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Peter Harrold
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No. 302 Harrold and Associates, The Broad Sector Approach to Investment Lending: Sector Investment Programs
## CONTENTS

**FOREWORD** ................................................................................................................................. ix

**ABSTRACT** .................................................................................................................................. x

**ACKNOWLEDGMENTS** ................................................................................................................ xi

**PART I. WHY COMPARE ASIA AND AFRICA?** ................................................................. 1

- Economic Performance of Africa and Asia: The Past Three Decades ............................................ 6
  - Growth in GDP and GDP per Capita ......................................................................................... 6
  - Government Behavior and the Budget Deficit ............................................................................ 8
  - Savings and Investment ............................................................................................................. 9
  - Sectoral Growth and Productivity ............................................................................................. 12
  - Growth in Manufacturing Value Added .................................................................................... 14
  - Export Performance ................................................................................................................ 14
  - Issues Arising from the Preceding Overview .......................................................................... 17
- Side-By-Side Country Comparisons .............................................................................................. 20
  - Nigeria and Indonesia ............................................................................................................. 20
    - Government Behavior and the Fiscal Deficit ........................................................................ 21
    - Exchange Rate Policy ........................................................................................................... 22
    - Growth in the Productive Sectors and Exports .................................................................... 23
  - Cote D'Ivoire and Malaysia ......................................................................................................... 26
    - GDP Growth .......................................................................................................................... 26
    - Sectoral Policies Prior to the Commodity Boom .................................................................... 27
    - Adjustment in Cote d'Ivoire and Malaysia .......................................................................... 30
  - Tanzania, Ghana and Thailand ...................................................................................................... 34
    - GDP Growth .......................................................................................................................... 34
    - Fiscal Policies and the Budget Deficit .................................................................................... 36
    - Exchange Rate Policy ............................................................................................................ 37
    - Sectoral Policies, Growth and Export Performance .............................................................. 38

**PART II. THE IMPORTANCE OF BASICS** ............................................................................. 43

- Macroeconomic Stability ........................................................................................................... 43
- Greater Outward Orientation ...................................................................................................... 46
- Investment in Human Capital ..................................................................................................... 48
- Selective Interventions ............................................................................................................... 49
PART III. THE HETERODOX APPROACHES OF EAST AND SOUTHEAST ASIA

Industrial Promotion and Policy .......................................................... 52
Government Business Relations .......................................................... 61
Export Development Policies .................................................................. 67
Free Trade Zones .................................................................................. 82
Industrial Training .................................................................................. 91

PART IV. EXCHANGE RATE POLICIES FOR TRADE PROMOTION ........ 98

East Asian Policies ..................................................................................... 98
African Exchange Rate Policy ................................................................. 100
Trade Policy, Exchange Rates and the "Dollar Index" .................................. 101
The Africa Difference ............................................................................... 103
Conclusions ............................................................................................... 106

PART V. OPERATIONAL IMPLICATIONS ............................................. 108

Policy Approaches to be Considered .......................................................... 109
Project Design Implications ..................................................................... 111
Technical Assistance Aspects ..................................................................... 111
Implications for Lending Operations ........................................................ 112

References ............................................................................................... 114

Figures in Text

1: GDP Growth in Africa, East Asia and Southeast Asia ........................................ 6
2: Real GDP Per Capita, Africa and Asia, 1960-93 .............................................. 7
3: Gross Domestic Saving as a Share of GDP, 1967-93 ........................................ 11
4: Gross Domestic Investment as a Share of GDP, 1967-93 .................................... 12
5: Share of Manufactured Exports in Total Exports ........................................... 15
6: Real Growth in Merchandise Exports ........................................................ 17
7: Real GDP Per Capita, Nigeria and Indonesia, 1960-93 ...................................... 21
8: Real Exchange Rates, Nigeria and Indonesia, 1980-92 ...................................... 22
9: Real GDP Per Capita, Cote d'Ivoire and Malaysia ........................................... 27
10: Exchange Rate and Terms of Trade Movements in Cote d'Ivoire ..................... 28
11: Exchange Rate and Terms of Trade Movements in Malaysia ......................... 30
12: Growth in Manufacturing Value Added ...................................................... 32
13: Real Growth in Manufactured Exports ....................................................... 33
14: GDP Growth, Tanzania, Ghana and Thailand .............................................. 35
15: Real GDP Per Capita, Tanzania, Ghana and Thailand ...................................... 36
16: Real Exchange Rates, Tanzania, Ghana and Thailand, 1979-93 ..................... 37
17: Growth in Merchandise Exports, Tanzania, Ghana and Thailand .................... 41
18: Overvaluation due to Balance of Payments Assistance .................................. 105
Tables in Text

1: Africa in 1990 and Asia in 1965 ......................................................... 4
2: Growth in GDP Per Capita ..................................................................... 7
3: Savings and Investment as a Share of GDP ............................................. 10
4: Agricultural Income, Labor Force and Productivity .................................. 14
5: Selected Economic Indicators, Nigeria and Indonesia ............................... 23
6: Structure of Export Earnings, Nigeria and Indonesia ................................. 25
7: Structure and Growth of Production, Tanzania, Ghana and Thailand .......... 40
8: Structure of Merchandise Exports .......................................................... 40
9: Average Inflation Rates, 1961-91 ............................................................ 55
10: Sources of Malaysia’s Growth (GDP at factor cost) ................................ 58
11: Countries Ranked by Overall Macroeconomic Policy Stance ...................... 59
12: Evaluation of Bureaucratic Quality .......................................................... 60
13: Survey Rankings ................................................................................... 64
14: Private Investment in Thailand and Ghana ............................................... 66
15: Average Appreciation Index 1978-80 ..................................................... 99
16: Foreign Exchange Market Premia and REERs in Africa ........................... 100
17: Dollar Indices and Exchange Rate Variation ........................................... 102

Boxes in Text

1: Commodity Dependence and Economic Growth ....................................... 16
2: Korea’s HCI Drive .................................................................................... 56
3: The Heavy Industries Corporation of Malaysia (HICOM) ......................... 57
4: Reciprocal Performance in Korean Government-Business Relations .......... 62
5: Private Investment and Business Confidence in Ghana ............................... 65
6: Korea’s Duty Exemption and Drawback Scheme ........................................ 70
7: Duty Rebates in Taiwan, China .............................................................. 72
8: The Domestic Letter of Credit and how it works ....................................... 75
9: Kenya’s Export Development Policies ..................................................... 77
10: Zimbabwe’s Inward Processing Rebate (IPR) and Duty Drawback Schemes .... 79
11: Export Development Policies in Cote d’Ivoire and Senegal ....................... 80
12: Malaysia’s Penang Free Trade Zone ....................................................... 83
13: The Philippines Bataan Export Processing Zones ...................................... 85
14: China’s Shenzhen Special Economic Zone ............................................... 86
15: The Mauritius Export Promotion Zone .................................................... 88
16: The Industrial Free Regime in Senegal .................................................... 89
17: Incidence of Training in Kenya, Zimbabwe and Malaysia ......................... 93
18: Well-designed levy-grant schemes can induce firms to train ................... 94
19: Tax Incentives to encourage training are seldom effective ......................... 95
20: Public-Private Collaboration in Training Provision .................................... 96
21: Calculation of Exchange Rate Overvaluation due to BOP Assistance ........ 103
FOREWORD

The purpose of the Africa Technical Department Series of Discussion Papers is to disseminate to a wider audience the results of our analytical work, in the expectation that this will contribute to development in Africa. The present report focuses on a set of issues of key interest to African policymakers. Many countries in Africa are impatient with their slow pace of per capita income growth. At the same time, the countries of East Asia have continued to enjoy rapid sustainable growth. What is the scope for African countries to adapt this East Asian experience to their own circumstances and enjoy similar rates of growth? That is the question that this report attempts to answer.

