough survey of modern theories of excess burden and optimal taxation, see Auerbach (1985).
8. For a more optimistic view on how the tenets of optimal taxation can be applied, or at least considered, in a developing country setting, see David Newbery and Nicholas Stern (1986).
9. Uniform taxation of all current consumption expenditures will not, however, be neutral in its effects on the choice between present and future consumption, except under very special conditions. See McLure (1980).
10. The outlines of this example are due to Gerald Brannon (1986).
11. This will be more likely in a world where: (a) VAT nations zero-rate exports of financial services (b) VAT nations do not impose special indirect taxes on financial institutions, and (c) non-VAT nations do not impose sales or excise taxes on financial services. The first condition prevails almost universally among VAT nations. The second condition does not prevail universally in insurance services, as many EC countries, for example, impose special indirect levies on insurance. The third condition prevails in

the US and Canada (both non-VAT nations). Practices in other non-VAT nations vary considerably.

12. Competitive disadvantages to domestic financial institutions will, of course, not occur to the extent that the 'equivalence theorem' applies. This theorem holds that any competitive disadvantage for domestic firms arising from unrebated taxes on exports (and untaxed imports) will be vitiated by subsequent depreciation of the exchange rate, restoring the previous pattern of incentives to export and import. But the equivalence theorem applies fully only under a set of very restrictive assumptions, including: (a) freely fluctuating exchange rates; (b) no international capital flows; (c) initial balanced trade between countries; and, (d) no net transfer payments between nations (Shoup, 1969, p. 205). In particular, competitive disadvantages to domestic financial firms could then easily result from either full application of VAT or a VAT exemption. Only zero-rating of financial services would insure that this would not occur.

13. For example, Feldstein and Horioka (1980, p. 328) identify several types of institutional restrictions that amount to implicit capital controls. In the US, these include laws that require savings institutions to invest in local real estate, and the 'prudent man' rules governing many pension funds that deter them from investing abroad.

14. Long-standing capital controls in Colombia before 1968, India and Argentina before 1979, and many other countries did not prevent the build-up of large resident-owned foreign currency holdings outside these countries in the past. Presumed stringency of capital controls did not prevent Indian multinational firms from exporting substantial capital while becoming significant foreign investors in South East Asia before 1975 (Wells, 1977).

15. Harberger (1980) concludes: 'In looking at rates of return in different countries and finding them basically uncorrelated with the capital labour ratio, concluded that there must be some force operating to prevent such a correlation from emerging, and the most natural explanation was that the world capital market was alive and well in Zurich'. The Harberger sample of countries included both developed and developing nations.

    Summers (1985) found significant evidence of a high degree of international capital mobility in a study embracing 115 countries, including both developing countries and OECD nations. The results were almost unchanged when the OECD countries were excluded from the sample.

16. In the EC, however, it is more common to find zero-rating only for export of financial services outside the EC. The UK and Ireland in the EC, however, as well as Sweden and New Zealand, zero-rate all exported financial services.

17. It is taken for granted here that VAT will apply to 'secondary' banking services.

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On the Inter-relation Between Trade and Growth in Developing Countries*

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Introduction

The proposition that an open trading environment promotes efficient use of available resources has received impressive support from the experience of an increasing number of developing countries which gradually opened their markets during the 1960s and 1970s. A first indication is that the removal of disincentives to exports (export liberalization) has caused manufactured exports from the Third World to expand spectacularly, outpacing both expansion of world trade and growth of domestic industrial output. As Table 1 shows, manufactured exports of developing countries grew on average at an annual rate of roughly 13 per cent in real terms in the period 1965–82, i.e. nearly twice as fast as world trade. Export expansion was predominantly carried by the 19 countries listed in Table 1, which accounted for 79 per cent of total Third World manufactured exports in 1982. With rapid domestic industrialization, their export portfolios significantly shifted towards manufactured goods, as shown by the shares of these goods in total exports, which increased from 7.2 per cent in 1965 to 44.8 per cent in 1982.

The 19 countries in Table 1 are quite diverse as there are some – the first generation of newly industrializing countries (NICs) – which had established a substantial industrial base already in 1965 while others – the second generation NICs – were latecomers which began to promote

* The analysis presented in this paper draws heavily on Hiemenz and Langhammer (1986) and Donges and Hiemenz (1985).

Table 1 Manufactured exports[a] of newly industrialized countries (NICs), 1965–82.

	Value (US $ × 10⁶)			*Share in total exports (%)*		*Annual real rates of growth (%)[b]*	
	1965	*1973*	*1982*	*1965*	*1982*	*1965–73*	*1973–82*
First generation NICs	*2 645.4*	*16 796.7*	*77 735.1*	*33.1*	*58.2*	*19.4*	*9.6*
Argentina	83.9	735.4	1 846.4	5.6	24.2	24.4	2.4
Brazil	124.3	1 216.9	7 720.9	7.8	38.3	26.1	13.5
Hong Kong[c]	819.7	3 649.5	13 161.0	93.2	96.3	14.3	6.6
India	812.8	1 560.7	5 000.0[d]	48.3	55.5[d]	2.9	5.3[e]
Israel	276.3	1 108.8	4 243.2	64.3	80.4	12.8	7.3
Mexico	165.9	1 129.9	2 012.9	14.5	9.6	20.5	−1.4
Singapore[c]	72.1	1 004.0	5 034.3	52.1	37.0	31.8	10.6
South Korea	103.8	2 717.2	19 121.3[d]	59.3	90.0[d]	42.6	16.2[e]
Taiwan	186.6	3 674.3	19 595.3	41.5	88.8	37.6	11.3
Second generation NICs	*230.1*	*1 500.6*	*10 326.2*	*0.7*	*20.5*	*20.6*	*14.6*
Chile	15.0	44.5	780.0[d]	2.4	20.8[d]	8.6	30.2[e]
Colombia	33.8	307.3	745.5	6.3	24.3	24.9	2.0
Indonesia	–	60.6	808.1	–	3.6	–	23.3
Malaysia	64.3	346.5	2 734.9	6.4	22.7	17.0	16.3
Morocco	23.1	129.9	706.0	5.4	34.3	24.1	11.6
Peru	4.1	28.6	377.3	0.6	13.7	20.7	23.1
Philippines	65.8	219.6	1 145.7	8.3	22.9	10.2	11.1
Thailand	12.1	255.4	1 871.8	2.0	21.9	38.8	15.4
Tunisia	11.9	83.9	833.7[d]	9.9	33.3[d]	21.1	21.3[e]
Uruguay	–	24.4	323.2	–	31.6	–	23.2

(continued)

Table 1 Manufactured exports[a] of newly industrialized countries (NICs), 1965–82. *(continued)*

	Value (US $ × 10⁶)			*Share in total exports (%)*		*Annual real rates of growth (%)[b]*	
	1965	*1973*	*1982*	*1965*	*1982*	*1965–73*	*1973–82*
Total	*2 875.5*	*18 297.2*	*88 061.3*	*7.2*	*44.8*	*19.5*	*10.1*
in % of developing countries' exports	68.3	79.0	79.0	–	–	–	–
in % of world exports	2.8	5.3	8.5	–	–	–	–
Manufactured exports of:							
Developing countries	4 212	23 148	111 519	–	–	17.3	10.1
World	102 137	346 851	1 042 052	–	–	10.5	4.5

[a]SITC 5+6+7+8-68. [b]Export values deflated by unit value indices for manufactured exports of industrialized countries.
[c]Excluding re-exports. [d]1981 [e]1973–81.

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industrialization and exports of manufactures only in the 1970s. Against the background of these countries' export performances, this paper focuses on the question whether or not successful export expansion of, in particular, manufactured goods was beneficial to the economy as a whole. The following section reviews the empirical evidence on the relationship between trade strategies and income growth and highlights the importance of domestic economic policies for trade-induced growth. One major objection against an open trading environment in developing countries concerns the dependence of outward-oriented economies on the vagaries of changing world market conditions. This argument and some policy conclusions are presented in the last two sections.

Trade strategies and income growth

Trade liberalization is supposed to free output expansion from the narrow limitations of domestic markets and to enforce more efficient production through international competition in domestic markets. Efficiency can result from higher rates of capacity utilization, the exploitation of economies of scale through exports, a better use of the abundant factors of production, in particular unskilled labour and primary commodities, and a greater responsiveness of entrepreneurs to changes in supply and demand. Likewise, it becomes more attractive for workers to improve discipline, quality consciousness and punctuality. All those factors should contribute to increasing the supply of goods and services to domestic markets at lower prices as well as to an expansion of exports. Both output growth in excess of domestic demand expansion and declining prices will, then, raise the rate of growth of real income.

Empirically, this relationship between trade regime and income growth has been analysed from various angles. A number of studies have simply focused on the effects of export expansion on national income growth. Michaely (1977), for instance, has shown for a sample of more than 40 developing countries that a growing share of exports in gross domestic product (GDP) was positively correlated with per capita income growth in 1950–73. However, there was no such relationship between the level of exports in GDP and income growth. This unsatisfactory result reflects a major shortcoming of Michaely's analysis which focuses on the impact of total exports, including exports of raw materials, on economic development. His sample includes a large number of low-income countries with highly dualistic economies which are important exporters of primary commodities. The beneficial effects of more trade and international competition will hardly be felt in such countries. It is hence not surprising that the relationship between export and income growth established in Michaely's analysis holds only for countries with a per capita income of US $300 and above.

The same qualification applies to other cross-country regression and correlation analyses covering different samples and periods of time (Balassa, 1978b; Krueger, 1978, pp. 273–4; Tyler, 1981; Kavoussi, 1984), which all provide additional evidence for the positive effects of export expansion on income growth. A more differentiated picture emerges from the recent study by Ram (1985), who splits his sample of 73 countries into a low- and a high-income group and ran separate statistical tests for the 1960s and 1970s. His results confirm the earlier findings but show a much lower income response to export expansion for the group of low-income countries. Their exports have, however, almost exclusively consisted of commodity exports, while industrialization was promoted by inward-oriented trade strategies. For this reason the productivity effects of export revenues remained limited.

The most interesting conclusion emerging from Ram's analysis is, however, that the positive relationship between exports and income growth was closer in the 1970s compared to the 1960s and that the differences in the performance of high- and low-income countries had almost disappeared in the 1970s. Ram explains the better economic performance observed in the 1970s by deliberate export promotion policies, applied in an increasing number of oil-importing developing countries, in the face of mounting balance of payments difficulties which hit low- and high-income countries alike.

The above scepticism remains valid, however, also with respect to Ram's analysis, since there is no differentiation between commodity-exporting countries and countries exporting manufactured goods. For commodity-exporting countries income responses to export performance may have been influenced by various commodity price bonanzas in the 1970s, and the rapidly changing composition of exports towards manufactured goods as an independent factor in the process of income generation has been neglected. Furthermore, the studies by Ram and the other authors tend to be misleading in the sense that they imply that export expansion *per se* is favourable for income growth. The important point is that trade liberalization promises more efficient production both for domestic and foreign markets. Especially in large countries, enhanced income growth can be gained from sales in large domestic markets once a more competitive environment has been created through lower barriers to international trade. Competition enforces innovative behaviour of entrepreneurs and contributes to human capital formation, which are both more important for sustained and high rates of income growth than export expansion *per se*. For these reasons, an analysis of income effects of trade liberalization should focus on economic policies applied in developing countries rather than just on performance indicators such as export growth. This has been done in a series of comparative country studies undertaken in the late 1960s and 1970s.

The pioneer study highlighting the relevance of policies is that of Little *et al.* (1970), which drew upon the experience of industrialization in the 1950s and 1960s in seven developing countries (Argentina, Brazil, Mexico, India, Pakistan, Taiwan and the Philippines). This group is representative for a wider range of countries since they applied very different industrialization policies. The study emphasizes the trade orientation of industrialization policies and shows that these countries had granted very different levels of import protection to domestic industries (very high levels in the case of India and Pakistan, low levels in Taiwan and Mexico, and moderate levels in Argentina and in Brazil). The countries with low levels of import protection, Taiwan and Mexico, were relatively successful in expanding manufactured exports. The same applies to Pakistan, which had introduced large export subsidies in the 1960s to offset the bias resulting from import protection against manufactured exports. The promotion of industrialization through import protection and high export subsidies in Pakistan meant a high discrimination of all other economic activities and implied a decline of raw material (jute) exports. The net benefit of such an excessive promotion policy remains doubtful.

In the Little *et al.* study Taiwan proved to be the most successful country with regard to income growth, and provides an example of how income growth and trade liberalization can be mutually reinforcing. Initial trade liberalization measures contributed to growth of income which, in turn, facilitated to sustain and broaden economic liberalization. The opposite was experienced by Argentina, Brazil and India in the 1950s and early 1960s. These countries attempted to overcome balance of payments problems typically associated with inward-oriented trade regimes by *ad hoc* devaluations of the exchange rate. The removal of overvalued exchange rates did not have the desired effects on output expansion but rather fuelled inflation since trade barriers against imports were not lowered simultaneously. Governments reacted by applying deflationary policy measures which led to economic recession. Slow output and income growth were conducive to continued efforts to promote exports and thus cemented the inward-orientation of the trade regime. Two lessons can be drawn from these early experiences. First, *ad hoc* devaluations of, in some cases, substantial magnitude may destabilize the economy because the sudden change of relative prices overtaxes the capacity of adjustment at the firm level, particularly in an otherwise highly regulated economic environment. From this point of view frequent small devaluation steps, a so-called crawling peg, as applied in Brazil in 1968 and thereafter (Donges, 1971), might have been preferable. But, secondly, even a crawling peg may not have been sufficient to eliminate the inward bias of the trade regime, as long as domestic inflation was not curtailed and highly selective import barriers remained

in place, because a devaluation alone does not bring about the needed changes of relative prices of importables and exportables.

The conclusion that a partial deregulation of foreign trade may be counterproductive was further supported by a series of country studies (Brazil, Chile, Colombia, Egypt, Ghana, India, Israel, Philippines, South Korea and Turkey) undertaken in the mid-1970s under the auspices of the National Bureau of Economic Research (Krueger, 1978). These studies could already draw upon empirical evidence from deliberate trade policy shifts as for example in Brazil (1968), Colombia (1967), South Korea (1961) and Israel (1962). However, only two countries in the sample, Brazil and South Korea, had liberalized their trade regimes consistently over a longer period of time and enjoyed both an enhanced expansion of exports and growth of income. The other countries frequently changed their policy interventions in trade and foreign exchange markets, for instance by switching between direct controls and pricing measures. The unsteady framework of incentives created uncertainty and encouraged speculative behaviour. It paid for investors to employ resources in order to collect rents accruing from policy interventions. Long-term investment in productive activities became less attractive. The studies show on balance that, in addition to a comprehensive approach to trade liberalization, a steady and foreseeable policy framework is essential for exploiting the productive potential of an economy.

Similar conclusions can be derived from other comparative country studies (Balassa, 1978a) which show that economic growth has been most rapid in countries such as South Korea, Singapore and Taiwan, which granted comparable incentives to exports and import substitution in manufacturing and ensured stability of the incentive system over time. Other countries either slackened export promotion efforts (Yugoslavia after 1966) or continued with import substitution (India, Chile till 1973). These countries experienced a decline in the rate of growth of value added in manufacturing and hence total economic growth. The economic success of a policy shift towards an open trading environment also emerges from studies of 15 semi-industrialized countries undertaken at the Kiel Institute of World Economics. Time-series analysis confirms that economic growth was significantly higher after the policy change than before in eight of twelve sample countries (Brazil, Colombia, Mexico, Pakistan, Spain, South Korea and Taiwan) (Donges and Muller-Ohlsen, 1978, pp. 124–126). From this evidence it becomes apparent that it is possible to shape a developing country's production structure towards world markets even after a long period of excessively inward-looking industrialization, without placing too heavy strains on the economy in terms of temporary unemployment and a sudden depreciation of the existing capital stock (Donges, 1976). The studies reveal two important aspects of export liberalization. First, constraints on the demand side did not impede manufactured export expansion (Donges

and Riedel, 1977). And, secondly, policy transition from import substitution to manufactured export expansion does not necessarily imply the removal of all, or even most, government interventions inherited from the inward-looking phase. In particular, some degree of import protection to promote industrialization may be justified on grounds of (non-pecuniary) externalities. What is needed, however, is to replace *ad hoc* government interventions by a stable and foreseeable policy framework, selective by uniform interventions, and quantitative restrictions by pricing instruments. This point will be elaborated in the last section of this paper.

Finally, the economic rationality of an outward-oriented trade regime has been confirmed by comparisons of the economic performance in Latin America and South East/East Asia. These studies point at a generally higher degree of trade and payments distortions in Latin American countries than in the Asian countries (Morawetz, 1981, pp. 145–60) and a persistent differential in per capita income growth, equity, industrial exports and agricultural performance between South Korea and Taiwan on the one hand, and Argentina, Brazil, Colombia, Mexico and Chile on the other hand (Ranis, 1980). Even Brazil, by far the most successful Latin American country, could not stand comparison with either South Korea or Taiwan.

To conclude, both in an inter-temporal as well as in an inter-country analysis, there is much empirical evidence from more than two decades that changes in a country's trade strategies towards an open trading environment accelerate export growth and economic growth, and that countries following export promotion policies achieved higher rates of growth of export earnings and GDP than those resorting to import substitution strategies (Table 2).

Exports, income growth and external shocks

A frequently raised objection against export liberalization concerns the dependence of outward-oriented economies on conditions in world markets. It is argued that open economies are vulnerable to external shocks while less trade orientation provides a protective shield against disruptive changes of external demand on prices. The experience of the 1970s and 1980s, when all developing countries were suddenly confronted with the need to overcome increasing balance of payments pressures in order to preserve the momentum of their development process, does, however, not support this view. Outward-oriented economies commanded enough flexibility both at the macro and micro level to meet the challenge of deteriorating world market conditions without incurring debt problems, while inward-oriented economies suffered from severe economic depression and, in many cases, mounting foreign indebted-

Table 2 Trade strategy, export growth and real GDP growth in selected developing countries.

Country	*Period*	*Trade strategy*	*Export earnings (average annual*	*Real GDP growth rate)*
Brazil	1955–60	IS	−2.3	6.9
	1960–5	IS	4.6	4.2
	1965–70	EP	28.2	7.6
	1970–76	EP	24.3	10.6
Chile	1960–70	IS	9.7	4.2
Colombia	1955–65	IS	−0.8	4.6
	1960–5	IS	−1.9	1.9
	1970–6	EP	16.9	6.5
Indonesia	1965–73	MIS	18.9	6.8
Ivory Coast	1960–72	EP	11.2	7.8
Pakistan	1953–60	IS	−1.5	3.5[a]
	1960–70	IS	6.2	6.8
South Korea	1953–60	IS	−6.1	5.2
	1960–70	EP	40.2	8.5
	1970–6	EP	43.9	10.3
Thailand	1960–70	MIS	5.5	8.2
	1970–6	MIS	26.6	6.5
Tunisia	1960–70	IS	6.8	4.6
	1970–6	MIS	23.4	9.4
Uruguay	1955–70	IS	1.6	0.7

[a] GNP growth rate for 1950–60.
IS Import substitution.
EP Export promotion.
MIS Moderate import substitution.
Source: Krueger (1983, p. 44).

ness. Balassa (1984) has shown that outward-oriented economies relied largely on output-increasing policies to offset the balance of payments effects of external shocks in the periods 1974–6 and 1979–81, and accepted a temporary decline in the rate of economic growth in order to limit their external indebtedness. In turn, inward-oriented economies failed to apply output-increasing policies of adjustment; they financed the balance of payments effects of external shocks by foreign borrowing in the period 1974–6 and had to take deflationary measures in 1979–81 as their increased indebtedness limited the possibilities for further borrowing. The policies applied led to economic growth rates substantially higher in outward-oriented than in inward-oriented economies,

with the differences in growth rates offsetting the differences in the size of external shocks several times.

The reasons for the striking differences of economic performance can be illustrated by a comparison of Latin American and East Asian responses to external challenges (Nunnenkamp, 1985):

- Non-oil exports of East Asian countries continued to expand rapidly after 1973, thus alleviating the balance of payments pressure of higher oil prices, while the corresponding export growth slowed down in Latin America and finally stagnated in the early 1980s.
- It fits into this picture that fluctuations in real exchange rates, which increase uncertainty for exporters, were twice as high in Latin America compared to East Asia in the period 1974–82.
- The share of investment in GDP which amounted to roughly 20 per cent in East Asia prior to 1973 was pushed up first to 23 per cent in 1974–8 and to 26 per cent thereafter. Part of this additional investment was foreign direct investment which did not increase the debt burden of recipient countries. In Latin America the investment share increased only moderately by about two percentage points from roughly 19 to 21.
- East Asian countries have had an import-to-GDP ratio high enough to allow some import curtailment without severely curbing long-term economic growth both in 1974–6 and in 1979–81. Latin American countries had already exhausted most import substitution possibilities prior to the first oil price shock, so further import restrictions inhibited the inflow of necessary intermediate inputs for the existing productive capacity and had to have recessionary effects, in particular during the second oil price hike in 1979–81 (see the computations presented in Balassa and McCarthy, 1984).
- Budget deficits were only allowed to rise within narrow limits in East Asia, while the major debtor countries in Latin America had high and growing public sector deficits.
- Correspondingly, average annual rates of inflation amounted to 14 and 62 per cent, respectively (1973–82). High inflation rates in Latin America have discouraged private capital formation and contributed to slow growth of investment.

These differences of adjustment policies do not only explain the superior economic performance of the relatively open economies of East Asia; they are also responsible for the tenable debt situation in this region.[1] In Latin America, it was in particular the voluminous public sector borrowing abroad that has caused severe debt problems in the 1980s. Public expenditure usually incorporated a high import content,

aggravating already existing balance of payments difficulties which in turn required new lending. In addition, the debt-servicing capacity was impaired in the medium term, since part of the foreign borrowing was used to finance consumption expenditure rather than investment and, hence, did not yield foreign exchange revenues or savings. And finally, high and growing public sector deficits in Latin American countries augmented balance of payments difficulties since they fuelled domestic inflation which, without appropriate exchange rate adjustment, discouraged the necessary expansion of exports.

A final question is whether this analysis of the causes for external indebtedness also applies to low-income countries. It is argued that these countries have to master special economic conditions such as a high susceptibility to commodity-induced external shocks due to their reliance on export earning from few primary commodities, a still rudimentary stage of market intermediation and a dependence on discretionary flows of foreign aid. According to this view, low-income countries are not mature enough to cope with external shocks in the framework of an open trading environment. This suggestion is, however, not supported by empirical evidence.

Wheeler (1984) has applied a cross-section analysis of African states with two sets of explanatory variables. The first set, so-called environmental variables, describes external factors influencing economic development in Africa such as climatic conditions (rainfall), terms of trade changes, inflow of foreign aid, stability of export earnings and military disruption. These variables taken together explain in Wheeler's analysis more of the Sub-Saharan economic malaise than the policy variables such as real effective exchange rates, import allocation policies and the trade balance included in the regression estimates. Despite the strong influence of environmental variables on economic growth, it was shown, however, that government behaviour summarized under import allocation policies had an important impact on the countries' ability to cope with external shocks. Countries maintaining previous levels of imports when the availability of foreign exchange was reduced, were found to perform substantially worse than countries adjusting their import policies to external shocks in a more flexible manner.

Essentially the same result emerges from an earlier study by Balassa (1982). If Sub-Saharan Africa, which comprises the bulk of low-income countries, is split into a group of relatively market-oriented countries and another group of relatively interventionist countries,[2] the first group has clearly achieved a superior economic performance. Countries like Botswana, Cameroon, Ivory Coast, Mauritius, Kenya, Malawi, Niger, Togo and Burkina Faso classified, by African standards, as relatively market-oriented, adjusted to the 1974–78 external shocks through export promotion and import substitution, thereby accelerating economic

growth, reducing capital–output ratios and increasing domestic saving rates. By contrast, more interventionist countries such as Benin, Ethiopia, Madagascar, Tanzania, Zambia, Zaire, Sudan and Senegal lost shares in export markets and failed to offset these losses through import substitution. Economic growth decreased since either incremental capital–output ratios increased or domestic savings declined (or both) as a result of an excessive reliance on quantitative interventions.

Policy conclusions

Country-specific peculiarities apart, the evaluation of the empirical evidence on balance supports the proposition that developing countries can benefit from an integration of their economies into the international division of labour. The outward-oriented trade regime has been successful in promoting sustained economic development and a rapid process of industrialization by exposing the domestic economy to international competition. External trade has contributed to improve the allocative efficiency of the economy as a whole by bringing the structure of production in line with the country's comparative advantage and to reap irreversible external benefits from:

- the exploitation of economies of scale through exports;
- the stabilization of export earnings through export diversification into manufactured goods;
- the increase of savings for investment through raising real incomes; and
- the acceleration of technological innovation and human capital formation through competition from, and contacts with, abroad.

Such gains are foregone in an inward-oriented trade regime, since import protection and the whole system of market regulations do not only discriminate against exports, distort the structure of production and make it rigid, but also cause losses in efficiency through cartelization, rent-seeking behaviour, the formation of a labour aristocracy and the expansion of bureaucracy.

Export promotion and outward-oriented trade regimes have frequently been misinterpreted to be policies which deliberately promote exports over other economic activities and beyond the level attainable under free trade conditions (see, for instance, Streeten, 1982). Such policies would indeed be doubtful, since artificial advantages for export production are likely to result in a wasteful use of capital and labour, as does excessive import substitution. The crucial point to be made is that

government incentives to industrialization should be compatible with an optimal allocation of resources to the largest extent possible (as elaborated in the rejoinders to Streeten by Henderson, 1982, and Balassa, 1983). Export promotion strategies provide incentives to exports sufficient to compensate for the discrimination of export production inherent in import protection; they provide a uniform incentive to both import substitution and exports and thus to saving and earning foreign exchange per unit of domestic resources used; but they do not aim at boosting exports by discriminating against production for the local market. The emphasis is on specialization based on comparative advantage, not on export expansion *per se*. It is in this sense, and only in this, that the export promotion strategy is differentiated from an import substitution strategy. The system of incentives is neutral with respect to sales in domestic or in world markets, if relative domestic prices of importables and exportables are allowed to reflect the respective world market prices.

Countries still adhering to an inward-oriented development strategy seem to be able to benefit from restructuring their trade and industrialization incentives in such a way that the new system of incentives encourages export expansion along with efficient import substitution. Trade liberalization entails the two tasks of substituting price signals for administrative controls and of adjusting domestic relative prices to international relative prices, either by gradual measures or shock treatment. Liberalization does not necessarily mean, as has been said above, the implementation of free trade and non-intervention in all other markets; it rather means a reform of economic policies, so that the price mechanism can work more effectively and competition is less distorted. The economically successful Asian NICs, which have not abstained from a substantial degree of government intervention in their development process, may serve as illustration. Government measures to remove market failures are perfectly justified, provided that such market imperfections are real (non-pecuniary externalities, public goods character of some goods or services, natural monopolies and the like) and not the result of excessive encroachment of public authorities into the market process (as in most cases, see Krueger, 1983, chapter 7). Dismantling economically harmful government interventions require *ad hoc* measures to be replaced by a stable and foreseeable policy framework, uniform rather than selective interventions and a return to price flexibility which allows for a proper response to market changes.

The previous conclusions have stressed that the main factors determining the success of outward-oriented economic development are to be found on the supply side of the economy. To be sure, world market conditions also matter and when they are as favourable as they were in the 1950s and 1960s, the chances for accomplishing a successful transition to an open trade regime are particularly good. But even a

buoyant external demand can only be transformed into an impetus to economic development if there is an adequate export potential. Nevertheless, scepticism holds on and fuels new variants of export pessimism which rest on the assumption that the revival of protectionism will further restrict access to markets of industrialized countries, that these markets cannot absorb expanding exports from a large number of developing countries, and that world demand will remain sluggish due to a weak economic performance of industrialized countries.

Though 'new protectionism' in industrial countries has not completely eroded the gains from earlier rounds of trade liberalization (Hughes and Waelbroeck, 1981, p. 131) and has not prevented export-oriented economies (in particular the East Asian NICs) from penetrating foreign markets, the danger is that it generates additional uncertainty among investors in developing countries concerning engagement in export-oriented activities. Investors may then turn to presumably 'safe' investment opportunities geared towards production for local markets, and political forces favouring an import-substitution type of economic development may succeed in forestalling or at least slowing down any attempt to liberalize the system of economic incentives. In this sense, protectionists in the industrial countries play into the hands of protectionists in developing countries.

As to the proposition that it will be impossible for all developing countries to emulate success stories, because the resulting surge of manufactured exports to Western markets would cause a glut on these markets and provoke further protectionist tendencies (Cline, 1982; Spraos, 1983, p. 140), it reflects a fallacy-of-composition. When moving in the direction of market liberalization, it takes a longer time for large, natural resource-rich countries, e.g. in Latin America, starting from a higher level of distortions, to arrive at the same manufactured export share in GDP than for small, labour-abundant countries of the Asian type. It would be even more likely that manufactured export shares in the former group would always fall behind those in the latter group, even at the same population and income levels. Nor would all developing countries export the same products, given differences in resource endowments and skills. Even in the labour-intensive segment of the product range, there is a wide variety of manufactures developing countries can specialize in, and for most of these products market penetration is rather marginal in industrialized countries. Moreover, the implementation of an outward-oriented trade regime would provide for some degree of import liberalization. This offers the chance to expand south–south trade along with south–north trade, in particular with labour-intensive and standardized capital-intensive products. And finally, should too many developing countries specialize in the same products for exporting, their terms of trade would deteriorate (other

things being equal). But this can be only a temporary effect because it is unreasonable to assume that investors and exporters do not learn; they will probably react to declining prices by changing the product mix.

As to export pessimism derived from slow economic growth in developed countries, it should be emphasized that for industrializing developing countries there is not a stringent and invariable link between the rate of expansion of world demand and that of export (Riedel, 1984). The composition of output changes and so does the structure of exports. In fact, the changing composition of exports was the major reason behind rapid export expansion of developing countries over the past 25 years. Third World manufactured exports grew twice as fast as real GDP in industrialized countries in the 1960s and more than four times faster after 1973 when industrialized countries experienced successive economic recessions.

Notes

1. An exception is, of course, the Philippines, which followed a Latin American type of development policy in the 1970s. See Hill and Jayasuriya (1985) and the literature cited there.
2. The range of income levels was fairly similar among the two groups of countries.

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The International Debt Problem: Do We Need a New Debt Strategy?*

ALEXANDRE KAFKA

Introduction

According to an old saying, when one is faced with a problem, the important thing is not to seek a solution, but to find a scapegoat. However, enough has been written about the causes of the present international debt crisis to justify leaving this aspect aside.[1] Rather, this paper concentrates on the techniques used to deal with the crisis, the partial results achieved so far and the new departures required. It recommends nothing radical but demands greater emphasis on growth-oriented policies, not only in the debtor but in the creditor countries, and on policies designed to lower interest rates and to promote appropriate capital flows.[2]

The problem defined

The present international debt crisis[3] means far more than a breakdown in 'normal' debt service[4] by a large number of developing countries and a breakdown in voluntary lending to them. It also means a rise in

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unemployment and a decline in living standards in these countries which may strain the social fabric. One cannot, even today, wholly ignore the risks it poses to the world's financial system. Further repercussions include a drag on the entire world economy, including the industrial countries.

Just to give an idea of the size and the scope of the problem, a few figures may be helpful. At the end of 1985, total gross debt of capital-importing developing countries (Tables 1 and 2) was close to US $900 billion, an increase of one-third since the start of the debt crisis. More than one-third of this debt was owed to commercial banks. Countries with recent debt-servicing problems[5] represented three-fifths of the total gross debt at the end of 1985. Total gross debt was more than one-and-a-half times the exports of goods and services of capital-importing less-

Table 1 Countries with recent debt-servicing problems (in alphabetical order).

311	Antigua and Barbuda	682	Mauritania
213	Argentina	273	Mexico
339	Belize	686	Morocco
638	Benin	688	Mozambique
218	Bolivia	278	Nicaragua
223	Brazil	692	Niger
626	Central African Republic	694	Nigeria
628	Chad	283	Panama
228	Chile	288	Paraguay
634	Congo	293	Peru
238	Costa Rica	566	Philippines
243	Dominican Republic	968	Romania
248	Ecuador	722	Senegal
469	Egypt	724	Sierra Leone
253	El Salvador	726	Somalia
648	Gambia, The	199	South Africa
652	Ghana	362	St Lucia
328	Grenada	732	Sudan
258	Guatemala	366	Suriname
656	Guinea	738	Tanzania
654	Guinea-Bissau	742	Togo
336	Guyana	746	Uganda
263	Haiti	298	Uruguay
268	Honduras	299	Venezuela
662	Ivory Coast	582	Vietnam
343	Jamaica	862	Western Samoa
522	Kampuchea, Democratic	473	Yemen Arab Republic
668	Liberia	188	Yugoslavia
674	Madagascar	636	Zaire
676	Malawi	754	Zambia
678	Mali		

Table 2 Countries without recent debt-servicing problems (in alphabetical order).

512	Afghanistan	542	Korea
612	Algeria	544	Lao P.D. Republic
313	Bahamas	446	Lebanon
419	Bahrain	666	Lesotho
513	Bangladesh	548	Malaysia
316	Barbados	556	Maldives
514	Bhutan	181	Malta
616	Botswana	648	Mauritius
748	Burkina Faso	558	Nepal
518	Burma	353	Netherlands Antilles
618	Burundi	564	Pakistan
622	Cameroon	853	Papua New Guinea
624	Cape Verde	182	Portugal
924	China, People's Republic	714	Rwanda
233	Colombia	716	São Tome and Principe
632	Comoros	718	Seychelles
423	Cyprus	576	Singapore
611	Djibouti	813	Solomon Islands
321	Dominica	524	Sri Lanka
642	Equatorial Guinea	361	St Kitts-Nevis
644	Ethiopia	364	St Vincent
819	Fiji	734	Swaziland
646	Gabon	463	Syrian Arab Republic
174	Greece	578	Thailand
532	Hong Kong	866	Tonga
944	Hungary	369	Trinidad and Tobago
534	India	744	Tunisia
536	Indonesia	186	Turkey
436	Israel	846	Vanuatu
439	Jordan	459	Yemen, P.D. Republic
664	Kenya	698	Zimbabwe

developed countries (LDCs) and almost two-fifths of their gross domestic product (GDP).[6] For countries with recent debt-servicing problems, total gross debt represented a much higher proportion of exports and GDP. Total debt net of gross international reserves was lower than total gross debt by only one-sixth for all capital-importing countries.[7]

Emergency action

When the debt crisis erupted, the most pressing problem seemed to be the avoidance of an extended interruption of interest payments to commercial banks. Such an interruption could have affected the profits and,

eventually, the capital of the major commercial banks that were involved in cross-border loans. The result could have been a threat to the world financial system. The interruption could also have led to an even worse crisis in debtor countries than occurred.[8] Emergency finance was arranged from the US Exchange Stabilization Fund and the Bank for International Settlements (BIS). Official export credits were also offered. In the case of Mexico, moreover, an ingenious use was made of the US strategic oil reserve as emergency finance. Also at that time, the International Monetary Fund (IMF or the Fund) was in certain cases able to make available its own type of emergency finance through its Compensatory Financing Facility (CFF).[9] In the meantime the nature of the CFF has changed radically. Emergency use of the facility is rarely possible today.

The need for emergency finance has been offset to an extent by greater experience with debt-servicing problems. The experience has helped banks (and others) to organize themselves to deal with such problems, e.g. by putting up emergency bridging loans until more lasting solutions can be found.[10] The need for emergency finance has also been moderated by increased primary bank capital and reduced fears that major borrowers would choose to default. Moreover, by contrast with what occurred in 1982, debtors are applying for help before their reserves are exhausted.

The debt strategy

The debt problem was not to be solved[11] solely by emergency finance. It was recognized that it would require adjustment by the debtor countries, as well as action to restore and, for a time, replace, voluntary bank lending by so-called concerted bank lending and by official finance. The relationship between recovery from the recession in the industrial countries, the motor of the world's economy, and the debt problem was also recognized, though the extent of the recovery needed was underrated and the whole problem was treated with complacency. Little, if anything, was done about direct interest rate relief.

Countries were encouraged to seek adjustment in co-operation with the Fund. It provided advice and where necessary, financial assistance. Also, the Fund assisted countries in obtaining financing, rescheduling of debts or 'new money', from others, essentially commercial banks; this role was not unprecedented, but its extent vastly increased.

The Fund's resources were loaned subject to arrangements which included programmes with increasingly strict conditions, aiming at sustainable balance of payments equilibrium.

The 'conditionality' of the Fund has been explained by various considerations, in particular the need to assure repayments and thereby

the revolving nature of the Fund's resources, as well as the timely recovery of access to the resources of this international credit co-operative[12] by a country that has borrowed from it.

The traditional policy instruments used in the Fund's programmes are those promoting demand restraint (restrictive fiscal and monetary policies) and exchange rate changes. To stimulate growth, the Fund has tried more and more to adopt 'supply-oriented' policies. Attention has increasingly been directed toward avoiding distortions of relative prices, not just exchange rates, but also interest rates so as to enable a country to increase savings and to allocate resources to those areas of its economy where they might be most productive and, therefore, most conducive to growth. This, of course, directed the Fund into increasingly sensitive policy areas, e.g. avoidance of all kinds of subsidies. On the other hand, at first, substantially larger resources were made available for substantially longer periods, so that adjustment could be extended.[13] Under certain circumstances, a more gradual approach could be expected to be less disruptive of growth. Access to the Fund's resources has, however, more recently been sharply reduced.

The conditionality of the Fund's arrangements has always created problems between the institution and its borrowers. The more conditionality was tightened, the greater these problems became. As a result of the debt crisis, moreover, the Fund's financial operations with developing countries expanded; at the same time, there were no such operations with industrial countries. This changed the role of the Fund. It became, like the World Bank, an institution which operated with only part of its membership as a lender, i.e. the developing countries. The resulting perception of an asymmetric role was reinforced by another fact. As a normative institution, the Fund oversees the international monetary system and is to exert 'firm surveillance' (an elastic concept) over the exchange policies of all member.[14] Fund surveillance, however, is effective only where it grants financial assistance, since withholding that assistance is its only effective sanction. However, the Fund's most important members, the industrial countries, have so far managed to escape this sanction and, therefore, the Fund's effective surveillance.

The effectiveness of Fund programmes in improving economic performance has been amply discussed. Countries have questioned their design. In turn, the Fund has questioned countries' programme implementation. There are conceptual problems involved in assessing success.[15] One author, referring to the 1970s, concludes that the current account of programme countries did improve, but he considers the statistical significance of the findings slight.[16] The results are somewhat, but not much, stronger for the basic and the overall balance of payments. Another author,[17] also comparing balance of payments (current account and overall) performance of programme and non-programme countries in the 1970s, finds improvement for programme countries but mentions

that borrowing constraints would in any case eventually lead to balance of payments improvement. One could speculate that programme countries had had larger or longer balance of payments problems.

Adjustment by debtor countries, combined with financial assistance, has been the essence of the debt strategy. To expect countries with debt-servicing problems to reduce their current account deficits (or produce surpluses) quickly enough to avoid a prolonged interruption of interest (not to speak of amortization) payments would have caused extensive hardship in most cases. The political support for sustaining the necessary measures would have been lacking. The measures could have caused, and in some cases did cause, major social unrest. They could also, in some cases, have undermined the ability of a country's export sector to continue or increase its exports, because of lack of imports of raw materials, fuel and spares. Financial relief beyond that for emergencies was required.

The Fund's loans in the debt crisis are entirely in line with the purposes for which it was endowed: to enable members to face balance of payments problems by adopting policies which would be less disruptive to international co-operation than those the country might otherwise choose.[18] The Fund's financial resources are derived from the quota (capital) subscriptions made by each member and paid up in its own currency and, to a limited extent, in Special Drawing Rights (SDRs) or other members' currencies (originally in gold).[19] The Fund also borrows members' currencies (with their permission) from them and can borrow in the market although it has never done the latter.[20] The Fund's own resources are, however, very limited. They have declined from the equivalent of almost 11 per cent of the value of world imports in 1951–5 and nearly 13 per cent in 1959, after the first quota increase, to less than 5 per cent at present.[21]

Since the first oil shock, the Fund has borrowed to a major extent from several members individually. Since the early 1960s, moreover, the General Arrangements to Borrow (GAB) has enabled the Fund to borrow from the so-called Group of 10 (G-10) and Switzerland, later reinforced by Saudi Arabia.[22] The GAB was initially intended to enable the Fund to borrow resources for use in loans to G-10 countries only. However, this rule was later changed to enable it to obtain loans from this group to relend to other countries. Such use has not occurred; the G-10 countries appear resolved to make GAB resources available only for one of their participants or in the event of a crisis threatening the 'stability of the international monetary system'. The meaning of this phrase has never been explained. The highly flexible central bank swap network[23] can perform functions similar to those of the GAB. Because of its own limited resources and difficulties in borrowing, the Fund, with the assistance of central banks, pressed other official and private lenders, particularly commercial banks, to assist with their much greater resources to extend

financial assistance to countries with debt-servicing problems. It has sometimes been said that the Fund and other official lenders were being used to 'bail out' the banks from the effects of their 'overlending'. The Fund has maintained that, on the contrary, it has been 'bailing in' the banks for their own protection, i.e. to avoid lengthy interruptions of interest payments.