The findings of this analysis should be of interest to a wide range of policymakers, officials and analysts. In line with what emerged in the "East Asia Miracle Study" much of the difference between performance in Sub-Saharan Africa and East Asia can be traced to differences in macroeconomic policy and to investment in education. However, the report then goes on to look at the so-called heterodox policies of East Asia, which have been used in those countries to underpin export-oriented development. It finds that several of these have potential value in Africa, and that simple application of these approaches, such as rebates schemes, credit for exporters, industrial training and industrial parks, merit support. The report also tries to see what may have gone wrong with such attempts in Africa in the past, and generally finds that most failures can be attributed either to excessive complication or to attempts to counter comparative disadvantage.

The study therefore offers practical advice on a number of approaches that can be used to accelerate the development of manufactured exports from Africa, the route that the authors consider to be critical for raising the overall rate of growth and of poverty alleviation in Sub-Saharan Africa.

Kevin M. Cleaver
Director
Africa Technical Department
ABSTRACT

This paper examines the economic performance of East and Southeast Asia and Sub-Saharan Africa, and attempts to identify some of the practical lessons that Africa can learn from Asia, in order to facilitate industrial development and export growth. Africa's factor endowments and economic structures are quite similar to those found in Southeast Asia in the 1960s. The Southeast Asian countries--Indonesia, Malaysia and Thailand--have achieved rapid industrial growth over the past three decades, while Africa has struggled with adjustment, and witnessed a marginal industrial response. The emergence of a significant gap in per capita incomes between these two groups of countries, however, is a relatively recent phenomenon, developing only since the second oil price shock (1979). This suggests hope for Africa, if an appropriate policy environment can be sustained over a period of years.

Three country comparisons, of Nigeria and Indonesia, Cote d'Ivoire and Malaysia, and Tanzania, Ghana and Thailand, illustrate the critical nature of government policies, such as exchange rate policy and the role assigned to the agricultural sector. Southeast Asia effectively redirected commodity rents to other tradables, through careful devaluations that stimulated a substantial non-oil export boom. Africa extracted agricultural savings through low producer prices to finance government consumption and investment in public enterprises. Real exchange rate appreciations combined with trade policies in Africa seriously distorted domestic incentives and resource allocation.

Southeast Asia, in addition to maintaining the "basics" of macroeconomic stability, high savings, and investment in human capital, used several complementary measures to place the development of exports as the central economic strategy. A key conclusion of this study is that the correct use of the exchange to maintain export competitiveness was of fundamental importance in East and Southeast Asia. The paper also suggests six elements that should be pursued in industrial lending: the development of training financing mechanisms; technical assistance programs for enterprises; the development of simple duty exemption schemes; export credit support mechanisms; public-private training institutions; and the development of industrial/export processing zones. While many of these have been tried in the past in Africa, this review suggests ways in which their design could be improved, or where necessary accompanying policies were missing. As African governments become more committed to development, and to developing the sort of long term-vision for their economies that was so crucial in East Asia, these sorts of policies could have a key role to play in Africa.
ACKNOWLEDGMENTS

This paper has been prepared with the assistance and collaboration of several people. The study was under the overall direction of Peter Harrold. The principal researcher was Malathi Jayawickrama. Deepak Bhattasali contributed primarily to the issues of "the basics", and the lessons from African experience in export promotion. Hong Tan contributed the section on industrial training, and Ed Campos the sections on industrial promotion and government-business relations. Yung Whee Rhee and Lionel Demery provided guidance on a range of issues, and Tyler Biggs and the RPED staff assisted with research data. David Lindauer and Jeff Lewis were generous both with advice and data from their own research in this area. Numerous members of the "East Asia Miracle Study" team also provided useful advice and guidance. The comments of Ravi Kanbur, Gene Tidrick, Peter Miovic, Don Keesing, Siddig Salih, Dani Rodrik and Peter Neary on the first draft of this paper are gratefully acknowledged. Finally, the authors wish to recognize Ishrat Husain, who initially generated the idea for this work.
PART I. WHY COMPARE ASIA AND AFRICA?

Over the past three decades, East and Southeast Asia achieved rapid economic growth and industrialization with decreasing inequality, while Sub-Saharan Africa (SSA) witnessed moderate growth, faltered and went into decline. The relative performance of the two regions has been brought into stark relief recently by two World Bank policy studies. The “East Asia Miracle Study” charted the success of the “High Performing Asian Economies (HPAEs)”, and attempted to explain the economic policy factors behind their achievements. The early studies of this performance were generally country specific, and offered few generalizable hypotheses. More recently, there has been a burgeoning of work that takes a regional view and attempts to identify patterns in the policies adopted by the East Asian countries.

This research activity has stimulated great curiosity on the part of African policymakers regarding the lessons for public policy that can be drawn from the experience of the successful East Asian countries. The completion by the World Bank of an evaluation of Africa’s development experience—Adjustment In Africa: Reform, Results, And The Road Ahead (1994)—has intensified this curiosity, not least because the study identifies failures in public policy as a major reason for the poor performance of many African countries. Together with a set of companion country studies, this analysis of SSA’s economic performance defines a clear need to carry out growth-oriented policies that draw from successful experience elsewhere among the developing countries. These two studies therefore beg the question: what can the African countries learn from the experience of East Asia, and what extent is this experience relevant?

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1 In general, East Asia refers to Korea, Hong Kong, Singapore and the the economy of Taiwan, China. Southeast Asia refers to Indonesia, Thailand, and Malaysia. Sub-Saharan Africa refers to all African countries except Algeria, Egypt, Libya, Morocco, Tunisia, South Africa. This follows the definition in the African Development Indicators 1994-95.

There are two broad lessons that emerge from the East Asian experience, and guide the present analysis. First, the "Miracle Study" concluded that sound macroeconomic management was at the heart of the success achieved. This has frequently been referred to as "getting the basics right". In addition to the basics, it is now accepted that governments contributed in a variety of ways to facilitate the process of economic development. It is this second aspect that is of particular interest, albeit in the context of the effort to achieve improved macroeconomic performance in SSA. There are many countries that have now gone a long way towards restoring the macroeconomic balance, even though the struggle is far from over. For these countries, in setting economic policies, the question is what the government can or cannot do, or should or should not do, to accelerate the process of economic growth. In this regard, policies to encourage the development of outward-oriented manufacturing industry are of particular interest; as this is what has set East Asia apart, and led many East Asian countries to relative prosperity.

Some would say that there is no basis for a comparison, or for drawing lessons, given the relative levels of development of the two regions. Indeed, for African countries now faced with the challenge of reversing their economic deterioration and accelerating growth, Asia's dominant position in the 1990s may appear somewhat discouraging in terms of remaining opportunities. However, from the perspective of the 1960s, some of today's successful Asian economies were not significantly different from Africa in 1990 (Perkins and Roemer 1994). In 1965, Asia's economic structure--Gross Domestic Product (GDP) shares of agriculture, manufacturing, investment and exports, and the proportion of population in urban areas--was quite similar to that found in Africa today (see Table 1). Economic conditions in the post-war era did not necessarily favor Asia, where poverty and population pressures were mounting, and governments seemed unstable. Africa, although behind in stocks of human capital, was much less densely populated, had a five times greater ratio of agricultural land per worker than Asia, and held great promise in the immediate post-colonial period.

It would be useful to try to identify the practical lessons for the SSA countries from the East Asian successes. This is not easy, for several reasons. First, the methodologies employed in this body of work—cross-country regressions and quantitative growth accounting—can, at best, only deliver some interesting general hypotheses that will need to be examined carefully through detailed country specific work. Second, there is no single "East Asian model" or a distinct "East Asian path." This is demonstrated in the individual country studies and acknowledged in some of the better cross-country work. And third, many of the hypotheses offered to explain the

---

3 Both China and Vietnam, whose successes are recent, and the Philippines whose economic performance has been mediocre in comparison to other developing countries, are normally excluded from consideration.
East Asian successes lack within-sample explanatory power, undermining confidence in one's ability to apply them more widely.

Perhaps a more important point is that just as in the case of the successful East Asian economies, the countries of SSA reflect diverse economic situations. One needs to distinguish between two groups of countries so as to focus on practical guidelines for African policymakers. One group of countries may gain most from the “basic” policies that seem to have promoted resource allocation and mobilization in the high performing East Asian countries. The other consists of countries that are reasonably advanced in their basic reform efforts and are now able to deploy a broader range of instruments that have yielded substantive results elsewhere. Economic stability is yet to be achieved in many SSA countries, and future efforts need to be concentrated on the set of basic stabilization and macroeconomic reform policies. For the leading countries of SSA, however, there is a need for closer examination of, and greater experimentation with, policies, instruments and institutions that have promoted rapid manufacturing and export growth in the East Asian high performers.

This paper therefore attempts to examine the question of whether Sub-Saharan Africa can and should follow Asia's development path, as also the pertinent lessons that Africa can draw from Asia's trade and industrial policies. The first half of Part I looks at the economic performance of Asia and Africa over the past three decades. In doing so, however, it is important first to identify the relevant East Asian countries with which to make a comparison. Given the rich diversity of both regions and the substantial variations in policy, it is not possible to generalize in terms of “Africa” or “East Asia”. Indeed, one of the main points made both in the East Asia Miracle Study, and in the Africa Region's recent report, Africa: A Continent in Transition: Sub-Saharan Africa in the Mid-1990s, is that it is increasingly difficult to refer to either region in a monolithic way. Rather, it is individual cases that have to be discussed. Therefore, the second half of Part I takes a closer look at countries with similar underlying characteristics in Asia and Africa, to compare the evolution of their development paths over the last thirty years. The report then turns to policy issues. Part II presents the lessons for the “basics” that emerge from East Asia, and Part III examines some of the specifics of industrial and trade policies. Part IV discusses the exchange rate policies adopted in East Asia and Africa. Finally in Part V, the paper presents some operational implications of the East Asian experience, especially with respect to industrial and trade policies.
Table 1: Africa in 1990 and Asia in 1965:
Differences in Means of Selected Indicators

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Mean Value for</th>
<th>Value of t-stat</th>
<th>Level of Signif.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Asia 1965</td>
<td>Africa 1990</td>
<td></td>
</tr>
<tr>
<td>GDP per capita (US$, ICP)</td>
<td>1261</td>
<td>658</td>
<td>1.87</td>
</tr>
<tr>
<td></td>
<td>874</td>
<td>583</td>
<td>1.79</td>
</tr>
<tr>
<td>Agriculture share GDP (%)</td>
<td>25.7</td>
<td>35.3</td>
<td>1.22</td>
</tr>
<tr>
<td></td>
<td>35.0</td>
<td>36.4</td>
<td>0.25</td>
</tr>
<tr>
<td>Manufact. share GDP (%)</td>
<td>15.4</td>
<td>11.5</td>
<td>1.40</td>
</tr>
<tr>
<td></td>
<td>11.7</td>
<td>11.7</td>
<td>0.01</td>
</tr>
<tr>
<td>Savings share of GDP (%)</td>
<td>17.0</td>
<td>8.7</td>
<td>1.88</td>
</tr>
<tr>
<td></td>
<td>16.0</td>
<td>8.8</td>
<td>1.56</td>
</tr>
<tr>
<td>Investment share GDP (%)</td>
<td>20.3</td>
<td>18.1</td>
<td>0.54</td>
</tr>
<tr>
<td></td>
<td>16.8</td>
<td>18.1</td>
<td>-0.36</td>
</tr>
<tr>
<td>Export (gnfs) share GDP (%)</td>
<td>42.8</td>
<td>23.5</td>
<td>1.11</td>
</tr>
<tr>
<td></td>
<td>21.6</td>
<td>22.0</td>
<td>-0.07</td>
</tr>
<tr>
<td>Urban population share GDP (%)</td>
<td>44.0</td>
<td>27.9</td>
<td>1.10</td>
</tr>
<tr>
<td></td>
<td>23.8</td>
<td>27.9</td>
<td>-0.80</td>
</tr>
<tr>
<td>Primary education</td>
<td>94.6</td>
<td>71.4</td>
<td>2.83</td>
</tr>
<tr>
<td>(% eligible population)</td>
<td>90.8</td>
<td>69.8</td>
<td>2.11</td>
</tr>
<tr>
<td>Secondary education</td>
<td>29.1</td>
<td>17.6</td>
<td>2.00</td>
</tr>
<tr>
<td>(% eligible population)</td>
<td>30.3</td>
<td>16.8</td>
<td>1.65</td>
</tr>
</tbody>
</table>

Significance Levels:
- means that the t-statistic is significant at the probability n or less;
- means the t-statistic is significant at a slightly higher probability than n;
The first row of numbers under each indicator is for all countries, and the second row is for all countries excluding Hong Kong, Singapore and Botswana.
Accept means the hypothesis of no difference in means cannot be rejected.

The Relevant Comparison

East Asia, although referred to as a single group, does not present a uniform model of success. The histories, size of the economies, and endowments of these countries are quite diverse, and economic approaches within the group as well as over time show considerable variation. In many important aspects, the three Southeast Asian countries (SE)—Indonesia, Malaysia and Thailand—with their rich natural resources of productive farmland, forests and minerals, and the weaker human capital base of three decades ago, have much in common with Africa today. Natural resources and primary exports played a pivotal role in industrialization in these countries. The countries of East Asia are generally homogeneous in ethnic composition, and relatively stable in political terms. Southeast Asian economies, in contrast, have had to cope with the problems raised by ethnic diversity, and the specific problem of an ethnic minority with a significant role in commercial and business life. Moreover, the three Southeast Asian countries have had to cope with periods of significant political instability, including coup d’etats and uprisings. Consequently, for African countries faced with increasing pressures to efficiently diversify production and exports, it seems that Southeast Asia presents a much more relevant model than East Asia.

The large East Asian countries—Japan and Korea—are less relevant. The pre-1939 era cannot be discounted, and their larger economy and the well-educated workforce hardly describe the characteristics of Africa. The small East Asian economies—the city-states of Hong Kong and Singapore—are insecure islands, with physical endowments and economic structures quite different from those found in Africa. These countries had rich stocks of human capital in the early stages of development, but lacked natural resources and an agricultural base. The lessons for Africa from Hong Kong and Singapore seem relevant only for Mauritius, and these have been well taken.