What the Fund did was to make access to its own resources conditional not only on a country's policy undertakings, but on its securing reschedulings and, where necessary, additional loans from the banks to which it was already indebted (so-called new money). This involved a great deal more than enunciating a policy. Fund staff and management acted to persuade financial authorities to encourage banks to co-operate, and sometimes they persuaded banks directly. The Fund's effort was based on the banks' self-interest. Fund financial arrangements would reduce or avoid banks' losses or the amount of new money they would have to put up to enable countries to pay interest and avoid non-accrual or non-performance of their loans.[24] Nevertheless, bank lending to countries with debt-servicing problems fell drastically after 1982 (see Table 3); the banks' lending fell to 30 per cent of the interest payments which they received.

The commercial banks insisted on Fund involvement through Fund financial arrangements when they were asked to make new money available through 'concerted' lending (despite the questions which can be raised on the effectiveness of Fund programmes). When a country's balance of payments had adjusted to the extent that it could not justify additional access to the Fund's resources and needed only reschedulings, not new money from other lenders, the banks demanded that some other form should be found to engage the responsibility of the Fund. This other form was so-called enhanced surveillance.[25] Under such surveillance, the country adopts a quantified economic programme which the Fund

Table 3 Percentage growth of gross debt.

	1979	*1980*	*1981*	*1982*	*1983*	*1984*	*1985*
Countries with recent debt-servicing problems							
Total	20	22	21	15	5	4	3
Official long-term	18	19	19	13	16	11	9
Other long-term	21	15	19	14	12	3	5
Countries without such problems							
Total	18	15	10	12	9	7	11
Official long-term	14	13	10	11	9	7	9
Other long-term	35	14	13	13	11	8	14

Source: IMF, *World Economic Outlook*, April 1986, Table A48, p. 245.

examines twice, rather than the usual once, a year. There is no conditionality because there is no involvement of Fund resources. The country is authorized to make available to its creditors the Fund's twice-yearly judgements. The banks are able to use these judgements to interrupt the rescheduling exercise, if they so choose. Whether this is a practical possibility is, of course, doubtful. Enhanced surveillance was by no means free of problems similar to those brought about by the conditionality of financial arrangements.

In the rescue operations resulting from the debt crisis, an important role was played from the outset by The World Bank and by regional development banks, and an appeal was also made to bilateral official lenders, including export financing and guarantee agencies. The World Bank, in particular, greatly speeded up the disbursement of its loans via so-called special deposits, and raised the proportion of its loans given in the form of general purpose structural adjustment loans, or sectoral loans, as distinct from project loans. Export financing and guarantor agencies were particularly slow to respond at the beginning of the debt crisis.

To simplify rescheduling of amortization payments after the need for concerted loans of new money had ended, the Fund encouraged banks to engage in multi-year rescheduling arrangements (so-called MYRAs), under which reschedulings were undertaken for a series of years, sometimes unconditionally, sometimes conditionally, so that the banks could, in theory, retract from their agreement. Both in MYRAs and in short-term arrangements the banks, at least until now, have insisted on strict proportionality, i.e. that all banks which had an exposure in a given country, however small and however unimportant to the bank, should participate in new money loans and in rescheduling in proportion to their exposure in the country concerned. For the larger countries this required the negotiation of rescheduling agreements with hundreds of banks, an extremely difficult and time-consuming proposition. Moreover, it was a process which very often enabled small banks practically to force the debtor country to make offsetting deposits or engage in other practices to bring in a reluctant creditor. Also, strict proportionality did not prevent banks from selling, at varying discounts, part of their loans to a country with debt-servicing difficulties.

An aspect of MYRAs is the reduction in spreads over the London interbank offered rate (LIBOR) or prime in rescheduled loans. These reductions, whatever their size in relation to the original spreads, were modest in their effect on borrowing costs. Even falling real interest rates after 1984 made only a relatively modest contribution to the alleviation of the debt-service problem.

The official bilateral lenders, essentially the Paris Club, have been reluctant to go ahead with MYRAs; where they have done so, however,

they have appeared to demand more searching examinations in enhanced surveillance arrangements than have commercial banks, though it is not clear that the lenders have obtained such examinations.

The Fund's limited resources and its dependence on borrowing at a time when the need for its assistance was unprecedentedly great, as well as the need to call on other lenders, have all created problems for the institution and the international financial community. Its increasingly close collaboration with the banks force it to be particularly careful to avoid giving even the impression of adopting banks' standards of proper policies (and, therefore, of creditworthiness). On the other hand, it had to avoid giving the impression of bending its own judgement to that of its debtor members so that rescue operations for the latter could be undertaken.[26]

Financial and enhanced surveillance arrangements, particularly if continued for long, are likely to pose increasingly severe political and management problems for the involved countries. The eternal tutelage by an international entity is resented, and the more complete the performance criteria or targets become, the more, despite the possibility of waivers and modifications, they tend to interfere with a government's freedom and need efficiently to manage its own economy.

Success and failure

The debt strategy has obviously been successful in preventing failures which could otherwise have occurred among banks with large exposure to countries with debt-servicing difficulties. Indeed many of those banks have been able to increase their profitability since the debt crisis erupted.[27] The strategy has also been called a success because there has been a remarkable reduction in current account deficits of the countries with recent debt-servicing problems.[28] However, a country's payment deficit may disappear simply because it has exhausted its reserves and credit. That is hardly a success.

Overall, the debt strategy has been less than successful. What one would expect of a successful debt strategy would be that it should, within a reasonably short time, enable countries with recent debt-servicing problems to re-establish or approach 'normal' debt service along with voluntary access to the international capital markets. This has certainly not occurred generally (see Table 3). What one would also expect of a successful debt strategy is a resumption of satisfactory and sustainable growth in the countries with recent debt-servicing difficulties. This also has not occurred as a general result (see Table 4). Moreover, the resumption of growth, where it occurred, drew on idle capacity created by the preceding negative growth or slowdown in growth; it has not yet reflected an ability to resume high investment.[29] The third oil shock – the

Table 4 Growth rates of real GDP.

	1968/77	*1978*	*1979*	*1980*	*1981*	*1982*	*1983*	*1984*	*1985*
				Per capita					
Countries with recent debt-servicing problems	3.3	0.8	3.1	2.2	−1.0	−2.5	−4.8	0.2	0.6
Countries without such problems	3.1	5.2	1.5	2.6	2.8	2.0	3.9	4.2	3.2
				Overall					
Countries with recent debt-servicing problems	5.6	3.5	5.4	4.6	1.2	−0.1	−2.5	2.6	2.8
Countries without such problems	5.8	8.0	4.1	4.8	4.9	4.3	6.0	6.9	5.5

Source: IMF, *World Economic Outlook*, April 1986, Table A6, p. 185.

fall in oil prices – has, moreover, brought the recurrence of severe crises for some countries, over and above the general malaise from which so many suffer.

There is thus no question, with the benefit of hindsight, that the debt strategy called the case-by-case method has been flawed. It purports to produce solutions adapted to the conditions of each country which faces debt-servicing problems, subject to treating similar cases in a similar fashion. The approach has concentrated on adjustment by the debtor countries, so-called concerted lending of new money to them and rescheduling of amortization payments by them; interest rates or, rather, concessions on spreads granted by lenders have been extremely limited, particularly in the beginning of the debt crisis. However, the case-by-case approach neglects, certainly so far, the need for general approaches designed to improve the worldwide economic environment. Such improvement is desirable for its own sake, but it is also an essential part of any successful debt strategy. Perhaps the neglect of this ingredient reflects a complacent belief that the world environment can be relied upon to improve sufficiently on its own.

It could perhaps be argued that the insistence on an improved world economic environment as a condition of progress on the debt problem is misplaced. Such an argument could allege that the debt crisis has affected only some capital-importing countries, while there are, on the whole, no obvious differences in the way the world economic environment has affected, and could affect, all these countries. However, this would be a simplistic view. The extent to which an improved world economic environment will enable a country to proceed to a solution of its debt

problem will certainly depend very much on its own policies, but without an improved world economic environment the best policies will not be enough. Moreover, the better the world economic environment in terms of industrial country growth, the smaller the number of developing countries that must do badly if others do well. Obviously, the greatest improvement in the world economic environment will not prevail over some types of country policies.

The present strategy, to conclude, has not solved the debt problem, and its continuation is unlikely to solve it.

Ingredients of a solution

The first need is, obviously, adequate debtor country policies. However there are others.

Consider, first, the growth of the world economy. With the exception of 1984, growth of industrial countries and the world economy has been slow.

Even developing countries without recent debt-servicing problems have had much lower growth rates in 1979–82 than before, though these rates rose strongly in 1983–4 (Table 4). However, for capital-importing countries both with and without debt-servicing problems, slow industrial country growth along with deteriorating terms of trade has meant inadequate growth of export opportunities since 1981 (Table 5).

The decline was particularly pronounced for countries without recent debt-servicing problems (and the average export market growth of the latter in 1982–5 was actually slightly lower than for countries with such problems). This fact casts doubt on the continuity of the growth performance even of the countries without recent debt-servicing problems

Table 5 Growth of export markets (volume).

	1978	*1979*	*1980*	*1981*	*1982*	*1983*	*1984*	*1985*
Countries with debt-servicing difficulties								
Total	7	6	2	0.2	−1	4	11	4
Non-oil	9	8	7	4	1	6	13	6
Countries without such difficulties								
Total	8	8	2	1	−0.1	5	10	3
Non-oil	10	10	6	5	2	6	12	5

Source:

Estimates. Export market growth represents change in volume of imports by industrial countries, plus twenty non-oil developing countries (NODCs) with largest imports in 1980, plus seven groups of non-industrial countries (i.e. the other NODCs in Africa, Asia, Europe Middle East, Western Hemisphere, Eastern Europe and oil-importing countries).

and *a fortiori* of those with such problems whose debt service (Table 6) is extremely high.

It has been suggested[30] that about 3 per cent of growth in the industrial countries would be adequate to permit something like 4.5 per cent GDP growth in developing countries as a group.[31] Even if 4.5 per cent were enough growth, a 4.5 per cent average growth rate composed of 6 per cent in countries without debt-servicing problems and 3 per cent in countries with such problems is totally inadequate (see Table 4).

Nor can one dismiss this argument by calling on the latter group to improve their economic policies. Other than demand restraints and, to some extent, exchange rate policies, economic policies do not produce their effect quickly. But that is not enough. Since the beginning of the debt crisis, progress has been made in many countries in eliminating waste and inefficiency. There is still the need for faster export market growth, at least at stable terms of trade; the group with recent debt-servicing problems particularly needs such growth. The consensus needed to adapt the demand restraint and supply-oriented policies necessary to promote balance of payments adjustment and continued debt service, as well as improved economic policies generally, all of which may damage the short-term interests of parts of the population, might not emerge in poor countries with little room for even temporary deterioration in the standard of living.

Even if a 3 per cent or slightly better growth rate was achieved by the industrial countries and a 4.5 per cent growth rate was reached for all or

Table 6 Debt service and interest payments.

	1978	*1979*	*1980*	*1981*	*1982*	*1983*	*1984*	*1985*
Debt-service and interest-payments ratios[a]								
Countries with debt-servicing difficulties								
Debt-service ratio	28	28	25	31	38	34	35	37
Interest-service ratio	10	12	13	18	23	22	23	23
Countries without such difficulties								
Debt-service ratio	11	11	11	12	14	14	15	16
Interest-service ratio	5	5	5	6	7	7	7	7
Debt-service and interest payments as percentage of GDP[b]								
Countries with debt-servicing difficulties								
Debt service	5	5	5	6	6	6	7	7
Interest service	2	2	3	4	4	4	5	4
Countries without such difficulties								
Debt service	3	3	3	3	4	4	4	4
Interest service	1	1	1	2	2	2	2	2

[a] IMF, *World Economic Outlook*, April 1986, Table A51, p. 251.
[b] Ibid. Table A38, pp. 224–5, and estimates.

most developing countries, these rates would be of doubtful adequacy. They would indeed permit developing country per capita growth of GDP (about 2 per cent)[32] but it is much more doubtful whether they would permit the absorption of unemployment created during the recession years of the early 1980s and prevent the further rise of unemployment.[33]

The accent on growth in countries with debt-servicing problems has been noted as the central thrust of the Baker initiative,[34] an important conceptual departure from the complacency so far prescribed and practised by industrial countries and many international institutions. It should be noted, however, that the Baker initiative is still based on the same prescription that has been followed until now: adjustment and lending. At best, it can work if the industrial countries grow at a much faster rate than so far and faster than the famous 3 per cent, but even that is unlikely to be enough.

There are several reasons for this. One is that industrial country growth with increasing protectionism regarding goods trade would be little help to the countries plagued by debt-servicing problems. From their point of view, attention in trade talks threatens to be excessively if not exclusively concentrated on services. However, industrial countries' growth will have to be quite fast if they are to open (or refrain from closing) their markets to developing country exports.[35]

One may ask, however, why industrial country growth – with open markets – is necessary for developing country growth. Can the developing countries not grow by expanding exports to each other? This would certainly be possible but would, for a considerable time, be an inefficient growth path, for it would require a major structural change in developing countries. One must also realize that the developing countries are just as reluctant to liberalize trade as are industrial countries.

Would additional lending be available to reinforce the effect of continued adjustment efforts by countries with debt-servicing problems, combined with faster industrial country growth and trade liberalization? Increased lending by commercial, or official, lenders has its own problems. The extent to which a debtor with debt-servicing difficulties can step up its borrowing is something which depends on the growth rate of its export markets. Again, faster industrial country growth appears crucial. One must also not underrate the extent to which commercial lenders still consider their capital inadequate to their exposure in developing countries, particularly those with debt-servicing problems, despite the decline in exposure to capital which has occurred since 1982.[36] The matter is further complicated by the reluctance of smaller banks to remain in the group of lenders. In so far as the commercial banks do not feel that they can step up their lending, the development banks will have to play a much greater role. They will require increased resources to do so. This would in any case be desirable, for they can bring to the task a special expertise in project and programme formulation. Indeed to encourage thecommercial banks to resume lending to countries

with debt-servicing problems may require their association with the multilateral development banks; this has, however, undesirable aspects for the borrowers. Export credit agencies have become more flexible recently but could do a lot more to help developing countries with debt-servicing problems.

Direct investment is exempt from some of the difficulties of lending, and there is no question that it would be in everybody's interest to make greater judicious use of such investment. However, it is generally considered[37] that, quantitatively, direct investment cannot supply enough resources. The same is true of such techniques as debt equity swaps. All this should be, and is being, tried, but one cannot eschew other avenues.

One may ask why increased borrowing cannot be replaced by higher domestic savings. It is certainly necessary for debtor countries to stimulate increased domestic savings, but this is unlikely to relieve the need for additional external lending. In the first place, to raise savings before real income has started to increase strongly may be a difficult undertaking. Also, the transformation of domestic savings into foreign exchange can be costly, difficult and slow.

Neither increased world growth, nor increased lending, nor direct investment are likely to be adequate complements to the adjustment efforts of countries with debt-servicing problems. The debt-servicing burden, which remains heavy (Table 6), must be reduced by either macro- or microeconomic measures or both. Macroeconomic policies to reduce still-high real interest rates (Table 7) run into budgetary difficulties in important industrial countries. They also run into difficulties of policy 'concertation' (co-ordination) among industrial countries. One must wait and see whether mutual surveillance promised in Tokyo, Japan, by the Groups of 5 and 7 brings any change.

Recently, there has been some discussions of the delicate problem of whether banks can grant interest rate relief to debtor countries beyond the modest reduction in spreads over LIBOR (or prime) already granted. Such relief, not 'capitalization' of interest, has been discussed in the United States in an agricultural context,[38] and also in the context of sovereign debt.[39] These discussions stress the limited effect on bank profits and on bank capital which interest concessions might have and point to the fact that they would not require, by themselves, new legislation. Fears are frequently expressed about moral hazard and that countries without (or with minor) debt-servicing difficulties would demand the same concessions as countries with major problems. These fears must be weighed against the likelihood that the former countries would not wish to damage their credit standing, though they might also require some concessions. Perhaps the most difficult problem would be how to take the first steps and who should take them.

It is obvious that from the point of view of current cash flow, there is

Table 7 Interest rates.

	1978	*1979*	*1980*	*1981*	*1982*	*1983*	*1984*	*1985*
Six-month Euro$[a]	9.1	11.9	14.0	16.7	13.6	9.9	11.3	8.6
Real rate on 6-month Euro$[b,c]	1.6	2.8	4.5	6.4	7.3	4.9	4.3	3.9
Countries with recent debt-servicing problems								
Export prices[d]	1.6	25.6	28.3	−0.2	−7.5	−5.8	0.6	−4.9
Export prices of industrial countries[e]	5.8	11.9	12.0	5.9	2.8	−0.4	1.6	0.6
Arithmetic average of preceding two lines	3.7	18.8	20.2	2.9	−2.9	−3.2	1.1	−2.2
Nominal 6-month Euro$ rate deflated by above	5.4	−6.9	−6.2	13.8	16.5	13.7	10.2	10.8
Countries without recent debt-servicing problems								
Average annual increase in export prices[d]	6.5	20.3	20.7	0.6	−4.4	−5.7	0.4	−2.6
Arithmetic average of above index and index of export prices of industrial countries	6.2	16.4	16.4	3.3	0.8	−3.5	1.0	−1.0
Nominal interest rate of 6-month Euro$ deflated by above	2.9	−4.2	−2.4	13.4	12.8	13.0	10.3	9.6

[a]IMF, *World Economic Outlook*, April 1986, Table A13, p. 192.
[b]Id., Table A53, p. 254.
[c]GNP deflator, id., Table A9, p. 188.
[d]Id., Table A26, p. 207.
[e]Id., Table A20, p. 200.

no difference between new money, interest capitalization and interest relief. However, the effect on the perception of a country's creditworthiness of these different methods of increasing the cash flow may be very different. The continued accumulation of debt, whether through new money or interest capitalization, could have a more (as well as a less) damaging effect than even a negotiated reduction (not to speak of a general fall) in interest rates. Another aspect which may greatly affect the perception of a country's creditworthiness is the distribution of additional lending by types of lenders. Certainly, the increased participation of international institutions and governments (the latter have been unusually reticent), would greatly improve the perception associated with any given method of relief.

In sum, beside adequate policies in the debtor countries, there are a number of other ingredients to the solution of the debt problem. One is more rapid, non-inflationary growth in industrial countries (which is required anyway for its own sake). Reduced protection is also necessary. Debt-service relief should also come from a general reduction in interest

rates, on which a basic ingredient of a successful debt strategy, namely faster industrial country growth, is also dependent. Interest rate concessions by banks in the context of greater lending to countries with debt-servicing problems present a major challenge. Additional lending, especially by multilateral organizations, is also required.

Notes

1. Jeffrey D. Sachs (1985). 'External Debt and Macroeconomic Performance in Latin America and East Asia'. 2 *Brookings Papers on Economic Activity* 229 (1985).
2. Tables quoted in the text are numbered 1 to 7. Data relevant to the possible causes of the crisis are presented in the Appendix as Tables A.1 to A.16.
3. The crisis is generally dated from August 1982, when Mexico requested assistance from the IMF and the United States. There were earlier crises involving individual (or few) countries and much smaller international debts.
4. 'Normal' debt service requires that a debtor country can either generate adequate surpluses on the balance of current account items other than interest due, or obtain voluntary loans to pay both interest and amortization. In practice, all debtor countries could not simultaneously generate the surpluses necessary to eschew borrowing completely.
5. For definition of group, see IMF, *World Economic Outlook* 174, Tables II and III (April 1986) [hereinafter cited as WEO].
6. Id., Table A50, p. 249.
7. Id., Table A44, p. 239.
8. See John Kraft, 'The Mexican rescue', pp. 9 *et seq.* (G–30, New York 1984); see C. Fred Bergsten, William Cline and John Williamson, *Bank Lending to Developing Countries: The Policy Alternatives* **13**, 17 (April 1985).
9. IMF, *Selected Decisions* pp. 57–9 (9th issue, 15 June 1981, Decision 6224-(79/135), 2 April 1979; and cf. IMF, *Selected Decisions* pp 79–82 (11th issue, 30 April 1985), esp. 'Guidelines on cooperation', Decision 7528-(83/140), 11 September 1983.

   Under the CFF, the first 50 per cent of quota could be made available merely on an undertaking by the country to co-operate with the IMF in the future, where appropriate, in the solution of the country's balance of payments problems; even the second 50 per cent could be made available merely on condition that the country had been co-operating with the Fund in the solution of its balance of payments difficulties, a condition which was satisfied if it had formulated a programme, not necessarily with the Fund and not necessarily in the upper tranches. As a result, the loans under this facility were available practically on a statistical demonstration that a loss had occurred.

   Almost the same degree of conditionality now attaches to CFF loans as to other, so-called tranche policy, loans, i.e. in most cases, the existence of an 'upper tranche' (highly conditional) financial arrangement with the Fund.

   The change in the facility was based on the belief that, in general, though not necessarily, a country would have balance of payments problems beyond

those that were determined by conditions outside its control and that were self-reversible.

10. For example, a bridging loan by Brazil, Colombia, Mexico and Venezuela for Argentina.

11. Strictly speaking, the concepts of liquidity and solvency are not to be applied to sovereign debt.

12. Peter B. Kenen, 'Financing, adjustment and the International Monetary Fund', *Studies in International Economics* pp. 40 *et seq.* (1986) [hereinafter cited as Kenen]. Kenen questions the need for or effectiveness of repayments to ensure the revolving character of the Fund's resources.

13. See, especially, IMF, *Selected Decisions* p. 41 (1986, Decision 6783-(81/40)), 'Enlarged access policy'. It should be noted that the Fund agreement places no absolute limit whatsoever on access to the Fund's resources by a given member country. IMF, *Articles of Agreement*, Art. V(4), notwithstanding Art. V(3)(a)(iii).

14. *Articles of Agreement*, Art. IV(3).

15. See *The quest for economic stabilization* pp. 117 *et seq.* (directed and edited by Tony Killick) (Heinemann Educational, London, in association with the Overseas Development Institution, London, 1984) [hereinafter cited as Killick]. The conceptual problems include, *inter alia*, the frequency of waivers and modifications of performance clauses of programmes.

16. Id., at pp. 233–5.

17. For the 1970s, Donal J. Donovan, 'Macroeconomic performance and adjustment under fund supported programs: the experience of the seventies', *IMF Staff Papers*, Vol. 24, No. 2, (1982) finds improvement in the balance of payments (pp. 180, 181), but see p. 197.

18. IMF, *Articles of Agreement*, Arts. I(v), V(3)(a).

19. Id., Art. III(3)(a).

20. Id., Art. VII(1)(i).

21. See Peter B. Kenen, Section IV N. 2 *supra* at pp. 20–1.

22. IMF, *Selected Decisions* pp. 128 *et seq.* (11th issue, 1986), Decisions 1289-(62/1) and 7337-(83/37). At 30 April 1986, total borrowings outstanding amounted to 14.6 billion SDRs; under the reinforced GAB, 18.5 billion are available; see *International Financial Statistics*, June 1986, 'Fund accounts'. Outstanding borrowings represented 16 per cent of quotas and the GAB (reinforced), more than 20 per cent; but the amounts are much higher proportions of the quota resources actually usable in any particular case or cases.

23. Federal Reserve Bank of New York, *Quarterly Review*, Winter 1985/6, Vol. 10, No. 4, p. 46.

24. For the much-discussed alternative of interest capitalization, see C. Fred Bergsten, Section III N. 1 supra at pp. 133 *et seq.*

25. Another form, considered quite exceptional (so far), is an arrangement like the one adopted in 1985 for Colombia. It is of the same form as a financial one, but no financial assistance is foreseen. This should be distinguished from those cases where financial assistance is available but not used.

26. Peter B. Kenen, Section IV N. 2 *supra* at p. 53.

27. See Joint Economic Committee, US Congress, Staff Study, *The impact of the Latin American debt crisis on the US economy* 4 (10 May 1986) [hereinafter cited as Joint Economic Committee].
28. They fell from 28 per cent of exports of goods and services in 1981 to 2 per cent in 1985 and from nearly 6 per cent to less than 1 per cent of GDP (*WEO*, April 1986, Table 35, p. 217, and IMF estimates of GDP).
29. *WEO*, April 1986, Table A7, p. 186.
30. See William Cline, *International debt, systemic risk and policy response* 46 (1983); *WEO*, April 1986, Table A53, p. 254. The study has been criticized from various points of view; see Mark Gersovitz, review of above book, XXIV *J. Economic Lt.*, No. 1, p. 105 *et seq.* (March 1986). Jack M. Guttentag and Richard J. Herring, 'The current crisis in international lending', *Studies in International Economics* 48 (1985).
31. See also *WEO*, April 1986, Table A53, p. 254.
32. Based on IMF estimates of population growth, excluding China.
33. The inflow into the labour markets of those countries is, for a variety of reasons, larger than population growth. Combined with productivity growth, the margin for employment growth may be negative unless there are profound changes in production methods, which are unlikely to come about quickly.
34. Joint Economic Committee, Section V N. 1 *supra* at p. 27.
35. Protection discriminates against LDCs; see Bela A. Balassa and Constantine Michalopoulis, 'Liberalizing world trade', discussion paper, The World Bank, pp. 4, 12 (October 1985).
36. See, e.g. *New York Times*, p. D5 (11 June 1986).
37. See Harold Lever and Christopher Huhne, *Debt and danger*, esp., pp. 80–2.
38. See Hearing Before the Senate Committee on Banking, Housing and Urban Affairs, 99th Cong., 2nd Sess., 11 March 1986. (Statement of Robert L. Clarke, Comptroller of the Currency.)
39. Joint Economic Committee, Section V N. 1 *supra* at 36–9.

Appendix

Table A.1 Growth of real domestic demand and GNP of industrial countries.

	1968/77[a]	*1978*	*1979*	*1980*	*1981*	*1982*	*1983*	*1984*	*1985*
Real domestic demand	3.5	4.0	3.6	0.1	0.5	−0.2	2.8	5.1	2.8
Real GNP	3.5	4.2	3.3	1.2	1.4	−0.4	2.6	4.7	2.8

[a]Compound annual rate of change.

Source: IMF, *World Economic Outlook*, April 1986, Table A2, p. 180.

Table A.2 Export unit values in US$ (annual average per cent change).

	1968/77	*1978/81*	*1982/5*
Countries with recent debt-servicing problems	12.4	13.8	−4.4
Countries without such problems	10.4	12.2	−3.1

Source: IMF, *World Economic Outlook*, April 1986, Table A26, p. 207.

Table A.3 Terms of trade (annual average per cent change).

	1968/77	*1978/81*	*1982/5*
Countries with recent debt-servicing problems	2.8	0.7	−1.9
Countries without such problems	1.2	−0.5	−0.4

Source: IMF, *World Economic Outlook*, April 1986, Table A28, p. 209.

Table A.4 Current account balances as percentage of exports of goods and services.

	1968/77	*1978/81*	*1982/85*
Countries with recent debt-servicing problems	−14.0	−21.5	−11.6
Countries without such problems	−8.3	−9.5	−7.2

Source: IMF *World Economic Outlook*, April 1986, Table A35, p. 217.

Table A.5 Export volume (annual per cent change).

	1968/77	*1978/81*	*1982/85*
Countries with recent debt-servicing problems	3.2	3.0	2.4
Countries without such problems	8.6	7.5	6.8

Source: IMF, *World Economic Outlook*, April 1986, Table A24, p. 205.

Table A.6 GDP[a] weighted: real effective exchange rates (countries with and without debt-servicing problems).

Year	*With*	*Without*
1978	100	100
1979	101	101
1980	105	101
1981	118	100
1982	109	98
1983	99	96
1984	101	93
1985	96	87

[a]Current GDP used for the weights.

Source:
Real effective exchange rates from IFS and GDP from IMF, *World Economic Outlook* estimates.

Table A.7 Official gross capital flows as percent of total gross capital flows.

	1978	*1979*	*1980*	*1981*	*1982*	*1983*	*1984*	*1985*
Capital-importing countries with recent debt-servicing problems	24	23	22	22	22	24	26	27
Capital-importing countries without such problems	46	45	47	44	42	43	43	42

Source: IMF, *World Economic Outlook*, April 1986, Table A48, p. 244.

Table A.8 Capital flight proxy (US$ $\times 10^9$).

	1979	*1980*	*1981*	*1982*	*1983*	*1984*	*1985*
Countries with recent debt-servicing problems							
1. Current account	−32	−39	−67	−62	−21	−8	−5
2. Change in gross total debt	49	63	63	62	23	21	14
3. (2 − 1)	17	24	−4	–	2	13	9
4. (3) as percentage of (2)	35	38	−6	–	9	62	64
Countries without such problems							
5. Current account	−18	−26	−32	−28	−27	−14	−22
6. Change in gross total debt	27	29	21	28	24	22	33
7. (6 − 5)	9	3	−11	–	−3	8	11
8. (7) as percentage of (6)	33	10	−52	–	−13	36	33

Positive values of lines 3, 4, 7 and 8 suggest capital flight.

Source:
IMF, *World Economic Outlook*, April 1986, Table A38, p. 233, and Table A48, p. 244.

Table A.9 Resource transfers (countries with recent debt-servicing problems).

	1979	*1980*	*1981*	*1982*	*1983*	*1984*	*1985*
			In US$ × 10⁹				
Net investment income	−14.6	−22.0	−31.7	−42.2	−41.3	−45.2	−43.8
Interest payments	−22.2	−35.0	−47.9	−55.3	−50.8	−56.0	−53.5
Change in total gross debt	*49.4*	*63.2*	*72.8*	*61.6*	*23.0*	*20.5*	*14.2*
Net of net investment income	+34.8	+41.2	+41.1	+19.4	−18.3	−24.7	−29.6
Net of interest payments	+27.2	+28.2	+24.9	+6.3	−27.8	−35.5	−39.3
Exports of goods and services	*178.2*	*237.3*	*236.3*	*208.0*	*202.5*	*217.5*	*209.3*
			As percentage of exports of goods and services				
Capital inflow, net of net investment income	20	17	17	9	−9	−11	−14
Capital inflow, net of interest payment	15	12	11	3	−14	−16	−19

Source:
IMF, *World Economic Outlook*, April 1986, Table A38, p. 224–5, for exports of goods and services, net investment income and interest payments, and Table A48, p. 245, for change in total gross debt.

Table A.10 Resource transfers (countries without recent debt-servicing problems).

	1979	*1980*	*1981*	*1982*	*1983*	*1984*	*1985*
			In US$ × 10⁹				
Net investment income	−5.9	−7.4	−10.3	−12.1	−12.5	−14.4	−16.3
Interest payments	−13.2	−18.3	−23.9	−25.8	−24.6	−28.1	−29.3
Change in total gross debt	*27.4*	*28.8*	*21.4*	*28.0*	*23.8*	*21.8*	*33.4*
Net of net investment income	+21.5	+21.4	+11.1	+15.9	+11.3	+7.4	+17.1
Net of interest payments	+14.2	+10.5	−2.5	+2.2	−0.8	−6.3	+4.1
Exports of goods and services	*217.0*	*277.0*	*302.4*	*297.7*	*300.3*	*332.4*	*335.5*
			As percentage of exports of goods and services				
Capital inflow, net of net investment income	10	8	4	5	4	2	5
Capital inflow, net of interest payment	7	4	−1	1	(−)	−2	1

Source:
IMF, *World Economic Outlook*, April 1986, Table A38, p. 224–5, for exports of goods and services, net investment income and interest payments, and Table A48, p. 245, for change in total gross debt.

Table A.11 Annual average growth (GDP percentage).

	1968/77	*1978/81*	*1982/5*
Countries with recent debt-servicing problems	3.3	1.3	−1.6
Countries without such problems	3.1	3.0	3.2

Source: IMF, *World Economic Outlook*, April 1986, Table A6, p. 185.

Table A.12 Annual average of median inflation rate (consumer prices).

	1968/77	*1978/81*	*1982/5*
Countries with recent debt-servicing problems	8.7	14.1	13.6
Countries without such problems	8.2	11.4	7.6

Source: IMF, *World Economic Outlook*, April 1986, Table A12, p. 191.

Table A.13 Incremental capital output ratios.

	1978	*1979*	*1980*	*1981*	*1982*	*1983*	*1984*	*1985*
Countries with recent debt-servicing problems	7.8	4.7	5.5	21.0	[a]	[a]	6.9	6.4
Countries without such problems	3.6	7.0	5.8	5.5	6.2	4.4	3.8	4.8

[a] Negative growth.

Source:

IMF, *World Economic Outlook*, April 1986, Table A5, p. 184 (GDP growth rate), and Table A7, p. 186 (GCF/GDP).

Table A.14 Average annual GDI and savings in percentage of GDP.

	1978/81		*1982/85*	
	Investment	*Savings*	*Investment*	*Savings*
	Average			
Countries with recent debt-servicing problems	25.9	25.0	19.4	23.4
Countries without such problems	28.2	24.5	26.6	24.7

Source:

Estimates. See also IMF, *World Economic Outlook*, April 1986, Chart 30, p. 89.

Table A.15 Central government fiscal balance as percentage of GDP.

	1978/81	*1982/85*
Countries with recent debt-servicing problems	−2.9	−3.75
Countries without such problems	−3.7	−4.8

Source: IMF, *World Economic Outlook*, April 1986, Table A19, p. 199.

Table A.16 Broad money (average annual percentage change).

	1978/81	*1982/85*
Countries with recent debt-servicing problems	44	76
Countries without such problems	27	24

Source:
IMF, *World Economic Outlook*, April 1986, Table A18, p. 197.

The Flow of Funds for National Development: Savings, Investment and the Mobilization of Resources in Malaysia*

LIN SEE YAN

Introduction

The Malaysian experience in national development is not unique. Not unlike other countries, growth can be sustained only when economic resources are efficiently mobilized and effectively transformed into productive activities. To achieve this, a steady flow of adequate savings must be forthcoming and channelled through the market place into long-term investment. In the case of an open economy, fluctuating terms of trade and its impact on export earnings (and hence, income) will have a marked influence on savings, domestic or national. Consequently, periodic imbalances will have to be financed from foreign capital inflows and, where necessary, a draw-down in reserves. Investment will be financed out of savings from private, public and external sources. Where domestic investment is in excess of national savings, capital will need to be raised from abroad to fill the gap.

This paper examines the flow of funds to finance national development, with particular emphasis on private savings and private investment. The second section discusses the overall savings–investment trends in Malaysia during the period 1961–87, emphasizing the latest developments. A systematic flow of funds arrangement tracing the

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sources and uses of funds in the 1980s is presented in the third section. The flow of sectoral balances in recent years is attempted in the subsequent section; and the following sections discuss national and domestic savings and gross investment (especially private investment), respectively. The sources and uses of funds for national development in the financial system, and the major conclusions and observations are presented in the last two sections.

Savings and investment

Historically, the nation had been blessed with an abundance of savings. The size of domestic and national savings relative to the major macroeconomic variables, in particular outlays for capital formation, including the savings–investment gap in the public and private sectors, are presented in Tables 1 to 3. Although the level of capital formation had increased rapidly from around 16.5 percent of gross national product (GNP) in the 1960s to 28.4 per cent of GNP in 1976–80, the nation had been able to generate sufficient domestic savings to finance much of

Table 1 Malaysia: expenditure on gross national product (GNP) at current prices (percentage of GNP).

	1961–5	*1966–70*	*1971–5*	*1976–80*	*1981–5*	*1986*	*1987*[a]
Consumption	82.4	79.9	77.3	69.9	72.9	74.0	68.4
Private	66.8	63.0	59.9	53.3	55.1	55.5	51.2
Public	15.6	16.9	17.4	16.6	17.8	18.5	17.2
Investment	16.4	16.3	25.7	28.4	35.7	27.2	24.0
Private	9.1	9.9	17.5	17.8	18.1	14.5	13.7
Public	7.3	6.4	8.2	10.6	17.6	12.7	10.3
Net foreign trade	1.2	3.8	−3.0	1.7	−8.6	−1.2	7.6
Gross national product	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Current account balance	−1.1	1.7	−3.7	2.2	−8.5	0.1	8.1
Gross national savings	15.3	18.0	22.0	30.6	27.2	27.3	32.1
Gross domestic savings	n.a.	n.a.	25.9	35.0	33.5	35.2	38.7

[a] Estimate.

Source: Bank Negara Malaysia.

the investment, without significant recourse to external financing. Consequently, there were no large and persistent deficits in the current account of the balance of payments that were not sustainable. By the end of 1980, the nation's external debt amounted to M$10 billion, with a debt-servicing ratio of 4 per cent. However, during the period 1981–5, with the increasing participation of the public sector in national development, persistent current payments deficits emerged. By 1982, gross domestic investment was as high as 39 per cent of GNP; consequently, the current payments deficit reached 14 per cent of GNP. This high ratio of investment to GNP reflected the changing mix of public and private investment, with public investment rising in 1981–5 to reach private investment's share of 18 per cent of GNP. The amount of public investment had increased from M$2.7 billion (or 44.3 per cent of total investment) in 1961–5 to a high of M$57.5 billion (or 49.3 per cent of total investment) in 1981–5. As a result, the nation's external debt rose to M$42.3 billion by the end of 1985, with a debt-servicing ratio of nearly 16 per cent. It was to the Government's credit that public investment was restrained in the turnaround in commodity prices and interest rates. By

Table 2 Malaysia: savings-investment, 1961–87 (percentage of GNP).

	1961–5	*1966–70*	*1971–5*	*1976–80*	*1981–5*	*1986*	*1987*[a]
Public gross domestic capital Formation	7.3	6.4	8.2	10.6	17.6	12.7	10.3
Public savings	1.8	1.3	2.5	6.7	12.3	5.8	3.0
Deficit/surplus	−5.5	−5.1	−5.7	−3.8	−5.3	−6.9	−7.3
Private gross domestic capital formation	9.1	9.9	17.5	17.8	18.1	14.5	13.7
Private savings	13.6	16.8	19.5	23.9	14.9	21.5	29.1
Deficit/surplus	4.5	6.9	2.0	6.1	−3.2	7.0	15.4
Gross domestic capital formation	16.4	16.3	25.7	28.4	35.7	27.2	24.0
Gross national savings	15.3	18.0	22.0	30.6	27.2	27.3	32.1
Balance on current account	−1.1	1.7	−3.7	2.2	−8.5	0.1	8.1
Gross domestic savings	n.a.	n.a.	25.9	35.0	33.5	35.2	38.7

[a] Estimate.

Source: Bank Negara Malaysia.

Table 3 Malaysia: savings-investment, 1961–87 (in M$ × 10^6).

	1961–5	*1966–70*	*1971–5*	*1976–80*	*1981–5*	*1986*	*1987*[a]
Public gross domestic capital formation	2 722	3 302	7 272	20 104	57 478	8 324	7 546
Public savings	657	599	2 237	12 796	40 041	3 833	2 185
Deficit/surplus	(2 065)	(2 703)	(5 035)	(7 308)	(17 437)	(4 491)	(5 361)
Private gross domestic Capital formation	3 389	5 094	15 363	33 750	59 138	9 545	10 012
Private savings	5 046	8 669	17 123	45 268	48 732	14 126	21 260
Deficit/surplus	1 657	3 575	1 760	11 518	(10 406)	4 581	11 248
Gross domestic capital formation	6 111	8 396	22 635	53 854	116 616	17 869	17 558
Gross national savings	5 703	9 268	19 360	58 064	88 773	17 959	23 445
Balance on current account	(408)	872	(3 275)	4 210	(27 843)	90	5 887
Gross domestic savings	n.a.	n.a.	22 810	63 884	109 335	23 156	28 299

[a] Estimate.

Source: Bank Negara Malaysia.

the end of 1985, public investment was reduced to 13.8 per cent of the GNP. More importantly, the current account deficit fell to 2.4 per cent of the GNP. Such decisive adjustment within such a short period is remarkable by any standard.[1]

Four other interesting points regarding the savings–investment balance are worth noting (Table 4).

1. The recent trend of gross national savings (GNS) and gross domestic investment (GDI) gap was a source of concern. It was as high as 8.5 per cent of the GNP on the average in 1981–5, a level that was clearly not sustainable.
2. With the discipline of continuing fiscal restraint in the face of improving commodity prices, the GNS/GDI gap narrowed and, by 1987, turned to a surplus equivalent to nearly 8 per cent of the GNP.
3. Traditionally, public savings are insufficient to finance public investment. In the 1960s and 1970s, this gap was readily bridged from non-inflationary sources, without any significant resort to external borrowing. By the first half of the 1980s, the absolute size of this gap (at nearly M$17 billion) was about three times that in the 1970s. The size of this gap remains large even today (M$5.4 billion in 1987), mainly because of declining public savings despite significantly lower public investment.
4. Unlike the public sector, the private sector was consistently a significant net saver in the 1960s and 1970s. In the first half of the 1980s, however, this surplus in savings turned negative as a whole, reflecting primarily lower private savings following the recession and poor commodity prices. The situation had improved moderately by 1984, but significantly by 1987.

Table 4 Malaysia: savings-investment balance, 1961–87 (percentage of GNP).

	GNS	*GDI*	*Current account*[a]
1961–5	15.3	16.4	−1.1
1966–70	18.0	16.3	1.7
1971–5	22.0	25.7	−3.7
1976–80	30.6	28.4	2.2
1981–5	27.2	35.7	−8.5
1986	27.3	27.2	0.1
1987	32.1	24.0	8.1

[a] Surplus (+)/deficit (−).

Source: Bank Negara Malaysia.

The mobilization of resources

The flow of capital funds in the 1980s are presented in Tables 5 to 7.[2] They identify the three major sources of funds (namely private savings, long-term capital from abroad and public savings) and show how these funds are used to finance public and private investment or placed abroad, part being for portfolio investments. The information in these tables is also presented in Figures 1 to 4, which provide additional information on how private savings are mobilized through the organized financial system including the banks. While these tables and figures contain a wealth of information, the following salient points are worth noting.

1. The annual flow of capital funds, which rose rapidly from nearly M$19 billion to M$29 billion between 1980 and 1984, had since slackened to only M$22.3 billion in 1987. This reflected mainly the deliberate move to rely less on foreign resources to reduce the Government's external debt burden (hence, significant pre-payments) and reverse the trend of declining public savings.
2. Since peaking in 1983–4, private investment and public capital outlays had become significantly lower by 1987, even though substantially larger amounts of private savings had since become available, especially in 1987.
3. By 1987, private savings had re-established its pre-eminent role as the single most important source of capital funds.
4. With the implementation of cut-backs in public expenditure in 1982–3, resort to external borrowing had slowed down significantly. By 1987, official foreign borrowing had turned negative, reflecting significant early loan pre-payments. Although the net inflow of foreign direct investment (FDI) had also slackened since 1983, following the recession, the annual rate of inflow had remained healthy and substantial. In 1981–5, the net inflow of corporate FDI amounted to M$12.7 billion, double the amount invested in 1976–80. The negative flow in 1987 reflected the substantial (M$2.4 billion) reversal of foreign currency swaps by the banks in preference for cheaper inter-bank borrowing in ringgit (M$). In 1987, the net inflow of corporate FDI would have reached M$1.5 billion, marginally higher than in 1986 (Table 8).
5. The Central Bank had begun moderately to accumulate external reserves since 1983 and substantially by 1986 and 1987.
6. In 1980, the financial system mobilized close to one-half of private savings. This share had fallen to nearly 40 per cent in 1981–5. By

Table 5 Malaysia: flow of capital funds.

	1980	*1981–5*	*1986*	*1987*	*1980*	*1981–5*	*1986*	*1987*
		(M$ × 10⁹)				*(% composition)*		
Sources of funds								
Private sector savings	12.5	48.5	14.1	21.2	66.8	39.4	65.9	95.1
Monetary system	6.0	21.2	5.4	2.9	(32.1)	(17.2)	(25.2)	(13.0)
Provident and life assurance funds	2.5	17.0	4.2	4.4	(13.3)	(13.8)	(19.6)	(19.7)
Savings and other financial inst.	0.5	9.4	−0.7	−0.2	(2.7)	(7.6)	(−3.3)	(−0.9)
(Other funds – foreign direct investment)	3.5	0.9	5.2	14.1	(18.7)	(0.8)	(24.4)	(63.3)
Inflow of long-term funds	3.1	34.0	3.5	−1.1	16.6	27.6	16.3	−5.0
Foreign direct investment	2.9	12.7	1.4	1.5	(15.5)	(10.3)	(6.5)	(6.7)
Official foreign loans	0.2	21.3	2.1	−2.6	(1.1)	(17.3)	(9.8)	(−11.7)
Public sector savings	3.1	40.6	3.8	2.2	16.6	33.0	17.8	9.9
Public sector surplus	1.5	30.5	2.3	1.6	(8.0)	(24.8)	(10.8)	(7.2)
Transfers to private sector	1.6	10.1	1.5	0.6	(8.6)	(8.2)	(7.0)	(2.7)
Total flow of capital funds	18.7	123.1	21.4	22.3	100.0	100.0	100.0	100.0
Uses of funds								
Private investment	10.1	60.5	9.5	10.0	54.0	49.2	44.4	44.8
Accumulation of international reserves	1.1	2.0	4.1	2.9	5.9	1.6	19.2	13.0
Unidentified private payments abroad	1.5	4.6	−0.5	1.9	8.0	3.7	−2.4	8.6
Public investment	6.0	56.0	8.3	7.5	32.1	45.5	38.8	33.6

Source: Bank Negara Malaysia.

Table 6 Malaysia: flow of capital funds (in M$ $\times 10^9$).

	1980	*1981*	*1982*	*1983*	*1984*	*1985*	*1986*	*1987*
Sources of funds								
Private sector savings	12.5	7.0	7.6	9.7	14.2	10.0	14.1	21.2
Monetary system	6.0	4.8	5.3	3.6	4.7	2.8	5.4	2.9
Provident and life assurance funds	2.5	2.1	3.4	3.9	3.5	4.1	4.2	4.4
Savings and other financial inst.	0.5	0.2	0.5	3.1	2.9	2.7	−0.7	−0.2
(Other funds – foreign direct investment)	3.5	−0.1	−1.6	−0.9	3.1	0.4	5.2	14.1
Inflow of long-term funds	3.1	6.1	8.8	9.0	6.3	3.8	3.5	−1.1
Foreign direct investment	2.9	3.1	3.6	2.7	1.6	1.7	1.4	1.5
Official foreign loans	0.2	3.0	5.2	6.3	4.7	2.1	2.1	−2.6
Public sector savings	3.1	7.7	7.4	7.4	8.5	9.6	3.8	2.2
Public sector surplus	1.5	3.9	5.0	6.0	7.1	8.5	2.3	1.6
Transfers to private sector	1.6	3.8	2.4	1.4	1.4	1.1	1.5	0.6
Total flow of capital funds	18.7	20.8	23.8	26.1	29.0	23.4	21.4	22.3
Uses of funds								
Private investment	10.1	11.1	11.7	12.3	14.0	11.4	9.5	10.0
Accumulation of international reserves	1.1	−0.6	−0.5	0.1	0.2	2.8	4.1	2.9
Unidentified private payments abroad	1.5	1.4	0.9	0.9	2.1	−0.7	−0.5	1.9
Public investment	6.0	8.9	11.7	12.8	12.7	9.9	8.3	7.5

Source: Bank Negara Malaysia.

Table 7 Malaysia: flow of capital funds (percentage of composition).

	1980	*1981*	*1982*	*1983*	*1984*	*1985*	*1986*	*1987*
Sources of funds								
Private sector savings	66.8	33.7	31.9	37.2	49.0	42.7	65.9	95.1
Monetary system	32.1	23.1	22.2	13.8	16.2	12.0	25.2	13.0
Provident and life assurance funds	13.3	10.1	14.3	14.9	12.1	17.5	19.6	19.7
Savings and other financial inst.	2.7	1.0	2.1	11.9	10.0	11.5	−3.3	−0.9
(Other funds – foreign direct investment)	18.7	−0.5	−6.7	−3.4	10.7	1.7	24.4	63.3
Inflow of long-term funds	16.6	29.3	37.0	34.5	21.7	16.3	16.3	−5.0
Foreign direct investment	15.5	14.9	15.1	10.4	5.5	7.3	6.5	6.7
Official foreign loans	1.1	14.4	21.9	24.1	16.2	9.0	9.8	−11.7
Public sector savings	16.6	37.0	31.1	28.3	29.3	41.0	17.8	9.9
Public sector surplus	8.0	18.8	21.0	23.0	24.5	36.3	10.8	7.2
Transfers to private sector	8.6	18.2	10.1	5.3	4.8	4.7	7.0	2.7
Total flow of capital funds	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Uses of funds								
Private investment	54.0	53.4	49.1	47.1	48.3	41.0	44.4	44.8
Accumulation of international reserves	5.9	−2.9	−2.1	0.4	0.7	11.9	19.2	13.0
Unidentified private payments abroad	8.0	6.7	3.8	3.5	7.2	0.8	−2.4	8.6
Public investment	32.1	42.8	49.2	49.0	43.8	46.3	38.8	33.6

Source: Bank Negara Malaysia.

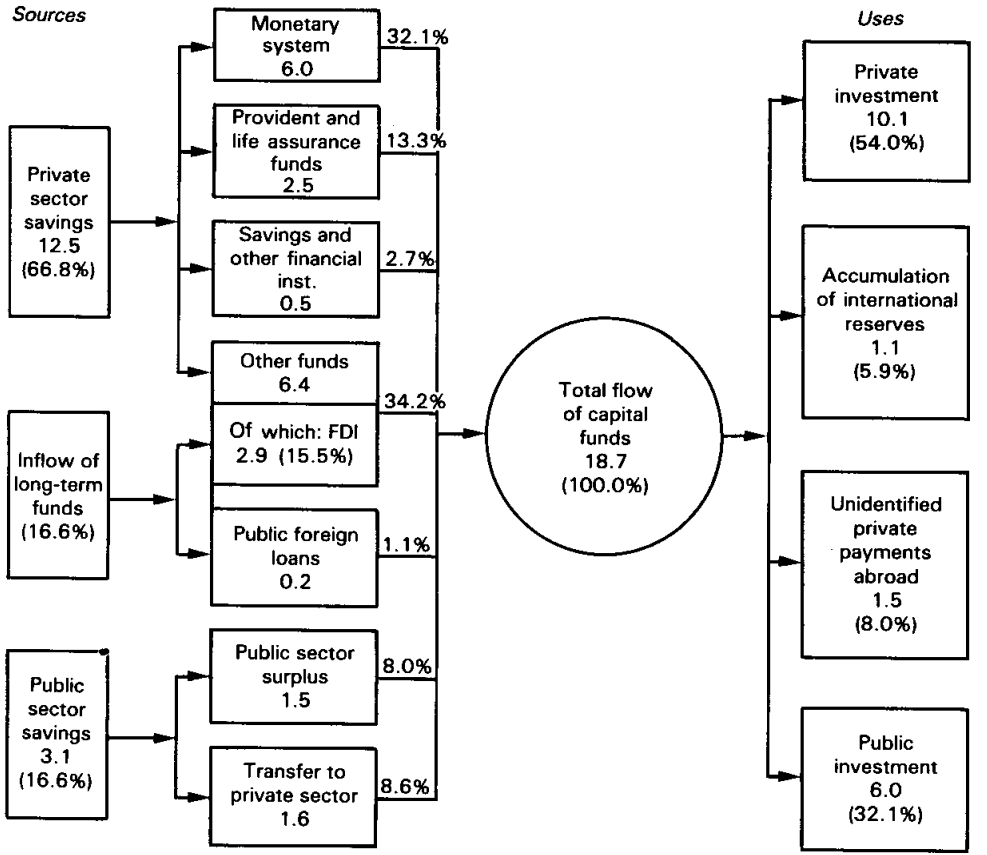

Figure 1 Flow of capital funds, 1980 (in M$ $\times 10^9$). (*Source*: Bank Negara Malaysia.)

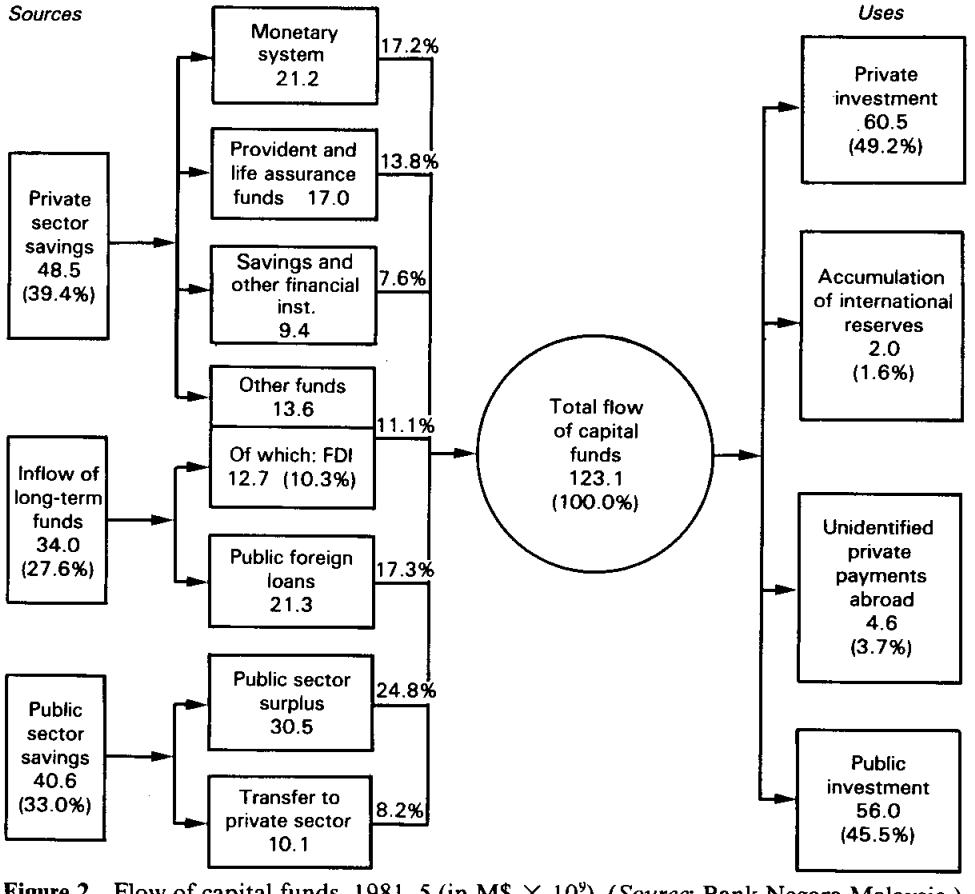

Figure 2 Flow of capital funds, 1981–5 (in M$ $\times$ 10^9). (*Source*: Bank Negara Malaysia.)

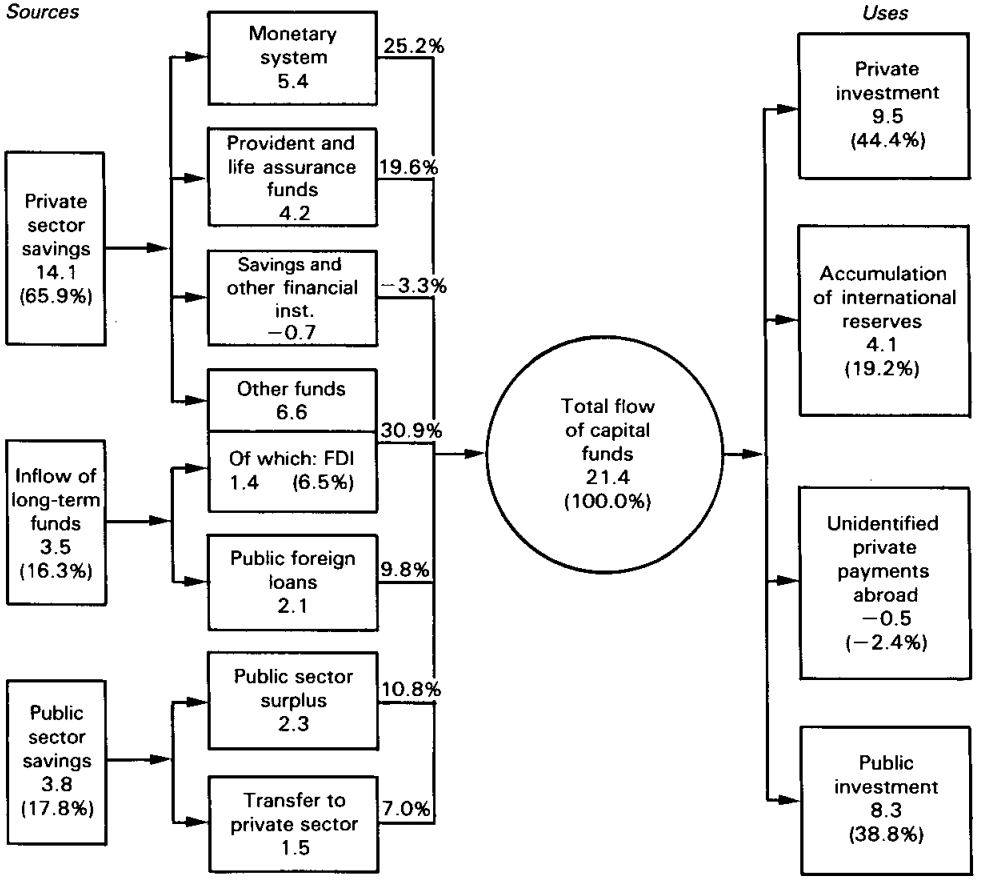

Figure 3 Flow of capital funds, 1986 (in M$ $\times$ 10^9). (*Source*: Bank Negara Malaysia.)

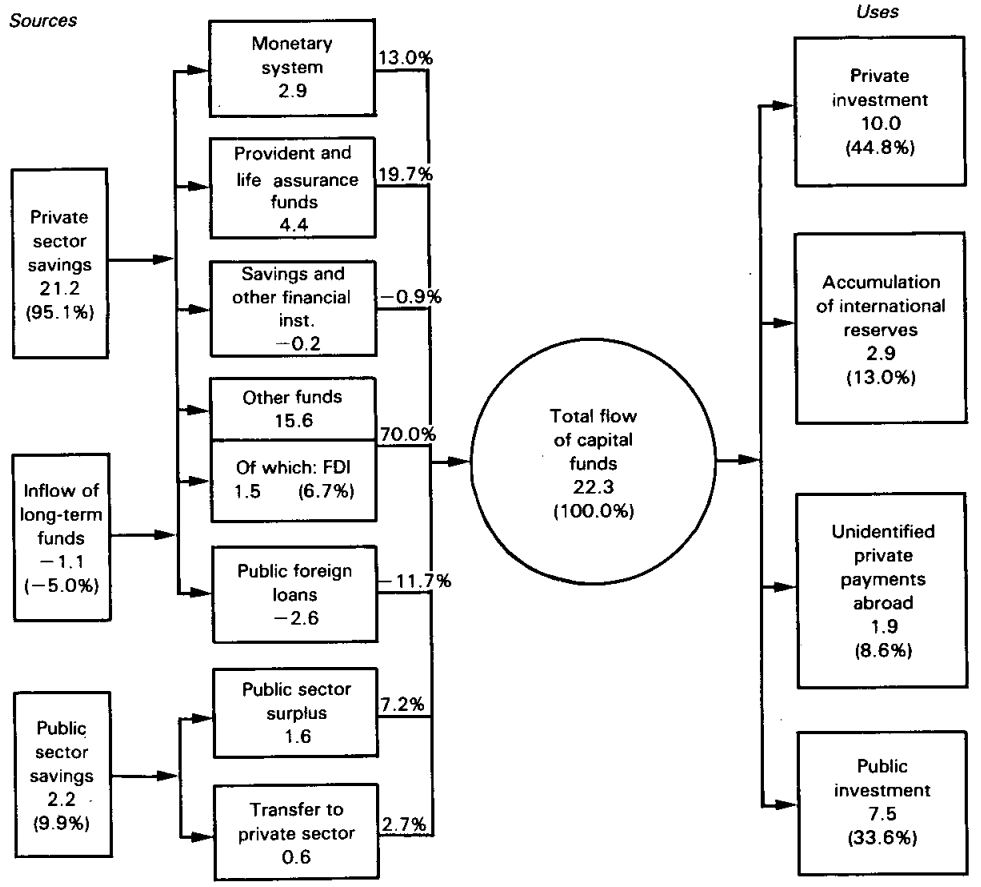

Figure 4 Flow of capital funds, 1987 (in M$ $\times$ 10^9). (*Source*: Bank Negara Malaysia.)

Table 8 Malaysia: foreign direct investment.

	Corporate	*Banks* ($M\$ \times 10^6$)	*Net*	*Corporate* (% of GNP)	*Net*
1961–5	1 000	57	1 057	2.7	2.8
1966–70	925	176	1 101	1.8	2.1
1971–5	3 259	339	3 598	3.7	4.1
1976–80	6 414	(2 406)[a]	4 008	3.4	2.1
1981–5	12 697	742	13 439	3.9	4.1
1986	1 431	85	1 516	2.2	2.3
1987	1 450	(2 406)[a]	(956)[a]	2.0	−1.3

[a] Outflow.

Source: Bank Negara Malaysia.

1987, it fell further to about 10 per cent, reflecting the steady growth of the capital market. Capital market institutions, including the unit trusts, accounted for about two-thirds of private savings in 1987 (50 per cent in 1980).

Sectoral flow of funds

In many ways, Malaysia's development has been rather traditional. Growth of agriculture and mining provided the surpluses, which were then mobilized by the Government and the financial system to develop manufacturing and the tertiary industries, and to expand the basic economic and social infrastructure. This view is presented in Table 9.[3] In the 1970s, plantation agriculture and mineral extraction (and later, oil and gas) yielded significant savings, enough not only to finance reinvestment within these sectors but also to pay taxes to finance Government spending on these sectors, and have a significant surplus left over to enable the economy to diversify its continuing dependence on these sectors.

Domestic and national savings

Traditionally, Malaysia has high aggregate savings. Indeed, its gross domestic savings (GDS) rose through the 1970s, bringing the nation on par with Japan and Singapore, and ahead of Thailand and Korea (Table 10). In 1976–80, its GDS accounted for more than one-third (35 per cent) of the GNP. This share fell to 34 per cent in 1981–5, but had risen to 39 per cent in 1987. As a producer and exporter of minerals (tin, oil

Table 9 Sectoral flow of funds, 1973–83 (M$ × 10^6, at constant 1970 prices).

	Savings	*Investment*	*Extraction*	*Direct taxes*[a]	*Government expenditure*[b]	*Resource surplus*
1973						
Mining	311	340	−29	38	17	−8
Petroleum	–	–	–	–	–	
Agriculture	1 524	435	1 089	207	352	944
Other	2 611	2 781	−170	464	340	−46
Foreign	−890	–	−890			
Total	3 556	3 556	–	709	709	
1978						
Mining	261	432	−171	59	33	
Petroleum	540	232	308	416	–	724
Agriculture	1 747	390	1 357	391	807	941
Other	3 387	4 362	−975	996	1 022	−1 001
Foreign	−519	–	−519			
Total	5 416	5 416	–	1 862	1 862	
1983						
Mining	292	212	80	85	42	
Petroleum	887	1 047	−160	914	–	754
Agriculture	2 050	598	1 452	595	1 244	803
Other	4 833	8 758	−3 925	1 769	2 077	−4 206
Foreign	2 553	–	2 553			
Total	10 615	10 615	–	3 363	3 363	

[a] Direct taxes are allocated in proportion to sectoral value added.

[b] Government expenditure is assumed proportional to sectoral employment.

Source:

Malaysia – intersectoral flows, Desmond McCarthy, World Bank Mimeo, January 1985.

and gas), Malaysia has a distinct advantage in generating resource surpluses. Similarly, that is why Algeria, Venezuela and Indonesia also have high GDS ratios (Table 10). However, what is significant is that much of the capital used to develop these basic and other industries was imported. Over time, net factor payments abroad (NFPA) assumed a constant claim on domestic resources. As a result, Malaysia's GNS were relatively lower (Table 11). Indeed, in the 1980s, they were lower than Japan and Singapore, and about on par with Thailand and Korea (Table 12).

What is particularly significant is the widening gap between GDS and GNS. This growing divergence between what is saved domestically

Table 10 Gross domestic savings (percentage of GNP).

	1971–5	*1976–80*	*1981–5*
Selected Asian countries			
Japan	36.8	32.5	31.2
Singapore	26.4	33.3	45.7
Korea	19.3	25.8	29.0
Malaysia	25.9	35.0	33.5
Thailand	23.3	24.0	19.5
Selected oil-exporting countries			
Indonesia	19.5	27.0	31.7
Venezuela	40.6	33.2	25.8
Malaysia	25.9	35.0	33.5
Algeria	32.0	41.7	n.a.

Source: IMF, *International Financial Statistics.*

Table 11 Malaysia: gross domestic and national savings (percentage of GNP).

	GDS	*GNS*	*NFPA*
1961–5	n.a.	15.3	n.a.
1966–70	n.a.	18.0	n.a.
1971–5	25.9	22.0	−3.6
1976–80	35.0	30.6	−4.2
1981–5	33.5	27.0	−6.2
1986	35.2	27.3	−8.0
1987	38.7	32.1	−7.1

Source: Bank Negara Malaysia.

Table 12 Gross national savings – selected Asian countries (percentage of GNP).

	1971–5	*1976–80*	*1981–5*
Japan	36.6	32.4	31.3
Singapore	25.2	31.3	43.2
Korea	20.0	26.7	25.2
Malaysia	22.0	30.6	27.2
Thailand	25.7	24.8	18.5

Source: IMF, *International Financial Statistics.*

Table 13 Marginal propensity to save.

	Total private savings	*Other private savings*
1971–8	0.462	0.425
1976–83	0.283	0.194

Source:
World Bank, 'Malaysia: development strategies and their financing'.

and what is available for investment in the domestic economy reflected mainly growing debt-servicing payments, despite the 'return' of major plantation and mining companies to Malaysian control in the late 1970s and early 1980s. With growing FDI it is unlikely that this trend to pay 7–8 per cent of the GNP abroad annually will be reversed in any significant manner.

Another significant observation is that GNS has been trending downwards since its peak in 1979, as a result of poor terms of trade and rising factor payments. However, the ratio of domestic investment to GNP had increased significantly, especially in 1982 (39 per cent) and 1983 (39 per cent). Nevertheless, the gap between them had been reduced to 2.5 per cent by 1985. In 1987, GNS had exceeded GDI, reflecting higher savings and lower investment. What had really emerged was that, in the Malaysian context, gross savings (in particular, private savings) are highly sensitive to movements in the level and growth of income. Indeed, empirical studies had established this, including the statistical insignificance of other factors like inflation, interest rate and financial intermediation.[4] In terms of policy, these observations do narrow the range of measures that can be introduced to raise savings.

Finally, the sharp fall in private savings in the first half of the 1980s to about 15 per cent of GNP (23.8 per cent in 1976–80) has been a matter of concern. Although this rate had bounced back to 29.1 per cent in 1987, reflecting mainly improvements in the terms of trade, the sustainability of this rate at a reasonably high level remains uncertain, considering that empirical studies had indicated a sharp decline in the elasticity of savings in terms of both the level and growth of incomes during the period 1976–83 (compared with the early 1970s).

As can be seen in Table 13, the marginal propensity to save (MPS) had trended downwards.

Domestic investment

Like private savings, until the mid-1980s gross investment in Malaysia had softened considerably since 1984, especially private investment

outlays (which fell to as low as 14 per cent of the GNP in 1987). Nevertheless, despite the 'big push'[5] in the early 1980s, the yield for the nation in terms of growth from the high capital accumulation had been low. It is true that the capital intensity of production in Malaysia had been rising since 1971. The incremental capital output ratio (ICOR)[6] in 1984 was about 60 per cent higher (Table 14) than in the second and third Malaysia Plan periods (1971–80). The rising ICOR reflected sharp increases in investment in social capital and in lumpy industrial projects (with long gestation periods) by the public sector, and a concentration in construction and property related projects.

On private investment, the following points are worth noting.

1. Despite the drive to push private activity to lead growth and cuts in public spending, private investment had continued to lag behind. In 1981, private investment accounted for 55 per cent of GDI. This share fell to 53.4 percent in 1986, but had since recovered to 57 per cent in 1987.
2. The composition of GDI is quite revealing: in 1985, about 50% (M$11.5 billion) was in building and construction. For the period 1981–5 the average share was 48 per cent. This trend also helps to explain the high ICOR.
3. In the first half of the 1980s there had been a growing predominance of GDI in the utilities and services (mainly office buildings and housing) sectors, from a combined share of 50 per cent in 1981 to 60 per cent in 1985. GDI in manufacturing and agriculture had tended to decline.
4. There had been a preponderance of new private investment in the services sector, mainly in building and construction (Table 15). By

Table 14 Public and private investment (in constant prices).

	1971–5	*1976–80*	*1981–5*	*1986*	*1987*
Incremental capital output ratio (ICOR)	3.1	3.1	7.2	20.6	5.2
% change					
Private investment	3.5	12.9	−0.7	−18.3	3.4
(excluding oil and gas)	(1.1)	(8.6)	(1.6)	(−18.2)	(3.0)
Private investment	16.0	12.6	12.7	−18.5	−10.7
(including oil and gas)	(18.5)	(17.7)	(8.2)	(−26.9)	(−8.9)

Source: Bank Negara Malaysia.

1985, new private investment in agriculture and utilities had continued to remain moderate, while that in mining and manufacturing had declined. For an economy which had identified agriculture, manufacturing, mining (oil and gas) and tourism as the lead sectors for growth, the annual flows of true private investment in these sectors have been disproportionately low. A re-orientation of the investment strategy will be necessary to foster private initiative and entrepreneurial ventures in order to enlarge the private sector's productive base.

5. The role of the private sector in the key areas of investment had diminished in the 1980s. The size and share of new private investment in the major areas of mining and manufacturing had declined. Such investments had remained active only in building and construction and the services areas (Table 16).

Table 15 Flow of private investment by sectors (current price, M$ $\times$ 10^9).

	1981	*1983*	*1984*	*1985*
Agriculture	0.5	0.5	0.4	0.5
Mining	2.2	1.6	1.3	1.2
Manufacturing	3.3	3.1	3.0	1.9
Construction	1.4	1.7	1.4	0.8
Utilities	1.7	1.6	0.1	–
Services	2.4	3.5	7.1	6.5
Total	11.5	12.0	13.3	10.9

Source: Bank Negara Malaysia.

Table 16 Share of private sector in GDI (M$ $\times$ 10^9, percentage of total in each sector).

	1981		*1985*	
	$	%	$	%
Agriculture	1.8	22	1.7	21
Mining	3.3	67	2.5	49
Manufacturing	3.8	87	4.2	46
Construction	1.4	90	0.9	80
Utilities	4.2	41	4.7	0.8
Services	6.3	39	9.2	71
Total	20.8	55	23.2	47

Source: Bank Negara Malaysia.

Although the above analysis is based on trends in the first half of 1980s, subsequent developments are unlikely to have changed the scene significantly, except that building and construction by the private sector has since pulled backed sharply.'Private sector' in these observations refers to the 'true' private sector, excluding Government agencies and enterprises where Government is in either direct or indirect control.

Sources and uses of funds in the financial system

The structure and process of financial intermediation in Malaysia has undergone rapid transformation. Tables 17 and 18 show the sources and uses of funds within the financial system. They attempt to highlight the major sources of funds, as represented by the range of financial instruments, such as deposits, loans and provident and pension claims, issued to the surplus units in the economy. At the same time, they also indicate the direction in which funds are used by the financial system, namely the assets which the institutions hold, in terms of the primary debt and securities of deficit units as well as the financial instruments of the institutions within the system.

During the 1980s, the major sources of new funds of the financial system continued to be derived from the various forms of deposits and from contractual savings. Of the total new resources of M$143.9 billion raised during the period 1980–7, deposits mobilized accounted for 42.1 per cent or M$60.6 billion, while contractual savings with the life assurance and provident funds represented about one-fifth of the new resources (M$27.9 billion). The balance came from increases in capital and reserves, and other liabilities.

The new resources mobilized were mainly channelled back to the public and private sectors in the form of loans and advances, which accounted for about 38.6 per cent or M$55.6 billion. The other major uses of the new resources were investment in Government securities, including Treasury bills (22.3 per cent or M$32.1 billion), placements within the system (16.3 per cent or M$23.4 billion), investments in gold and foreign exchange reserves by the Central Bank (6.8 per cent or M$9.8 billion) and funding for the corporate sector through the investment in stocks and shares (5.4 per cent or M$7.8 billion).

Resources of the financial system rose at an average annual rate of 12.6 per cent in the 1960s and accelerated to 20.4 per cent in the 1970s to total M$74.2 billion at the end of 1980. However, this pace of growth slackened to 16.7 per cent per annum during the period 1980–87, reflecting mainly the slowdown in the growth of deposits from an average annual rate of 21.6 per cent to 14.1 per cent. However, the slowdown in

Table 17 Sources and uses of funds of the financial system (in M$ × 10^9).

		Annual change		
	1980	*1981–5*	*1986*	*1987*
Sources of funds				
Capital and reserves	0.5	10.2	1.6	0.8
Currency reserves	0.7	1.7	0.4	0.8
Demand deposits	0.8	3.9	−0.6	1.4
Other deposits	6.6	40.9	5.1	2.5
Borrowings	0.6	2.2	0.4	0.7
Funds from other financial inst.	1.0	6.9	–	−0.2
Life assurance and provident funds	2.5	16.8	4.2	4.4
Other liabilities	2.3	12.2	5.6	7.0
Total	15.0	94.8	16.7	17.4
Uses of funds				
Currency reserves	0.2	0.2	–	–
Deposits with other financial inst.	1.7	17.0	2.8	1.9
Bills				
Treasury	–	1.4	0.2	1.0
Commercial	0.9	3.2	–	−0.3
Loans and advances	7.4	42.9	4.7	0.6
Securities				
Malaysian Government	2.2	16.9	3.3	7.1
Corporate	0.5	4.5	1.1	1.7
Gold and foreign exchange reserves[a]	0.9	2.1	3.9	2.9
Others	1.2	6.6	0.7	2.5
Total	15.0	94.8	16.7	17.4

[a] Including special drawing rights.

Source: Bank Negara Malaysia.

the growth of total resources was moderated to some extent by the continuing growth in contributions to the life assurance and provident funds. The flow of resources contracted further in 1987, reflecting lower deposits and a decline in inter-financial institution placements. Given the lower growth of total resources, loans extended by the financial system also moderated, from 24.1 per cent in the 1970s to 16.8 per cent in the 1980s. Faced with ample liquidity, a significant part of these funds were invested in the securities of both the Government and the corporate sector. At the same time, the external reserves of the Central Bank rose significantly.

Table 18 Malaysia: sources and uses of funds in the financial system as at end of period (M$ × 10^6, percentage of total).

	1960		*1965*		*1970*		*1975*		*1980*		*1985*		*1986*		*1987*	
	$	%	$	%	$	%	$	%	$	%	$	%	$	%	$	%
Sources of funds																
Capital and reserves	288	8.1	630	9.7	960	8.3	1 771	6.6	3 894	5.3	14 051	8.3	15 630	8.4	16 431	8.1
Currency	865	24.3	1 131	17.4	1 132	9.7	2 425	9.1	5 104	6.9	6 773	4.0	7 146	3.8	7 965	3.9
Demand deposits	477	13.4	714	11.0	1 068	9.2	2 198	8.2	5 326	7.2	9 272	5.5	8 674	4.7	10 123	5.0
Other deposits:	817	23.0	1 719	26.4	3 984	34.3	10 714	40.1	34 374	46.4	75 288	44.6	80 415	43.3	82 894	40.8
Public sector	218	6.1	362	5.6	1 222	10.5	1 662	6.2	6 777	9.1	8 349	5.0	8 540	4.6	9 220	4.5
Other financial intermediaries	53	1.5	185	2.8	292	2.5	1 678	6.3	5 832	7.9	15 709	9.3	17 405	9.4	13 567	6.7
Private sector	546	15.4	1 172	18.0	2 470	21.3	7 374	27.6	21 765	29.4	51 230	30.3	54 470	29.3	60 107	29.6
Loans:	47	1.3	135	2.1	250	2.2	528	2.0	1 668	2.2	3 848	2.3	4 252	2.3	4 917	2.4
Domestic	47	1.3	125	1.9	230	2.0	495	1.9	1 649	2.2	3 807	2.3	3 794	2.0	4 559	2.2
Foreign	0	0.0	10	0.2	20	0.2	33	0.1	19	0.0	41	0.0	458	0.3	358	0.2
Funds from other financial inst.:	131	3.7	323	5.0	679	5.8	1 384	5.2	3 915	5.3	10 864	6.4	10 877	5.9	10 667	5.3
Domestic	58	1.6	103	1.6	426	3.6	573	2.1	1 189	1.6	5 182	3.1	5 341	2.9	6 113	3.0
Foreign	73	2.1	220	3.4	253	2.2	811	3.1	2 726	3.7	5 682	3.3	5 536	3.0	4 554	2.3
Provident, pension and life insurance	768	21.6	1 624	25.0	2 882	24.8	5 388	20.3	12 218	16.5	29 042	17.2	33 189	17.9	37 612	18.5
Other liabilities:	160	4.6	229	3.4	667	5.7	2 270	8.5	7 656	10.2	19 817	11.7	25 428	13.7	32 368	16.0
Domestic	153	4.4	212	3.2	533	4.5	1 991	7.5	7 128	9.5	19 124	11.3	24 771	13.3	31 760	15.7
Foreign	7	0.2	17	0.2	134	1.2	279	1.0	528	0.7	693	0.4	657	0.4	608	0.3
Total	3 553	100.0	6 505	100.0	11 622	100.0	26 678	100.0	74 155	100.0	168 955	100.0	185 611	100.0	202 977	100.0

Uses of funds																
Currency	80	2.3	83	1.3	97	0.8	155	0.6	420	0.6	598	0.4	676	0.4	649	0.3
Deposits with other financial inst.:	513	14.4	791	12.2	972	8.4	2 334	8.7	6 910	9.3	23 872	14.1	26 650	14.3	28 587	14.1
Domestic	190	5.3	336	5.2	783	6.8	2 117	7.9	5 682	7.7	22 147	13.1	24 309	13.1	25 485	12.6
Foreign	323	9.1	455	7.0	189	1.6	217	0.8	1 228	1.6	1 725	1.0	2 341	1.2	3 102	1.5
Bills:	52	1.5	232	3.5	663	5.7	1 372	5.1	3 790	5.1	8 383	5.0	8 592	4.6	9 273	4.6
Treasury	41	1.2	164	2.5	545	4.7	1 007	3.8	1 416	1.9	2 777	1.7	2 970	1.6	3 966	2.0
Commercial	11	0.3	68	1.0	118	1.0	365	1.3	2 374	3.2	5 606	3.3	5 622	3.0	5 307	2.6
Loans and advances:	669	18.8	1 541	23.7	3 437	29.6	9 296	34.8	29 892	40.3	72 786	43.1	77 488	41.7	78 065	38.5
Public sector	0	0.0	21	0.3	18	0.1	287	1.1	796	1.0	1 136	0.7	1 187	0.6	1 142	0.6
Other financial intermediaries	51	1.4	112	1.7	425	3.7	858	3.2	938	1.3	5 525	3.3	5 732	3.1	6 261	3.1
Private sector	582	16.4	1 357	20.9	2 790	24.0	7 691	28.8	27 485	37.1	66 088	39.1	70524	38.0	70 462	34.7
Foreign	36	1.0	51	0.8	204	1.8	460	1.7	673	0.9	37	0.0	45	0.0	200	0.1
Securities:	967	27.2	1 934	29.7	3 641	31.3	7 887	29.6	17 991	24.3	39 451	23.3	43 855	23.6	52 609	25.9
Malaysian Government	712	20.0	1 602	24.6	3 091	26.6	6 896	25.8	15 959	21.5	32 904	19.5	36 234	19.5	43 287	21.3
Foreign	235	6.6	219	3.4	195	1.7	126	0.6	31	0.0	44	0.0	41	0.0	41	0.0
Corporate	20	0.6	113	1.7	355	3.0	865	3.2	2 001	2.8	6 503	3.8	7 580	4.1	9 281	4.6
Gold and foreign exchange reserves	1 073	30.2	1 565	24.1	2 229	19.2	3 989	15.0	9 709	13.1	11 773	7.0	15 499	8.5	18 569	9.1
Other assets:	199	5.6	359	5.5	583	5.0	1 645	6.2	5 443	7.3	12 092	7.1	12 851	6.9	15 225	7.5
Domestic	171	4.8	277	4.2	561	4.8	1 596	6.0	4 788	6.4	10 616	6.3	10 996	5.9	12 998	6.4
Foreign	28	0.8	82	1.3	22	0.2	49	0.2	655	0.9	1 476	0.8	1 855	1.0	2 227	1.1
Total	3 553	100.0	6 505	100.0	11 622	100.0	26 678	100.0	74 155	100.0	168 955	100.0	185 611	100.0	202 977	100.0

Source: Bank Negara Malaysia.

Observations and conclusions

To summarize: throughout the 1970s, as was also the case in the 1960s, favourable commodity prices had enabled the Government to bring about an average annual growth rate of 8 per cent, with a minimum of external borrowing. That is, sufficient private sector surpluses were generated to finance much of domestic investment, both public and private. The growing financial system provided the necessary modern intermediation services, efficiently and effectively. By the early 1980s, led by expansionary public spending, the pace of national development rose to a point where the availability of domestic resources was stretched to its limit. By 1982, GDI was at 39 per cent of GNP and GNS was at 25 per cent, resulting in a payments deficit equivalent to 14 per cent of GNP. This was clearly not sustainable, particularly at a time of soft commodity markets, sluggish world growth and poor prospects of a strong and early recovery. During this period, domestic resource imbalances had to be made good by resorting to external borrowing to tap foreign savings. To the Government's credit, fundamental adjustments were promptly instituted. By 1985, public investment was reduced to 13.8 per cent of GNP (19.6 per cent in 1982) and the external payments deficit dropped to 2.4 per cent of GNP. In 1987, public investment fell further to 10 per cent of GNP and the current account of the balance of payments recorded a surplus of nearly 8 per cent of GNP.