Therefore, while some of the experience of East Asian countries is referred to, it is the Southeast Asian economies to which most reference will be made, and which are used in making the individual country comparisons in this report.
Growth in GDP and GDP Per Capita

During 1961-93, GDP and population growth in Sub-Saharan Africa averaged 3.2 percent and 2.8 percent a year respectively. In East Asia and Southeast Asia, GDP grew at average annual rates of 9.4 and 6.6 percent during this period, while annual population growth averaged 1.9 and 2.2 percent (see Figure 1).4

Africa's experience has varied over time and across countries. In the early 1960s, growth was moderate, although slower than the average for other developing countries. After 1967 GDP growth picked up, helped by record commodity prices, high investments financed by export earnings, commercial borrowing and aid. In the mid-1970s, however, countries began to falter, and Sub-Saharan Africa, excluding the oil economies, has since then recorded generally declining output (World Bank, 1989).

Figure 1: GDP Growth in Africa, East Asia and Southeast Asia

Source: Bank Economic and Social Data base (BESD), The World Bank.

4 Average annual GDP growth rates in Africa during the period 1961-93, range from 0.4 percent in Niger to 5.5 percent in Burundi, 6.5 percent in Cape Verde and 11.4 percent in Botswana, while the most impressive performer in Asia is Korea, with 10.2 percent.
This pattern is even more striking if one looks at GDP per capita growth in Table 2 and Figure 2. Africa's economic performance begins to diverge from that of Southeast Asia around 1977, following the first oil price shock. What this means, as Figure 2 shows very dramatically, is the emergence since the mid-1970s of growing disparities between African and Southeast Asian countries. Given a similar initial resource base, and similar per capita GDP until that time, the extent to which government policies differed in the countries of the two regions as an explanatory factor in this regard needs to be examined.

Table 2: Growth in GDP Per Capita

<table>
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<tr>
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</thead>
<tbody>
<tr>
<td>Africa</td>
<td>1.3</td>
<td>0.7</td>
<td>-0.9</td>
<td>0.3</td>
</tr>
<tr>
<td>East Asia</td>
<td>7.0</td>
<td>7.1</td>
<td>9.4</td>
<td>7.4</td>
</tr>
<tr>
<td>Southeast Asia</td>
<td>3.2</td>
<td>4.9</td>
<td>4.3</td>
<td>4.3</td>
</tr>
<tr>
<td>South Asia</td>
<td>1.3</td>
<td>1.6</td>
<td>3.3</td>
<td>1.8</td>
</tr>
</tbody>
</table>

Source: Bank Economic and Social Data base (BESD), The World Bank.

Figure 2: Real GDP Per Capita, Africa and Asia, 1960-93

Source: Bank Economic and Social Data base (BESD), The World Bank.
Government Behavior and the Budget Deficit

In the 1980s, Africa had generally higher budget deficits than Asia. Africa's budget balances ranged from a small surplus of 0.3 percent of GDP in Nigeria to a deficit of 14.2 percent of GDP in Zambia (Lewis and McPherson 1994). In Asia, they ranged from a surplus of 3 percent of GDP in Singapore to an average deficit of 11 percent of GDP in Malaysia. Most Asian countries ran small deficits, ranging from 0.3 percent in China to under 4 percent in Thailand. The outlier is Malaysia, but this is essentially because of very high savings in the National Provident Fund and the National Oil company, and therefore the consolidated fiscal deficit was more in line with other Asian countries.

In most countries in Africa and Asia, there was little change in the average deficit/GDP ratio between the two periods 1972-74 and 1986-88, and over the entire 15-year span. The fiscal restraint of Asian governments is reflected in the low volatility of their deficits between 1970-90. The average deficit/GDP is bunched between -2 and 2 percent for Asia, whereas nearly all the African countries average between -3 and -8 percent, with substantially higher variability as well. Africa's revenue share of GDP shows far greater variability than Asia's, probably reflecting the continuing importance of commodity exports for Africa. Most African governments do not appear to have resorted to excessive Central Bank financing of their deficits. Over the period 1980-89, the Central Bank-financed share of the deficit as an average share of GDP ranged from negligible to 1.6 percent in Africa, with the exception of Zambia's 3.2 percent.

The aggregate data with respect to fiscal performance would tend to suggest the following:

- In Africa, governments had less success in curtailing the level as well as the variability of fiscal deficits, leading to greater destabilizing pressures.

- The problem of financing deficits in Africa appears to be reflected in the "crowding out" of private investment, rather than in higher inflation in most countries. However, we need to make the distinction between Francophone

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5 For a fuller discussion of this, see Lewis and McPerson, 1994.

6 In Ghana and Korea, deficits decreased slightly, while in Nigeria and Zambia they increased substantially. Botswana is at the extreme, with a deficit of 11 percent in 1972-74, and a surplus of 22 percent in 1986-88.

7 Measured by the standard deviation of the average deficit/GDP ratio.
Africa, where inflation rates were generally very low, and Anglophone Africa, where seignorage was much more prevalent as a source of government financing.

- Africa's fiscal problem is not one of revenue performance, but the inability to manage expenditure. In both Asia and Africa, the shares and trends in revenue are quite similar. In Asia, while governments acted to ensure that expenditures would not generate instability, in Africa, governments appear to have promoted development irrespective of the implications of spending on macroeconomic stability.  

What is even more critical, however, is the fact that, for a variety of reasons, aggregate savings performance in SSA was very poor in comparison with East Asia. The fiscal deficits of Africa were consequently less "affordable" in development terms than those of East Asia, because they left so few resources for private sector development. Thus, behind these fiscal numbers, lies the fundamental issue of whether it was the private or the public sector that drove economic development.

Savings and Investment

Sub-Saharan Africa's savings rates, especially in the 1980s, were well below those of Asia (see Table 3 and Figure 3). In East and Southeast Asia, most countries saved at least 20 percent of their GDP on average between 1967 and 1992, and many saved over 30 percent. In Africa, only a few saved over 20 percent, while most saved less than 7 percent of GDP. Foreign capital and aid appear to have compensated for Africa's savings deficiency, as indicated in the higher investment rate during most of the past decade, but, of course, these tend to be used by the public rather than the private sector (see Figure 4).

East and Southeast Asian governments boosted savings through a combination of fundamental and interventionist policies. The former included maintaining macroeconomic stability—primarily controlling inflation, and ensuring the security of banks. Low to moderate inflation and largely positive real interest rates lowered the risk of holding financial assets, and hence encouraged financial savings. While interest rates were on average lower in nominal terms—and indeed, were frequently controlled at such low levels by governments—these low rates still assured positive real returns to savers of 3-6 percent per annum.

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8 See Lewis and McPherson, 1994, p. 132.
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<thead>
<tr>
<th></th>
<th>Gross Domestic Savings</th>
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<td>SSA</td>
<td>15.7</td>
<td>20.7</td>
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<tr>
<td>East Asia</td>
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<td>28.4</td>
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<tr>
<td>Southeast Asia</td>
<td>18.9</td>
<td>28.1</td>
<td>31.9</td>
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<td>South Asia</td>
<td>14.4</td>
<td>17.1</td>
<td>19.1</td>
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<table>
<thead>
<tr>
<th></th>
<th>Gross Domestic Investment</th>
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<td>SSA</td>
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<td>17.9</td>
<td>19.1</td>
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<tr>
<td>East Asia</td>
<td>25.4</td>
<td>27.0</td>
<td>27.7</td>
<td></td>
</tr>
<tr>
<td>Southeast Asia</td>
<td>20.1</td>
<td>21.0</td>
<td>22.1</td>
<td></td>
</tr>
<tr>
<td>South Asia</td>
<td>16.2</td>
<td>16.5</td>
<td>17.0</td>
<td></td>
</tr>
</tbody>
</table>

Source: Bank Economic and Social Data base (BESD), The World Bank.
East Asia also built a secure bank-based financial system through strong prudential regulations and supervision. Banking was made more convenient to small and rural savers, and transactions costs were reduced through postal savings systems. Some of the more interventionist mechanisms used to encourage private savings in Asia include mandatory provident fund contributions, and high interest rates on loans for consumer items. Asia also maintained high public savings through tax policy and expenditure restraint. During 1970-90, East and Southeast Asia had the lowest share of average public consumption in GDP, compared to OECD and low-and middle-income countries (World Bank 1993a).
In Sub-Saharan Africa, on the other hand, unanticipated high inflation eroded the real value of financial assets, and discouraged private savings. The state had a strong hand in the development of the banking sector, often through the nationalization of the colonial banking system. Moreover, at the time of independence of many African states, international institutions were encouraging the creation of national development banks as a vehicle for the transfer of resources to the private sector. It is only relatively recently that attention has turned in Africa to the strengthening of central banks and to the framework for the creation of a private commercial banking system. 9

Fundamental policies that encouraged investment in Asia were: the provision of infrastructure to complement private investment; the creation of an investment-friendly climate, through a combination of tax policies favoring investment; and policies that kept the relative price of capital goods low by avoiding high tariffs on imported capital. The more controversial policy was financial repression—holding deposit and lending rates below market clearing levels. 10

**Sectoral Growth and Productivity**

Over the past three decades, the relative contribution of agriculture to GDP declined in both East Asia and Africa, while that of industry increased. In Asia,

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9 See Popiel (1994) for a full discussion of the pattern of the development of financial systems in Africa.

10 This is examined further in Part II.
however, one can observes the growth in manufacturing being facilitated and accompanied by the continued growth in the agricultural sector. This is best demonstrated by the fact that Asian countries increased their shares of world agricultural export markets during this same period in which they were making their well-publicized inroads into markets for manufactured products. Indeed, their gains in world markets for agricultural products were usually at the expense of Africa, which steadily lost market shares over the same period.

In Africa, the decrease in the share of agriculture in GDP does not reflect any fundamental transformation of the production structure, or major steps towards industrialization. In the 1960s, Africa's agricultural production increased at 2.7 percent a year—about the same as population growth. From 1970 to 1985, agricultural growth slowed to an average of 1.4 percent a year, about half the rate of population growth (World Bank 1989). In Asia, the lower relative importance of agriculture reveals the path of successful structural transformation and industrialization. Increasing agricultural productivity permitted the movement of labor into manufacturing, without a fall in agricultural output. Indeed, a comparison across developing regions suggests that the largest decreases in agriculture's share of output and employment are observed in countries where agricultural output and productivity have increased the most (see Table 4). Of twenty-one countries showing a declining output per worker over the period 1965-88, Sub-Saharan Africa accounted for all but four. The East Asian region, on the other hand, recorded the highest growth in both agricultural output and productivity (Turnham 1993). Moreover, a recent survey of twenty-one SSA economies showed that during the period 1960-87 productivity declined in eighteen cases, and these declines could not be explained by adverse initial conditions and political instability alone.11

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11 One of the controversies about the performance of these countries relates to the relative contributions on increased inputs and productivity growth to the spectacular increases in growth that were seen among these countries. The extreme position (developed from empirical analysis by Lawrence Lau and Jong-Il Kim in 1992)—that all increases in output could be attributed to increases in human and physical capital inputs and labor force growth—has not been validated by more recent analysis. Instead, for most countries in this group productivity increases seem to have been positive and in most may account for about 30 percent of the growth in output (see Alwyn Young, 1994; John Page, 1994; and Nirvikar Singh and Hung Trice, 1994) for estimates. Paul Krugman's recent article in Foreign Affairs ("The Myth Of Asia's Miracle", November-December 1994), which selectively uses the recent empirical studies, draws faulty conclusions about the sustainability of East Asian growth by attributing output growth almost exclusively to factor accumulation, as in the former Soviet Union. Also see Vikram Nehru and Ashok Dhareshwar, May 1994.
Table 4: Agricultural Income, Labor Force and Productivity

<table>
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<tr>
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<th>Agricultural Income</th>
<th>Agricultural Labor Force</th>
<th>Productivity</th>
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<tr>
<td>(average annual growth rate)</td>
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</tr>
<tr>
<td>SSA</td>
<td>1.9</td>
<td>1.6</td>
<td>0.3</td>
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<td>East Asia</td>
<td>3.2</td>
<td>1.0</td>
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<tr>
<td>South Asia</td>
<td>2.4</td>
<td>1.7</td>
<td>0.6</td>
</tr>
</tbody>
</table>


Growth in Manufacturing Value Added

In Africa, growth in manufacturing value added exceeded 8 percent a year in the 1960s, but this initial surge did not last (World Bank, 1989). Unlike Asia, Africa continued with high protectionist barriers against imports of manufactures, long after these industries ceased to produce growth. Import substitution industries depended heavily on imported inputs and were vulnerable to foreign exchange shortages, as oil prices increased and other commodity prices fell. Growth in manufacturing value added in Africa declined in the first half of the 1970s, and was negative in the second half. The share of manufacturing in GDP and employment has stagnated at about 11 percent and 9 percent respectively.\(^\text{12}\)

The four East Asian "tigers" and Southeast Asia have sustained growth rates of manufacturing value added in excess of 12 percent and 11 percent a year from 1965 to 1992. In contrast, Africa's slow pace of industrialization is disappointing. Especially during the late 1980s, when Asian countries accelerated industrialization, Sub-Saharan Africa's industrial value added slowed to an annual rate of 1.3 percent (World Bank 1994d).

Export Performance

Rapid export growth provided the foundation for industrialization in East and Southeast Asia. In Indonesia, Malaysia and Thailand, while primary exports played a prominent role in the 1960s and 1970s, the share of manufactured exports in total

\(^{12}\) During the period, 1965-87, rising petroleum production accounted for about 5 percent of the annual growth of industrial output.
exports rose from 6 percent or less in 1965 to 41 percent, 61 percent and 77 percent respectively in 1992 (see Figure 5). In Africa, the manufacturing share of exports was 7 percent in 1965 and only 8 percent in 1990.

Figure 5: Share of Manufactured Exports in Total Exports

![Figure 5: Share of Manufactured Exports in Total Exports](image)

Source: Bank Economic and Social Data base (BESD), The World Bank.

During the 1960s, export volumes from Africa grew on average by 6 percent a year. Since 1973, Africa's total export volume (including that of oil exporters) has declined by about 0.7 percent a year. Agricultural exports, which had grown at 2 percent a year during the 1960s, declined in the 1970s through the mid-1980s. African exporters have failed even to maintain their world market shares in the commodities in which they had a comparative advantage (Tomich, Roemer and Vincent 1994). In cocoa, coffee, rubber, spices, tin and tropical vegetable oils, African countries have lost their world market shares to Indonesia, Malaysia and Thailand. The structure of Africa's exports has remained largely unchanged since the early 1960s, with a heavy reliance on primary commodities, including oil. These accounted for 83 percent of merchandise exports in 1970 and 76 percent in 1992. The extent to which this dependence itself explains Africa's poor development performance is examined in Box 1, where it is not found to be a decisive factor.
Box 1: Commodity Dependence and Economic Growth

Africa's economic decline is frequently attributed to external factors, mainly unfavorable terms of trade. Over the first half of the 1980s, despite the fall in Africa's terms of trade, terms of trade remained higher than in the 1960s. Overall, the Africa region has experienced a positive income effect of terms of trade changes since 1961 (in constant prices). There is ample variation in individual country export price trends. However, terms of trade movements from 1970 to 1988 for groups of countries show no empirical evidence to support the hypothesis of strongly differentiated terms of trade, or a much greater impact on Sub-Saharan Africa, compared to Asia, and fail to explain the divergence of GDP and export growth since the 1970s.