The growing savings–investment gap in the 1980s had been a source of concern. Although the recent strengthening of commodity prices had helped to bridge this gap and indeed, brought about a surplus of savings by 1987, the worrisome features had remained: viz. (1) the growing divergence between GNS and GDS, reflecting rising factor payments abroad (currently equivalent to about 7 per cent of GNP); (2) GNS had been trending downwards since 1979 and, considering that both total and private savings are highly dependent on the level and growth of income, the range of policy measures that can be taken to raise savings is rather limited; and, (3) the sharp fall in the elasticity of savings in terms of both the level and growth of income.

Given continuing high GDS of over 30 per cent of GNP, an apparent 'dilemma' had emerged in that Malaysia could incur such large and persistent current payments deficits in 1981–5, while growing at only a modest 5 per cent per annum. Resolution of this lies in two key factors, namely rising factor payments abroad, which significantly reduced the size of the GNS, and a high ICOR that was 60 per cent above that in the 1970s.

For Malaysia, domestic investment had been particularly high in the 1980s; it reached a peak of 39 per cent of GNP in 1982. Nevertheless, a number of factors had since emerged which call for a reorientation of the

investment strategy to encourage greater private initiative, entrepreneurship and the taking of risks. These factors included: (1) a rapidly rising ICOR, reflecting sharp increases in social capital and lumpy industrial investments as well as a concentration of GDI in housing and real estate; (2) too high a proportion of GDI had assumed the form of building and construction; (3) the share of GDI in manufacturing and agriculture had been declining; (4) the annual flows of 'true' private investment in the key sectors of agriculture, mining (oil and gas) and tourism had been disproportionately low and declining; and, (5) the preponderance of new private investment in the services sector, especially housing, building and construction.

Finally, as a result of the recession and the structural adjustments experienced in the first half of the 1980s, the annual flows of capital funds had slackened since 1984. This reflected mainly the deliberate move to rely less on foreign savings to finance public sector development and to reverse the trend of declining public savings. By 1987, private savings had been re-established as the single most important source of capital funds. The broad financial system has been sufficiently developed effectively to intermediate and efficiently to mobilize the bulk of these savings for productive use, with the capital market institutions playing an increasingly major role. Inflows of corporate FDI have resumed a vital role in response to the Government's clear promotional initiatives. Reflecting growing confidence, the Central Bank has accumulated significant amounts of external reserves since 1986.

Notes

1. See Lin See Yan, 'Prospects for the Malaysian economy', presented at the Royal Institute of International Affairs, London: A Chatham House Conference on 'Malaysia as a commercial partner', for a chronological account of Government policy in the 1980s.
2. A section on 'Flow of funds, 1983' first appeared in the Bank Negara Malaysia Annual Report, 1983. Data for subsequent years are available in subsequent Annual Reports of the Bank.
3. The methodology used in the calculation of inter-sectoral Flow of Funds can be found in Ishikawa (1967):

   The term 'Extraction' is defined as follows:

   Extraction = Savings − Investment;

   while 'Resource surplus' is defined as:

   Resource surplus = Extraction + Direct taxes − Government expenditure.

4 Using different variables, the World Bank Study on 'Malaysia: development strategies and their financing', estimated that the best fitting equations for GNS and GDS for the period 1972–83 were as follows:

$$GNS = -1.908 + 1.045\ GNY + 1.456\ GNY\ growth$$
$$(-1.31) \quad (7.24) \quad (7.55)$$

(t-statistics in parentheses) Adj $R^2 = 0.979$
D.W. $= 1.86$

$$GDS = -1.748 + 1.037\ GDY + 1.263\ GDY\ growth$$
$$(9.51) \quad (6.93)$$

(t-statistics in parentheses) Adj $R^2 = 0.979$
D.W. $= 1.84$

5. 'Big Push' refers to the strategy of accelerating growth and modernization by pressing ahead with industrial, social and infrastructure investments despite falling revenues as a result of the recession and falling commodity prices.

6. Incremental capital output ratio (ICOR) is calculated as:
Total Investment/Change in GDP.

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Economic Performance of Asian Developing Countries

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Introduction

The most significant development in world trade in the 1980s is the overall slower export growth. As shown in Table 1, world trade stagnated in the early 1980s, and although the situation has improved somewhat more recently, the real growth of world trade is expected to continue at 30 per cent below the average rate in the 1970s. In addition, many of the important developing-country exports are facing lower prices or are being constrained by restrictions. Prices of primary commodities, which constitute a significant share of developing countries' exports, have been depressed over a long period. And protection against developing countries' labour-intensive and other manufactured exports has been increasing in the markets of developed countries.

These changes in the international environment have affected the Asian developing countries in different ways. In the mid-1980s, growth slowed in the three outward-looking countries, Hong Kong, Korea and Taiwan. But these economies quickly rebounded as they responded to the exchange rate realignment which increased the competitiveness of their exports. The drop in commodity prices also helped improve their balance of payments position, such that they became surplus countries.

Singapore and the other four large, resource-rich members of ASEAN, Indonesia, Malaysia, the Philippines and Thailand, also had lower real economic growth rates in the 1980s. Falling commodity prices negatively affected all of these countries and are reflected in the negative growth of average exports in the 1980s. For the oil-exporting countries,

Table 1 Real growth rate of world trade, 1969–88[a] (percentage of average annual change in volume).

	Average 1969–78[b]	*1979*	*1980*	*1981*	*1982*	*1983*	*1984*	*1985*	*1986*	*1987*[c]	*1988*[c]
World trade[d]	6.7	6.4	1.2	0.7	−2.2	2.9	8.6	3.2	4.9	3.3	4.4
Exports											
Industrial countries	7.3	7.2	3.9	3.7	−2.0	2.8	9.7	4.4	2.9	3.4	4.6
Developing countries	4.6	4.4	−4.2	−6.0	−7.6	3.2	7.1	1.0	8.2	2.8	5.8
Africa	3.1	8.4	−1.2	−14.9	−5.1	3.4	5.6	7.1	2.2	1.6	3.9
Asia	10.8	9.0	8.8	8.5	1.1	10.7	13.6	5.0	17.1	6.1	6.3
Europe	3.3	−1.7	3.9	3.1	1.7	8.3	13.4	4.2	2.4	3.2	4.9
Middle East	4.8	0.4	−15.2	−17.6	−19.7	−9.3	−4.4	−8.8	16.6	−3.2	5.4
Western Hemisphere	1.7	7.6	1.2	6.0	−2.4	8.2	8.5	–	−8.8	0.1	7.2
Imports											
Industrial countries	6.9	8.9	−1.6	−2.3	−0.3	4.8	12.4	5.0	8.9	4.3	4.6
Developing countries	7.2	3.5	7.3	7.8	−4.0	−2.4	1.8	−0.2	−3.1	−0.2	2.9
Africa	7.2	−3.5	8.7	11.3	−8.1	−10.1	−0.4	−7.3	−11.0	−4.0	1.6
Asia	8.6	12.3	9.5	7.2	0.9	8.3	5.3	7.4	4.3	4.9	4.3
Europe	1.3	–	−2.5	−1.4	−8.3	2.6	6.7	6.1	5.6	2.8	4.4
Middle East	15.1	−4.1	8.8	16.7	5.6	−2.4	−6.1	−14.9	−18.3	−12.5	−1.0
Western Hemisphere	6.4	8.3	9.7	−3.5	−17.8	−22.5	2.8	2.2	−4.8	−0.8	2.4

– The figure is zero or less than half the final digit shown.

[a] Excluding China prior to 1978 except as indicated in note *b*.

[b] Compound annual rates of change. [c] Estimate.

[d] Averages of growth rates for world exports and imports based on data for the two groups of countries shown separately below and on partly estimated data for the USSR and non-member countries of Eastern Europe and for China prior to 1978.

Source: IMF, *World Economic Outlook*, April 1987.

Indonesia and Malaysia, the situation was especially bad in the mid-1980s. Oil price declines, on the other hand, benefitted Thailand and the Philippines but the lower prices for rice, copra, tin and other important export commodities slowed export growth. Singapore was also affected by the slower growth of its neighbours, but has been helped by the exchange rate realignment and domestic measures to improve its competitiveness. The worst seems to be over for the ASEAN countries as internal adjustments take effect and commodity prices firm. Growth, however, continues to be lower than in the 1970s and early 1980s.

Unlike the ASEAN countries, the growth of the South Asian countries generally improved in the 1980s as they began to experiment with more liberal economic policies. Policies were taken to reduce disincentives and improve efficiency in the agricultural sector and, as a result, agricultural output improved. Several countries, including India, have attained self-sufficiency in food. Importantly, because of technological improvements, agricultural production is now less susceptible to changing weather conditions. The lower import costs of commodities, primarily oil, has further improved growth prospects for most of these countries.

China emerged as a participant in world trade in the late 1970s. As a result of China's new open-door policy, growth rates of income and exports were among the highest in the world in the early 1980s. However, the country's large trade deficit in recent years has forced China to proceed more cautiously. Nevertheless, China continues to be among the fastest growing countries in the world.

The primary message of this paper is that, despite the economic difficulties of the mid-1980s, the Asia–Pacific economies are making adjustments and appear to be resuming a pattern of growth considerably higher than the world average. This paper will look at some of these policy responses in three broad subject areas: financial development, industrialization and trade. In particular, the paper will emphasize the role of government in economic development in terms of short-, medium- and long-term development strategies. The changing conditions mean that the selection and implementation of appropriate policies is even more important in the 1980s. The paper will conclude with an assessment of future growth prospects and problems, and suggest policy adjustments that will enable these countries to sustain growth in the face of altered economic conditions in the 1980s.

First of all, it will be useful to look at some general characteristics of the countries in question.

Comparative analysis

In the Asian developing countries, like developing countries as a whole, sharp differences exist in availability of natural resources, structure of

production, degree of participation in world trade, political stability, importance of private enterprise, population size and quality of labour force. It is, therefore, not easy to generalize about the economic performance of a group of developing countries. Despite these differences, there are enough common characteristics in the levels of income, the structure of production, and development strategies and policies of these countries to allow a coherent analysis. Three main groups of Asian developing countries can be distinguished by income level, economic structure and overall economic performance over the past quarter century. Included in this study are four newly industrializing countries (NICs): Hong Kong, Korea, Singapore and Taiwan; four middle-income South East Asian nations: Indonesia, Malaysia, the Philippines and Thailand (hereafter referred to as ASEAN-4); and six low-income South Asian countries: Bangladesh, Burma, India, Nepal, Pakistan and Sri Lanka.[1] Although China's increasingly outward-looking policies and more rapid growth are important developments, its policies and problems are unique and require a separate analysis.

The above three groupings are based on certain common characteristics shared by the countries. These common characteristics are: per capita income, structure of economy, openness to trade and policy orientation. There are, however, differences among countries within each group. These are taken into account wherever important. We recognize that statements made in relation to a group of countries may not apply with equal force to each country of that group.

Newly industrializing countries

The Asian newly industrializing countries (NICs), Hong Kong, Singapore, Korea and Taiwan, have achieved unprecedented economic growth rates (Table 2). Per capita real gross domestic product (GDP) growth was sustained at an average rate of 7 per cent for nearly two decades (Table 3). Because of this rapid growth, Hong Kong and Singapore, with per capita incomes of $6288 and $6238, respectively, have almost graduated from the ranks of developing countries. Korea and Taiwan, with populations of 41 and 19 million, have attained per capita incomes of $2099 and $3095, respectively.

The speed with which the NICs have industrialized is astonishing. As shown in Table 4, the share of the agricultural sector in the GDP of Korea and Taiwan has declined sharply in the past 20 years. In 1985, agriculture was down to 14 per cent of GDP for Korea and only 6 per cent for Taiwan. Hong Kong and Singapore have very little agriculture; more than 60 per cent of their GDP is contributed by the service sector.

In the NICs, the policy emphasis on labour-intensive exports made the manufacturing sector important in terms of both total output and employment. Labour absorption by the rapidly growing manufacturing

Table 2 Average annual rates of growth of real GDP.

Group/country	*1960–70*	*1970–80*	*1980–5*	*1983*	*1984*	*1985*	*1986*
NICs							
Hong Kong	10.0	9.0	6.7	6.5	9.5	0.6	8.7[a]
Korea	8.8	8.6	5.8	10.9	8.6	5.4	11.9
Singapore	9.6[b]	9.6	6.8	7.9	8.2	−1.8	1.9
Taiwan	9.3	9.8	6.3	7.7	9.6	4.3	9.9
ASEAN-4							
Indonesia	3.9[b]	7.9	5.4	4.2	6.1	1.9	2.0[a]
Malaysia	6.5	7.8	5.6	6.3	7.8	−1.0	0.5[a]
Philippines	4.8	6.0	0.5	0.9	−6.0	−4.4	1.1
Thailand	8.1	6.9	5.1	5.8	5.5	3.2	3.4
South Asia							
Bangladesh	n.a.	5.9[c]	3.5	3.6	4.2	3.7	4.4
Burma	3.3	4.0	5.7	4.4	5.6	4.3	3.7
India	3.9[b]	3.5	5.6	7.8	3.8	6.3	5.0[a]
Nepal	1.6	2.1	2.9	−3.0	7.8	3.0	4.2
Pakistan	4.3	4.0	6.9	6.3	5.4	8.0	7.5
Sri Lanka	5.8	5.7	5.1	4.8	4.1	5.0	4.0[a]
Other Asia							
China[d]	4.8	7.4	10.4	10.2	13.0	19.1	7.4[a]
Developed countries							
Japan[e]	11.9	5.1	4.0	3.2	5.1	4.5	2.5
United States	3.8	2.5	2.1	3.7	6.6	3.0	2.5
World	4.9[b]	3.7	2.3	2.2	4.1	2.8	2.9[a]

n.a. Not available.
[a] Preliminary estimate.
[b] 1961–70.
[c] 1974–80.
[d] Real national income (NI).
[e] Real GNP.

Sources:
Asian Development Bank, *Key Indicators of Developing Member Countries of ADB*, April 1983, April 1984, July 1987.
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Table 3 Size of Asia–Pacific countries in 1985.

Group/country	Population (millions)	Area (1000 km^2)	GDP (US$ × 10^6)	GDP Per capita (US$)	Average annual growth of GNP per capita 1965–85 (%)
NICs					
Hong Kong	5.5	1	34 081	6 288.0	6.1
Korea	41.1	99	86 180	2 098.9	6.6
Singapore	2.6	1	15 970	6 238.0	7.6
Taiwan	19.1	36	59 141	3 094.8	n.a
ASEAN-4					
Indonesia	164.1	1919	86 445	523.4	4.8
Malaysia	15.7	330	33 360	2 127.5	4.4
Philippines	54.7	300	32 789	599.8	2.3
Thailand	51.7	542	38 572	751.9	4.0
South Asia					
Bangladesh	99.2	144	14 208	144.0	0.4
Burma	36.6	678	6 812	186.2	2.4
India	750.9	3288	187 609[a]	255.0[a]	1.7
Nepal	16.7	147	2 280	136.7	0.1
Pakistan	96.2	804	30 029	322.3	2.6
Sri Lanka	15.8	66	5 823	367.6	2.9
Other Asia					
China	1040.0	9561	232 302[b]	222.7[b]	4.8[b]
Developed countries					
Japan	120.8	372	1 325 208	10 970.3	4.7
United States	239.3	9363	3 957 000	16 537.1	1.7

[a] 1984.

[b] National income.

Sources:

Asian Development Bank, *Key Indicators of Developing Member Countries of ADB*, July 1987.

Far Eastern Economic Review, *Asia 1986 Yearbook*.

IMF, *International Financial Statistics*, July 1987.

World Bank, *World development report 1987*.

Table 4 Structure of GDP in the Asia–Pacific developing countries, Japan and the US (percentage of GDP at current prices).

Group/country	1970				1978				1985			
	Agriculture	*Manufacturing*	*Other industries*[a]	*Services*	*Agriculture*	*Manufacturing*	*Other industries*[a]	*Services*	*Agriculture*	*Manufacturing*	*Other industries*[a]	*Services*
NICs												
Hong Kong	2.0	30.9	6.3	60.8	1.1	24.3	7.9	66.6	0.5	21.6	7.9	70.0
Korea	26.9	20.9	8.6	43.6	20.2	28.0	10.3	41.5	13.5	28.2	12.7	45.6
Singapore	2.3	20.4	9.7	67.5	1.5	26.4	8.5	63.6	0.8	24.6	13.4	61.2
Taiwan	15.6	33.5	7.8	43.2	9.5	41.9	9.7	38.9	5.9	40.9	9.2	44.0
ASEAN–4												
Indonesia	47.2	9.3	8.6	34.9	29.5	10.6	25.1	34.7	23.6	13.5	22.4	40.5
Malaysia[b]	29.6	14.3	12.4	43.7	25.1	19.0	15.9	40.0	20.8	19.7	16.9	42.5
Philippines	27.6	22.6	7.1	42.7	26.7	24.6	9.9	38.8	26.7	24.7	8.2	40.4
Thailand	28.3	16.0	9.3	46.4	27.5	19.0	8.6	44.9	17.4	19.8	10.0	52.8
South Asia												
Bangladesh[c,d]	57.9	6.4	3.7	32.0	54.7	9.1	4.4	31.7	50.1	7.3	5.9	36.7
Burma	38.3	10.4	4.0	47.4	44.2	10.0	2.6	43.2	47.8	9.9	3.4	38.9
India	47.4	14.2	7.5	30.9	38.6	16.9	8.5	36.0	31.4	16.7	10.6	41.3
Nepal[e]	67.5	9.0	2.4	21.0	63.0	4.3	7.6	25.0	56.6	4.3	10.8	28.3
Pakistan[c]	35.7	16.3	6.0	42.0	31.6	15.0	7.8	45.6	25.6	17.7	8.4	48.3
Sri Lanka	32.9	9.1	7.7	42.0	27.1	22.6	7.3	43.0	24.4	16.6	10.2	48.8

(continued)

Table 4 Structure of GDP in the Asia–Pacific developing countries, Japan and the US (percentage of GDP at current prices). — *(continued)*

Group/country	1970				1978				1985			
	Agriculture	*Manufacturing*	*Other industries*[a]	*Services*	*Agriculture*	*Manufacturing*	*Other industries*[a]	*Services*	*Agriculture*	*Manufacturing*	*Other industries*[a]	*Services*
Other Asia												
China[f]	n.a.	n.a.	n.a.	n.a.	35.4	n.a.	50.9	13.7	41.5	n.a.	47.0	11.5
Developed countries												
Japan[f]	6.1	35.9	10.7	47.3	4.6	29.6	12.1	53.7	3.2	29.8	11.1	56.0
United States[g]	2.7	25.7	9.2	62.4	2.9	24.4	9.9	63.0	2.0	21.1	10.6	66.3

[a] Includes construction, utilities and mining.
[b] 1971. Data in constant 1970 or 1978 prices.
[c] 1973.
[d] Manufacturing includes mining; other industries includes only construction and utilities.
[e] 1984.
[f] Percentage of national income (NI).
[g] 1983.

Sources:
Asian Development Bank, *Key Indicators of Developing Member Countries of ADB*, April 1984, April 1985, July 1987.
Organization for Economic Cooperation and Development, *National accounts statistics*, 1963–80, 1972–84.

sector was exceptional. In 1970, the manufacturing sector accounted for 21 per cent of GDP for Korea and 34 per cent of GDP for Taiwan, while its share of employment was 13 and 20 per cent, respectively (Table 5). By the 1980s, manufacturing activities made up 28 per cent of GDP and 23 per cent of employment in Korea, and in Taiwan, the manufacturing sector grew to 41 per cent of GDP and employed 34 per cent of those currently working. In Singapore, manufacturing had modest but steady gains in terms of output and employment. In Hong Kong, growth in the service sector was more significant, although employment in manufacturing accounted for 25 per cent of GDP and 36 per cent of employment in 1985.

The development strategy of the NICs has also made them among the most trade-oriented countries in the world. Table 6 shows that exports and imports comprise nearly 40 per cent of GDP in Korea to more than 100 per cent in Hong Kong. Even in Japan, which is considered to be an export-oriented economy, the comparable figures are 17 per cent for exports and 13 per cent for imports.

ASEAN-4 countries

The four resource-rich ASEAN countries, Indonesia, Malaysia, the Philippines and Thailand, also demonstrated strong economic growth. Although lower in the ASEAN-4 than in the NICs, GDP growth rates of these countries were much higher than the average for developing countries. Growth of real income per capita has also been impressive except in the Philippines. In 1985, per capita income for the ASEAN-4 ranged from $523 for Indonesia to $2128 for Malaysia, which is classified as an upper middle-income country by the World Bank. The other three are classified as middle-income countries.

Indonesia is the third largest of the Asian developing countries, both in terms of land area and population. With 164 million people, it is the fifth most populous country in the world. The Philippines and Thailand had populations of a little more than 50 million people in 1985. Both are endowed with considerable natural and human resources, but in the Philippines, political tensions and economic mismanagement have held back growth. Malaysia is a resource-rich country with a small population of approximately 16 million.

Significant structural transformation has occurred in the ASEAN-4. During the past two decades, the share of industry in GDP rose while the share of agriculture fell. In Indonesia, the share of industry in GDP increased from a low base of 18 per cent in 1970 to 36 per cent in 1985, but much of this gain was due to the petroleum boom. The Philippines started at the highest base with the share of industry to GDP at 30 per cent in 1960. But the country experienced slower rates of growth through the 1970s, and in 1985 industry accounted for only 33 per cent of GDP.

Table 5 The structure of employment (percentage of total employed).

Group/country	*1970*					*1978*					*1985*				
	Agriculture	*Industry*	*Manufacturing*	*Mining*	*Other*	*Agriculture*	*Industry*	*Manufacturing*	*Mining*	*Other*	*Agriculture*	*Industry*	*Manufacturing*	*Mining*	*Other*
NICs															
Hong Kong[a]	1.9	n.a.	35.4	n.a.	62.7	1.4	n.a.	43.3	n.a.	55.8	1.6	n.a.	36.2	n.a.	62.2
Korea	50.4	n.a.	13.2	1.1	35.2	38.4	n.a.	22.4	0.8	38.4	24.9	n.a.	23.4	1.0	50.6
Singapore	3.4	n.a.	22.0	0.3	74.3	1.9	n.a.	28.8	0.1	69.1	0.7	n.a.	25.9	0.2	73.2
Taiwan	35.4	n.a.	20.4	1.6	42.7	24.9	n.a.	30.5	0.8	43.7	17.5	n.a.	33.5	0.5	48.6
ASEAN-4															
Indonesia[b]	61.6	n.a.	8.4	n.a.	30.1	60.9	n.a.	7.4	n.a.	31.6	54.7	n.a.	9.3	0.7	35.4
Malaysia	53.2	n.a.	9.0	2.6	35.2	43.3	n.a.	14.6	1.8	40.3	35.7	n.a.	15.1	1.1	48.0
Philippines	53.8	n.a.	11.9	n.a.	34.3	52.8	n.a.	11.5	n.a.	35.7	49.3	n.a.	9.7	0.6	40.4
Thailand[c]	72.2	n.a.	7.7	0.7	19.4	73.7	n.a.	6.8	0.1	19.4	59.2	n.a.	10.9	0.4	29.5
South Asia															
Bangladesh[d]	73.9	n.a.	6.8	n.a.	19.3	70.3	n.a.	7.7	n.a.	22.0	64.0	n.a.	8.5	n.a.	27.6
Burma	66.7	n.a.	6.8	n.a.	26.4	67.2	n.a.	7.5	0.5	24.7	65.8	n.a.	8.5	0.6	25.1

India[e]	74.0	11.0	n.a.	n.a.	15.0	70.3	12.7	n.a.	n.a.	17.0	71.0	13.0	n.a.	n.a.	16.0
Nepal	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Pakistan[d]	57.3	n.a.	12.5	n.a.	30.2	54.8	n.a.	13.6	n.a.	31.6	52.7	n.a.	13.4	n.a.	33.8
Sri Lanka[f]	50.1	n.a.	9.3	0.4	40.2	n.a.	n.a.	n.a.	n.a.	n.a.	45.5	n.a.	9.9	0.8	43.7
Other Asia															
China	n.a.	n.a.	n.a.	n.a.	n.a.	73.8	12.6	n.a.	n.a.	13.6	62.5	16.7	n.a.	0.2	20.5
Developed countries															
Japan	20.0	34.0	n.a.	n.a.	46.0	13.3	38.1	n.a.	n.a.	48.6	12.0	39.0	n.a.	n.a.	49.0
United States	3.7	34.4	n.a.	n.a.	61.9	2.3	32.5	n.a.	n.a.	65.2	2.0	32.0	n.a.	n.a.	66.0

n.a. Not available.

[a] 1971 and 1979

[b] 1976 and 1978.

[c] 1972.

[d] 1973.

[e] Only India's data was obtained from World Bank. Percentage of labour force, not percentage of employed.

[f] 1971 and 1981.

Source:

Asian Development Bank, *Key Indicators of Developing Member Countries of ADB*, April 1984, April 1985, July 1987.

Republic of China, Council of Economic Planning and Development, *Taiwan statistical data book, 1985*. World Bank, *World tables*, 3 Ed, Vol. II, 'Social indicators'.

Table 6 Export and import ratios (percentage of GDP at current prices).

Group/country	*Exports*			*Imports*		
	1970	*1978*	*1986*	*1970*	*1978*	*1986*
NICs						
Hong Kong	101.1	98.9	105.8[a]	95.7	102.2	99.4[a]
Korea	14.0	31.1	40.9	23.6	35.1	35.1
Singapore[b]	77.1	122.8	122.8	122.7	154.9	136.2
Taiwan	29.7	52.4	60.4	29.7	45.9	40.8
ASEAN-4						
Indonesia	12.8	21.7	22.7[a]	15.8	14.8	21.0[a]
Malaysia	46.1	49.1	54.9[a]	44.4	43.5	49.8[a]
Philippines	19.1	18.2	25.1	19.4	23.3	18.4
Thailand	16.7	21.5	26.3[a]	21.5	25.5	27.5[a]
South Asia						
Bangladesh	6.0[c]	5.5	6.5	5.0[c]	14.0	14.5
Burma	5.6	5.8	5.0	8.2	10.1	7.7
India	4.4	7.3	7.4[d]	4.5	7.6	9.1[d]
Nepal	4.9	10.6	13.0[a]	8.3	15.5	19.0[a]
Pakistan	14.9[c]	9.3	10.9[a]	14.4[c]	18.3	21.1[a]
Sri Lanka	25.5	34.8	23.7	28.6	39.5	35.3
Other Asia						
China[b]	n.a.	5.4	10.8	n.a.	6.0	16.5
Developed countries						
Japan	11.3	11.8	16.5[a]	10.2	10.0	12.7[a]
United States	5.6	8.2	6.8	5.5	9.4	10.2

n.a. Not available.
[a] 1985.
[b] Merchandise trade only.
[c] 1973.
[d] 1984.
[e] Percentage of national income.

Sources:
Asian Development Bank, *Key Indicators of Developing Member Countries of ADB*, April 1984, July 1987.
Hong Kong, *Monthly Digest of Statistics*, August 1986.
IMF, *International Financial Statistics*, Yearbook 1986 and July 1987.
World Bank, *World tables*, 3 Edn.
World Bank, *World development report 1986*.

Industry accounted for less than 27 and 25 per cent of GDP in 1970 for Malaysia and Thailand, respectively, and increased to approximately 37 and 30 per cent by 1985.

The resource wealth and the more inward-looking development strategies of these countries contributed to a greater emphasis on capital-intensive industries producing for the home market. Though generally lower than those of the NICs, export-to-GDP ratios are relatively high but these consist largely of primary commodities. In addition, industrial employment did not increase as rapidly as industrial output. In the 1980s, the manufacturing sector employed approximately 10 per cent of the total labour force in Indonesia, the Philippines and Thailand, and a little more than 15 per cent in Malaysia. A shift toward more outward-looking policies in the 1970s, however, has increased the importance of labour-intensive manufactures in the ASEAN-4.

South Asian countries

The South Asian countries are all low-income countries, with per capita GDPs in 1985 ranging from $137 in Nepal to $368 in Sri Lanka. Average annual rates of real GDP growth have been lower in the South Asian countries (Bangladesh, Burma, India, Nepal, Pakistan and Sri Lanka) than in the NICs and ASEAN-4 throughout the 1960s and 1970s. However, real economic growth rates for several countries began to accelerate in the late 1970s. In the 1980s, economic growth rates in South Asia (except for Bangladesh and Nepal) averaged 5 and 6 per cent, thus converging with those of other Asian countries. None the less, real GDP per capita has grown very slowly in large parts of South Asia (in India, Bangladesh and Nepal), but in Burma, Pakistan and Sri Lanka per capita real growth has averaged better than 2 per cent per year since 1965.

India is the largest Asian developing country next to China and one of the largest countries in the world in terms of both land area and population. In addition to India's 750 million people, populations of almost 100 million are in Bangladesh and Pakistan, 37 million in Burma, 17 million in Nepal and 16 million in Sri Lanka.

Industrial development has been relatively slow in the South Asian countries. These countries are still predominantly agricultural, though large industrial sectors exist in India, Pakistan and Sri Lanka. The poor growth rates of industry in these three countries cannot be attributed to the difficulties usually associated with the initial phase of industrialization, since they had built up a sizeable industrial sector early on. By 1970, the manufacturing sector comprised 16 per cent of GDP in Pakistan, 14 per cent in India and 9 per cent in Sri Lanka. This was similar to Malaysia and Thailand. In the 1980s, manufacturing's GDP share increased to 18 per cent in Pakistan and 17 per cent in India and Sri Lanka, but labour absorption has been minimal.

The low growth of output and industrial employment prompted the South Asian governments to re-examine their development strategies in the late 1970s, and since then, industrial growth and employment have improved.

With the exception of Sri Lanka, however, trade continues to comprise a very small portion of GDP. Export-to-GDP ratios are less than 8 per cent in Bangladesh, Burma and India. In Nepal and Pakistan, the share of exports is slightly higher at 13 and 11 per cent, respectively.

Strategies to restore growth

There is general recognition in the region that external conditions for growth are unlikely to be favourable in the foreseeable future. There is also a realization that internal problems can pose obstacles to sustained economic growth. Many governments, including those with centrally planned economies, are engaged in serious reassessments of past development strategies. The reassessments have often led to the adoption of economic policy reforms designed to increase efficiency of resource allocation through the introduction of market-based pricing, increased internal and external competition, and wider latitude to private businesses. Although implementation of broad policy reforms to liberalize the economy often encounters resistance, delays and deflections, many Asia–Pacific governments are demonstrating flexibility and considerable political resolve in introducing necessary changes.

In adjusting to the more difficult external environment of the 1980s, the Asian developing countries have continued their long-term strategy of outward-looking development policies. These policies involve more than just export orientation, though openness to world trade and investment is a crucial element. Openness requires that price distortions in national economies be minimal and that prices correspond with changing conditions in the world economy. A World Bank study found that the relatively open developing Asian countries do indeed have a lower composite index of price distortions than developing countries in other regions.[2]

Outward-looking development strategies also involve a market or private sector oriented approach. Business activities are mainly left to the private sector and the allocation of resources is basically left to the market. For the government to overrule or replace the market requires that governments have the knowledge, foresight and administrative capacity to undertake complex intervention. In practice, however, administrators are often not able to accomplish these tasks. Not surprisingly, countries that tried to replace the market through direct controls have generally had inferior records of development. It is, therefore, important for government not to over-extend itself and try to take over decision-making in areas best left to the market. The difficulties

of planning and the mis-allocation and corruption resulting from numerous regulations and controls have thus far been underestimated, and good effects have been overestimated.

The role of the government, however, does not necessarily have to follow the textbook *laissez-faire* model. Government planning and regulation is still required. Nevertheless, the emphasis on direct controls should be reduced and government decrees should become less important. Rather, government should influence resource allocation and economic development through policies that are implemented primarily through indirect controls that work through the price mechanism.

The governments of the Asian developing countries have all (with the possible exception of Hong Kong) been a determining force in economic development. The NICs have been especially successful in selecting appropriate policies. They have used financial policies to reduce uncertainties and encourage investment in new industries. Industrial and trade policies were adopted to shift the structure of production in line with changing comparative advantage. Even Singapore, which generally adopted a policy of non-interference in trade, has used policies to stimulate certain industries, though perhaps to excess in some areas. Yet, the governments did not try to overwhelm the market and they were flexible enough to adjust policies when necessary.

Clearly the Asian developing countries, particularly the South Asian countries, can go further in adopting appropriate policies in order to raise their saving rates, foreign exchange earnings, industrial output and thus rates of growth in GDP and per capita GDP. Increases in the level of development and sophistication of the economic structure of the NICs, and to a lesser extent ASEAN-4 countries, make the selection of policies more complex. This section will look at short-term as well as long-term problems facing these countries in the 1980s and the challenges they will have to overcome.

Financial development

Appropriate financial policies are among the most important factors in industrial development.[3] Finance is needed to increase productive capacity, infrastructure and trade. The financial system is the link between suppliers and users of capital. Both domestic and foreign sources of finance are needed to increase rates of private investment.

The high liquidity of the world in the 1970s owing to the recycling of oil money is gone. Table 7 shows that total financial flows to all developing countries dropped sharply after 1982. External financial flows into Asian developing countries also dropped absolutely in this period. Of the NICs, only Korea had a substantial inflow of official flows, but these flows have generally decreased over time, reflecting Korea's higher level of development. Private sector flows, the largest component of flows to both NICs and ASEAN-4 countries since the early 1970s, have

Table 7 Financial flows from OECD, OPEC and multilateral institutions (US$ × 10^6).

			Official flows			*Private flows*[a]			
Group	*Period*	*Total flows*	*Sub-total*	*Bilateral*	*Multilateral*	*Sub-total*	*Direct investment*	*Portfolio investment*	*Export credits*
All less-developed countries	1970–2	16 326	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	1973–5	33 077	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	1976–8	59 577	28 774[b]	20 280[b]	8 494[b]	36 327[b]	10 704[b]	16 220[b]	9402
	1979–82	88 193	42 116	29 408	12 709	46 077	13 298	23 191	9588
	1983–5	69 655	43 787	28 104	15 684	25 868	9 014	13 065	3367
14 Asian less-developed countries	1973–5	6 732[c]	4 814	3 363	1 451	1 918	n.a.	n.a.	n.a.
	1976–8	8 852	6 226	3 985	2 241	2 626	1 050	442	1135
	1976–82	14 777	8 952	4 876	4 076	5 825	2 543	1 183	2084
	1983–5	13 332	9 118	4 319	4 799	4 214	1 435	2 073	706
NICs	1970–2	1 087	621	493	128	466	n.a.	n.a.	n.a.
	1973–5	1 492[c]	805	542	263	687	n.a.	n.a.	n.a.
	1976–8	2 048	905	533	372	1 143	403	78	661
	1979–82	3 979	1 141	714	427	2 837	1 322	520	996
	1983–5	2 070	417	77	340	1 654	1 071	724	−142

ASEAN-4	1970–2	1 194	837	726	111	356	n.a.	n.a.	n.a.
	1973–5	2 513[c]	1 238	884	354	1 274	n.a.	n.a.	n.a.
	1976–8	3 267[c]	1 806	1 122	685	1 460	624	380	456
	1979–82	5 509	2 898	1 516	1 382	2 611	1 120	622	869
	1983–5	6 036	3 841	2 034	1 807	2 195	323	1 136	737
South Asia	1973–5	2 727[c]	2 771	1 936	835	−44	n.a.	n.a.	n.a.
	1976–8	3 537	3 515	2 330	1 184	23	23	−17	17
	1976–82	5 289	4 913	2 646	2 267	376	101	41	219
	1983–5	5 225	4 860	2 209	2 652	365	41	213	111

n.a. Not available.

[a] DAC countries only; no private flows recorded from other countries or agencies.

[b] 1977–8.

[c] Sum of components; does not add to total given in source (1975 only).

Sources:

Organization for Economic Cooperation and Development, *Geographical distribution of financial flows to developing countries*, various issues.

Organization for Economic Cooperation and Development computer tape, as cited in ADB mimeos.

also slowed and official flows have not risen enough to offset the slowdown in private flows. This reflects both a more cautious approach of commercial banks and the austerity policies adopted by some of the countries. The South Asian countries still rely largely on official flows. Private and commercial sources of external funds have not been vigorously sought, nor have opportunities been such to attract the private sector lender. The increasing trend in the share of private flows in the late 1970s stopped in 1980, and private flows declined absolutely.

Yet, external debt increased significantly in the 1980s, particularly for the ASEAN-4 countries and Pakistan because of continued, depressed commodity prices. Debt service ratios are very high in Indonesia (16 per cent), the Philippines (30 per cent), and Thailand (31 per cent) and have risen sharply in Malaysia (10 per cent).[4] This, in conjunction with a slowdown in export growth, has forced the ASEAN-4 countries to implement stabilization measures to cut imports, spending and growth. Countries have also become more cautious and have placed stricter controls on foreign borrowing. On the other hand, by the mid-1980s the achievement of current account surpluses in Korea, the largest Asian debtor, allayed fears that a debt repayment crisis was imminent.

Reductions in real interest rates in the 1980s will ease the burden of debt-servicing to a certain extent, though real interest rates will continue to remain above historical levels. The decline in real interest rates allows many of the countries to pre-pay older loans with new loans at better terms. Dowling *et al.* (1986) estimated the savings to be approximately $450 million for Korea in 1986, between $150 and $200 million for Indonesia, Malaysia and the Philippines, and $90 million for Thailand. The savings are, however, very small for South Asian countries, except for India at $68 million.

But the appreciation of the yen and European currencies *vis-à-vis* the US dollar has had the opposite effect. Indonesia, Korea and Malaysia have substantial amounts of yen-denominated loans. These non-dollar denominated loans will require more domestic currency to service.

The volume of capital inflows affects the extent to which the developing Asian countries can make necessary structural adjustments. Slowdown of official flows and private lending means less resources are available for investment. Accumulating more debt, however, is not the solution.

In the future, these countries will have to increase domestic resource mobilization. An additional source of non-debt creating flows is direct foreign investment.

Domestic resource mobilization

With the slowing of external financial flows, it is imperative for the domestic economy to redirect sufficient resources from consumption

towards saving so that economic growth is not limited by the amount of resources which can be utilized for productive investment. The NICs and ASEAN-4 countries have generally been very successful at mobilizing their domestic resources. Savings-to-GDP ratios increased or maintained high levels through the 1970s, especially in the NICs (Table 8). By 1978, domestic saving was about 30 per cent of GDP in these countries, financing the majority of gross domestic investment. By 1986, these countries emerged as capital-surplus countries.

The ASEAN-4 countries also improved their saving and investment performance in the 1970s. Thailand's saving and investment increased to 25 and 27 per cent of GDP by 1978. This dropped, however, to less than 22 per cent in 1986. In the Philippines, saving increased in the 1970s but dropped at the end of the Marcos regime, being less than 17 per cent in 1986. Indonesia and Malaysia achieved high saving ratios with the aid of high earnings from oil exports. With the exception of Indonesia, however, in the 1980s private saving rates have fallen in the ASEAN-4. The situation is serious and may affect future investment and growth.

Of the South Asian countries, only India and Pakistan increased their saving ratio to 21 and 12 per cent, respectively, in 1985. The other South Asian countries have not been able to overcome the 'vicious circle of poverty', though Burma, Nepal and Sri Lanka now save about 10 per cent of their GDP. However, although saving rates remain relatively high in India, normally suggesting good economic performance, low capacity utilization and inefficiency of capital use have retarded growth. Incremental capital-output ratio (ICOR), defined as the ratio of the change in capital stock to the change in GDP, is high and increasing (Table 9).

New initiatives emphasizing efficiency in both the private and public sectors, however, will hopefully remove this constraint to growth. Fiscal and financial reforms will be needed to revitalize private savings to enable these countries to finance a larger share of capital formation. A financial sector that provides consumers of financial services the greatest choice in terms of accessibility, variety of instruments with respect to size and maturity, while guaranteeing depositors a positive real rate of return is more likely to call forth additional savings.

The theoretical case for financial liberalization is well known. Financial liberalization allows interest rates to reflect relative scarcities, stimulate saving and exports, and discriminate more efficiently between alternative investments (Lee and Jao, 1982). Shaw (1973) and McKinnon (1973) underlined the importance of financial deepening (or the increased use of money and financial instruments relative to real output) for developing countries. They conclude that realistic policies on interest rates and exchange rates, and policies to curb inflation have contributed significantly to economic growth in these two countries. Other more recent studies (Cole and Patrick, 1986) confirm these findings and extend them to other Asian developing countries. An extensive study by the

Table 8 Saving and investment ratios (percentage of GDP at current prices).

Group/country	*Gross domestic saving*			*Gross domestic investment*			*Resource gap*		
	1970	*1978*	*1986*	*1970*	*1978*	*1986*	*1970*	*1978*	*1986*
NICs									
Hong Kong	25.0	26.4	27.2	21.4	30.0	23.0	3.6	−3.6	4.2
Korea	15.4	28.2	34.9	25.4	31.5	29.2	−10.1	−3.2	5.6
Singapore	20.5	32.1	40.5	38.7	39.0	40.0	−18.1	−7.0	0.5
Taiwan	25.6	35.1	36.3	22.7	27.0	19.8	2.9	8.1	16.5
ASEAN-4									
Indonesia	10.6	27.4	24.3	13.6	20.5	26.2	−3.0	6.9	−1.9
Malaysia	22.0	32.2	31.4	20.3	26.7	25.7	1.7	5.6	5.7
Philippines	22.1	24.0	16.5	21.2	28.9	13.1	0.9	−4.9	3.4
Thailand	20.6	24.7	21.8	26.2	27.0	21.5	−5.6	−2.4	0.4
South Asia									
Bangladesh	9.9[a]	2.8	2.7	8.9[a]	11.3	10.6	1.0[a]	−8.5	−8.0
Burma	9.2	13.8	12.7	11.8	18.2	15.4	−2.6	−4.4	−2.7
India	16.5	19.3	21.3[b]	18.3	23.5	25.3[b]	−1.7	−4.2	−4.0[b]
Nepal	n.a.	7.7	11.9[b]	n.a.	17.8	20.7[b]	n.a.	−10.1	−8.8[b]
Pakistan	13.1	8.8	9.3	15.8	17.9	16.7	−2.8	−9.1	−7.5
Sri Lanka	15.8	15.3	12.1	19.0	20.1	23.7	−3.2	−4.8	−11.6
Other Asia									
China[c]	n.a.	37.3	43.9[b]	32.0	36.1	44.7[b]	n.a.	1.2	−0.8[b]
Developed countries									
Japan	40.3	32.6	31.9[b]	39.0	30.9	28.5[b]	1.3	1.7	3.4[b]
United States	18.0	20.2	15.4	17.9	21.3	18.8	0.1	−1.2	−3.4

n.a. Not available.

[a] 1973.

[b] 1985.

[c] Percentage of net material product (NMP).

Sources:

Asian Development Bank, *Key Indicators of Developing Member Countries of ADB*, July 1987.

Hong Kong, Census and Statistics Department, *Estimates of gross domestic product 1966 to 1983.*

Hong Kong, Census and Statistics Department, *Hong Kong Monthly Digest of Statistics*, August 1987.

IMF, *International Financial Statistics*, Yearbook 1987 and January 1988.

Republic of China, Council for Economic Planning and Development, *Taiwan Statistical Data Book 1987.*

Asian Development Bank (1984) also found that financial development in Asian developing countries positively influenced saving and economic growth. Three major findings of this study are: (1) positive real interest rates had a positive but quantitatively small effect on real domestic savings; (2) raising real deposit rates substantially increases deposits in financial institutions, indicating that there is considerable scope for substitution between various forms of saving; and (3) the overall efficiency of investment is improved with greater use of financial intermediation as opposed to self-finance or government appropriation. Empirical studies have not shown the direction of causation, but they have shown that financial development is closely related to economic growth and development.

Financial deepening is an indicator of financial development. There are various measures of financial deepening; the one used here is the ratio of M2 (currency and demand, savings and time deposits) to GDP. Table 10 shows that the average ratio increased in the 1980s in all countries and

Table 9 Capital-output ratio and saving rate.

Group/country	*Incremental capital-output ratio*		*Marginal saving rate (%)*	
	1966–75	*1976–82*	*1966–75*	*1976–82*
NICs				
Hong Kong	2.8	2.5	24.3	24.6
Korea, Republic of	2.7	4.3	24.6	31.2
Singapore	3.2	4.3	33.8	48.2
Taiwan	3.0	3.8	29.1	31.9
ASEAN-4				
Indonesia[a]	2.2	3.3	18.0	22.6
Malaysia	3.2	3.7	24.6	26.0
Philippines	3.3	4.7	26.5	21.8
Thailand	3.3	3.7	24.2	21.8
South Asia				
India[a]	4.4	4.7	20.2	21.8
Pakistan	2.6	2.2	9.0	5.5
Sri Lanka	2.5	3.4	8.5	10.7

[a] Data cover only up to 1981.

Source:

Seiji Naya and William James, 'External shocks, policy responses, and external debt of Asian developing countries', paper presented at the Fourteenth PAFTAD Conference, Singapore, June 1984, Table 11.

Table 10 Selected financial indicators.

Group/country	*M2/GDP*[a] *(%)*			*Real deposit rate*[b] *(%)*	*Inflation rate*[c] *(%)*	
	Average 1961–70	*Average 1971–80*	*Average 1981–6*	*Average 1961–81*	*Average 1971–80*	*Average 1981–5*
NICs						
Hong Kong	89.3[d]	87.5	132.3	1.8	8.5	9.2
Korea	19.0	33.7	36.6[e]	1.0	16.5	7.4
Singapore	59.8[f]	61.7	71.7	2.8	6.7	3.3
Taiwan	34.1	58.1	96.2	4.1	11.1	4.1
ASEAN-4						
Indonesia	7.5[g]	16.1	20.6[e]	−35.4	18.0	9.7
Malaysia	29.4	44.2	62.0	3.0	6.0	4.7
Philippines	22.0	19.8	21.9	−0.7	13.8	21.3
Thailand	26.0	35.8	49.0[e]	2.6	10.0	5.0

South Asia						
Bangladesh	n.a.	19.9	25.6	1.5	20.7	11.9
Burma	27.6	23.3	30.9[e]	1.0	11.3	4.6
India	24.0	31.2	51.2[e]	−1.1	8.0	9.3
Nepal	9.3[h]	16.6	29.8[e]	−0.9	7.8	9.2
Pakistan	49.5[g]	44.2	45.2[e]	−1.0	12.7	7.3
Sri Lanka	25.5	23.1	30.4[e]	0.3	8.9	12.2

n.a. Not available.

[a] Currency and demand, savings and time deposits divided by GDP in current prices.

[b] The real deposit rate is represented by continuously compounded nominal 12-month deposit rate of interest minus the expected rate of inflation (i.e. continuously compounded rate of change in GNP deflator).

[c] Average percentage change in consumer prices over previous year, calculated from indices.

[d] 1965–70.

[e] 1981–5.

[f] 1963–70.

[g] 1966–70.

[h] 1968–70.

Sources:

Asian Development Bank, *Key Indicators of Developing Member Countries of ADB*, July 1987.

IMF, *International Financial Statistics*, Yearbook 1986 and May 1987.

Asian Development Bank, *Domestic resource mobilization through financial development*, Vol. II.

is especially high in the NICs, except for Korea.[5] In fact, the M2/GDP ratios for three NICs exceed that of the United States (62 per cent, 1980) and are comparable to that of Japan (88 per cent, 1980). India, Malaysia, Pakistan and Thailand have also made significant progress in increasing the monetization of their economies. Indonesia, the Philippines and low-income South Asian countries have not been as successful.

A major inhibitor of financial development in developing countries is inflation. Rapid inflation encourages commodity stockpiling rather than productive investment and often brings about financial repression. In other words, inflation can lead to a reduction in flows to the financial system because it changes the expected real returns on financial assets relative to consumption. Because the Asian developing countries have generally adopted prudent macroeconomic policies to control budget deficits and restrain excessive demand, inflation rates have been relatively low (Table 10). Even those with serious bouts of inflation managed to keep the average rate well below those of many other middle-income countries.

The degree of regulation in the financial sector also affects financial development. There is wide variation among the countries. Hong Kong and Singapore are international financial centres and Taiwan is a net capital exporter. Among the ASEAN-4 countries, Malaysia has allowed a substantial degree of foreign bank participation; although Thailand has allowed private commercial banks, it has limited their number. Indonesia and the South Asian countries have kept banking under public sector control. Recent reforms, notably in Korea (1982) and Indonesia (1983), have eased some restrictions and it is hoped will induce further financial development.

Direct foreign investment

With the slowdown in other financial flows and the precarious debt situation of many developing countries, direct foreign investment (DFI) and other non-debt creating forms of financial flows are becoming more attractive sources of foreign capital. Most of the Asian developing countries have recently moved to encourage DFI and all offer various incentives to attract foreign firms. There is an increasing awareness of DFI's benefits in South East and South Asia and many governments have taken steps to encourage DFI in their countries. Furthermore, the tone of discussions concerning DFI has changed considerably in the last few years. In the past, it was very common to hear multinationals being accused of exploiting developing countries and being responsible for a host of economic evils. Now the focus has shifted to discussions of: (1) how multinationals can be encouraged to invest; and (2) how they can then be encouraged positively to contribute to the host country. More significantly, host countries have developed more confidence in dealing

with multinationals and have generally accepted the proposition that host country policy itself is an important element influencing the benefits imparted by multinationals. For example, if a host country encourages a multinational to engage in production behind a highly protective wall, then that government is to blame for any welfare losses that may be incurred. On the other hand, if a country maintains relatively open trade and industrial policies which encourage competition and efficient production by all firms, domestic or multinational, then it clearly deserves most of the credit for the welfare gains resulting from DFI.

Despite this more positive attitude, increases in DFI have not been substantial. Table 11 shows that DFI's share of total capital inflows generally increased in 1983–5 over 1979–82, though it fell in several countries (Indonesia, Malaysia and most of South Asia). Thus, these data show that reduced borrowing has not yet resulted in increased DFI shares of total flows into these countries.

Even if DFI's share of total capital inflows increases, however, it will remain a very small part of total investment in Asia. Table 11 shows ratios of DFI to gross domestic capital formation (GDCF) for the last two decades. Significantly, most of these ratios are well under 5 per cent. The major exception is Singapore, with DFI being particularly large, and a share of almost 10 per cent for Malaysia.[6] Even allowing for the probable understatement of DFI flows (caused by not accounting for reinvested earnings, etc.), the data show that most host countries cannot rely on DFI as a major source of capital formation.

Foreign firms may be more important than the DFI/GDCF ratios might suggest, however. First, foreign firms often account for a larger share of trade flows. Korean and Taiwan data sources show, for example, that foreign firm trade accounts for between 22 and 34 per cent of Korea's total trade flows and for 13–29 per cent of Taiwan's total trade flows (Ramstetter, 1987), while wholly foreign establishments accounted for 66–72 per cent of Singapore's domestic exports (Pang and Tan, 1986). Second, although value added of foreign firms in Korea and Taiwan is a small portion of total GNP, the value added of foreign manufacturing firms is a larger portion of manufacturing output (Ramstetter, 1986). Moreover, foreign firms can contribute strongly toward transfer of technology and management skills. The above suggests that foreign firm activity has large impacts on the trade and manufacturing sectors of the host economies, despite relatively low levels of DFI. This characteristic in turn indicates the potential value of DFI to industrializing host countries.

However, Asian developing countries should review the incentives they give foreign investors and work towards co-ordinating such policies in the region. The proliferation of incentives may not have a significant effect on bringing in new investment and, if done competitively by several countries, may have the effect of a costly subsidy for DFI. It is

Table 11 Net direct foreign investment (DFI), shares of gross domestic capital formation (GDCF) and shares of net foreign capital inflows (FCAP), 1966–85.

Group/country		*Total DFI inflows into host economies*[a]				
		1966–72	*1973–5*	*1976–8*	*1979–82*	*1983–5*
NICs						
Korea	DFI (US$m)	28.2	90.5	87.7	53.5	137.2
	% of GDCF	1.6	1.7	0.8	0.3	0.6
	% of FCAP	4.3	5.6	10.9	1.1	7.4
Singapore	DFI (US$m)	83.1[b]	532.0	423.9	1186.6	1158.9
	% of GDCF	12.7[b]	26.4	17.3	21.7	14.5
	% of FCAP	23.4[b]	78.1	107.6	104.0	281.3
Taiwan	DFI (US$m)	36.9	59.3	78.7	136.7	229.9
	% of GDCF	2.9	1.4	1.2	1.1	2.0
	% of FCAP	n.a.	15.4	n.a.	n.a.	n.a.
ASEAN-4						
Indonesia	DFI (US$m)	58.0	147.4	286.0	191.3	257.0
	% of GDCF	5.8	3.3	3.1	1.2	1.0
	% of FCAP	18.3	39.5	35.4	30.4	7.4
Malaysia	DFI (US$m)	76.9	364.2	428.9	1042.8	914.4
	% of GDCF	9.5	15.6	12.9	12.8	8.7
	$ of FCAP	n.a.	137.3	n.a.	78.0	47.2
Philippines	DFI (US$m)	−8.7	52.3	147.3	22.2	34.3
	% of GDCF	−0.5	1.5	2.4	0.2	0.5
	% of FCAP	−4.1	10.6	11.6	0.8	2.0
Thailand	DFI (US$m)	47.4	96.1	81.2	183.1	304.9
	% of GDCF	2.3	2.4	1.2	1.5	2.1
	% of FCAP	27.0	23.6	8.2	8.8	12.8
South Asia						
Bangladesh	DFI (US$m)	–	–	–	–	0.0
	% of GDCF	–	–	–	–	0.0
	% of FCAP	–	–	–	–	0.0
India	DFI (US$m)	−5.5	−10.0	−2.7	0.0	0.0[c]
	% of GDCF	−0.1	−0.1	−0.0	0.0	0.0[c]
	% of FCAP	−1.3	−2.3	n.a.	0.0	0.0[c]
Nepal	DFI (US$m)	–	–	0.0	0.0	0.0
	% of GDCF	–	–	0.0	0.0	0.0
	% of FCAP	–	–	0.0	0.0	0.0
Pakistan	DFI (US$m)	–	8.5	17.0	73.3	72.8
	% of GDCF	–	0.7	0.6	1.7	1.4
	% of FCAP	–	0.9	1.0	2.1	1.8
Sri Lanka	DFI (US$m)	−1.0	0.6	0.1	50.7	33.7
	% of GDCF	−0.3	0.1	0.0	4.1	2.3
	% of FCAP	−1.4	0.5	0.1	6.5	4.3

(continued)

Table 11 Net direct foreign investment (DFI), shares of gross domestic capital formation (GDCF) and shares of net foreign capital inflows (FCAP), 1966–85. *(continued)*

Group/country		*Total DFI inflows into host economies*[a]				
		1966–72	*1973–5*	*1976–8*	*1979–82*	*1983–5*
Other Asia						
China	DFI (US$m)	–	–	–	429.5[d]	1184.2
	% of GDCF	–	–	–	–	–
	% of FCAP	–	–	–	n.a.	63.2

– Not available.
n.a. Not applicable, i.e. there was a new capital outflow.
[a] Total inflow of DFI in the host economy as reported in balance of payments data. Ideally, this figure includes equity capital, reinvested earnings and other capital movements associated with the operations of foreign affiliates (both long- and short-term), although several of these items often go unreported. For this series, FCAP = − (current account balance) + (unrequited transfers) as reported in balance of payments statistics.
[b] 1967–72. [c] 1983. [d] 1982. [e] 1983–4.

Sources:
Asian Development Bank, *Key Indicators of Developing Member Countries of ADB*, July 1986.
IMF, *Balance of Payments Statistics*, Yearbooks 1970 to 1986.
International Monetary Fund, *International Financial Statistics*, Yearbooks 1979, 1986, and January 1987.
Republic of China, Central Bank of China, *Balance of Payments, Taiwan District, Republic of China*, 1958–82 summary and September 1986.
Republic of China, Central Bank of China, *Financial Statistics, Taiwan District, Republic of China*, January 1981 to September 1986.

more important for the investor that domestic resources are available at reasonable costs, that the business environment is stable and that government policies are predictable.

Industrialization and trade policies

The distinguishing feature of industrialization in Asian developing countries is that they have opted for an export-oriented strategy. All of the Asian developing countries have moved away from import substitution toward export promotion policies. Export promotion has involved dismantling or offsetting previously imposed protection measures that discriminate against exports, e.g. redemption of duties on imported inputs, ending of multiple exchange rates and correction of overvalued

currencies. Promotional measures in favour of exports, especially cheap bank loans and tax concessions for exports, were implemented to neutralize import protection. Some countries have set up export processing zones. Generally, the countries moved toward more neutral policy stances, reducing distortions caused by import substitution policies. In other words, policy incentives for firms to produce for the domestic and external markets became more balanced.

Because of variations in terms of level of development and factor endowments among the countries in the region, the exports of the countries differed. There were elements of competition in the region but at the same time, the differences contributed to complementarity and smooth changes in comparative advantage. Countries moved up the ladder of comparative advantage: beginning with specialization in primary products, moving to unskilled labour-intensive manufactures, skilled labour-intensive products, capital-intensive goods and finally to knowledge-intensive goods. As one group of countries moved up the ladder, another group took their place.

The sequential development of industries in the region can be explained by the 'catching-up product cycle' hypothesis, first developed by Akamatsu (1962) and later extended by Kojima (1979). Import of a new product gives rise to domestic demand for that product which subsequently induces domestic production. As domestic production expands, imports are gradually substituted by domestic production as a source of supply (due to decreasing costs brought about by economies of scale, technological improvement, etc.). This process can be called natural import substitution. When domestic production becomes internationally competitive, export begins. Export expansion slows, however, as costs of production begin to increase due to such factors as increasing labour costs and declining demand as newcomers enter the import-substitution phase and begin domestic production.

As discussed at the beginning of this section, the governments have always participated actively in selecting and implementing a growth strategy. The shift to export promotion included some degree of selection of priority industries. In addition, export promotion did not mean an end to import restrictions. Domestic production of selected goods continued to enjoy some tariff and non-tariff protection, though overall protection rates were reduced. The shifting comparative advantage in the region, both induced and natural, can be seen clearly in the industrial development of the three groups of countries described below.

NICs

During the 1960s, Korea and Taiwan substantially reduced tariffs and corrected exchange rate misalignments while Hong Kong and Singapore

have long been virtually free-trade economies. With the exception of Hong Kong, the NICs introduced policies to encourage investment in export-oriented, labour-intensive manufacturing industries with outstanding success. They were able to 'pick the winners' and replace Japanese exports of light manufactures such as clothing and footwear in the world market. Export growth did not have to depend only on increases in import demand. Despite the prevailing export pessimism of the 1960s, their exports of textiles, clothing and other labour-intensive manufactures grew rapidly.

At the end of the 1970s, further structural adjustments began. The NICs began to lose their comparative advantage in exporting labour-intensive goods. They shifted their industrial policies from labour-intensive to more skill- and capital-intensive industries, moving towards a second round of import substitution. Intermediate and engineering goods continued to receive tariff and non-tariff protection. In Taiwan and Singapore, the emphasis was primarily on electronics, while Korea opted for chemicals and other heavy industries like steel. To some extent, this is a natural process of industrial structural evolution. A second round of import substitution will be natural in the more advanced NICs; export promotion and import substitution can go hand in hand.

But the shift to skill- and capital-intensive products was strongly induced by government intervention. The experience of the NICs, however, illustrated that 'picking the winners' is far more difficult when the sectors involved are high-technology, heavy industries where it is more difficult to anticipate changes in comparative advantage. Picking losers becomes costly, and both Korea and Singapore have made major mistakes. The policy shift to encourage skill- and high-technology industries in Singapore, and more capital- and skill-intensive industries in Korea had to be re-evaluated by both countries.

None the less, the key to the success of the NICs has been their ability to learn from past mistakes and reverse their decisions if necessary. As long as they are able to maintain their flexibility, they will be able to adjust to changes in the international environment and grow more rapidly than most other countries.

ASEAN-4

The ASEAN-4 countries have not been as outward-looking as the NICs because of a number of economic and political constraints. They have generally followed more restrictive trade policies designed to foster industries producing for the domestic market. The Philippines began its import-substitution process early (in the 1950s) and provided substantial protection to its domestic producers of consumer goods. Malaysia and Thailand also followed the usual pattern of import-substitution in the

1960s and early 1970s, but neither government favoured widespread import-substitution. Indonesia, on the other hand, could be characterized as having the most inward-looking industrial orientation despite the dismantling of some controls by the present government in the 1970s.

But in the 1970s, the ASEAN-4 followed the NICs and began to adopt a more export-oriented approach. Although in 1970 their exports were largely confined to primary products by the mid-1970s they became important exporters of labour-intensive goods. In the 1980s, this process was stimulated by low international prices for ASEAN-4's other exports, in particular primary goods. Their rich natural resources allowed the ASEAN-4 to continue import-substitution policies and the accompanying high exchange rates and large import requirements. They have pursued programmes to diversify exports and to increase the degree of domestic commodity processing to add value to exports. Additionally, several countries substantially devalued their currencies to stimulate exports. Indonesia's recent rupiah devaluation is a good example.

With the decline in oil prices, Indonesia has had to reassess its policy of import restrictions and has sought to accelerate growth of non-oil exports. The Indonesian government announced major reform packages to convert quotas into tariffs and to reduce tariffs, and devalued its currency by about 31 per cent against the US dollar in an attempt to spur non-oil and gas exports. Other steps to improve the efficiency of the Indonesian trade sector included the unusual abolishment of the inefficient Indonesian customs service and turning over clearance procedures to a private Swiss company in 1985. Although many restrictions still remain, a process of change has begun that Indonesia's economic planners hope will improve economic efficiency and export performance.

Thailand has shown a remarkable ability to adapt to changing patterns in international demand. Not only has the government expanded production in agricultural products, including cassava, but it has increased the value added in agricultural exports. The more diversified Thai agricultural base helped to cushion low commodity prices for some of its export products. However, the growth in the Thai economy, at a time when the other ASEAN countries were experiencing contraction, came from an expansion of exports of manufactured goods, notably textiles. Like some of the NICs, Thai industries were able to capitalize on favourable elements in the world economy: the high value of the yen and reduced petroleum prices.

However, the ASEAN-4 countries also provide numerous examples of the difficulties in using a 'pick the winner' approach, two instances being the attempts to nurture the development of automotive industries in Malaysia and Thailand. These are industries which will require costly subsidies for an extended period of time and may, in fact, never become competitive in a global context. It is important here to remember that flexibility has been an important factor in the success of the NICs.

South Asia

The South Asian countries have been more inward-looking. Policies have been geared toward establishing a diversified national industrial sector with emphasis on basic industries such as chemical products, steel and cement. Governments have been involved with every step of production and distribution. They have set up a plethora of controls including licensing and quotas on a wide range of imports, which has raised costs and reduced competitiveness of their goods in foreign markets. Foreign exchange shortages have arisen from weak export performance as well as from unrealistic exchange rate policies.

None the less, there has also been a movement to reduce import barriers selectively and to create better incentives for manufacturing activities with export potential in South Asia countries. Granting more freedom to the private sector has yielded an upswing in industrial output growth in several of the countries. Export shares of manufactured goods, especially clothing, increased dramatically. Efforts to liberalize trade, however, have been constrained by mounting trade deficits. India and Sri Lanka have had to review their ambitious plans, but their long-term growth prospects have improved. South Asia's experience indicates that national policies can enhance industrial development, despite foreign exchange constraints and the deficiencies in infrastructure that the South Asian countries face.

Changing conditions in the 1980s

In the light of slower growth in world trade and increasing protectionism, many people have begun to question whether the outward-looking development strategies adopted by these countries will remain viable. Outward-looking strategies were a key to the success of the NICs in the 1960s and 1970s, when they were virtually the only countries to follow such policies. But their success encouraged other countries, including other Asian developing countries, to adopt similar policy directions and problems associated with such policies have now become apparent. Outward-looking policies increase trade dependency and integrate the domestic economy into the global economy. As a result, externally generated problems increase.

Export-led strategies work best when trade is growing rapidly and world demand is rising. With slow trade growth countries find it harder to move up the ladder and allow other countries to take their place. Structural adjustments become more painful and pressures to protect declining industries grow. This means, therefore, that the movement toward more capital- and skill-intensive products by the NICs will be difficult, as will the expansion into labour-intensive exports of the ASEAN-4 and South Asian countries. The question is therefore, can the

Asian developing countries continue on their path towards outward-looking policies?

The resurgence of protectionism, evident in the developed world as a whole, threatens the continued liberalization and the economic and trade growth of the Asian developing countries. Although the average tariff level has been reduced under the General Agreement on Tariffs and Trade (GATT), non-tariff barriers and bilateral agreements outside the GATT framework have increased. The amount of world imports affected by these various non-tariff restrictions has risen by more than 20 per cent from 1981 to 1986 (World Bank, 1987). Unfortunately, the bulk of these restrictions are concentrated in a few labour-intensive sectors – textiles, clothing and footwear – which particularly affects exports of developing countries.

Protectionist tendencies in the United States are of particular concern to the NICs as the US is a major source of growth in demand for the NICs' exports. Almost half of Taiwan's exports and more than one-third of Korea's and Hong Kong's are directed to the US (Table 12). The US also constitutes a major market for exports of ASEAN-4 countries. And as the ASEAN-4 and South Asian countries continue to diversify into manufactured exports they will also look to the US market.

However, access to the relatively open American market will become more difficult. Because of the large size of the US trade deficit, continuation of stimulus to world trade from the US is not likely. Although the US trade deficit is partly an internal problem caused by productivity declines and large budget deficits, political movements to reduce the budget deficit (Gramm-Rudman) and to protect failing domestic industries have strengthened. The expected slowdown in US import demand will affect the growth of world trade unless other developed countries expand their demand.

With the large depreciation of the dollar in 1986, the US trade deficit and expectations of future US import demand have slowly begun to improve. And the appreciation of the yen increased the competitiveness of NICs' exports relative to Japanese goods, allowing the NICs to replace some Japanese goods in the US market. This has resulted in increasing visibility of developing Asian countries, especially the NICs, as major contributors to the large US trade deficits (Table 13) and protectionist actions have begun to be directed toward them.

GATT and the new role of the Asian developing countries

For the NICs, in particular, negotiations under the new GATT round will mean a substantial change in their future roles in world trade. Because of the large trade surpluses enjoyed by the NICs, the major trading partners of Taiwan and Korea have insisted that import restrictions can no longer be justified on the basis of balance of payments considerations. The NICs

Table 12 Direction of exports (percentage of total exports in f.o.b. values).

Originating country	*Destination*									
	1970					*1986*				
	NICS[a]	*ASEAN-4*	*US*	*Japan*	*EEC*	*NICS*[a]	*ASEAN-4*	*US*	*Japan*	*EEC*
NICs										
Hong Kong	5.7	4.7	35.7	7.1	21.3	6.2	3.6	31.4	4.7	14.5
Korea	6.3	1.2	47.1	28.1	7.6	7.3	2.1	38.5	15.2	12.5
Singapore[b]	4.7	26.7	10.3	7.1	14.5	9.2	23.1	23.0	8.5	11.0
Taiwan	13.5	5.8	38.1	14.6	9.3	10.5	3.0	47.7	11.5	10.8
ASEAN-4										
Indonesia	17.5	5.6	13.0	40.8	5.9	15.3	1.8	19.6	44.8	9.3
Malaysia	27.0	3.3	13.0	18.3	19.3	27.9	4.8	16.6	22.5	14.7
Philippines	6.8	0.3	41.5	40.1	7.3	13.0	4.0	35.7	17.8	18.3
Thailand	20.0	8.0	13.5	25.5	18.3	17.4	5.3	17.9	14.1	21.5
South Asia										
Bangladesh[c]	4.2	0.0	16.9	2.2	28.0	3.7	0.6	23.7	8.0	20.7
Burma	15.1	12.3	0.0	7.5	20.8	21.9	8.3	2.8	8.8	9.2
India	2.5	1.6	13.5	13.9	18.7	5.8	1.5	21.7	11.5	20.8
Nepal	0.0	0.0	9.5	4.8	19.0	1.6	0.0	23.7	1.0	28.5
Pakistan	7.9	1.1	11.7	5.9	23.9	10.1	2.4	10.8	9.8	27.9
Sri Lanka	0.9	0.0	7.2	3.3	32.8	4.1	0.7	26.0	5.6	24.0

(continued)

Table 12 Direction of exports (percentage of total exports in f.o.b. values). *(continued)*

Originating country	*Destination*									
	1970					*1986*				
	NICS[a]	*ASEAN-4*	*US*	*Japan*	*EEC*	*NICS*[a]	*ASEAN-4*	*US*	*Japan*	*EEC*
Other Asia										
China	32.1	5.8	–	13.7	18.8	35.0	2.1	8.4	15.1	12.8
Developed countries										
Japan	13.7	7.2	31.1	–	9.6	14.2	3.6	38.9	–	14.8
United States	4.2	2.0	–	10.8	26.1	8.1	2.3	–	12.4	24.5

– Not available.

[a] All countries' exports to Taiwan are derived using Taiwan's import data. To account for the costs of freight and insurance, Taiwan's imports are divided by 1.1 and shown as estimates of the countries' exports to Taiwan.

[b] Because Singapore does not record trade with Indonesia, Singapore's exports are derived using Indonesian import data. To account for the costs of freight and insurance, Indonesian imports from Singapore are divided by 1.1 and shown as estimates of Singapore's exports to Indonesia.

[c] 1972.

Sources:

International Monetary Fund, *Direction of Trade Statistics*, Yearbook 1970–6 and 1987.

Republic of China, Department of Statistics, Ministry of Finance, *Monthly Statistics of Exports and Imports, The Republic of China*, January 1987

Table 13 Trade deficit of the US with its trading partners (percentage of total US deficit).

Group/country	*1982*	*1983*	*1984*	*1985*	*1986*
World (US$m)	42 608	69 352	123 281	148 474	169 784
NICs					
Hong Kong	8.08	6.15	4.73	4.18	3.80
Korea	1.13	2.50	3.28	3.20	4.21
Singapore	n.a.	n.a.	0.36	0.63	0.89
Taiwan	12.75	11.12	9.14	8.95	9.46
ASEAN-4					
Indonesia	5.83	6.04	3.77	2.79	1.61
Malaysia	0.52	0.75	0.79	0.58	0.47
Philippines	0.24	0.51	0.69	0.64	0.46
Thailand	0.10	n.a.	0.25	0.47	0.55
South Asia					
Bangladesh	n.a.	n.a.	n.a.	0.01	0.06
Burma	n.a.	n.a.	n.a.	0.00	n.a.
India	n.a.	0.73	0.95	0.56	0.55
Nepal	n.a.	n.a.	0.00	0.03	0.02
Pakistan	n.a.	n.a.	n.a.	n.a.	n.a.
Sri Lanka	n.a.	0.19	0.17	0.16	0.18
Other Asia					
China	n.a.	0.44	0.31	0.25	1.26
Western Hemisphere	14.11	25.76	16.53	12.17	7.68
Developed countries					
Australia	n.a.	n.a.	n.a.	n.a.	n.a.
Canada	30.68	20.62	16.54	14.94	13.73
EEC	n.a.	n.a.	10.48	15.24	15.53
Japan	44.51	31.24	29.85	33.51	34.50
New Zealand	n.a.	0.30	0.14	0.16	0.13

n.a. Not applicable; i.e. the US has a trade surplus with this country.

Sources:

IMF, *Direction of Trade Statistics*, Yearbook 1987.

United States Department of Commerce, *1986 US foreign trade highlights.*

have been pressured to revalue their currencies against the US dollar, remove barriers to imports and act on complaints of unfair competition. Additionally, some of the US tariff privileges under the Generalized Scheme of Preferences (GSP) have recently been removed, and the movement to 'graduate' the NICs from other preference schemes for developing countries has gained momentum. These more advanced developing countries will not be able to avoid graduation from GSP status and many of their exports are already ineligible for GSP benefits.

The Asian developing countries have already begun to move towards trade liberalization under pressure from the US, The World Bank, or the International Monetary Fund (IMF), or on their own volition. For example, both Korea and Taiwan have significantly reduced tariffs and have allowed their currencies to appreciate against the US dollar. The liberalization of trade in services like finance, banking, shipping and insurance is also gathering momentum in the NICs. In Taiwan, import liberalization is to be accompanied by relaxation of foreign exchange controls.

Until recently, the Asian and other developing countries have resisted active participation in GATT negotiations because of their insistence on specialized access to GATT based on non-reciprocity. Yet many of the Asian developing countries have come to realize that they can no longer maintain this attitude. By actively participating in GATT, Asian developing countries can win major concessions on products of interest to them rather than having to give concessions bilaterally with no returning concessions. For the ASEAN-4 countries, for example, the inclusion of agriculture in the new GATT round may have important consequences. It will mean, of course, reducing current high levels of protection for some manufactured products and services, but this process is already occurring in most Asian developing countries without the benefit of reciprocal concessions.

Conclusion

Despite recent difficulties in the international economy, the Asian developing countries have not abandoned outward-looking strategies. They understand that countries poised to take advantage of opportunities in the world market have been far more successful in realizing high economic growth and improved social development than countries that closed their economies.

For the NICs, it is expected that they will continue to grow faster than other developing countries, though below the rates achieved in the 1960s and 1970s (Table 14). India and Pakistan will also do well, but because of serious drought conditions the figures need to be revised downward. Despite poor commodity prices, the four resource-rich

Table 14 Real GDP growth forecasts.

Group/country	*1987*	*1988*	*1989*	*1990*	*1991*	*Average annual (1987–91)*
NICs						
Hong Kong	7.9	6.8	5.4	4.8	5.4	6.1
Korea[a]	11.0	8.6	6.5	7.8	7.5	8.3
Singapore	4.3	5.4	5.7	5.3	5.0	5.1
Taiwan[a]	8.3	6.4	5.7	5.6	5.6	6.3
ASEAN-4						
Indonesia[a]	2.1	2.4	3.1	2.6	3.6	2.8
Malaysia	1.5	4.9	4.8	4.3	5.2	4.1
Philippines[a]	4.6	4.5	4.9	5.0	4.9	4.8
Thailand	4.6	4.7	4.5	4.0	4.4	4.4
South Asia						
India	4.9	5.1	5.5	6.2	6.5	5.6
Pakistan	6.5	6.8	7.0	7.0	6.5	6.8
Other Asia						
China	9.5	7.8	7.9	7.8	7.9	8.2
Total developing	4.6	4.8	4.9	5.3	5.6	5.0
World	3.3	3.4	3.3	3.3	3.7	3.4

[a] GNP.

Source:

L. R. Klein, *et al.*, 'Project LINK world outlook, 31 August 1987 Summary', University of Pennsylvania, mimeo.

ASEAN countries will have respectable, albeit lower, growth. None the less, much will depend on economic expansion in Japan, as well as in Europe and the US. Yet an adjustment on the part of the US will mean lower import demand and slower growth in the US. This may contribute to a slowdown in trade unless other developed countries spur their domestic demand.

The role of Japan is especially important. With the continued growth of the surplus in the Japanese current account, the need for positive policies by Japan to reduce the imbalance has become apparent. In this connection, there has recently been an indication that Japan will move towards expanding its domestic demand and opening its markets. At the same time, it is important for Japan to continue its efforts in recycling some of the surplus to the developing world. As yet, the shift away

from reliance on exports for growth and the need for industrial structural adjustment called for by the Maekawa report is not evident. Japan must proceed with structural changes necessary to sustain its growth and to facilitate the changes in comparative advantage occurring throughout the region. Whether there will, in fact, be an effective change in Japanese government policies remains to be seen.

A long-term development strategy reflecting export pessimism is a mistake for the Asian developing countries. Outward-looking policies have been an important factor in their rapid growth and this remains true. The South Asian countries especially need to continue to liberalize their economies, and provide a healthy economic environment where private initiatives can prosper. It is easier to push import-substitution with the excuse that world demand is poor than it is to search for new opportunities. But the future should not be viewed in terms of simply dividing up a fixed amount of exports. Diversification of exports and markets will be important. Countries like Thailand and Malaysia achieved a great deal of diversification within primary products in addition to manufactured goods.

In addition, there is increasing scope for trade among the countries themselves. Intra-regional trade in Asia continued to increase in the 1970s, indicating that the rapid economic growth, varying resource endowments and different stages of the countries' development increases the potential for expansion of trade. Trade expansion might be enhanced if the various Asian countries would together reduce import protection and adopt more outward-oriented policies. Import-substitution policies tend to be aimed at products in which other developing countries have a comparative advantage.

The efforts of ASEAN are notable in this connection. Although results have been limited as yet, the framework for reducing protection among member countries has been established and there have been some promising developments. It is hoped that the proposed summit meeting of ASEAN will inject new vigour into co-operative efforts to expand trade and investment in the region.

Moreover, there is a need for further import liberalization by the Asian developing countries, particularly Korea and Taiwan. Although the US has traditionally accepted relative inequality in terms of market access, growing trade deficits have resulted in pressures to develop reciprocal market opportunities. This means that the Asian developing countries will not have the same advantage that Japan enjoyed, of an export promotion strategy based on protected domestic markets. The complementarity that was present in the 1970s will be much more difficult to achieve.

Until now, the Asian developing countries have been passive participants in the politics of world trade co-ordination. But as their exports begin to challenge those of the most developed countries, they

must accept the responsibilities of maintaining an open international economy. Many of the developing countries have significantly reduced trade barriers under World Bank direction. It would be more useful to do so under the auspices of GATT. By trading for concessions with their own tariff reductions, developing countries are more likely to stave off the wave of protectionism.

Notes

1. The usefulness of the classification scheme is somewhat complicated by Singapore, which is included as one of the NICs despite its membership in ASEAN. Structurally, Singapore is very similar to the other NICs with its small agricultural sector, its openness to trade, its high per capita income and its vibrant industrial sector. Furthermore, Burma is included in South Asia, although it is geographically located in South East Asia, because its economic performance and development strategy is closer to that of the South Asian countries.
2. World Bank (1983, p. 63). The study also found a high correlation between price distortions and growth.
3. See McKinnon (1980) for a good overview on the role of the financial (banking) system.
4. Organization for Economic Cooperation and Development (1984). *External Debt of Developing Countries, 1983 Survey*. Paris: OECD; Organization for Economic Cooperation and Development (1986). *Financing and External Debt of Development Countries, 1985 Survey*. Paris: OECD; Asian Development Bank (1987). *Key Indicators of Developing Member Countries of ADB*. Manila: ADB
5. One reason for the low figure for Korea is its highly developed informal credit sector not included in these figures. See Cole and Patrick (1986).
6. These ratios are significantly different for Singapore (8.6 per cent) and Malaysia (1.3 per cent) when OECD data are used. For Malaysia, this may be explained by the more limited coverage of the OECD data; DFI from Singapore is not included. The reason for the discrepancy for Singapore is unknown. DFI from OECD (various issues). *Geographical Distribution of Financial Flows to Developing Countries*. Paris: OECD.

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The Choice of an Exchange Rate Regime*

JACQUES J. POLAK

Why choices have to be made

Those who knew Byanti Kharmawan well may find it somewhat paradoxical to encounter, in a collection of essays in his honour, a paper on the choice of an exchange rate regime. This was certainly *not* a topic that would have appealed to Kharmawan. I have a lively recollection of his absolute devotion to the Bretton Woods exchange rate regime, under which countries did not have this choice: each member country of the International Monetary Fund (Fund) was obliged under this regime to maintain a par value for its currency. Kharmawan was a firm believer in the par value system, a view that he expounded frequently in the Board of the Fund.

But the world developed otherwise and in the exchange rate system that was born out of the turmoil of the 1970s, each country has to make choices with respect to the exchange rate regime under which it wants to operate its currency.

These were hardly choices that many countries had clamoured for, in particular not the smaller countries – whether industrial or developing – that had pursued stable domestic policies; policies that found support in the structure of rates of the par value system.

Indeed, the par value system was not replaced by some other system as a matter of choice. Rather, the par value system broke down in the late

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1960s and the early 1970s. The sharply increasing role of capital movements after the remarkable post-war recovery of the world economy put the exchange rates of the main currencies under far more pressure than had been anticipated when the par value system had been designed. Against such pressures, actual or potential, any system based on stable (even if occasionally adjustable) exchange rates could, perhaps, exist if the participating countries put great value on the maintenance of that system and were prepared to go quite far in adjusting national policies to make it possible. It is an open question whether, with the best will in the world, any system of relatively stable rates could exist among the world's major trading countries, as it does continue to exist among the European countries that participate in the European Monetary System (EMS), and whether such a system would have best served the need for adjustment in the face of large real shocks. Suffice it to observe that 'the best will in the world' to subordinate national monetary and fiscal policies to an exchange rate system of that nature is not in evidence.

In 1973 and 1974, the breakdown of the par value system became a *fait accompli*. The double shock of two changes within two years in the value of the US dollar – the first finally established in the Smithsonian Agreement (December 1971) after four months of negotiation and the second in early 1973 – was more than that system could stand, and the discussions in the Committee of Twenty were unable to breathe life into a substitute system based on 'stable but adjustable rates'. In June 1974, the Committee realized that its task was hopeless and voted itself out of business. Thereafter, the Fund amended its Articles of Agreement to reflect the prevailing position that there no longer existed a general prescription defining the exchange rate regime for each member. As the amended Article IV states lamely: 'Each member shall notify the Fund . . . of the exchange arrangements it intends to apply . . .' (Article IV, Section 2(a)).

The par value system had given countries the advantage that pegging on one currency yielded a fixed rate on all other currencies, except when the par value of the peg or that of another partner country was changed. Thus, between 1949 and 1967, pegging on the pound sterling came to the same as pegging on the US dollar, and either of these pegs produced a fixed rate to the yen (at Y360 to the US dollar) for the whole period and a fixed rate to the Deutschmark for most of that period. Parities could be changed for good reason, defined in the Articles as 'fundamental disequilibrium', but this did not change the structure, which was one of fixed rates for any pair of currencies except for changes at the moment of parity change. The experience of 1971 even proved what many had believed to be impossible, that the par value of the US dollar could be changed in terms of gold and the SDR, and thereby in terms of all currencies except those pegged to the dollar.