*Global Economic Prospects* (World Bank 1994a) examines the extent to which trends in world commodity markets are responsible for the poor performance of low-income primary commodity exporters in Africa. Although the economic growth of non-oil commodity exporters as a group declined during the last three decades, and commodity trade, as a share of world trade has declined, several LDC commodity exporters have been very successful at maintaining high growth rates. To name a few, Malaysia, Thailand, Brazil, and Chile were heavily dependent on primary commodities for export earnings a few decades back. Today, they have successfully diversified their export base, and are no longer dependent on primary commodities for export earnings. Virtually every one of these countries has also experienced a higher GDP growth rate compared to the average non-oil commodity exporter.

Technical progress in commodities has helped some of the traditional commodity exporters like Southeast Asia to achieve rapid economic growth while commodity production and exports declined. Productivity growth in agriculture has allowed manufacturing to draw labor without a fall in primary production. In Sub-Saharan Africa, on the other hand, post-independence strategies of import substitution have impeded competitiveness in the primary export sectors. As agricultural productivity has stagnated, agricultural exports have failed to provide the base for further industrialization.

The decisive difference in this area of policy is the role that was assigned to the agricultural sector in East Asia, compared to Africa. In Asia, the sector was regarded as a key source of growth and employment provision. Through appropriate pricing policies, agricultural savings were generated, and these were available for two purposes: a part was available as financial savings which were available for the private sector to borrow for investment in industry; a second part was used for reinvestment in agriculture. In Africa, in contrast, agricultural savings were extracted through low producer prices offered by state marketing boards, and used to finance government consumption and inappropriate industrialization policies via investment in public enterprises. In East Asia, the emerging private industrial sector further boosted government revenues, permitting strong government actions in support of agriculture, including investment in infrastructure, provision of extension services, investment in research, especially in end-uses, and, more controversially, provision of subsidies for the use of fertilizers and for replanting with improved varieties, notably in palm oil and
rubber. The justification for the latter was to compensate farmers for the loss of tree-crop income until the new varieties became productive.\textsuperscript{13}

**Figure 6: Real Growth in Merchandise Exports**

![Bar chart showing real growth in merchandise exports from 1970-80 to 1980-92 for different regions.](image)

Source: Bank Economic and Social Data base (BESD), The World Bank.

**Issues Arising from the Preceding Overview**

This quick review of development patterns in East Asia and Africa in the past three decades guides the rest of the analysis of this paper, and in three key respects.

(a) Given a similar physical and human resource endowment in Southeast Asia and Africa at the start of the period, development strategies and government policies must have made a significant difference to the final outcome. Some of the general characteristics of these policies have been itemized in the above section, but, as argued earlier, this really needs to be seen in the context of individual country circumstances. Therefore, the country comparisons in the next section of the paper, are carried out

\textsuperscript{13} This contrasting pattern can also be seen in the case of China. There, the agricultural sector was exploited for many years through low farmer prices, to finance a massive state-led investment in industry. After the launching of the reform program in 1978, agricultural prices and reform were the first thing to be addressed, and immediately generated a response in terms of output and economic growth. Moreover, the new rural savings then financed the rapid development of small-scale rural industry, which has been the strongest source of growth since the mid-1980s, which has in turn boosted the local tax base, and led to increased local investment.
with a particular view to the development of government policies over
time, and how these affected development paths.

(b) Two clear lessons that emerged from the East Asia Miracle Study were
the following:

- That this was no “miracle”, in that the record of East Asian
countries is fundamentally explained by sound policies; and

- That the foundation of these policies was the maintenance of sound
macroeconomic management, which can be regarded as the
necessary condition for development success.

It therefore seems appropriate to devote some space in this paper to a
clear restatement of the elements of that sound macroeconomic strategy.
In the rest of this paper, considerable emphasis is given to exchange rate
management as a key aspect of macroeconomic policy. However, this is
not to downplay in any respect the critical role that sound fiscal and
monetary policies have played in East Asia, especially in the promotion
of domestic savings and investment. Indeed, it is those very policies
that have facilitated exchange rate management, especially in South-East
Asia. It will have to be constantly re-emphasized that most of the
additional measures that East Asian countries have adopted to
encourage the development of their manufacturing sectors were only
successful because they were carried out in the presence of these sound
basics.

(c) What is undoubtedly the most striking phenomenon from this brief
overview is the rapid growth of export-oriented manufacturing in East
Asia, and especially in Southeast Asia during the 1980s. In this regard
there are distinct differences between the supporting policy framework
in East Asia and in Southeast Asian countries. In East Asia, the direct
role of the state was very important, notably through strong industrial
policies, the use of directed credit to implement such policies, and
through financial repression to ensure that directed credit would be
effective. The Southeast Asian countries did not favor such policies,
perhaps recognizing their own relative weakness in administrative
capacity. However, these governments did intervene in market-friendly
ways to support the development of this sector, essentially by placing
the sector at the top of all national priorities, and assessing other
policies—such as exchange rate policies—by the extent to which they
helped or hindered the export sector. Therefore, the third part of this
paper looks at the ways that different East Asian countries have supported this sector, and compares the application of these policies with such past attempts in Africa.
SIDE-BY-SIDE COUNTRY COMPARISONS

This section of the paper, looks at the development path of the three Southeast Asian economies—Indonesia, Malaysia and Thailand—but in individual comparisons with African economies with a similar background. While the first of these—Indonesia and Nigeria—is perhaps obvious and has been done before, the other comparisons appear to be equally valid and enlightening. Cote d'Ivoire is compared with Malaysia, in many respects its rival in export markets, and Thailand with both Tanzania and Ghana. What emerges in each case is the critical nature of certain government policies, and above all, the fundamental importance of exchange rate policies. Another factor is, (despite the distance that now exists between these groups of countries,) that the emergence of the gap is a relatively recent phenomenon, suggesting hope for the future if an appropriate policy environment can be sustained over a period of years.

NIGERIA AND INDONESIA

Nigeria and Indonesia have a wealth of natural resources, mainly primary energy resources and agricultural land. In the early 1960s, Nigeria was ahead of Indonesia in several aspects: income per capita was US$ 762 against Indonesia's $461; savings, investment, and export shares of GDP were 29 percent, 15 percent and 40 percent, compared to Indonesia's 8 percent, 8 percent and 13 percent; the share of manufacturing in GDP was 7 percent and 8 percent respectively, and primary and secondary school enrollments were 70 percent and 19 percent in Nigeria, and 72 percent and 12 percent in Indonesia.

The experience of these two countries over the past three decades illustrates how critical it is to undertake timely adjustments in the exchange rate in response to shocks and imbalances. In 1972, fuel exports accounted for 83 percent and 51 percent of total export earnings in Nigeria and Indonesia. During the oil crisis period, 1973 to 1981, these two large producers collected sizable windfalls from oil revenues, amounting to about 20 percent of GDP (World Bank 1994e). Indonesia spent its income cautiously and grew steadily. Nigeria encountered a substantial decline in GDP per capita growth after 1973, and by the end of the 1980s, its real GDP per capita was below that in 1973 (see Figure 7).
Figure 7: Real GDP Per Capita, Nigeria and Indonesia, 1960-93

![Real GDP Per Capita Chart]

Source: Bank Economic and Social Data base (BESD), The World Bank.

Government Behavior and the Fiscal Deficit

The oil boom increased Nigeria's oil revenues fivefold between 1972 and 1974, (constituting percent of total revenue), and financed massive increases in public investment. Government expenditures doubled between 1973 and 1974, and again between 1974 and 1975. Most of these investments were undertaken without due attention to their economic viability. Large investments in roads, ports and social services raised the relative prices of non-tradables, and undermined the non-oil export base in cocoa, groundnuts and cotton (World Bank 1993 b). Although oil revenues had sustained a budget surplus, by 1976, Nigeria's federal and state budgets began to show deficits. In 1983, with the fall in oil prices, the budget deficit/GDP reached 13 percent. The government financed its fiscal and external imbalances by incurring debt, depleting international reserves, and going into arrears in external payments.

Indonesia's fiscal policy was more conservative, due partly to the balanced budget law.\textsuperscript{14} Also, Indonesia's increase and subsequent decline in government consumption was not as dramatic. While Nigeria directed spending to the cities, and most agricultural and non-agricultural spending went to large-scale capital-intensive projects with low returns, Indonesia balanced its investments between physical infrastructure, agricultural development and education, and directed most spending to

\textsuperscript{14} This prohibits government spending to exceed revenues, including official foreign borrowing.
rural areas. When oil prices collapsed, Nigeria slashed investment, and Indonesia continued to invest a large share of its GDP (World Bank 1994e).

Exchange Rate Policy

The effects of "Dutch disease" influenced both countries. Real exchange rate (RER) movements in Nigeria and Indonesia are shown in Figure 8. In Nigeria, the real exchange rate appreciated almost 50 percent by the end of the second oil price increase in 1981, and continued to appreciate (by about 40 percent) despite a drop in oil revenues between 1981 and 1983. Nigeria did not adjust to these external imbalances. Policymakers rode the oil boom up to its peak, until the economy reached a crisis in 1983-84 (Lewis and McPherson 1994). Oil prices declined by 40 percent from their 1980 level, export earnings fell by 75 percent, and foreign exchange problems emerged. The GDP growth rate in 1983 was -6.7 percent, non-oil sector growth fell to -9.3 percent and petroleum sector growth to -2.5 percent. The government resorted to trade controls, including foreign exchange rationing, restrictions of import licenses, and import deposit programs. In 1983, per capita private consumption in real terms was 20 percent below its 1978-79 level. Between 1980 and 1984, urban income declined by 34 percent and rural income by 20 percent (World Bank 1994 e). This crisis drove Nigeria to devalue in 1986 and 1987.15

Figure 8: Real Exchange Rates, Nigeria and Indonesia, 1980-92

Source: Demery 1994.

15 Gelb & Associates argue that Nigeria’s growth rate would have been higher without oil revenues. It would have been higher if Nigeria had avoided the real exchange rate appreciations between 1974 and 1984. Indonesia actually had a greater real exchange rate appreciation than Nigeria after the first oil boom in 1973-74, but devalued sooner, in 1978.
In 1978, Indonesia devalued substantially even though export earnings were rising sharply. This was driven by concern over what the real exchange rate appreciation of the previous six years had done to the competitiveness of the non-oil sector (Lewis and McPherson 1994). When oil prices declined in 1983, total export earnings did not drop off as drastically as it did in Nigeria. Indonesia's further careful devaluations in 1983 and 1986 were sufficient to stimulate a substantial non-oil export boom. Indonesia had an explicit exchange rate policy, based on some notion of an appropriate real rate, while Nigeria simply fixed its nominal rate and maintained until foreign reserves ran out (Lewis and McPherson 1994).

Table 5: Selected Economic Indicators, Nigeria, and Indonesia

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<tbody>
<tr>
<td>Public consumption (% of GDP)</td>
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<td></td>
</tr>
<tr>
<td>Indonesia</td>
<td>7.3</td>
<td>9.5</td>
<td>10.9</td>
<td>9.2</td>
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<tr>
<td>Nigeria</td>
<td>8.4</td>
<td>12.4</td>
<td>15.6</td>
<td>11.6</td>
</tr>
<tr>
<td>Investment (% of GDP)</td>
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<tr>
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<td>23.3</td>
<td>28.1</td>
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<tr>
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<td>26.5</td>
<td>16.5</td>
<td>15.5</td>
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<tr>
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<td>0.9</td>
<td>1.3</td>
</tr>
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<td>1.2</td>
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<td>0.5</td>
<td>1.3</td>
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Growth in the Productive Sectors and Exports

Agriculture

The rising public expenditures fueled by oil revenues shifted Nigeria's production from agriculture to services. During the period 1970 to 1984, agricultural GDP declined at an average annual rate of 0.1 percent, while services grew at 10 percent. In 1986 and 1987, however, substantial devaluations led to a cumulative depreciation of the real exchange rate (RER) by 51 percent between 1986 and 1992. This combined with trade policy reforms shifted relative prices in favor of the rural sector, and revived production in traditional food crops and exports of cash crops. Agricultural output grew at an average of 5 percent between 1987 and 1992. Cocoa output increased by 122 percent in volume terms between 1986 and 1990. The grain
equivalent tonnage of all domestic foods rose by over 31 percent, yielding an annual growth rate of nearly 5 percent (Husain and Faruqee 1994).  

Indonesia's sustained annual agricultural growth of 4 percent over the period 1965-90, was driven by the 4 percent per year increase in rice output. This drive for self-sufficiency in rice was based on a strategy of massive investments in agricultural infrastructure and services, a favorable incentive regime (including large fertilizer subsidies), and strong central direction. The government played a major role in the development of tree crops and the diversification of farm crops. The former included subsidized credit for expanding smallholder plots, while diversification efforts focused on special programs in sugarcane and soybean. These policies however, were not as successful as in the rice sector.

Manufacturing

Nigeria's manufacturing output increased by 5.1 percent and 12.9 percent in 1987 and 1988, compared with a decline of 3.9 percent in 1986. Textile output, which had dropped by 40 percent between 1981-86, more than doubled over the period 1986 to 1989. Nigeria's manufacturing exports as a share of total exports, however, have remained at about 1 percent (see Table 6).

In 1986, Indonesia's devaluation and the sharp appreciation of the yen boosted Indonesia's comparative advantage in labor-intensive production. Manufacturing exports, which had been primarily based on the exploitation of natural resources, witnessed a notable shift to labor-intensive products. The share of unskilled labor-intensive output in total output increased marginally, from 22.9 percent to 26.2 percent between 1977 and 1988. However, the share of unskilled labor-intensive exports in total exports grew rapidly, from 1.8 percent in 1977 to 22.9 percent in 1988. Manufactured exports as a share of total exports in Indonesia increased from 2 percent in 1972 to 41 percent in 1991.

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16 It was this performance that led to Nigeria's inclusion among the successful adjusters in Adjustment in Africa. (World Bank 1994e).
Table 6: Structure of Export Earnings, Nigeria and Indonesia

<table>
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<tr>
<th></th>
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<th>1992</th>
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<tr>
<td>Manufactures</td>
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<td>1.1</td>
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<p>| | | | |</p>
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<td>Indonesia</td>
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<td>Nonfuel Primary Prod.</td>
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<tr>
<td>Manufactures</td>
<td>1.2</td>
<td>13.2</td>
<td>47.6</td>
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</table>

Source: Bank Economic and Social Data base (BESD), The World Bank.