The system that came into being in 1973 is often described as a sys-

tem of floating exchange rates. That is a highly inaccurate description. It is a system of a variety of exchange rate options, of which floating is one, and the one used until recently by only a very small number of currencies. For example, in mid-1984, the list of floating currencies was limited to eight, including those of four of the largest countries: the US, Japan, the UK and Canada.[1]

Thus the description of the system as 'floating' was (and still is), inaccurate. No substantive description of the system can be given in terms of a simple epithet. As a first approximation the system can be described by a table with many columns and footnotes as periodically published by the Fund. A recent version is reproduced as Table 1.

Even this description, however, does not do full justice to the many variations in the present system. An exchange rate is by definition an attribute not of a single country, but of a set of countries. Strictly speaking, therefore, the world's exchange rate regime cannot be described country by country, but only by *sets* of countries; not in terms of n arrangements, but in terms of $1/2\ n(n-1)$ country-pair arrangements. This is more than a theoretical nicety. Notice, for example, the unsatisfactory way in which the Fund classifies the Deutschmark. The Fund table describes the Deutschmark as linked to other (EMS) currencies, and thus does not include it in the last group, the floaters; yet, every one knows that perhaps the most important floating rate in the system is the Deutschmark/US dollar rate.

Under the amended Article IV it is said that each member can adopt the exchange arrangement 'of a member's choice' (Article IV, Section 2(b)). But a moment's thought will show that this is not really true. No country can fully determine by itself under what exchange rate system it wants to live; each country's freedom of choice depends in part on the choices of other countries. For example, a country in the Far East whose own policies give it reasonable price stability might well want to have fixed rates on its two main trading partners with low inflation rates: the US and Japan. That was the arrangement it had up to 1971 as a result of observing its own par value. But, at present, that choice is not open to it. As long as the yen/dollar rate floats, the country can peg on the yen and undergo a floating dollar, or peg on the dollar and suffer a floating yen; it can select any gradation of halfway houses; or it can float its own currency. But what might well have been its really preferred choice, a fixed rate on both currencies, would not be among the available options.[2]

In the circumstances, the authorities will have to worry continuously whether they made the optimum second-best choice; whether to keep reserves in dollars or in yen; whether to cover foreign exchange positions in the forward market, and so on; worries that did not occupy much of their waking (or sleeping!) hours as long as the par value system gave them the automatic benefit of fixed rates on the two most important currencies. Is it surprising, against this background, that the G-24 Report

Table 1 Exchange rate arrangements as of 30 June 1987[a]

Pegged						Flexibility limited *vis-à-vis* a single currency or group of currencies		More flexible		
Single currency				Currency composite						
US dollar		French franc	Other	SDR	Other	Single currency[b]	Co-operative arrangements[c]	Adjusted according to a set of indicators	Managed floating	Independently floating
Afghanistan[d]	Lao P.D. Republic[d]	Benin	Bhutan	Burma	Algeria[d]	Bahrain[e]	Belgium[d]	Brazil	Argentina	Australia
Antigua and Barbuda	Liberia	Burkina Faso	(Indian rupee)	Burundi	Austria	Qatar[e]	Denmark	Chile[d]	China	Bolivia
The Bahamas[d]	Mozambique	Cameroon	Kiribati	Iran, Islamic Rep. of	Bangladesh[d]	Saudi Arabia[e]	France	Colombia	Costa Rica[d]	Canada
Barbados	Nicaragua[d]	Central African Republic	(Australian dollar	Jordan	Botswana	United Arab Emirates[e]	Germany	Madagascar		The Gambia
	Oman				Cape Verde		Ireland	Portugal	Dominican Republic[d]	Ghana
Belize	Panama	Chad	Lesotho[d]	Kenya[f]	Cyprus		Italy		Ecuador	Guinea
Djibouti	Paraguay[d]	Comoros	(South African rand)	Libya[g]	Fiji		Luxembourg[d]		Egypt[d]	Japan
Dominica	St Kitts and Nevis	Congo	Swaziland (South African rand)	Rwanda	Finland[f]		Netherlands		Greece	Lebanon
El Salvador	St Lucia	Ivory Coast		São Tomé and Principe	Hungary					Maldives
Ethiopia		Equatorial Guinea			Israel				Guinea-Bissau	New Zealand
Grenada	St Vincent and The Grenadines	Gabon		Seychelles	Kuwait				Iceland	Nigeria[d]
Guatemala[d]		Mali		Vanuatu	Malawi				India[h]	Philippines
Guyana[d]	Suriname	Niger	Tongo (Australian dollar		Malaysia[f]				Indonesia	Sierra Leone
Haiti	Syrian Arab Republic[d]				Malta					Somalia
Honduras	Trinidad and Tobago	Senegal			Mauritius				Jamaica	
Iraq		Togo			Nepal				Korea	South Africa[d]
	Uganda				Norway				Mauritania	United Kingdom
	Venezuela[d]				Papua New Guinea				Mexico[d,i]	United States
	Vietnam[d]				Poland				Morocco	
	Yemen Arab Republic				Romania				Pakistan	
	Yemen P.D.R				Singapore				Peru[j]	Uruguay
	Zambia				Solomon Islands				Spain	Zaire
					Sudan[d]				Sri Lanka	
									Tunisia	

(Continued)

Table 1 Exchange rate arrangements as of 30 June 1987.[a] *(continued)*

Pegged					Flexibility limited *vis-à-vis* a single currency or group of currencies		Adjusted according to a set of indicators	More flexible	
Single currency			Currency composite						
US dollar	French franc	Other	SDR	Other	Single currency[b]	Co-operative arrangements[c]		Managed floating	Independently floating
				Sweden[l]				Turkey[k]	
				Tanzania				Western Samoa	
				Thailand					
				Zimbabwe				Yugoslavia	

[a] No current information is available relating to Democratic Kampuchea.
[b] In all cases listed in this column, the US dollar was the currency against which exchange rates showed limited flexibility.
[c] This category consists of countries participating in the exchange rate mechanism of the European Monetary System. In each case, the exchange rate is maintained within a margin of 2.25 per cent around the bilateral central rates against other participating currencies, with the exception of Italy, in which case the exchange rate is maintained within a margin of 6 per cent.
[d] Member maintains dual exchange markets involving multiple exchange arrangements. The arrangement shown is that maintained in the major market.
[e] Exchange rates are determined on the basis of a fixed relationship to the SDR, within margins of up to ±7.25 per cent. However, because of the maintenance of a relatively stable relationship with the US dollar, these margins are not always observed.
[f] The exchange rate is maintained within margins of ±2.25 per cent.
[g] The exchange rate is maintained within margins of ±7.5 per cent.
[h] The exchange rate is maintained within margins of ±5 per cent on either side of a weighted composite of the currencies of the main trading partners.
[i] As of 30 June 1987, the spread between the two exchange rates was less than 1 per cent.
[j] Member maintains a system of advance announcement of exchange rates.
[k] The Central Bank establishes its selling rate daily and the buying rate is set at 1/2 per cent below the selling rate. Commercial banks must use the Central Bank's selling rate, but are free to set their own buying rate.
[l] The exchange rate is maintained within margins of ±1.5 per cent.

on Reform of the International Monetary System showed much greater enthusiasm than the G-10 Report for the only exchange rate policy option that could bring greater stability to the currencies of the developed countries, the target zone proposal?

But however much we may regret the disappearance of the stable economic relations of the fifties and the sixties, we cannot ignore the fact that the 'good old days' of fixed exchange rates all around are gone, perhaps forever, and that concerns about exchange rates, the composition of reserves and forward cover have become part of the job description of central bank presidents all over the world, even in countries with exemplary domestic financial policies. It is interesting to see how the developing countries have responded to the necessity, forced upon them by the adoption of floating rates among the world's major currencies, to select an exchange rate regime.

The choices made by developing countries

How did the smaller countries respond to this new challenge? To answer this question it seems best to distinguish between countries that are essentially stable, and those with unstable internal financial conditions.

The group of unstable countries had, in any event, been unable to function effectively at a par value for their currencies; if they still had a declared par value, that par value needed to be frequently changed or it had led to serious overvaluation of the currency. Hence, if they had not already done so before, often with the consent of the Fund, these countries naturally shifted to the first or the second category of 'more flexible' arrangements listed in Table 1: either an announced crawling peg regime ('adjusted according to a set of indicators'), or less precisely defined forms of managed floating. Similar choices were later made by countries that initially countinued to peg on their main reserve currency but were forced to abandon these arrangements due to financial instability.

The label of 'managed floating' is attached to arrangements under which the authorities retain discretionary powers to adjust the rate which cannot readily be reduced to a simple formula. None the less, two approaches to adjustment have found increasing application under the general umbrella of managed floating: adjustment in response to indicators of competitiveness and adjustment in response to exchange market conditions. In the former category, the country adjusts the exchange rate from time to time in the light of movements in its real effective exchange rate; in the latter, attention is paid to the movements in a rate in the parallel market as a basis for judging the continued suitability of the level of the official rate. Both forms of managed floating have found increasing application in Fund stand-by arrangements in recent years.

The 'managed floating' group also includes a few countries with relatively stable financial policies, such as China, India and Korea. It is interesting to observe from exchange rate statistics that for both India and Korea, the result of a recent year and half of 'managed floating' (from the second quarter of 1985 to the first-quarter of 1987) was a nearly unchanged exchange rate against the US dollar during the period when that currency depreciated in terms of other major currencies.

For many of the stable countries, the initial reaction was to continue to peg to the same currency as during the par value period. But, as Table 2 shows, there has been a gradual shift away from single-currency pegs, at least up to about the end of 1983. This resulted from a combination of natural developments. Countries that did not clearly belong in a given currency area on economic grounds, but were pegged to a given currency only on historical grounds, broke the link if it entailed too low a value (the pound sterling between 1975 and 1979) or too high a value (the dollar in recent years) for their own currency *vis-à-vis* their other trading partners. These countries found a natural way out in pegging to a basket of currencies.

Since the end of 1983, the practice of pegging on a single reserve currency (essentially the dollar and the French franc) has ceased to decline further, and the role of basket-pegging (on the SDR or otherwise) has ceased to increase. The crawling peg has continued to be chosen by only

Table 2 Exchange arrangements of developing countries, 1975–87.

	Mid-1975	*End-1983*	*Mid-1987*
Pegged to a single currency	*78*	*60*	*57*
US Dollar[a]	52	42	38
French Franc	13	13	14
Other currency[b]	12	5	5
Pegged to a basket	*15*	*35*	*33*
SDR	6	12	10
Other basket	9	23	23
More flexible arrangements	*14*	*23*	*40*
Based on indicators	4	5	5
Managed floating	9	22	22
Independent floating	1	3	13
Total	*107*	*125*	*130*

[a] Including currencies maintained with relatively narrow margins to the US dollar.

[b] Including eight countries pegging on the pound sterling in 1975, one in 1983 and none in 1987.

Source: IMF.

half-a-dozen countries, and the number of countries practising 'managed floating', in its various forms, has also stabilized. The only major change has been the sharp rise in the number of true floaters among the developing countries (Table 2).

A special question of the choice of an exchange rate arrangement arises when a country with a previously highly unstable condition decides to adopt a crash stabilization programme. Recent examples of such programmes have typically included the choice of a fixed exchange rate as a 'nominal anchor' e.g. in Argentina, Brazil and Israel. Should that anchor be a peg on a single currency or on a basket? In all three cases, these countries chose the US dollar, and I believe for good reasons (Frenkel, 1983, pp. 172–3). The countries needed a clearly recognizable demonstration of stability; for that purpose an exchange rate on the US dollar was a clearer signal than an index number for the basket. The test of the stabilization programme was the achievement of price stability in the short-term; for that purpose stability *vis-à-vis* prices in a single major currency was sufficiently precise, and relative fluctuations among major currencies were of secondary importance.[3] In these countries, capital movements, predominantly in dollars, were important and there would be no clear answer to the question of how their role should be accounted for in a trade-weighted basket. The peg on the dollar was the sensible answer for the immediate stabilization period.

Floating by developing countries?

Until recently, it was taken as axiomatic that a developing country could not allow the value of its currency to be determined freely in the market.[4]

> 'There appears to be wide agreement that independent floating is either not feasible or undesirable for most developing countries, due to factors such as limited capital markets, restrictions on capital flows, thin foreign exchange markets, and a prevalence of real shocks that should be financed from the reserves.'
>
> (Williamson, 1982, p. 39)

In the last few years, however, over a dozen developing countries, including a number of very small countries, have adopted a truly floating rate and the subject therefore deserves a somewhat extended discussion.[5] Almost all these countries adopted floating in the context of financial programmes with the Fund and starting from a position of extreme weakness, including severe balance of payments difficulties, external payments arrears, a breakdown in the administrative allocations of foreign exchange and the prevalence of black markets in foreign currencies. In these circumstances, the adoption of a free float gave the authorities an opportunity to liberalize the restrictive system – which had

typically become oppressive – and at the same time 'to shed political responsibility for the adjustment of the exchange rate', (Quirk *et al.*, 1987, p. 4) a task of which the authorities obviously had not acquitted themselves with notable success.

Most of the countries that have recently adopted floating rate systems rely on an interbank market to set the rate (Quirk *et al.*, 1987, pp. 4–14). This is also the system followed in developed countries that have floating rates. According to the Fund, this system had worked satisfactorily even in countries as small as Somalia and the Gambia, with only a few banks. A useful reminder in this connection is that countries that resorted to floating rates typically had extensive legal or illegal parallel markets where brokers could have gained experience in active foreign exchange trading. In a few other countries, the market is made by the central bank auctioning the foreign exchange which exporters have to surrender for this purpose. Inevitably, under that system, the central bank reserves important powers that will affect the exchange rate, such as the amount put into each auction, the qualifications set for access to the market, or the reserve price that may be set. In so far as floating has been adopted to remove the responsibility for allocating and pricing foreign exchange from the authorities, the auction system constitutes essentially a half-way house and the Fund staff's preference runs toward the first system.

The fear that floating rates in small developing countries would give rise to extreme exchange rate variability does not appear to have been confirmed by the experience so far on the basis of before-and-after tests made by the Fund. For most of the countries concerned, variability (measured in various ways) has been lower since the introduction of floating rates than it had been before. But this finding deserves to be interpreted with two considerations in mind. First, most of the countries that sought refuge in the floating rate system did so after years of sharp variability in nominal exchange rates, real exchange rates, or both; that variability improved somewhat over that experience, while gratifying, does not constitute a very demanding test for floating rates. Second, the introduction of a new exchange rate regime was in almost all cases part of a Fund-supported stabilization programme, and other elements of that programme (assuming it succeeded) might deserve part of the credit for the improved variability.

The experience so far with floating rates for developing countries shows that this is a viable option in a situation that has become virtually unmanageable by other means. It may therefore be the lesser evil for governments that are unable to manage a pegged rate or a managed float, and who had to abandon any attempt to allocate foreign exchange rationally over time – by permitting fluctuations in reserves – in order to gain back the rational use of foreign exchange at any time. But countries that have avoided getting themselves into such a position would probably

want to reserve judgement on whether to plunge into a floating regime without compelling necessity. It would seem premature, to say the least, for the Fund staff paper to portray the adoption of floating by a dozen hard-pressed developing countries as the evolutionary counterpart to the beginning of floating among some industrial countries in 1973, or, as the Fund puts it, 'since the adoption of generalized floating by industrial countries in 1973' (Quirk *et al.*, 1987, p. 1). In pondering this last clause, one should recall that the term 'generalized floating', which (if I recall correctly) was coined in 1971, was designed to describe the system as it operated since 1971, not to describe the exchange rate practices of some members. The term was intended to convey the notion that, as a result of the breakdown of the par value system, no member any longer observed the obligation of the Articles of Agreement before the Second Amendment to maintain the value of its own currency against all other currencies within the prescribed margins. In other words, generalized floating was not 'adopted' by any group of countries; rather, it came about even though, for more than a year after December 1971, the industrial countries reverted to a fixed rate system on the basis of central rates. Even now, fewer than half of the 19 industrial countries in Table 1 float their currencies, with six independent floaters and two managed floaters (Iceland and Spain); while eight participate in the EMS[6] and three are long-time basket-peggers (Finland, Norway and Sweden).

Pegging – on what basket?

For countries that wanted to pursue stable domestic policies, the par value system provided helpful constraints. An excessive creation of domestic money would lead to a loss of reserves, or a rise in domestic prices beyond those in trading partners or competitors, and such a loss would serve as a warning signal that policies might need to be tightened, lest the country slip into a position of fundamental disequilibrium. If the country responded to these signals in time, it was able to stay within the bounds of stable internal policies. Stability did not mean that all changes in reserves should be avoided by instant policy changes; there would be every justification for using fluctuations in reserves to absorb temporary shocks of internal or external origin.

Belonging to a par value system did not, however, safeguard a country against any and all shocks that might come from abroad, such as changes in the terms of trade or fluctuations, or more lasting changes, in the demand for its export products. The unwritten understandings of the par value system were not that any such changes should be met by declaring a new par value ('changing the peg'), but rather that within a reasonable range such changes would be absorbed by the country concerned while maintaining its par value unchanged. Favourable

changes, such as an improvement in the terms of trade, more generous foreign aid, enlarged foreign investment, would permit a relaxation of demand policies (on the fiscal or the monetary side), leading to a speeding up of growth rate. Unfavourable changes required some tightening of policies and a slow-down in growth rate. In practice, reserve movements would serve as a prima-facie signal for a change in the direction of policy, whether the causes of the reserve changes were external or internal, a distinction that might in any event be difficult to make on the basis of current data. Only when there was clear evidence to the authorities that the causes behind (especially negative) reserve changes were transitory in nature could the signal safely be ignored. Any country that assumed too readily that reserve losses would right themselves would soon find itself in repeated trouble with its par value obligations and would cease to qualify as an internally stable country.

I am rehearsing here these well-worn rules of thumb of the par value system to emphasize the fundamental point that the same rules should apply in the post-1973 circumstances, when the par value system as such had ceased to exist and a great many countries moved to the next best thing available, namely pegging on a basket of currencies. Indeed many persevered with the system of pegging on a single major currency, even after a decade of adjustment of exchange rate arrangements (see Table 2), and this may well have been a rational choice for most of them, on the grounds that preservation of the simple discipline of the par value system was more valuable than the reduction of external shocks that might be gained by moving to a multi-currency peg.

There is no reason to believe that in present circumstances basket-pegging could deliver what par value pegging had not provided to a country in the past: the assurance of a stabilized external milieu, as defined in terms of some preferred indicator (export prices, import prices, terms of trade, or whatever). The best that a country can hope for is that the impact of fluctuations in the values of individual partner currencies (corrected for price movements in the countries concerned; see below) could be mitigated by a plausible system of relevant weights.

Against this background, it seems to me that much of the extensive literature that has sprung up on the subject of the 'optimal peg'[7] has aimed at a level of precision that is both unnecessary, if we recall the modest aim of pegging under the par value system, and unattainable, because the parameters required for the 'optimal peg' cannot be derived statistically with respect to the past and cannot be assumed to be constant for even the near future.

Williamson summarizes the objective of all these studies as the choice of a peg that 'minimizes the instability imposed by movements between third currencies that are noise as far as the domestic economy is concerned' (Williamson, 1982, p. 51). Different authors implement this objective in different ways. I do not enter into the details of the argument

because I do not think that it can be pushed to an operationally relevant degree of precision. Suffice it to cite Williamson's conclusions (Williamson, 1982, p. 56): 'there may be a case for country trade weights, or for some combination of import weights and world trade weights, or even for a combination of import weights, manufactured export weights, and world trade weights ...'. The trade weights that would reflect any of the preceding options should in principle be reweighted by means of the corresponding combinations of home/foreign–demand/supply elasticities to arrive at 'elasticity weights'; but since 'there is rarely an adequate statistical basis on which to estimate elasticity weights, trade weights may in practice be the best that are feasible'.

The considerable degree of imprecision of these conclusions) (e.g. that with elasticities running from 0 to ∞ , elasticity weights can be radically different from trade weights), makes it clear that one cannot expect to find a scientifically compelling basket on which to peg; while trade weights for a country's major trading partners[8] constitute a plausible way of constructing such an index, there should be no illusion that they yield the correct basket, to the exclusion of other possible baskets.

This conclusion is reinforced by the consideration of the issue of nominal versus real exchange rates discussed in the following section.

The choice of a basket if exchange rates and prices among trading partners fluctuate

Whatever the formula for a basket of currencies, such a basket must be a combination of nominal exchange rates. Only nominal rates are known on a daily basis and if the Central Bank is to set a daily exchange rate, the variations in this rate can only be derived from nominal quotations of the prices of partner currencies against a numeraire currency, e.g. the US dollar. Yet, competitiveness in terms of exports and import substitutes is not determined by exchange rates alone, but also by a comparison of prices at home and abroad. Hence, a basket chosen to minimize the effects of exchange rate fluctuation on the economy should 'minimize the real exchange rate changes that occur as a result of nominal exchange rate fluctuations among trading partners'. (Lipschitz and Sundararajan, 1980, p. 82; 1982, pp. 121–34.[9])

Before we proceed on the basis of this desideratum, three glosses on the preceding sentence need to be spelled out.

1. Our discussion of a basket suitable as a reference point for stabilizing the effective exchange rate does not carry the implication that a policy of a stable exchange rate against all shocks is optimal. As Lipschitz (1978, pp. 650–75) has shown, such a policy is suited as

a response to temporary supply shocks, when fluctuations in absorption can properly be absorbed by fluctuations in reserves, but not (or, I would say, much less obviously) in response to demand shocks, which can better be neutralized by fluctuations in the exchange rate. This distinction is relevant whether exchange rate stability is maintained on a simple currency or on a basket, and it underlines the point made earlier that pegging (the par value version or the basket version) is compatible only with an internal regime of financial stability.

2. To minimize or eliminate real exchange rate changes originating among trading partners is not the same thing as stabilizing a country's real exchange rate. That objective would require a further step, namely to correct the exchange rate for the differential movement between an appropriately weighted composite of foreign prices and the movement of domestic prices. Where a country is in the throes of rapid inflation, the predominant component of a policy of maintaining a stable real exchange rate will normally be the correction for the difference between the high rate of domestic inflation and the comparatively low rate of foreign inflation, with the latter usually measured on the basis of a price index for a single foreign country, typically the US (see above). But when we are considering the real exchange for a relatively stable country, shifts in the real rates among partner countries can become of considerable importance.
3. Even when a country pursues a policy of pegging the real value of its currency in the two ways just described, this does not necessarily imply that it has protected itself against exchange rate changes abroad, nor of course against other shocks that may affect its competitiveness; competitiveness might, for example, on occasion be crucially affected by a change in the value of the currency of a competitor country, even though that currency had only a small (or zero) weight in our country's exchange rate basket, and this might, therefore, constitute a valid reason for a change in the peg.[10]

If the purpose of pegging on a basket is to avoid the distortions that arise from differences in real exchange rates among trading partners, this objective can conveniently be allowed for in the construction of the nominal exchange rate index for these trading partners. This proposition, which is the implicit message of the papers by Lipschitz and Sundararajan cited above,[11] has been generally recognized as regards the currencies with high rates of inflation. If, say, one can assume that depreciation of the Mexican peso *vis-à-vis* the US dollar is, to a very large extent, offset by corresponding changes in the Mexican price level compared to the US price level, omission of the Mexican peso from the basket (with a corresponding increase in weight for the US dollar) would be the best and

most economical way to ensure that the nominal index would not need subsequent correction to take care of price increases in Mexico. But the point is of more general applicability.

Starting from the simplest possible, one-currency basket one can see that its drawback, from a stabilization point of view, is that the real exchange rates of currencies of other trading partners against the intervention currency might change. To the extent that this does not happen, i.e. to the extent that approximate purchasing power parity (PPP) prevails among the trading partners, nothing is gained by adding the currencies that meet this test instead of simply adding their weight to that of the reserve currency. Worse, pegging on a nominal basket containing the country's main reserve currency plus a collection of PPP-obedient currencies would needlessly change the value of the currency being pegged in terms of its reserve currency; needlessly, because it would lead to currency corrections when there was no real change that required correction. This is in itself an argument for not including small countries in a currency basket, since they are much less likely to have 'a price level of their own' than are larger countries. But among some pairs of larger trading partners too, price movements and exchange rates may have a sufficiently close adherence to PPP to make the separate inclusion of each of these currencies not only redundant but in fact incompatible with the stability objective pursued. Thus, the authors found, over the sample period 1974–6, no statistically significant deviation from PPP *vis-à-vis* the UK for either Germany or Japan (Lipschitz and Sundararajan, 1982, p. 91). This finding would support the proposition that a currency basket for any country for this particular period would have been a more stabilizing influence to that country if it had contained only one of these three currencies (with the combined weight of all three), rather than each of the three with its individual weight. The fourth currency tested, the US dollar, did not meet the PPP test against sterling, but the covariance of the relative price levels in the US and the UK was still 70 per cent of the variance of the dollar/sterling exchange rate. On this ground, the authors argued that the weight for the US dollar in the basket be reduced to 30 per cent of the calculated elasticity weight.

Conclusions on the choice of a basket

The preceding observations lead to certain conclusions on the choice of a basket, including the suitability of the SDR as peg for a country's currency. But before drawing these conclusions, and to avoid misunderstanding, it is important to stress that the question of the most suitable basis for a pegged currency essentially arises only for countries whose fundamental financial policies are sufficiently stable to justify attaching their currency for a rather protracted period to a major currency or to a

basket of currencies. Countries that continue to have relatively high inflation rates (in comparison to rates in the main industrial countries), or whose economic future is in other ways highly uncertain, would not be well advised to adopt exchange rate regimes that might make it unduly difficult to move their exchange rates as needed.

One inference from the preceding sections is that the 'single-currency basket' may, after all, be a reasonably satisfactory solution for a larger number of small, stable, developing countries than seemed plausible in the heyday of basketry. And, of course, pegging on a single currency, which would then be the country's intervention and main reserve currency, has other advantages. The most important of these is probably that it gives economic agents in the country effective use of the forward markets in the reserve centre. If the country's 'peso' is pegged on the dollar, an exporter who sells against the Deutschmark or yen can sell these currencies forward in New York for dollars, and thereby cover his or her proceeds in terms of 'pesos', except against the event that the 'peso'/dollar peg is moved. Single currency pegging also connotes the transparency of a policy which a country's business community may value and that not even a basket of announced composition can achieve. Baskets of undisclosed composition or a policy of managed floating may give the authorities much leeway (see the cases of India and Korea mentioned above), but at the expense of forsaking a clear policy anchor.

Still, the argument should not be carried too far. Evidence of 'statistically non-significant deviation from PPP' over a certain period does not carry promise of similar behaviour for a later period. The 1980s have seen wider deviations from PPP among major currencies than few had believed possible, and the substantial reversal of these extremes in the last two years or so surely is not sufficient to convince one that the deviations of PPP in the early 1980s were one-time aberrations, never to be repeated.

There thus remains a strong case for countries that are financially strong enough to peg, and that have a wide distribution of trade shares, to peg on a small basket of currencies, without the pretence of a sophisticated system of weights. Such a basket should include the US dollar, the yen and a few European currencies.

This conclusion puts quite a different light on the rationality of pegging on the SDR. Williamson reports on various studies that have established that SDR pegging would give most countries a more stable (nominal) effective exchange rate (EER) than pegging on a single currency. (The exceptions were the Francophone African countries and small countries in the Caribbean.) That, however, still left the question, as Williamson put it, 'whether it makes sense to adopt an SDR peg, rather than a basket individually tailored to stabilize a country's EER exactly' (Williamson, 1982, p. 61). Perhaps that would be a question if it were possible to devise a basket that performed this task 'exactly' and that, in

addition, could eliminate the false signals where changes in the EER were offset by the workings of PPP. From what we have seen, this is obviously not the case. For a country with a wide distribution of trade, the choice in baskets is not between an exact one and the SDR, but between a rough and ready combination of a few major currencies and the particular (also far from scientific) five-currency package that is the SDR.

At present, no basket can be used as an intervention medium, and this is cited by Williamson (1982, p. 60) and others as an argument against any form of basket-pegging. The argument does not strike one as being of great importance. Any country that pegs on a basket (including the SDR) must announce daily exchange rates for the main currencies in its market. It also must hold its reserves, at least predominantly, in one or more reserve currencies. Its central bank will then stand ready to intervene in a reserve currency, at the announced rate. The rate can change from day to day, but the intervention technique need not be different from what the central bank would do if the country pegged on a reserve currency. Even if SDRs could be used for intervention – a concept that this author strongly supports as a means of enhancing the status of the SDR as a reserve asset – it would not be necessary for a central bank that pegged on the SDR to conduct its intervention activities exclusively in that medium; at the same time, central banks that did not peg on the SDR, or that did not peg at all, would be able to intervene by buying or selling SDRs in the market. The SDR has, moreover, a facility that other baskets do not have: the existence of forward markets in SDRs in London and Brussels (although these are not, at present, particularly active). By means of these markets, SDR peggers are able to hedge exchange contracts expressed in major currencies in terms of their own currency.

Notes

1. The four others were Australia, South Africa, Lebanon and Uruguay.
2. Aghevli (1981) noted 'the reluctance of Asian countries to undertake large adjustments in their exchange rates' (p. 311). In a comment, Chaiyawat Wibulswasdi explains this reluctance to 'the fact that Asian countries still regard stability of the exchange rate as a key target of their exchange rate policies' (p. 320).
3. In terms of trade flows, Israel was the country for which stabilization of the national currency on the US dollar, in the summer of 1985, was probably the least appropriate. It worked out exceedingly well, however, as the gradual depreciation of the dollar against other major currencies enabled Israel to maintain its nominal anchor much longer than had it chosen to attach the currency to a basket.
4. For many years up to 1982, Lebanon was the only developing Fund member with a floating rate.

5. Information on the arrangements for these countries has been derived from: Quirk *et al.* (1987). The paper lists the following 15 Fund members as having adopted such arrangements: Bolivia, Dominican Republic, the Gambia, Ghana, Guinea, Jamaica, Lebanon, Nigeria, the Philippines, Sierra Leone, South Africa, Uganda, Uruguay, Zaire and Zambia.
6. Of which one, Germany, could be considered to stand with one foot in the floating camp (see Quirk *et al.*, 1987, p. 1).
7. This is the expression used by John Williamson (1982, pp. 39–61) in his review article dealing with the literature up to that point. The production of papers on the subject has not let up since.
8. For the reason for eliminating small countries, see below.
9. The ideas in the later paper are worked out with greater clarity.
10. When Sweden, in September 1982, depreciated its currency by 16 per cent, Finland followed quickly with devaluations of 6 per cent to protect its competitive position, especially in the timber industry. It felt compelled to do this in spite of the fact that the Markka was pegged on a basket of currencies that included the Swedish Krona. Clearly, the extent of automatic depreciation of the Markka *vis-à-vis* all third currencies that resulted from the weight of the Swedish Krona in the basket was not considered large enough to deal with the new competitive situation.
11. I am afraid that the message was so implicit that it was missed by Williamson in his review article.

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Monetary Policy in Developing Countries

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Introduction

It is a pleasure for me to participate in this memorial volume in honour of Byanti Kharmawan, a dear friend and a respected colleague, who in his lifetime contributed greatly to member countries in the South East Asia voting group by serving as their Executive Director in the International Monetary Fund (IMF). In approaching the subject of monetary policy in developing countries as my topic in this memorial contribution, I recall with admiration that Kharmawan was a man of wide-ranging interests with long-term vision. In this paper, therefore, I would like to deal not so much with the technicalities of monetary policy, which have often been discussed extensively. Instead, I shall deal with the wider issues of monetary policy in developing countries, as seen from the perspective of someone who has been serving as a member of the monetary authority for some time.

Considerable technical writings have been devoted to the actual conduct of monetary policy in developing countries. These technical analyses are important because they provide the foundation for a more thorough knowledge of monetary policy in such countries. However, the picture they provide tends to refer to specific cases of special experiences. It would be better to have a broader perspective that would tie together the various countries' experiences. Having said this, I shall try to do something more modest here by presenting my views in a context that emphasizes the experience of Indonesia. I do this not because I believe that the Indonesian case can be generalized to all developing countries,

but rather, I wish to make a number of general points based upon that country's experience with which I am most familiar. I do not necessarily claim that the experience of Indonesia has broad application; whether or not these points are useful in a wider context is something that I must leave the reader for to conclude.

Longer-term goals of monetary policy in developing countries

Most developing countries have a long history of monetary policy since independence. A major distinguishing characteristic of this history has been the importance attached to development goals in determining the direction of monetary policy. Although the specific operational content and emphasis have differed from country to country, and from time to time within each country, development has usually been singled out for special priority.

The reasons for this emphasis are easily understood. Unlike industrial countries, where the problems of population and poverty are less pressing, developing countries have been compelled to concentrate more on growth. Only through a long, sustained period of strong growth can the developing world hope to achieve the higher levels of output and income to which we all aspire. In the case of Indonesia, our development view has been centred on the triple objectives of equity, growth and stability. In its most compact form, the combination of these goals may be summarized as the need to achieve a sufficiently high economic growth rate so as to provide prosperity that can be enjoyed by a growing population under stable conditions. Within the broader context of these long-term objectives, the monetary authority must strive to attain its immediate goals.

While recognizing the importance of the development goals, it has been our experience in Indonesia that the other aspects of the problem need also to be stressed. In particular, we have found that the development functions of the central bank do not free it from the imperative to perform properly the more traditional functions of a central bank in any country, be it developing or industrial. By referring to the more traditional functions of a central bank, I should mention that I have in mind the broad range of responsibilities that include: containment of inflationary pressures, protection of official foreign exchange reserves, fostering improvements to the banking and financial system and the creation of new instruments and practices that could support these tasks. In the long-term, development objectives performed by central banks are only meaningful when this traditional part of their functions is also performed effectively.

In the context of a developing country, providing finance for

development purposes probably constitutes the most visible component of a central bank's activities. Unfortunately, the role of central banks in developing countries has often been equated with the provision of such financing in the form of massive, long-term credits at subsidized rates, usually channelled through development banks. This was especially the case during the early period of development financing when a widespread optimism fostered the belief that massive injections of funds would lead to rapid entrepreneurial development; it was thought that the resulting expansion of business activity would in turn lead to more rapid economic growth.

In Indonesia we have learned that the problems of a central bank in a developing country are not solved as simply as that. From the policy-maker's point of view, the problems of development financing may be split into three aspects: creating the development institutions; providing them with funds; and ensuring effective use of those funds.

The sequence that most countries have followed in proceeding with development financing has been first to deal with providing the appropriate outlets for credit. In the case of Indonesia, the provision of credits is a task that has been shared by many institutions in the financial system. For example, the commercial banks have played a major role in the case of development funds channelled to the agricultural and small-scale business sectors, owing to their more extensive branch network. There is a national development bank (BAPINDO), created in 1960, and several regional development banks whose activities were expanded after the late 1960s. As a follow-up to these institutions, since 1972 non-bank financial institutions have been permitted to become established, to assist with the development of the money and capital markets and to help the capitalization of enterprises. Today, Bank Indonesia actively supervises and encourages the institutional development of these entities.

A second aspect of the problems of development financing concerns the provision of funds to the development institutions. Central bank financial resources have been channelled to these institutions in several ways, including direct equity participation and various types of credit extended to development institutions. In the case of Indonesia, the capital of BAPINDO comes from the government funds in the form of state participation, while the regional governments provide the capital for the respective regional banks; Bank Indonesia provides equity participation for some non-bank financial institutions. In addition, Bank Indonesia has played a dynamic role in development financing through credits extended to the state commercial banks and, to a lesser extent, the private commercial banks.

But, the lesson – which I referred to above as the third aspect of the problem of development financing – does not involve simply the creation of institutions and the provision of funds. Rather the problem lies in ensuring that these funds actually generate business activities in the

target sectors, such as the small-scale and rural areas. The relevant issue is the effective use of these credits – how to develop the capacity of the target sectors to absorb development capital in projects that will yield a rate of return adequate at least to service the liabilities incurred. A counterpart to this issue on the funding side, has been the need to avoid excessive subsidized credits that would lead to inflationary pressures.

Recognition that simply making funds available is not the most vital part of successful development banking has forced central banks in developing countries to adapt to frustrating realities. On the one hand, we are obliged to accept the slow pace of many of the crucial processes of development, but on the other, we recognize the urgency of development. This situation, I believe, has caused central banks in developing countries to be conscious of the importance of non-credit aspects of development activities such as supervising special programmes and encouraging the development of the small-scale industries and the rural sector. More crucially, it has taught the central banks to accept the futility of trying to accelerate the speed of development faster than the economy can absorb by providing excessive and cheap funds. In the long-term, sustained, large-scale subsidized credits beyond the limit of the absorptive capacity of the target sectors will only create inflationary pressures and perpetuate excessive distortions.

As a consequence, central banks in some developing countries have moved in the direction of promoting non-inflationary growth by concentrating on steady improvements of the necessary institutions, practices and support systems while providing adequate funds, but controlling inflation. Along similar lines, to the extent that the central bank is duty-bound to be the guardian of the external value of a country's currency, it lays an important basis from which to launch development efforts.

In pursuing such policies which, when taken individually, often seem to constitute rather small improvements to the financial system, while in fact the central bank is performing its development function. It is unfortunate that such functions have tended to be overshadowed by more dramatic roles of development financing.

Monetary policy in developing versus industrial countries

As discussed above, the challenge to monetary policy in developing countries is to ensure the provision of adequate financial resources to the economy, while restraining inflation so that growth can take place on a steady and sustained long-term basis. In this way, it will be possible to create sufficient incremental growth in income so that a more equitable redistribution of the fruits of development will be viable under stable conditions. Although these aims are a common focus of monetary policy

in both developing and industrial countries, in the case of developing countries there is an added emphasis on growth owing to the compelling need to increase per capita income.

A second characteristic of monetary policy in many developing countries concerns the elementary nature of financial markets within which the central banks must operate. The monetary authority in developing countries must not only strive to attain the general objectives of economic policy as set out by the Government, but often it must simultaneously create the tools to implement that policy. For example, if the monetary authority wishes to implement certain policies, it cannot be taken for granted that the instruments needed for policy action already exist. Often, the monetary authority in developing countries must create the instruments needed to conduct monetary policy while that policy is being implemented. This is one of the major, but not fully appreciated, challenges to policy-makers in developing countries. And yet, from the perspective of the development objectives, the contribution of monetary policy often hinges on the success of creating these institutions and instruments as needs arise.

A third notable difference between the conduct of monetary policy in developing and industrial countries concerns certain general characteristics of the external environment in which the respective central banks operate. Developing countries are typically more susceptible to shifts in external demand, owing to their tendency to be dependent upon a limited number of commodities for foreign exchange earnings. To complicate matters, the nature of the markets for these commodities is often such that abrupt price changes are commonplace. This combination tends to result in volatile shifts in a developing country's balance of payments, which further constrains the monetary authority's room for manoeuvre.

Another observation about the special nature of conducting policy in developing countries relates to certain characteristics of their labour markets. While the employment problem in industrial countries is sometimes a matter of shifting resources among sectors using more or less the existing stock of capital, in developing countries the employment problem is more complicated. It is more a question of creating new employment opportunities in combination with investment projects that embody appropriate technology and expand the stock of capital in a major way.

As an additional comment regarding the operations of central banks in developing versus industrial countries, it should be noted that there may be some additional constraints on monetary policy in some developing countries. To illustrate the point, economic literature often juxtaposes monetary policy and fiscal policy as alternative approaches to achieving a given end. However, in the case of developing countries, it is necessary to stress the need to be more pragmatic; we must be flexible in

our choice of options and be aware that monetary and fiscal policies are often complementary.

Growth and balance of payments objectives, which are often explicit in the planning strategy of developing countries, usually involve specific targets for the economy. This generally implies that fiscal policy must play an active role in order to achieve those targets. For example, government expenditure may be directed at specific sectors so as to achieve the growth target, or the fiscal deficit may have to be reduced to ease pressures on the balance of payments. Conflicts often develop between these objectives and it has been the unhappy experience of many developing countries that monetary policy may be obliged to assume the role of an accommodative, financing mechanism for fiscal policy. Ultimately, of course, such an outcome is detrimental to all of the country's objectives, including growth, inflation and balance of payments targets. At other times, the monetary authority may move in a different direction from fiscal policy to ensure short-term financial or exchange-rate stability. But, at all times, growth and balance of payments objectives require that both monetary and fiscal policies maintain active roles in economic management and remain vigilant to threats to the country's long-term objectives.

The experience of developing countries in monetary policy

In discussing the experience of monetary policy in developing countries, I find it useful to describe the experience of Indonesia, with which I am most familiar. And as mentioned earlier, I wish to caution the reader that I do not claim universal application of this experience to all developing countries.

For present purposes, the experience of my country may be conveniently divided into several stages. The period prior to 1966 constitutes the earliest stage of our development, when monetary policy was not given the opportunity to play any significant role in the economy. During these years, the Indonesian Government gave high priority to political issues rather than economic development. Consequently, there was serious deterioration in several important aspects of the economy: for many years annual growth in real GDP was less than the increase in population; fiscal deficits financed by central bank credit brought about hyper-inflation; extremely restrictive exchange controls attempted to ration dwindling foreign exchange reserves; and capital flight and speculative activities were rampant.

In such a situation, the monetary authority plays at best a secondary role. Understandably, the Indonesian people channelled little of their

savings through the banking system; instead they invested their savings in commodities whose values were expected to keep pace with inflation. As a consequence, the banking system could not attract deposits and the central bank was forced to provide the commercial banking system with financial resources, mostly at unrealistically low interest rates, thereby stimulating more inflation. This period made such an impact on Indonesian society that subsequent management of the economy cannot be adequately understood without mentioning the turbulance of those years.

Our second stage, the period between 1966 and 1973, can be characterized as a period of transition when the tools of monetary policy were being developed so that they could provide monetary stabilization consistent with the commitment of the new Government to economic development. As part of its stabilization efforts, the Government introduced a balanced budget policy, took action designed to reduce its direct intervention in the economy and gradually liberalized the extremely restrictive foreign exchange system. These measures were supplemented by an anti-inflationary monetary policy, which consisted of measures to mobilize resources from savers, channel credits to priority sectors of the economy and adjust interest rates to more realistic levels.

As inflation gradually ceased to be a disruptive element in the economy, the Government was able to devote more attention and resources to reconstruction of the economy and the promotion of investment and growth. Towards the end of this second stage, emphasis was shifted from stabilization to longer-term development when the First Five-year Development Plan (Repelita I) was introduced in 1969/70.

The third stage in our monetary history is identified with the period from 1973 to 1983. During these years, monetary policy in Indonesia faced the unusual challenge of mitigating the negative effects arising from the upsurge of income derived from soaring oil revenue and rising commodity prices. The policy applied during that period included sterilization of foreign exchange earnings, the introduction of certain central bank refinancing facilities known as 'liquidity credits', the introduction of credit ceilings, selective credit policy, and the application of administered interest rates for a wide range of credits. In addition, a gradual shift to more external loans on less concessional terms, such as export credits and commercial bank loans, necessitated the pursuance of a prudent foreign borrowing policy. This policy of prudence in borrowing, which remains in effect today, was designed to limit the debt burden in future years by carefully selecting the best combination of terms and conditions on external loans and by limiting the amount of foreign borrowings. This third stage of Indonesia's development was also a time of rapid economic expansion; real growth rates averaged more than 7 per cent annually during this period. In this context, it is notable that during

the Second Five-year Plan, which began in 1973/74, monetary policy was delegated additional responsibility of redistributing some of the fruits of this economic success.

After June 1983, monetary policy entered its most recent phase, of adjusting to a prolonged slump in the prices of oil and many other primary commodities. In response to an unexpected deterioration in the prices of our major exports, the Government undertook a thorough reappraisal of its development strategy in 1983. It was accepted that, given the tighter external resource constraint, greater efforts would have to be made to mobilize domestic savings and to promote more efficient use of domestic resources if acceptable rates of economic growth were to be achieved. Also, increased emphasis would need to be placed on the promotion of non-oil exports which had lost much of their international competitiveness in the preceding years.

As a result of this reappraisal, the Government announced a series of packages containing fundamental, and sometimes painful, adjustment measures. These included a large devaluation, tax reform, postponement of important government projects and a series of measures to boost non-oil exports. With regard to this final item, there has been substantial deregulation in the trade and industry sector, and significant measures have been taken to improve the international competitiveness of our exporting industries by lowering their domestic cost component. In the financial sector, deregulation measures have included: abolishing credit ceilings and the selective credit policy; restricting access to the central bank refinancing facility; and the introduction of new indirect instruments of monetary control, such as the Bank Indonesia Certificate (SBI), the Money Market Certificate (SBPU) and the central bank rediscounting facility.

Future prospects of monetary policy

After more than three decades of independence, monetary policy has a mixed record in serving developing countries in their pursuit of development goals. During this time, the conduct and instruments of policy have changed, while institutions and practices in the financial system have evolved towards greater sophistication and complexity. While any process continues to evolve it must be nurtured carefully in order to ensure that the process moves in the intended direction.

Given the introduction of indirect instruments of control and the increasing sophistication of the financial system, it has become the task of the monetary authority to continue the development of these institutions and instruments in a way consistent with the aims of

deregulation. This new task will present the monetary authority with an on-going series of challenges yet to be met.

Over the past few decades, virtually all developing countries have moved along the path of growth and development. Considerable improvements in income levels have been attained in most countries, productive capacity has expanded and greater diversification of economic activities has been achieved. At the same time, financial systems have moved on a parallel course. In some countries, the financial sector has developed faster than the real sector, while in others, the financial sector has lagged behind in response to demands by the real sector.

Against the background of the progress achieved to date and the tasks that remain to be done, what can be envisaged about the prospects for monetary policy in the medium term? Although there are many ways to look at this question, I wish to deal with the issue by trying to visualize how developing countries, like Indonesia, might evolve in the coming years. By restricting myself in this way, the process of envisioning future prospects can be anchored in a more concrete, realistic situation.

In envisioning a future scenario, it is useful for the monetary authority to remember that it should practise a certain amount of humility in knowing that the monetary sector exists to service the needs of the real sector. The monetary sector exists only because mankind has invented money as a medium of exchange and a store of value. Because of the abstract nature of money, and because of its pivotal role in the conduct of economic transactions, monetary stability, and therefore the monetary authority, occupies a central position. That is why the job of the monetary authority is crucial for the continued progress and orderly functioning of a modern economy. But, as I just noted, the counterpart to the importance of the monetary authority's role is that it remains conscious of the fact that it exists only to ensure proper functioning of the real sector.

In view of the proven benefits accruing from an open trading system, it seems that developing countries are likely to continue in the direction of greater external trade. To operate successfully in this environment there is a clear requirement for the monetary authority to pursue a policy broadly consistent with the maintenance of domestic and external balance.

In the real sector what can we envision? If present trends continue we may anticipate that developing economies will continue in the direction of greater processing and industrial activities. If, as noted above, these activities are going to be export-oriented there is an obvious need for these countries to maintain a cost structure that allows them to be competitive in the international market.

In terms of corporate entities, we can envisage that enterprises will

increase in size and that they will expand the international scope of their operations. In view of such prospects, financial institutions must at least keep pace with these developments and, if possible, move to the forefront of such endeavours.

Because development objectives tend to include the obligation to ensure an equitable distribution of the fruits of development, the monetary authority will probably continue to have some responsibility for translating this obligation into concrete action. In this case, we can interpret our obligation as the need to ensure that efficient, effective and supportive financial services continue to expand so that the economically weak sectors will enjoy these services at lower cost. There are other aspects to this process of financial deepening. For example, in some rural, previously inaccessible areas, the process of monetization is still in an early stage of development. In such cases, it is a special duty of the monetary authority to promote modernization of that part of the financial system.

Summary

This paper has taken a wide perspective on monetary policy in developing countries, beginning with a discussion of the longer-term goals. The special problems of encouraging growth and development are described, with special emphasis on the need for central banks to aim at traditional targets while pursuing development goals. Against this background, several differences are indicated regarding the conduct of monetary policy in developing versus industrial countries. The specific experience of Indonesia was cited as one interesting example in this context, followed by an indication of where monetary policy in developing countries might be headed in the coming years.

Elements of these discussions point towards an irony in the role of a central bank during the early stages of development efforts; monetary policy is expected to shoulder a heavy burden at a time when it has few instruments at its disposal and few supporting institutions to assist with its tasks. Looking ahead, as monetary authorities steadily gain experience and develop the necessary supporting institutions, the burden should diminish as the new instruments and institutions share the task of supporting the growth objective. This leads to a comforting but anti-climatic conclusion; the monetary authority faces a sort of 'planned obsolescence' in some aspects of its direct involvement in growth and development functions as the economy achieves long-term sustained growth. At that stage, monetary authorities may find it easier to concentrate on their more fundamental role of ensuring monetary stability and equilibrium in the balance of payments.

It might also be added that, while changes are continuous and

steady, reforms tend to occur in spurts and discrete steps usually associated with immediate challenges. Accordingly, at all times the monetary authority of a developing country should have a clear idea of what future major reforms are likely to be needed in the course of development and should remain alert for opportunities to introduce change. Being aware of needed reforms, the flexible monetary authority can introduce changes – with wide public support – at moments made ripe by the emergence of direct challenges.

Byanti Kharmawan understood these issues very well and he rarely hesitated to speak out on them at the appropriate moment. He was indeed an excellent representative of the school of monetary professionals who combined enthusiasm for rapid change with the realism to wait for the proper opportunity for taking action. He would probably be delighted to know that such important issues continue to be discussed in his memory.

The Role of Developing Countries in the International Monetary System

U TUN WAI*

Introduction

This paper reviews the economic position of developing countries and examines the role of those countries as a whole in the functioning of the international monetary system over the past several decades. It covers developments under the Bretton Woods system, as well as those under the current exchange rate system governed by the amended Article IV of the Articles of Agreement of the International Monetary Fund (Fund).

The international monetary system consists of two parts. The first part is the world economy where financial transactions between countries take place. These transactions are mainly mirror images of real economic transactions relating to production and international trade. Over the past decade and a half, however, financial transactions relating to capital flows have increasingly had a life of their own and have frequently dominated the determination of exchange rates and interest rates in industrial countries.

The second part is the Fund, an international organization, assigned certain tasks by its members both under the Articles of Agreement, which can be considered as the constitution, and according to the decisions of the Executive Board of Directors under the chairmanship of the Managing Director of the Fund. The wide-ranging and diverse interests of Fund members have often polarized them into two groups, namely,

*The author gratefully acknowledges the assistance of Mrs Leilei M. Aung for the computational work.

industrial countries and developing countries. But the polarization arising from the interests of creditor and debtor countries has been equally important. A number of oil exporting developing countries became creditor countries in the 1970s. Thus, the interests of developing countries are not as uniform as they might appear. The Fund, however, generally operates on the principle of universality of treatment to all its members.

The economic position of developing countries

Although developing countries outnumber industrial countries, their contribution to world output and trade (sum of exports and imports) constituted only 24 and 27 per cent, respectively, in 1985. In terms of per capita incomes and per capita exports, the disparity was even greater. Industrial countries' per capita income ($12 460) and per capita exports ($1696) in 1985 were 16.2 times the per capita income ($768) and 13.4 times the per capita exports ($127) of developing countries.

For many decades the developing countries have aspired to close the gap between their standards of living and those of industrial countries. But the prospect of this in the foreseeable future is rather remote, with the exception of a few high-growth developing countries, such as Brazil, Korea, Malaysia, Singapore, Tunisia and Thailand. For the developing countries as a whole, although the 3.4 per cent p.a. growth rate per capita in 1969–78 was higher than the 2.5 per cent p.a. growth rate per capita in industrial countries, it slowed to 0.2 per cent p.a. during 1979–86, while in industrial countries it was 1.7 per cent. The prospects for faster growth rates in developing countries in the years ahead are not good because the low world demand for exports of developing countries, shortages of foreign exchange and the need to adopt balance of payments adjustment measures, have led most developing countries to cut back their gross capital formation in relation to gross national product (GNP) (see Figure 1 and Appendix Table A.1). Other factors inhibiting the ability of developing countries to invest is the international debt overhang and the reduction in the flow of financial insert resources, both official and private, from industrial countries. External financing available to developing countries declined by more than half, from $160 billion in 1981 to $68 billion in 1986.

World output and prices

Over the past three decades (1960–87), the world has experienced five complete business cycles and it is now in the upward phase of the sixth. Percentage changes in gross domestic product (GDP) in industrial and

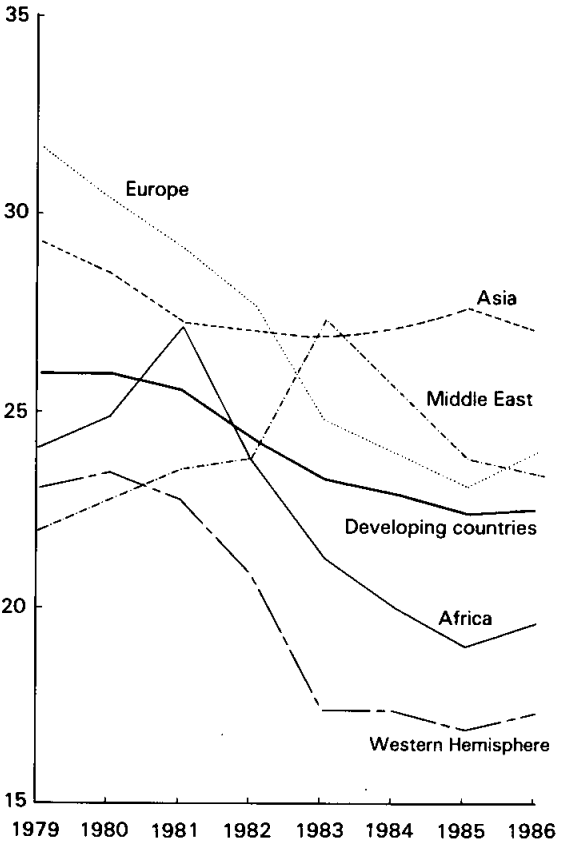

Figure 1 Gross capital formation of developing countries, by region, 1979–86 (in percentage of nominal GDP). (*Source*: IMF, *World Economics Outlook*, April 1987.)

developing countries are shown in Figure 2 (see also Appendix Table A.2). Fluctuations in the final demand for goods and services in industrial countries have dominated the world economy and the developing world feels the impact of recessions in industrial countries through a decline in demand for their exports and a consequent decline in commodity prices.

Output in developing countries (Y_{dc}) will depend positively on lagged output at constant prices in developing countries (Y_{dc-1}), current output in industrial countries (Y_{ic}), and lagged real investment (I_{dc-1}), and negatively with the ratio of the current price index in developing countries to the current price index in industrial countries (P_{dc}/P_{ic}).

The regression results of this equation in log form (L) for the period 1961–85 are as follows:

$$LY_{dc} = 0.77\ ^{**} + 0.78\ ^{**}\ LY_{dc-1} + 0.22\ ^{**}\ LY_{ic} + 0.16\ ^{**}\ LI_{dc-1} - 0.002\ (LP_{dc}/LP_{ic})$$

The overall probability F of this equation is close to 1.00; and two asterisks indicate a 99 per cent level of probability. As expected, domestic output in developing countries depends mainly on domestic factors such as lagged output and investment, but a 1 per cent change in the current output in industrial countries causes a 0.22 per cent change in domestic output in developing countries.

Regressions for developing countries by region showed that the influence of industrial countries on each region's output varied considerably. It was highest for the Western Hemisphere countries, where the elasticity of their output in response to industrial countries' output was 0.40 at the 99 per cent confidence level. In Africa, the elasticity was 0.28 at the 94 per cent confidence level, in non-industrial Europe it was 0.23 at the 83 per cent confidence level, in the Middle East it was 0.18 at the 66 per cent confidence level and in Asia it was the lowest at 0.11 at the 56 per cent confidence level.

Prices in developing countries would be affected by the degree of worldwide inflation, which affects the international price of both exports and imports. But it is internal factors which would have a greater

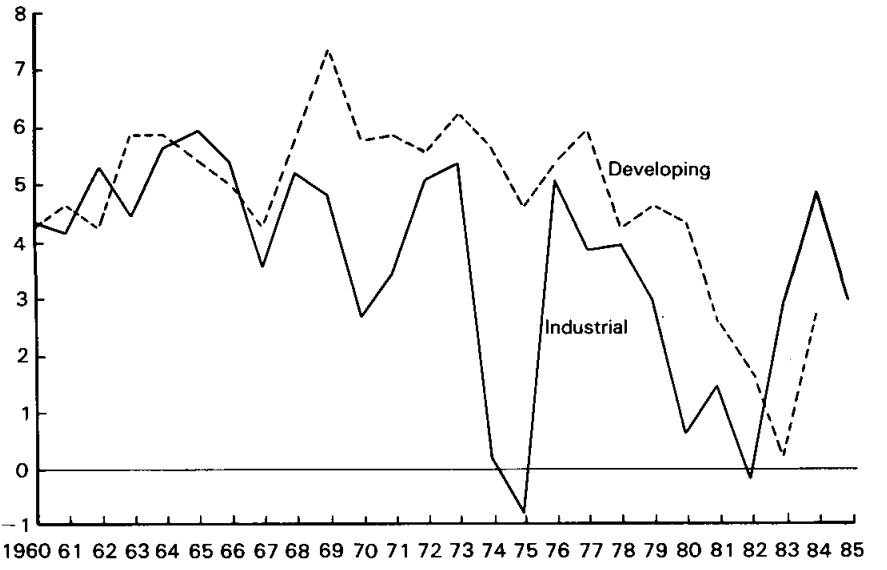

Figure 2 GDP at constant prices in industrial and developing countries, 1960–85. (*Source*: IMF, *International Financial Statistics*, Yearbook, 1986).

influence. Prices (P_{dc}) are expected to be positively related to lagged prices in developing countries (P_{dc-l}), to current prices in industrial countries (P_{ic}), and to current liquidity creation, i.e. money plus quasi-money (MO_{dc}),[2] and negatively to lagged output (Y_{dc-l}). The results in log form (L) are as follows:

$$LP_{dc} = 4.93\ ^{**} + 0.57\ ^{**}\ LP_{dc-l} - 0.52\ ^{**}\ LP_{dc-l} + 0.51\ ^{**}\ LMO_{dc} - 0.25\ LP_{ic}$$

The coefficients of lagged prices in developing countries and of lagged output have the correct signs and are significant at 99 per cent probability. The coefficient of the lagged liquidity variable also has the correct sign and is also significant at the 99 per cent level of probability. The coefficient of current prices in industrial countries has the incorrect sign, but it is not significant. The equation was also estimated by geographic regions and, in general, had the same results for the effects of real output and liquidity creation on prices. As regards the effect of current prices of industrial countries, there were correct positive signs for Africa, the Middle East and the Western Hemisphere, but not for Asia and Europe.

Trade and payments

As with output, the developing countries' share of exports and imports in world trade is much smaller than that of industrial countries. Developing countries' exports and imports constituted 30 per cent and 28 per cent, respectively, of world exports and imports in 1976–86.

The level of activity, the degree of protectionism and imports of industrial countries are major factors which determine the exports of developing countries. The balance of trade, based on f.o.b. (free on board) for both exports and imports, is usually positive for developing countries, but current accounts are in deficit as developing countries have net payments to make on services and factor income accounts. Current account deficits are financed mainly by capital flows from industrial countries and occasionally by changes in foreign exchange reserves.

Developing countries have tried to increase their share of manufactured goods in total exports as one of the means of promoting more rapid growth of export earnings on the grounds that: (1) the net barter terms of trade of manufactures compared to primary products improves in the long term; (2) the income elasticity of demand for manufactures is higher than that for primary products; (3) the demand for primary products is less price-elastic than that for manufactures; (4) in the short term, the supply elasticity of primary products is less than that of manufactured goods; and (5) export diversification may help to circumvent barriers to trade.

While developing countries as a group have increased their share of manufactured goods in total exports, the commodity composition of their exports is still predominantly primary products, except in the case of newly industrialized countries, such as Brazil, Hong Kong, South Korea, Singapore and Taiwan.

The demand for imports in developing countries depends mainly on the growth in real output and on their prices relative to their trading partners'. To the extent that exchange rates are overvalued, the level of imports would tend to be higher. Other variables affecting imports are terms of trade, commercial policy and the real rate of interest. Quantitative trade restrictions on imports would tend to limit the level of imports. Of the 131 developing countries which are members of the Fund, restrictions exist in about 90 of them. In contrast, there are no restrictions in any industrial country.

Trade deficits have generally become larger in the past few decades because imports have increased more rapidly than both exports and output. During the period 1967–72, growth of real imports in developing countries exceeded the growth of output by about 1 per cent p.a. and, in the period 1973–81, it exceeded output growth by 3.8 per cent p.a. From 1982 to 1985, largely owing to financing difficulties and the need to adopt stabilization measures, the growth of imports was 4.1 per cent below the growth of output.

International capital flows and external debt

In the fifties and sixties, capital flows to developing countries, with some exceptions (Argentina, Brazil, Mexico, Ivory Coast, Korea, Malaysia and Thailand), consisted mainly of official transfers. There was little in the way of direct private investment or external borrowing. In the 1970s, with the advent of the oil crisis and the excess liquidity in international banks, developing countries began to borrow very heavily. By 1980, 90 per cent of capital flows ($119 billion) to developing countries consisted of net external borrowing and only 10 per cent was in the form of non-debt-creating flows.

The growing size of the external debt of developing countries, which rose from $533 billion in 1978 to $898 billion in 1982, and to $1095 billion in 1986, has posed problems for the smooth functioning of the international monetary system. There are many reasons for the growing size of this debt, namely: (1) eagerness on the part of creditor countries and international banks to recycle petro-dollars; (2) desire on the part of developing countries in the 1970s to finance their balance of payments deficits which arose in part from the oil shocks; (3) some of the loans received from commercial banks were not invested wisely by developing countries and, (4) rises in nominal interest rates in world markets and a changeover from the system of fixed interest rates to variable interest

rates. In the 1950s and 1960s, with fixed interest rates, developing countries had been able to repay their debts with cheaper money because of inflation.

In late 1982, the Fund adopted a strategy for addressing the debt-servicing difficulties of developing countries on a case-by-case basis. The approach involved co-ordinated adjustment efforts by debtor countries and financial support from creditor countries, commercial banks and multilateral financial institutions. In the process, the current account deficit of capital-importing developing countries was reduced from about $100 billion in 1981 to an average of some $25 billion in 1984–5. Despite this progress, the developing countries remained highly vulnerable to a number of disturbing developments in the world economy. Consequently, the US Secretary of the Treasury, James A. Baker III, launched an initiative at the Annual Meetings of The World Bank and the Fund in October 1985 at Seoul, Korea. This initiative consisted of three mutually supporting elements. Firstly, debtor countries had to adopt comprehensive macroeconomic and structural policies to promote growth, encourage external adjustment and reduce inflation. Secondly, the Fund was expected to continue to play a central role in managing the debt problem. Thirdly, additional net lending from commercial bank sources as well as increased commitments of funds by The World Bank and other multilateral development banks, would be needed to underpin sound economic policies.

Two years later, in September 1987, Mr Baker, while reaffirming his earlier initiative, supplemented it with more flexible approaches. Some of the instruments suggested by him included trade and project loans, new money bonds, exit bonds, debt-equity swaps and limited voluntary interest capitalization. Time alone will tell to what extent these and other proposals will improve the debt situation, which still remains serious, judging by at least one indicator, namely the ratio of debt service payments in export earnings (see Figure 3 and Appendix Table A.3).

The debt problem has so far been confined to the developing countries. Most of the industrial countries also have external debts. In 1986, for example, the US ($800 billion), Japan ($260 billion), Germany ($225 billion), France ($215 billion) and Italy ($130 billion) all had large amounts of debts,[3] but they generally have offsetting claims abroad. However, net foreign claims are negative in a few countries and in 1986, in relation to GNP they constituted −36.0 per cent in Canada, −5.3 per cent in the US and −4.9 per cent in Italy.[4]

International reserves and SDRs

International Reserves

International reserves are a necessary ingredient for the proper functioning of the world trade and payments system. They are a major component

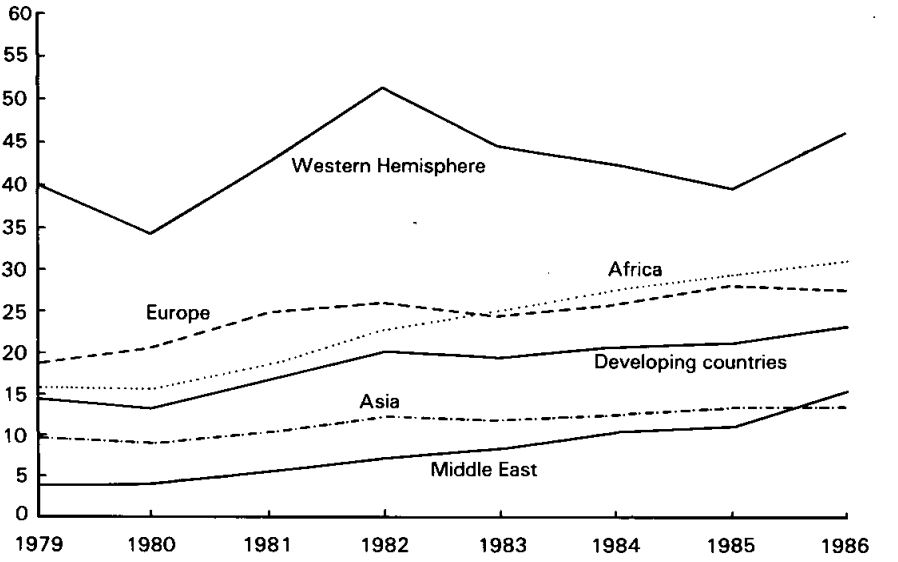

Figure 3 Debt-service payments of developing countries, as percentage of exports, 1979–86. (*Source*: IMF, *World Economics Outlook*, April 1987).

of international liquidity which includes gold, foreign exchange, SDRs, borrowing arrangements, swaps, overdrafts, trade credits and other forms of international finance. The movements in international reserves of industrial and developing countries are shown in Figure 4 (see also Appendix Table A.4). The reserve holdings of industrial countries have always been much larger than those of developing countries. In 1960, out of a world total reserve holdings of SDR 60 billion, industrial countries held SDR 49 billion, or almost five times the holdings of developing countries.

During the 1970s, reserve holdings of developing countries rose more rapidly and by 1976 the gap between the two groups of countries narrowed. Industrial countries' reserves of SDR 123 billion were only 20 per cent higher than those of developing countries, largely due to the rapid increase in reserves of the Middle Eastern countries between 1971 and 1976, as a result of the oil shocks. In the 1980s, however, the gap widened again because the reserves of industrial countries grew more rapidly than reserves of developing countries; during the period 1984–6, holdings of the latter even turned downwards.

In the 1960s, in relation to imports, the reserves of industrial countries (average 36 per cent), were higher than those of developing countries (average 27 per cent), but in the 1970s, developing countries had a higher average ratio of 39 per cent as against 29 per cent for industrial countries (see Figure 5 and Appendix Table A.5). The

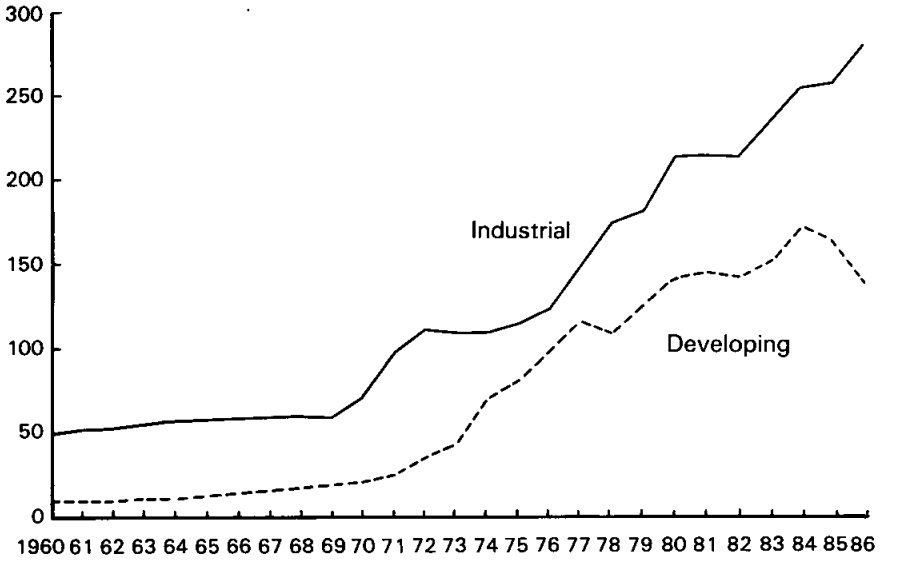

Figure 4 Total international reserves of industrial and developing countries, 1960–86. (*Source*: IMF, *International Financial Statistics.*)

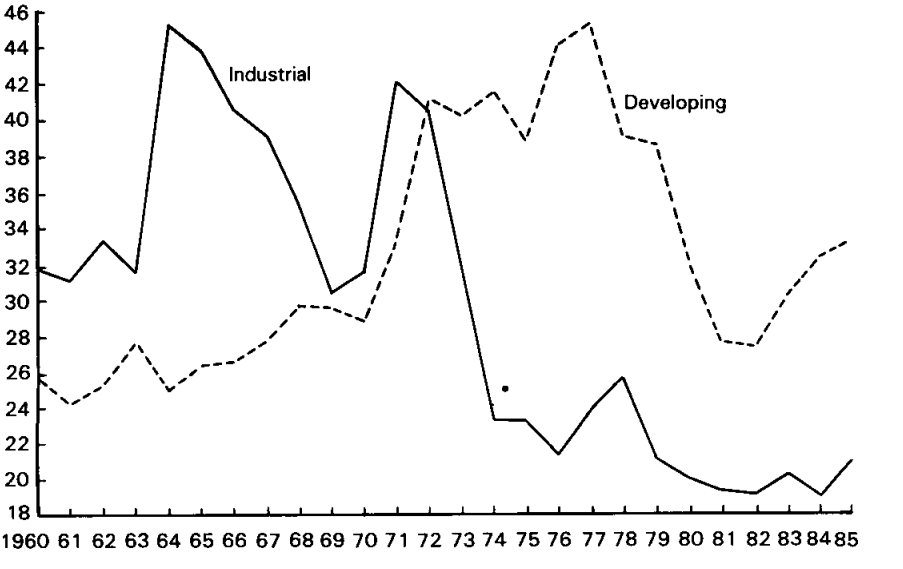

Figure 5 Ratio of reserves to imports of goods in industrial and developing countries, 1960–85. (*Source:* IMF, *International Financial Statistics.*)

reserve–import ratio varies greatly by region. In the Middle East, after rising from about 40 per cent in 1960 to about 120 per cent in 1974, the reserve–import ratio fell to about 45 per cent in 1985. In Europe, except for a sharp rise in the ratio during 1970–3, it fell from about 22 per cent in 1960 to about 15 per cent in 1985. In Africa, there have been sharp cyclical swings, but the overall trend is downwards from about 25 per cent in the early 1960s to about 15 per cent in the early 1980s. In Asia and the Western Hemisphere there have been cyclical swings too, but the trend of the reserve–import ratio has been upwards in the Western Hemisphere and it has moved sideways in Asia. In all regions, the absolute level of reserves has risen in the last decade or two (see Figure 6 and Appendix Table A.6).

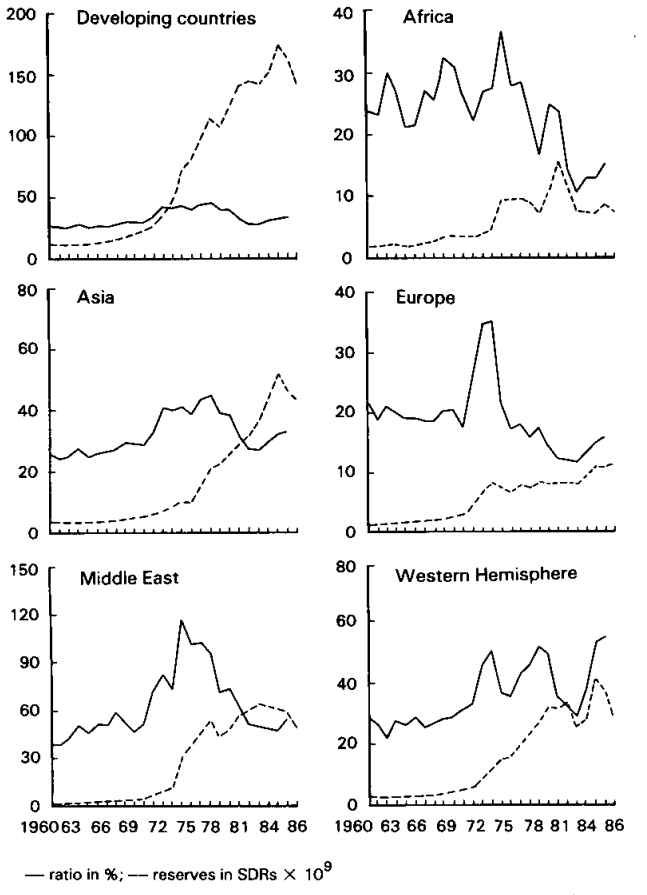

Figure 6 Total reserves and ratios of reserves to imports of developing countries, 1960–86. (*Source*: IMF, *International Financial Statistics*.)

In relation to debt, the reserves of developing countries as a whole declined from 31 per cent in 1979 to 15 per cent in 1986, mainly because of the decline in reserves of the oil importing countries. However, the reserves of the Middle Eastern countries in 1986 were still 40.4 per cent of external debt, followed by Asia (19.5 per cent), Europe (9.9 per cent), the Western Hemisphere (8.7 per cent) and Africa (5.8 per cent).

SDRs

In the 1960s, the world was facing a potential shortage of international liquidity as the US, which had been providing liquidity to other industrial countries by running large payments deficits, was about to take policy measures to eliminate its deficits. Initially, the industrial countries were considering having an SDR allocation only for themselves.[5] However, in part because of the tradition of reaching a broad consensus among Executive Board members on Fund decisions, and in part because the then Managing Director, Mr Pierre Paul Schweitzer, strongly espoused the principles of universality and uniformity of treatment, it was made applicable to all Fund members wishing to participate.

The SDRs are placed in a separate department of the Fund but allocation among members has been based on quotas in the Fund. The first allocation was made on 1 January 1970, and successively on 1 January 1971 and 1 January 1972. After some time, three new allocations were made, one on 1 January 1979, another on 1 January 1980 and the third on 1 January 1981. The six allocations totalled SDR 21 433 million, of which SDR 14 438 million were allocated to industrial countries and SDR 6995 million to developing countries. In the early years, SDRs were used by the industrial countries, but over the past two decades the main users have been the developing countries (see Table 1). Until 1978, users had to reconstitute holdings so that, on average, they would hold 30 per cent of the cumulative allocations. But since April 1981, there is no longer any need to reconstitute. Participants, however, are still expected to pay due regard to the desirability of pursuing, over time, a balanced relationship between their holdings of SDRs and their other reserves.

At one time, the developing countries were very eager to have a link established between SDRs and development finance; the total allocations would then be greater and they could expect to get a greater share of the allocations. It should be noted, however, that while SDRs have not been allocated explicitly for financing development, they have provided balance of payments support. To the extent that balance of payments difficulties arise from an excess of domestic investment over national savings, the use of SDRs indirectly provides development finance.

The relative importance of SDRs in the reserve assets of Fund membership is shown in Table 2. It was highest in 1972, when it constituted almost 6 per cent of total reserves. Despite the objective of

Table 1 Net cumulative use of SDRs by groups of countries[a] as of July 1987 (in SDRs × 10^6).

	Net cumulative allocation	*Holdings of SDRs*	*Net cumulative use*
All countries	21 433	20 359	1 074
Industrial countries	14 438	16 526	−2 088
Developing countries	6 995	3 833	3 162
Africa	1 383	272	1 111
Asia	2 044	1 010	1 034
Europe	531	64	467
Middle East	986	1 245	259
Western Hemisphere	2 051	1 242	809

[a] The figures are rounded and may not add to totals.
Source: IMF, *International Financial Statistics*, various issues.

Table 2 Holdings of SDRs as a percentage of total reserves: selected years, 1970–86.

	1979	*1972*	*1976*	*1980*	*1982*	*1986*
Total Fund membership	3.4	5.9	3.9	3.3	4.9	4.3
Industrial countries	3.7	6.4	5.9	4.2	6.6	5.8
Developing countries	2.4	4.4	1.5	2.1	2.6	2.5
Africa	3.9	8.1	3.2	2.1	5.3	3.6
Asia	1.8	6.8	2.5	2.6	3.2	2.5
Europe	0.4	1.3	1.0	0.3	0.5	0.9
Middle East	0.1	1.2	0.3	1.1	2.0	2.4
Western Hemisphere	5.0	6.2	2.6	3.7	2.9	3.1

Source: IMF, *International Financial Statistics.*

making SDRs the principal reserve asset, they amounted to only 4.3 per cent of total reserves in 1986 because there have been no new allocations since 1981. In order for the Managing Director to make any proposal for new allocations he has to ascertain that there is broad support among participants for the proposal. So far, the needed support from key industrial countries, such as the US and Germany, has not been forthcoming.

This section has reviewed in general terms the main economic events in the world economy during the past few decades. These events influence the policies of the Fund which, in turn, have an influence on the world economy. The allocation of SDRs is one example. In the next

section it will be shown how some of the policies of the Fund, e.g. the establishment of the Oil Facilities, resulted from the sharp increase in oil prices in the 1970s.

A developing country should formulate its economic policies, taking into account the world economic situation and likely developments in industrial countries on the one hand, and the changing policies of the Fund on the other hand.

Developing countries' role in the Fund

Quotas and voting power

At the Bretton Woods Conference in July 1944, the Committee on Quotas recommended that 34 developing countries should have quotas of $3.2 billion out of a total projected membership of 46 countries with quotas totalling $8.8 billion.[6] Thus, at the beginning, the financial share of developing countries constituted 36.2 per cent of the total. Since 1944, there have been new additions to the list of industrial countries, such as Japan and West Germany, as well as Italy, Sweden and Spain, which were not in the original membership. Consequently, in January 1970, developing countries' quota of $6.7 billion constituted 31.3 per cent of total quotas. Over the years, more developing countries became independent and joined the Fund, and there have been eight reviews of quotas, with the Ninth Quota Review now under way. In July 1987, there were 131 developing countries out of a total membership of 151 countries, and their quotas of SDR 34 billion amounted to 37.7 per cent of total quotas of SDR 90 billion, a percentage not much different from that in 1944.

Quotas in the Fund are decided upon according to the economic position of each member country relative to other members. The so-called Bretton Woods Formula determined a member country's quota as the sum of 2 per cent of national income in 1940, 5 per cent of international reserves in 1943, 10 per cent of imports (1934–8), which was then increased by the ratio of exports to national income in 1934–8. At each quota review, these and other economic variables with updated data are considered, but the weight given to each variable has varied with each quota exercise in accordance with the need to have a broad balance of quotas between potential creditors and debtors of the Fund, and the desire to maintain a fair distribution of Executive Directors representing industrial and developing countries. In the Eighth Quota Review, the variables used were gross domestic product (1980), average monthly reserves (1980), annual average current payments, annual average current receipts in 1976–80, and the variability of current receipts.

The quotas determine the votes assigned to each member country as well as its financial rights and obligations in the Fund. Each member

country is given 250 votes plus one vote for each SDR 100 000 of its quota. There are 22 Executive Directors on the Board, 11 representing industrial countries[7] and 11 representing developing countries. The 11 Executive Directors representing 102 developing countries out of a membership of 151 countries have 34.1 per cent of the total votes. The industrial countries have 64.1 per cent; the balance of 1.8 per cent consists of the votes of Democratic Kampuchea, Poland and South Africa, which are not represented by any Executive Director.

Decisions on issues placed before the Executive Board are determined either by simple or special majorities. For ordinary issues a simple majority is sufficient, but for important issues, either a 70 or an 85 per cent special majority is required. Thus, since the Fund, unlike the United Nations, does not operate on the principle of one member one vote, the developing countries as a whole can exercise considerable influence on important issues facing the Fund.

Special majorities were introduced in order to obtain a broad consensus on important issues and thus protect the interests of major member countries, such as the US which has 19.14 per cent of voting power, as well as the interests of developing countries as a whole. The number of issues for which special majorities are required was increased by the Second Amendment made effective in 1978.

Currently, a 70 per cent majority is required for such issues as postponement of repurchases beyond the maximum period, determination of rates of charges and remuneration, distribution from general reserve and determination of the rate of interest on special drawing rights and changes in the rules for their reconstitution.

An 85 per cent majority of the Executive Board is required for changes in the period of repurchase, sale of gold, use of assets of the Special Disbursement Account not authorized by other provisions and transfer of proceeds from the sale of gold to the Investment Account. An 85 per cent majority of the Board of Governors is required for such issues as maintenance or changes in the number of elected Executive Directors, allocation or cancellation of special drawing rights, compulsory withdrawal of member and overrule of decisions of the Committee on Interpretation.

The Executive Board, generally does not vote.[8] A general consensus is usually sought on the basic merits of each case and, in this process, all Executive Directors, irrespective of the votes at their command, can make constructive suggestions to mould the opposing views of industrial and developing countries, the creditor and debtor countries, and the regional points of view. Hence, Executive Directors representing small countries have succeeded in exercising much greater influence than the amount of voting power at their disposal. Mr Byanti Kharmawan of Indonesia, Mr Alexandre Kafka of Brazil, the present Dean of the Executive Board, and Mr Pieter Lieftinck, former Executive Director

from the Netherlands, a small industrial country, have played important roles in the past few decades.

The Managing Director has a key role in the decision-making process. With the support of the staff, he has to bring about changes and compromises in opposing positions by submitting new staff studies and scheduling innumerable discussions as needed.

Financial facilities of the fund

Compensatory financing and buffer stock financing facilities

During the first two decades of the Fund, financial resources were available to member countries only under the credit tranche facility and were limited to 100 per cent of quota. The first liberalization came in 1963 when the Compensatory Financing Facility (CFF) was established to cater to the needs of member countries suffering from temporary shortfalls in export earnings, largely attributable to circumstances beyond the control of the member, provided the member was willing to co-operate with the Fund in seeking solutions as needed for its balance of payments difficulties. This facility, amounting to 25 per cent of quota, could be additional to the credit tranche drawings; although available to all member countries, it has benefited mainly the developing countries. It was enlarged to 50 per cent of quota in 1966, 75 per cent in 1975 and to 100 per cent in 1979. In 1981, the CFF was expanded to include balance of payments difficulties produced by an excess in the cost of cereal imports. However, the limits were fixed at 85 per cent of quota for export shortfalls and 83 per cent of quota for cereal import excesses, with a total limit of 105 per cent of quota. The addition of the buffer stock financing facility in 1969 meant that members could have access to Fund resources equivalent to another 25 per cent of quota and, later, access to the buffer stock facility was enlarged to 45 per cent of quota. The Fund has authorized use of its resources in connection with tin, cocoa, rubber and sugar buffer stocks.

Oil facilities

The oil crisis, which began in 1973, led to tremendous balance of payments difficulties for oil importing countries. The industrial countries had greater resiliency, ability and availability of suitable policy instruments to adjust. The non-oil producing developing countries were in a difficult position. The international banks had the liquid funds deposited by the surplus countries. The consensus of the international community was that the oil crisis would be temporary and, therefore, the imbalances should be financed. The Fund contributed to the functioning

of the international monetary system by establishing the two Oil Facilities; the first in 1974 and the second in 1975. Access limits under both facilities were based on formulas taking into account the increase in the price of oil and the quantum of oil imports in a base year period to determine entitlement. Drawings under the Oil Facilities had to be repaid in eight equal semi-annual instalments starting in three years.

The Fund financed the Oil Facility by borrowing from the oil exporting countries and a few industrial countries at market rates. Charges were thus related to the market. The Oil Facility was used by both the developed and developing countries (see Table 3), and a subsidy account for interest payments was established for the most seriously affected countries with per capita incomes of less than $400 per year. Subsidy payments were made at the rate of 5 per cent per year. During the three-year period ending April 1978, subsidy payments of SDR 66.3 million were paid to 18 member countries.

Extended fund facility

The Extended Fund Facility (EFF) was established in September 1974, partly to ameliorate the disappointment of developing countries that no link between SDRs allocations and development finance would be established and partly because of the growing feeling in these countries that the temporary use of Fund resources under the credit tranche facility did not give them enough time to change the structure of their economies. They wanted to be able to use the Fund's resources for a more extended period. This facility enabled the Fund to give members assistance to meet balance of payments deficits over longer periods and in amounts larger in relation to quotas than available under the then-existing credit tranche policies. Purchases under this facility may reach up to 140 per cent of quotas, normally over a three-year period, and repurchases must be made in 12 equal instalments within four and one-half to ten years after each purchase. The facility is available to all members that can satisfy the requisite payments need and criteria of the facility,[9] but it was expected that it would benefit developing countries in particular. In the seventies, only a handful of developing countries used the extended facility. Between 1974 and 1978, only Kenya, the Philippines, Mexico, Jamaica, Egypt and Haiti used it.

There were two main reasons for this situation. Firstly, the Fund was making available financing under the Oil Facility and the liberalized CFF. Secondly, the facility required broader changes in policies, including investment and pricing policies, and other agencies (e.g. planning, trade and agriculture), besides the ministry of finance and the central bank, had also to be involved in the programming exercise. Developing countries, however, felt that the facility had not been used more because the conditions were too strict and members had to undertake difficult

Table 3 Drawings under the 1974 and 1975 oil facilities (in SDRs × 10^6).

Member	*Under the 1974 Facility*	*Under the 1975 Facility*	*Total*	*Member*	*Under the 1974 Facility*	*Under the 1975 Facility*	*Total*
All countries	2499.24	4403.17	6902.41	Asia	520.34	706.89	1227.23
				Bangladesh	51.50	40.47	91.97
Industrial countries	1097.70	2393.87	3491.57	Fiji	0.34		0.34
Finland		186.36	186.36	India	200.00	201.34	401.34
Iceland	17.20	21.97	39.17	Korea	100.00	152.69	252.69
Italy	675.00	780.24	1455.25	Pakistan	125.00	111.01	236.01
New Zealand	109.30	129.37	238.67	Papua New Guinea		14.80	14.80
Spain	296.20	275.93	572.13	Philippines		152.03	152.03
UK		1000.00	1000.00	Sri Lanka	43.50	34.13	77.63
				Western Samoa		0.42	0.42
Developing countries	1401.54	2009.30	3410.84				
Africa	181.14	283.40	464.54				
Burundi	1.20		1.20	Europe	380.00	522.11	902.11
Cameroon	4.62	11.78	16.40	Cyprus	8.10	21.97	30.07
Central African Rep.	3.30	2.66	5.96	Greece	103.50	51.75	155.25
Chad	2.20		2.20	Portugal		114.76	114.76
Ghana		38.60	38.60	Turkey	113.20	148.11	261.31
Guinea	3.51		3.51	Yugoslavia	155.20	185.52	340.72

Ivory Coast	11.17	10.35	21.52	Western Hemisphere	246.26	371.95	618.21
Kenya	36.00	27.93	63.93	Argentina		76.09	76.09
Madagascar	14.30		14.30	Chile	118.50	125.22	243.72
Malawi		3.73	3.73	Costa Rica	18.84	18.83	37.67
Mali	5.00	3.99	8.99	El Salvador	17.89		17.89
Mauritania		5.32	5.32	Grenada		0.49	0.49
Morocco		18.00	18.00	Haiti	4.80	4.14	8.94
Senegal	15.52	9.91	25.43	Honduras	16.78		16.78
Sierra Leone	4.91	4.97	9.88	Jamaica		29.20	29.20
Sudan	28.71	18.30	47.01	Nicaragua	15.50		15.50
Tanzania	31.50	20.61	52.11	Panama	7.37	17.25	24.62
Uganda	19.20		19.20	Peru		52.66	52.66
Zaire		77.53	77.53	Uruguay	46.58	48.07	94.65
Zambia		29.72	29.72				
Middle East	73.80	124.95	198.75				
Egypt		31.68	31.68				
Israel	62.00	81.25	143.25				
Yemen, PDR	11.80	12.02	23.82				

Sources:
Margaret G. de Vries, *The International Monetary Fund 1972–1978* Vol. 1, page 347.
IMF, *International Financial Statistics*, August 1987.

basic adjustments in their domestic policies to receive only a small amount of financial assistance.

Supplementary financing facility (1979–84)

In the late 1970s, the payments imbalances of a number of members were large in relation to their quotas. Hence, in February 1979 the Fund established the Supplementary Financing Facility (SFF), financed by resources from surplus countries. The funds under this facility would supplement existing facilities on certain ratios to the amounts available under existing credit tranche policies and extended arrangements. Another feature was that the period required for an adequate adjustment programme was normally in excess of one year and could extend up to three years. Repurchases have to be scheduled three and one-half years from the purchase date and completed not later than seven years. In December 1980, a Subsidy Account was established to reduce the high cost of the market-related interest rates charged for borrowing by low-income developing countries under the SFF.

Enlarged access to fund resources

By March 1981, the full commitment of resources available under the SFF led the Fund to adopt the new policy on Enlarged Access to Fund Resources (EAR), which became operational in May 1981. Its objectives were similar to the SFF; it was designed to enable the Fund to provide assistance to members whose balance of payments deficits are large in relation to their quotas and which need resources in large amounts and for longer periods than are available under the regular credit tranches. Drawings under the enlarged access policy have to be repaid in eight semi-annual instalments, three and one-half years from the purchase date, and completed in not later than seven years. As this was a temporary facility it has been reviewed a number of times, but is still in force (in 1987), whereas the SFF facility has been terminated. As with the SFF, the EAR is financed by borrowed resources, the charges are market related and countries have access to EAR on similar ratios of borrowed to ordinary resources and to extended arrangements as under the SFF ratios.

Of the various facilities handled by the General Resources Account, it can be seen (Table 4) that in the eighties the use of regular facilities under the credit tranche policies accounted for one-fifth to one-quarter of the total resources used. In 1980, both the compensatory financing facility and the Oil Facility, each accounting for about one-third of the total, were more important than the regular facilities. More recently, e.g. 1986–7, the latter have been superseded by the extended Fund facility, the supplementary financing facility and the enlarged access policy.

Table 4 Outstanding Fund credit by facility and policy: selected years, 1980–7[a] (in SDRs × 10^6).

	Financial year ending 30 April											
	1980		*1981*		*1983*		*1984*		*1986*		*1987*	
	Amount	*As % of total*	*Amount*	*As % of total*	*Amount*	*As % of total*	*Amount*	*As % of total*	*Amount*	*As % of total*	*Amount*	*As % of total*
Regular facilities	1606	20.0	2349	24.6	4 721	20.0	5 197	16.4	6 315	18.2	6 575	20.8
Compensatory financing facility	2875	35.8	2617	27.4	6 837	29.0	7 304	23.0	6 430	18.6	4 779	15.1
Buffer stock financing facility	74	0.9	–	–	307	1.3	375	1.2	73	0.2	34	0.1
Oil facility	2494	31.0	1581	16.6	27	0.1	–	–	–	–	–	–
Extended Fund facility	487	6.1	980	10.3	3 317	14.1	5 568	17.5	6 498	18.8	6 242	19.7
Supplementary financing facility	502	6.2	2018	21.1	6 039	25.6	6 920	21.8	5 276	15.2	3 769	11.9
Enlarged access policy	–	–	–	–	2 342	9.9	6 378	20.1	10 047	29.0	10 047	32.4
Total	8038	100.0	9545	100.0	34 640	100.0	31 742	100.0	34 639	100.0	31 646	100.0

[a] General Resources Account.

Source: IMF, *Annual Reports*, 1986, 1987.

Trust fund and structural adjustment facility

Besides the General Resources Account of the Fund, funds are also available from the Special Disbursement Account (SDA), which used to handle the Trust Fund and still does handle the Structural Adjustment Facility (SAF).

The Trust Fund, established in May 1976, provided concessionary balance of payments assistance to eligible low-income member countries by using part of the proceeds of gold auctioned by the Fund. The Trust Fund was terminated on 30 April 1981, at which time SDR 2991.5 million had been disbursed. Trust Fund loans bear interest at a rate of one-half of 1 per cent p.a. and are to be repaid in ten semi-annual instalments, five and one-half years from the date of the loans and completed not later than ten years. Since 1981, repayments have been made and, on 30 April 1987, there remained SDR 1658.8 million of loans outstanding.

The SAF was established in March 1986 to provide balance of payments assistance to low-income developing countries on concessional terms. The genesis for this facility was the availability of funds in the SDA of the Fund's General Department from repayments of Trust Fund loans, and the continuing balance of payments and debt problems of low-income developing countries. Of the 60 countries eligible to borrow under this facility, China and India indicated that they would not avail themselves of this facility. Qualifying members could initially receive resources equivalent to 47 per cent of their quota in the Fund over three years on approval by the Fund of a three-year arrangement. This limit was raised to 63.5 per cent of quota in July 1987. One of the important innovations was the requirement that the staffs of the Fund and the Bank, in close collaboration with the authorities, develop a policy framework paper which will describe the major economic problems and challenges facing a country, the objectives of a three-year medium-term programme, the priorities and the broad thrust of macroeconomic and structural adjustment policies, the likely external financing requirements, and the available sources of such financing.

Many developing countries naturally were concerned that this collaboration would give rise to cross-conditionality, i.e. that the conditions of the Bank would also be applied to Fund loans and the conditions of the Fund also applied to Bank lending. However, Mr Jacques de Larosière, the Managing Director of the Fund at that time, stated that the co-operation with the Bank would be conducted in a manner that will not give rise to cross-conditionality. The Fund would pay particular attention to macroeconomic developments and macroeconomic policies, while in conjunction with the World Bank, which has particular expertise and competence, it would also look at development and sectoral policies, investment priorities, microeconomic reforms, etc.

Interest on SAF loans would be charged one-half of 1 per cent p.a. to

be repaid in ten semi-annual instalments five and one-half years from the purchase date, and completed not later than ten years after the date of the disbursement. By the end of July 1987, the Fund had approved SAF arrangements with 16 countries totalling SDR 612 million.

In addition to these loan arrangements, the Fund has provided emergency assistance after natural disasters, such as crop failure, earthquake, drought and hurricanes. Between 1967 and 1983, such assistance was provided to nine member countries (Egypt, Yugoslavia, India, Nicaragua, the Dominican Republic, Dominica, St Lucia, St Vincent and the Grenadines, and the Yemen Arab Republic), totalling about SDR 290 million.

Use of fund credit and conditionality

Use of fund credit

The Fund has financed the payments imbalances of both industrial and developing countries. Until 1971, the use of Fund credit from the General Department[10] by industrial countries was larger than the use of credit by developing countries. Since then, Fund resources have been used mainly for financing payments imbalances of developing countries. Since 1982, the industrial countries as a whole have not used any Fund credit (see Figure 7 and Appendix Table A.7)

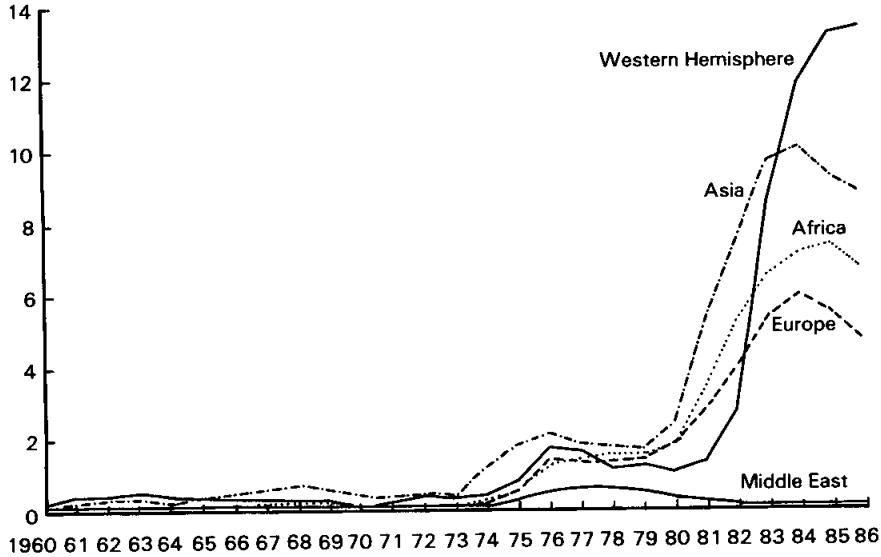

Figure 7 Use of Fund credit, General Department, in industrial and developing countries, 1960–86. (*Source*: IMF, *International Financial Statistics.*)

Among developing countries, the Western Hemisphere region has used the most resources, followed by Asia and Africa; Europe and the Middle East have used less than the other regions (see Figure 8 and Appendix Table A.8)

Conditionality

Sometimes members wonder why the Fund provides financial resources in the upper credit tranches and under the various facilities such as EFF, SFF and EAR only under certain conditions. If the Fund was concerned about receiving repayments surely it could ask for suitable collateral, such as gold. This view, however, misunderstands completely the role and functioning of the Fund, which bears some responsibility for promoting the smooth functioning of the international monetary system. Firstly, conditions are needed to encourage member countries to reduce and eliminate balance of payments deficits through appropriate adjustment measures. And, for this purpose, the Fund is well-equipped to provide suitable advice to members borrowing from the Fund. Secondly, certain policies, especially in the exchange rate field, should not adversely affect the interests of other member countries. Thirdly, the resources of the Fund are limited and have to be revolving so that all members can benefit and, therefore, conditionality is needed. Fourthly, and perhaps the most important point, is that the conditions are not

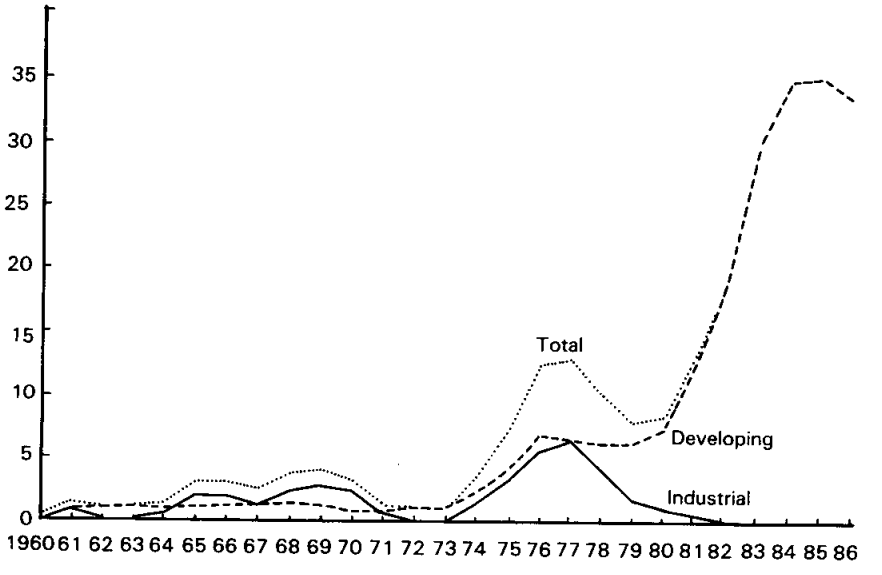

Figure 8 Use of Fund credit, General Department, in developing countries, 1960–86. (*Source*: IMF, *International Financial Statistics*.)

meant to restrain the member's freedom of action, but rather to provide a set of measures which is in the best economic interest of the member.

It is alleged by many developing countries that Fund conditionality has increased during the past decade. This would be true if one compared the absolute amount of adjustment measures required by the Fund in the sixties with the eighties. But, if one were to judge conditionality in relation to the degree of adjustment needed to establish a viable balance of payments position over the medium term, then one would not arrive at the same conclusion. However, it is evident that with the debt crisis and the recent worldwide recession, developing countries have not obtained as much financing as they would like and, hence, have had to adjust, even in a relative sense, to a greater extent than before.

In the light of mixed-world economic developments in 1986 and 1987, some developing countries have achieved a satisfactory external position, while others have not. Furthermore, most low-income countries still have a level of external indebtedness that will require substantial support from abroad on concessional terms. Under these circumstances, the current issues in conditionality facing the Fund are: (1) how to improve the design of adjustment programmes in both the theoretical and practical aspects, so that these programmes can be more growth-oriented and more effective; (2) how to obtain adequate external resources on appropriate terms, so as to ease the path of adjustment and provide for an orderly adjustment process that benefits both the adjusting country and the global economic community; (3) how to ensure that the adjusting country has a strong political commitment to adopt a coherent and comprehensive strategy; (4) how to monitor the implementation of adjustment programmes to ensure the success of members' adjustment actions and the revolving character of Fund resources; (5) the relationship between performance criteria and prior policy actions; and (6) the need for flexibility, given the uncertainties in the world economic environment.

Discussion on these and other issues take place in the Executive Board and at the Annual Meetings of the Board of Governors. An interesting proposal was made by Mr Baker, at the October 1987 Annual Meeting in Washington, for the creation of a new external contingency facility which would help to cushion the adverse effects on stand-by programmes of external, unforeseen developments beyond a country's control.

Reform of the international monetary system

Exchange rates and surveillance

After a few years of operating the international monetary system under the Second Amendment of the Fund's Articles of Agreement, many

economists became disillusioned with the wide gyration in the relative values of the key currencies. A number of debates took place in the 1980s and many articles were written, some by the Fund staff, on the merits of different exchange rate systems. The majority view of member countries in terms of voting power is that no formal reform of the international monetary system is needed. The working of the present exchange rate system can be improved by increasing the role of the Fund under Article IV, so that it can exercise more effective surveillance through the use of economic indicators. The minority view, again in terms of voting power, is that exchange rates should be more stable and, if necessary, there should be a return to some kind of target zones, more intervention, and adoption of fixed exchange rates.

A few landmarks are worth mentioning. First, in 1985, just before the Annual Meeting in Korea, the Group of Five met in New York in September and agreed to intervene more actively to prevent a further rise in the value of the dollar. Eighteen months later the dollar began to fall. At first it was welcomed, but when the decline exceeded 30 per cent, the Group of Five[11] met again and agreed to intervene more actively. Although the Articles of Agreement have not changed, at least the major currency countries have intervened more actively than in the first seven years after the Second Amendment was adopted in 1978.

The role of developing countries in evaluating the exchange rate system of the key currency countries manifests itself in a number of ways. Firstly, each Executive Director elected by a group of developing countries is able to present his views at the Executive Board session at the conclusion of the Article IV Consultation discussions of all industrial countries. Of course, their views have only the effect of moral suasion, but there is a growing realization among all Fund member countries that it is in their interest to consider the 'fall out' effects of their policy stances on the economies of other member countries. Secondly, the governors from groups of developing countries are also members of the Interim Committee which discusses the evolution of the world economy and the international monetary system twice a year. Thirdly, there are groups (bodies), such as the G-10[12] representing the industrial countries and the G-24[13] representing the developing countries.

The guidance given by members to the Fund on how it should conduct its surveillance is determined by the decision on surveillance and the Communiqués of the Interim Committee. It is interesting to note that the proposals of the G-10 and G-24 have different nuances. For example, as reported in the Fund's 1986 Annual Report, (p. 35), the G-24 emphasizes

> 'Through assessment of the national economic policies of major industrial countries, seek to establish a consistent set of targets that appear to be sustainable in the medium term, identify policies to

achieve agreed objectives, and follow-up reports on achievement of policies against the background of the world economic outlook exercise'.

The Group of Ten, though asking for precise suggestions for policy changes, have not concentrated on the industrial countries alone.

The Communiqué of the Interim Committee of the Board of Governors of the International Monetary Fund, after the April 1987 meeting, stated that the committee discussed ways in which the process of policy co-ordination and multilateral surveillance could be strengthened through further development of the use of economic indicators. These indicators were expected to clarify the interaction between national economies and to identify potential sources of tension. It also asked the Executive Board to pursue this work so that indicators could be designed for use in the assessment of world economic developments, including the impact of industrial countries' policies on developing countries.

Adjustment and financing for developing countries

The G-24 at its April 1987 meeting urged the creation of a Joint Committee of Ministers from developing and industrial countries to study reform of the global monetary system. It naturally focused greater attention in its communiqué on problems of developing countries. The G-24 expressed deep concern over unfavourable developments in the world economy in 1986, expressed grave concern at the sharp decline in the flow of resources to developing countries and emphasized that for many developing countries the implementation of growth-oriented programmes are not possible under the existing external environment of slow growth of the world economy, as characterized by growing protectionism, unstable exchange rates, high real interest rates, low and declining prices of oil and primary commodities and sharp deterioration in the balance of trade of developing countries. It also pointed out that the rapidly aggravating debt crisis is entering a new and dangerous phase in which an increasing number of developing countries are not in a position to meet their debt obligations. Since the existing strategy offers no prospects for a lasting solution to the debt problems, the G-24 urged an increase in Official Development Assistance (ODA), removal by industrial countries of protectionist barriers and recycling of their huge surpluses and terms of trade gains.

The Interim Committee members noted that the situation of many heavily indebted developing countries remained extremely difficult, but did not fully endorse the recommendations of the G-24. The Interim Committee members did reiterate that the Fund has a central role in assisting countries to design adequate growth-oriented adjustment programmes, in providing financial support on a case-by-case basis and in

helping to mobilize external financing. While the Interim Committee recognized the importance of a favourable world economic environment, with stable financial conditions and access for debtor countries to expanding export markets, it also emphasized the tenacious pursuit of needed economic reforms in debtor countries to mobilize and retain domestic savings.

The two positions between that of the G-24 and that of the Interim Committee[14] highlighted the difference in emphasis between industrial countries and developing countries on the need for adjustment, financing and world environment. While there is agreement on world environment, the G-24 puts more weight on financing, including a further allocation of SDRs, and the Interim Committee puts more weight on adjustment.

The industrial countries in general feel that developing countries should make more effort to adjust, while the developing countries would like to obtain more financing. The latter points to the tremendous burden of debt-servicing which, for a growing number of developing countries, has exceeded the level of servicing ratio to exports considered safe (25 per cent) a few decades ago.

Exchange rate policies of developing countries

Most developing countries have been uncomfortable with the fact that the major currencies have fluctuated widely in value. Those countries pegged to an individual currency, e.g. the US dollar or the French franc, may have achieved stability in relation to their reserve currency, but there is instability in relation to other currencies. As of June 1987, there were 53 developing countries pegged to an individual major currency. The solution for a growing number of developing countries has been to peg their currencies to either the SDR basket (10 countries), or a trade-weighted basket (27 countries).

During the past four years, 15 developing member countries have instituted market-related floating exchange rate arrangements, some of which are based on foreign exchange auctions or interbank markets. A study published in the Fund's Occasional Paper series (No. 53) by a staff team notes that they adopted floating rates because of severe balance of payments difficulties, as reflected in sizeable external payments arrears. Most of them introduced the floating rate system in the context of a Fund-supported adjustment programme and with technical assistance from the Fund. The adoption of floating rates has enabled most of these 15 countries either to greatly reduce or nearly to eliminate exchange and trade restrictions, but outward controls on capital have been retained. The concern that the relative thinness of financial markets would tend to make floating rates either unstable or cause a free fall has been unfounded. In fact, in part owing to other accompanying policy

measures, the external current account balance has either improved or remained unchanged during the programme year in all countries with floating exchange rates. On the other hand, it worsened in one-fifth of those countries with managed exchange arrangements.

The lesson to be drawn from this experience is that developing countries should also take advantage of the possibility that they can float independently if circumstances warrant and not be wedded to the idea that their currencies must be pegged to an individual currency. One of the advantages of floating is that the level of the exchange rate would be more in line, depending on the degree of intervention, with the underlying economic and financial conditions, than under a system of pegged exchange rates, and balance of payments disequilibria would be less pronounced and shortlived.

Concluding remarks

It has been noted that developing countries play a minor role in the functioning of the world economy. Conventional wisdom is correct in stating that developing countries do not have an independent influence on the world economy. However, they play an adaptive and a multiplier role in production, trade and international capital movements.

In the workings of the Fund, the role of developing countries in the surveillance and world economic outlook exercise has been to give views on how industrial countries' policies and performance have affected the rest of the world. Although developing countries as a whole have been net users of Fund resources, a growing number of developing countries, especially the oil-rich, have also contributed important amounts of credit to the Fund.

On the issue of financing and adjustment, the views of developing countries, represented by the G-24, and the views of industrial countries, represented by the G-10, have diverged markedly. The former group would like to obtain more financing on longer and easier terms from the Fund and the international community, while the latter group would like more adjustment measures to be adopted by the developing countries.

Although there is weighted voting in the Fund, developing countries are able to exercise considerable influence, in part because of the special majorities (70 and 85 per cent) required on fundamental issues, and in part because the practice in the Board of Executive Directors of the Fund is to achieve a consensus rather than to put issues to a formal vote.

Over the past four decades, the character of the Fund has changed considerably. From a very conservative financial institution, it has become a liberal one with many financial facilities catering to the needs of member countries. Member countries expect more from the Fund and it is exercising greater authority through more effective and enhanced

surveillance in the fields of exchange rates, payments imbalances and external debt management. And, in this endeavour, developing countries as a whole will continue to play an essential role.

Notes

1. Output in billions of dollars at 1980 prices, investment as a percentage of GDP, and consumer prices, 1980 = 100.
2. Money and quasi-money, 1980 = 100.
3. Estimates provided by the Bureau of Statistics of the Fund.
4. International Monetary Fund, *World Economic Outlook*, April 1987, p. 18.
5. There exists a General Arrangements to Borrow by the Fund, begun in 1962, originally from ten industrial countries, later enlarged to include Switzerland (1964) and to associate Saudi Arabia (1983), for the purpose of supplementing Fund resources should a need arise to finance drawings by one or more large industrial countries. The original arrangement in 1962 was for $6 billion and currently it is for SDR 17 billion.
6. The countries which ratified the agreement were slightly different from those that attended the Bretton Woods Conference, e.g. the Soviet Union did not join.
7. Two Directors, those from Australia and Canada, also have a number of developing countries in their constituency.
8. Between 1946 and 1968, only 30 formal votes occurred and nine of these votes were successive motions on the same issue. Between 1968 to date, formal voting has taken place only on a few occasions.
9. The criteria are: (1) that the member is experiencing balance of payments difficulties owing to structural imbalances in production, trade and prices; or, (2) that the member is unable to pursue active development policies because of its weak balance of payments.
10. The sum of General Resources Account and the Special Disbursement Account.
11. The Group of Five (G-5) consists of France, Germany, Japan, UK and USA.
12. The Group of Ten (G-10) comprises Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, UK and USA and occasionally includes Switzerland.
13. The Group of Twenty-Four (G-24) consists of developing countries: Algeria, Argentina, Brazil, Columbia, Egypt, Ethiopia, Gabon, Ghana, Guatemala, India, Iran, Ivory Coast, Lebanon, Mexico, Nigeria, Pakistan, Peru, Philippines, Syria, Sri Lanka, Trinidad, Venezuela, Yugoslavia and Zaire.
14. Both industrial and developing countries are represented on the Interim Committee.

Appendix

Table A.1 Developing countries' gross capital formation, by region, 1979–86 (as percentage of nominal GDP).

Year	*Africa*	*Asia*	*Europe*	*Middle East*	*Western Hemisphere*	*Developing countries*
1979	24.0	29.2	31.9	21.9	23.0	25.9
1980	24.8	29.4	30.3	22.7	23.4	25.9
1981	27.1	27.2	29.1	23.5	22.7	25.5
1982	23.7	27.0	27.7	23.8	20.8	24.3
1983	21.3	26.9	24.8	27.3	17.4	23.3
1984	20.0	27.1	24.0	25.5	17.4	22.9
1985	19.0	27.6	23.1	23.8	16.9	22.4
1986	19.6	27.0	24.0	23.4	17.3	22.5

Table A.2 Industrial and developing countries' GDP at constant prices, 1960–85 (percentage change over previous year).

Year	*Industrial*	*Developing*
1960	4.4	4.3
1961	4.2	4.7
1962	5.4	4.3
1963	4.5	6.0
1964	5.8	6.0
1965	6.1	5.5
1966	5.5	5.1
1967	3.6	4.3
1968	5.3	5.9
1969	4.9	7.6
1970	2.7	5.9
1971	3.5	6.0
1972	5.2	5.7
1973	5.5	6.4
1974	0.2	5.8
1975	−0.8	4.7
1976	5.2	5.5
1977	3.9	6.1
1978	4.0	4.3
1979	3.0	4.7
1980	0.6	4.4
1981	1.5	2.7
1982	−0.2	1.8
1983	3.0	0.2
1984	5.0	2.8
1985	3.0	

Table A.3 Developing countries' debt-service payments, 1979–86 (as percentage of exports).

Year	*Developing*	*Europe*	*Western Hemisphere*
1979	14.1	18.2	39.6
1980	12.9	20.0	33.4
1981	16.2	24.0	41.9
1982	19.5	25.2	51.0
1983	18.9	23.6	43.9
1984	20.1	25.0	41.7
1985	20.5	27.2	38.7
1986	22.4	26.7	45.6
	Africa	*Asia*	*Middle East*
1979	15.3	9.4	3.7
1980	15.2	8.7	3.8
1981	18.0	10.0	5.3
1982	22.1	11.9	6.9
1983	24.3	11.4	8.0
1984	26.8	12.1	10.0
1985	28.7	12.9	10.6
1986	30.2	13.0	14.8

Table A.4 Industrial and developing countries' total international reserves, 1960–86 (in SDRs $\times 10^9$).

Year	*Industrial*	*Developing*
1960	49.4	10.3
1961	52.1	9.8
1962	52.5	10.2
1963	54.8	11.8
1964	57.1	11.7
1965	57.7	13.2
1966	58.1	14.4
1967	58.7	15.5
1968	59.7	17.8
1969	58.8	19.5
1970	70.8	21.8
1971	96.9	26.1
1972	110.3	36.1
1973	108.4	44.3
1974	108.8	71.1
1975	114.1	80.7

(Continued)

Table A.4 Industrial and developing countries' total international reserves, 1960–86 (in SDRs $\times 10^9$). *(continued)*

Year	*Industrial*	*Developing*
1976	123.2	99.0
1977	149.7	115.0
1978	174.1	108.0
1979	180.8	125.4
1980	211.9	141.1
1981	212.7	144.6
1982	211.9	141.7
1983	232.5	151.1
1984	252.0	172.0
1985	254.9	162.8
1986	278.0	

Table A.5 Industrial and developing countries ratio of reserves to imports of goods, 1960–85 (in per cent).

Year	*Industrial*	*Developing*
1960	31.7	25.6
1961	31.1	24.2
1962	33.3	25.3
1963	31.5	27.7
1964	45.3	25.0
1965	43.9	26.4
1966	40.6	26.6
1967	39.2	27.8
1968	35.4	29.7
1969	30.4	29.6
1970	31.6	28.9
1971	42.2	33.3
1972	40.5	41.3
1973	32.5	40.3
1974	23.3	41.7
1975	23.3	38.9
1976	21.4	44.2
1977	23.9	45.5
1978	25.8	39.2
1979	21.2	38.8
1980	20.1	32.3
1981	19.4	27.8
1982	19.2	27.5
1983	20.3	30.3
1984	19.1	32.5
1985	21.1	33.5

Table A.6 Developing countries' total reserves and ratios of reserves to imports, 1960–86 (ratio in per cent; reserves in SDRs × 10^9).

Year	*Developing countries*	*Africa*	*Asia*	*Europe*	*Middle East*	*Western Hemisphere*
			Ratio of reserves to imports (%)			
1960	25.6	23.9	23.6	21.4	37.4	29.3
1961	24.2	23.3	22.1	18.6	38.0	26.8
1962	25.3	30.4	22.6	20.8	42.4	22.2
1963	27.7	26.9	25.0	19.7	50.4	28.1
1964	25.0	21.3	22.3	18.8	45.4	26.5
1965	26.4	21.7	23.0	18.8	50.8	29.1
1966	26.6	27.4	23.0	18.3	50.1	25.8
1967	27.8	25.7	24.1	18.3	58.3	27.0
1968	29.7	32.7	25.8	20.0	52.5	28.7
1969	29.6	31.3	27.7	20.2	46.4	29.2
1970	28.9	26.3	26.4	17.5	51.3	31.7
1971	33.3	22.2	27.4	25.9	73.3	33.5
1972	41.3	27.2	30.4	34.7	82.2	45.8
1973	40.3	27.7	26.7	35.0	72.3	50.9
1974	41.7	37.1	21.9	21.1	116.6	36.9
1975	38.9	28.0	19.7	16.9	100.3	35.7
1976	44.2	28.8	27.8	17.8	101.8	43.1
1977	45.5	23.4	35.0	15.5	95.4	46.7
1978	39.2	16.7	31.0	17.2	70.8	52.2
1979	38.8	25.2	28.0	14.1	73.0	49.7
1980	32.3	24.0	23.1	12.0	63.8	35.4
1981	27.8	14.2	20.7	11.7	51.5	32.8
1982	27.5	10.5	23.2	11.4	50.4	28.8
1983	30.3	13.0	25.9	13.1	48.5	38.2
1984	32.5	13.0	26.7	14.6	47.8	53.8
1985	33.5	15.5	25.6	15.6	54.3	55.8
			Reserves (US$ × 10^9)			
1959					3.9	
1960	10.3	1.8	3.0	1.2	1.5	2.8
1961	9.8	1.8	2.7	1.2	1.6	2.7
1962	10.2	2.1	2.7	1.3	1.8	2.3
1963	11.8	2.1	3.1	1.4	2.3	2.8
1964	11.7	1.8	3.1	1.5	2.4	2.9
1965	13.2	2.0	3.4	1.6	2.9	3.2
1966	14.4	2.5	3.7	1.8	3.2	3.1
1967	15.5	2.5	4.0	1.9	3.7	3.4
1968	17.8	3.4	4.4	2.2	3.8	4.0
1969	19.5	3.6	5.0	2.6	3.9	4.4
1970	21.8	3.6	5.4	2.8	4.6	5.5
1971	26.1	3.2	5.7	4.2	7.0	5.9
1972	36.1	4.0	7.2	6.4	9.4	9.1
1973	44.3	4.8	8.4	8.0	11.2	12.0
1974	71.1	9.4	10.1	7.1	29.5	15.0

(continued)

Table A.6 Developing countries' total reserves and ratios of reserves to imports, 1960–86 (ratio in per cent; reserves in SDRs × 10^9). *(continued)*

Year	*Developing countries*	*Africa*	*Asia*	*Europe*	*Middle East*	*Western Hemisphere*
1975	80.7	9.4	10.2	6.5	38.5	16.1
1976	99.0	9.8	15.3	7.5	45.9	20.5
1977	115.0	9.0	21.5	7.1	54.0	23.5
1978	108.0	7.1	22.7	8.1	42.8	27.3
1979	125.4	10.8	26.3	7.8	48.1	32.4
1980	141.1	15.7	29.3	8.0	56.6	31.6
1981	144.6	11.0	31.7	8.1	59.8	34.0
1982	141.7	7.7	36.7	7.7	64.1	25.6
1983	151.1	7.4	44.5	9.0	62.3	28.0
1984	172.0	7.2	52.7	10.8	59.7	41.6
1985	162.8	8.7	47.1	10.6	58.6	37.8
1986	137.0	7.4	43.3	11.2	47.8	27.3

Figure A.7 Industrial and developing countries use of Fund credit: general department, 1960–86 (in SDRs × 10^9).

Year	*Total*	*Industrial*	*Developing*
1960	0.4	0.0	0.4
1961	1.4	0.7	0.8
1962	1.0	0.1	0.9
1963	1.1	0.1	1.0
1964	1.4	0.5	0.9
1965	3.0	1.9	1.1
1966	3.0	1.9	1.1
1967	2.5	1.2	1.3
1968	3.7	2.3	1.4
1969	4.0	2.8	1.3
1970	3.2	2.4	0.8
1971	1.3	0.5	0.8
1972	1.1	0.0	1.1
1973	1.0	0.0	1.0
1974	3.7	1.5	2.3
1975	7.4	3.3	4.1
1976	12.6	5.7	6.9
1977	13.1	6.5	6.6
1978	10.3	4.1	6.2
1979	8.0	1.7	6.3
1980	8.5	1.0	7.4
1981	13.4	0.5	12.8
1982	19.3	0.1	19.2
1983	29.9	0.0	29.9
1984	34.9	0.0	34.9
1985	35.2	0.0	35.2
1986	33.4	0.0	33.4

Figure A.8 Developing countries use of Fund credit: general department, 1960–86 (in SDRs $\times 10^9$).

Year	*Africa*	*Asia*	*Europe*	*Middle East*	*Western Hemisphere*
1960	0.0	0.1	0.0	0.1	0.2
1961	0.0	0.2	0.1	0.1	0.4
1962	0.0	0.3	0.1	0.1	0.4
1963	0.0	0.3	0.1	0.1	0.5
1964	0.0	0.2	0.1	0.1	0.4
1965	0.1	0.4	0.1	0.1	0.4
1966	0.1	0.5	0.1	0.1	0.3
1967	0.2	0.6	0.1	0.1	0.3
1968	0.2	0.7	0.1	0.1	0.3
1969	0.2	0.6	0.1	0.1	0.3
1970	0.1	0.4	0.1	0.1	0.1
1971	0.1	0.4	0.1	0.1	0.2
1972	0.1	0.5	0.1	0.1	0.4
1973	0.1	0.4	0.1	0.1	0.3
1974	0.3	1.2	0.2	0.1	0.4
1975	0.6	1.8	0.6	0.3	0.8
1976	1.2	2.1	1.4	0.5	1.7
1977	1.4	1.8	1.3	0.6	1.6
1978	1.5	1.7	1.3	0.6	1.1
1979	1.5	1.7	1.4	0.5	1.2
1980	1.8	2.4	1.9	0.3	1.0
1981	3.3	5.2	2.8	0.2	1.3
1982	5.2	7.3	3.9	0.1	2.7
1983	6.5	9.6	5.3	0.1	8.4
1984	7.1	10.0	5.9	0.1	11.8
1985	7.3	9.2	5.4	0.1	13.2
1986	6.6	8.7	4.6	0.1	13.4

Name Index

Subject Index

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economic problems faced by developing countries. In particular, the fast growing debt burden, and the increasing income gap relative to industrialized countries. Despite all the theoretical studies and the most detailed analyses, these problems still remain to be resolved.

What has gone wrong and what can be done to improve the situation? Is there any positive role for the international monetary system to play in solving these problems? And can developing countries benefit from the present international monetary system?

In this book, which has been specially commissioned by the South East Asian Central Banks Research and Training Centre in honour of the late Byanti Kharmawan, eight distinguished writers in the field of international monetary affairs and economic development attempt to answer some of these questions. The contributions include:

- Professor S. Malcolm Gillis on the VAT in developing countries
- Dr Ulrich Hiemenz on the inter-relation between trade and growth in developing countries
- Professor Alexandre Kafka on the international debt problem
- Dr Lin See Yan on the flow of funds for national development
- Professor Seiji Naya and Pearl Imada on the economic performance of Asian developing countries
- Dr Jacques J. Polak on the choice of exchange rate regime
- Dr Arifin M. Siregar on monetary policy in developing countries
- Dr U Tun Wai on the role of developing countries in the international monetary system

The Foreword is contributed by Michel Camdessus, the present Managing Director of the International Monetary Fund.

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