The main lessons that emerge from this country comparison are that Indonesia actively adjusted—mainly through timely devaluations—in response to external shocks, and followed prudent fiscal policies, focusing public investments on agriculture and infrastructure in rural areas. These swift macroeconomic countermeasures allowed Indonesia to avoid the problems of "Dutch disease", and convert the wealth from primary exports into sustainable development in other sectors. Nigeria, on the other hand, passively waited until a crisis forced a devaluation (Lewis and McPherson 1994). Massive public investments in projects with poor long-run returns, mainly in the urban areas, shifted the terms of trade in favor of non-tradables, almost destroying agricultural production and exports. However, the lessons from Nigeria’s temporarily successful adjustment during the period 1986-92 are twofold: the restoration of an appropriate policy framework can yield rapid results even after a sustained period of inappropriate policies; and such a recovery can be equally rapidly stifled if such policies are not maintained.
COTE D'IVOIRE AND MALAYSIA

Cote d'Ivoire and Malaysia have rich endowments of agricultural cropland and have relied on primary commodities for export earnings over most of the past three decades. In the 1960s, agriculture accounted for about 48 percent of GDP in Cote d'Ivoire, and primary commodities—dominated by cocoa, coffee and timber—brought in 95 percent of export earnings. In Malaysia, agriculture's share of GDP and total exports was 35 percent and 70 percent respectively. Primary commodities, mainly rubber, tin, and palm oil, accounted for over 85 percent of total export earnings. During the 1960s and 1970s, both these economies were highly susceptible to terms of trade shocks. For Cote d'Ivoire, this was due to its increasing dependence on cocoa and coffee, which represented 22 percent and 8 percent of total world trade by volume by the end of the 1970s, and for Malaysia, because of the large share of exports (55 percent) and imports (42 percent) in GDP. A secondary reason for this comparison is that in 1970, Cote d'Ivoire had reached middle-income status, and was judged the most likely country in Africa to succeed; Malaysia, in the aftermath of the civil strife and communist uprising, was considered the East Asian country with perhaps the dimmest prospects.

GDP Growth

Figure 9 shows real GDP per capita income growth in Cote d'Ivoire and Malaysia. Few SSA countries achieved anything like the economic success enjoyed by Cote d'Ivoire in the 1960s and 1970s, when GDP growth rates averaged 12 percent and 6 percent per annum respectively. In 1976, however, this steady growth was disrupted by a favorable external shock—a surge in coffee and cocoa prices—and events took a different course. Following the commodity boom, both Cote d'Ivoire and Malaysia experienced periods of destabilization stemming mainly from lax fiscal discipline: Cote d'Ivoire from 1975 to 1980; and Malaysia, from 1979 to 1984. When prices entered a persistent downward trend in the 1980s, Malaysia acted through fiscal contraction and exchange rate depreciation to restore macroeconomic balance, and to shift the economy to a sustainable growth path. Cote d'Ivoire, however, failed to control public expenditures. This, combined with an appreciation of the real exchange rate in the late 1980s has hindered adjustment and growth in Cote d'Ivoire. Annual GDP growth in Malaysia averaged 8.4 percent since the recession in 1985/86, while the figure in Cote d'Ivoire was -0.2 percent during the period 1981-90.

17 Even the East Asian economies—Taiwan, China, Korea, Singapore and Hong Kong—could not match the 12.4 percent per annum GDP growth rate achieved by Cote d'Ivoire during the period 1961 to 1970.
Figure 9: Real GDP Per Capita, Cote d'Ivoire and Malaysia

Source: Bank Economic and Social Data base (BESD), The World Bank.

Sectoral Policies Prior to the Commodity Boom

In the 1960s, Cote d'Ivoire invested in cocoa and other export crops, but continued to increase its dependence on coffee and cocoa. Malaysia implemented a range of policies designed to intensify and diversify agricultural production, including the provision of input subsidies, extension services, research support, water and drainage supply. These programs had a particularly strong impact on rice acreage and productivity. During the years 1961 to 1970, agricultural and rural development accounted for 22.3 percent of spending, while industrial development received only 2.4 percent (Demery 1994). The government also promoted import substitution in manufacturing through selective quotas and tariffs, but it did not protect manufacturing at the expense of agriculture. The main form of industrial intervention was the creation of a favorable investment climate. The 1970s witnessed a significant structural change in Malaysia: in agriculture, programs in palm oil, cocoa cultivation and forestry were accelerated; and in industry, policies shifted to export promotion.

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18 The Central Bank closely monitored inflation, and the 1960s were marked by unusually stable prices. Malaysia had a balanced budget and a balance in the external current account. The foreign currency debt was about 10 percent of annual exports.
Cote d'Ivoire's Ambitious Investment Program and the Period of Destabilization: 1975-80

The expectation that the world economy was entering a phase of increased commodity prices in the 1980s underlay the fiscal expansion in Cote d'Ivoire in the late 1970s. Between 1975 and 1977 international coffee and cocoa prices doubled, and Ivorian terms of trade increased dramatically (see Figure 10). The government held producer prices significantly below world market levels through the Agriculture Price Stabilization Fund. The receipts (which totaled 16 percent of GDP in 1977 and half of all government revenue during the period 1976 to 1980), were used to embark on an ambitious investment program in 1976. This plan, Cote d'Ivoire 2000, was characterized by significant public sector overspending on low-yielding infrastructure projects, and underinvestment in tradables (Demery 1994). The price boom was short-lived, and Cote d'Ivoire's export prices fell by 30 percent between 1977 and 1980. However, expectations of high prices, especially for cocoa, influenced the government's expenditure plans. The commodity boom and the coinciding investment boom, partly financed by internal borrowing, eventually led to increased domestic inflation, an appreciation of the real effective exchange rate and the loss of international competitiveness during the latter half of the 1970s (Demery 1994).

Figure 10: Exchange Rate and Terms of Trade Movements in Cote d'Ivoire

The RER appreciation combined with trade policies seriously distorted domestic incentives and resource allocation during the years 1976 to 1982. Overall, agriculture and exports were taxed heavily, while importables received positive net
protection.\textsuperscript{19} Total exports, cash crop and manufactured exports, which were projected to grow at 7.3 percent, 5.4 percent and 15.9 percent annually under Cote d'Ivoire 2000, grew at only 4.2 percent, 3.6 percent and 7.4 percent respectively. Building and public works, grew at an annual rate of 11.1 percent, compared to the projected rate of 9.3 percent. National savings fell dramatically, from 25 percent of GDP in 1977 to 6.8 percent in 1981, further destabilizing the economy. The low savings combined with the poor export performance meant greater foreign borrowing to finance the investment program, particularly by the public sector. External debt surged from 20 percent of GDP in 1970 to 50 percent in 1980, and the fiscal deficit mushroomed to 12.2 percent of GDP. Higher world interest rates following the second oil price shock contributed to increased debt service, and a financial crisis in the early 1980s. The debt-to-export ratio, projected at 7.5 percent under Cote d'Ivoire 2000, increased to 18 percent in 1978-80. A large share of the debt was to commercial banks, which left the government even more vulnerable to interest rates (Demery 1994).

\textit{A Lag in Expectations, an Unprecedented Fiscal Expansion in Malaysia: 1979-84}

Malaysia's macroeconomic imbalances stemmed from three factors: the rapid deterioration in the terms of trade, due mainly to the OECD recession, expansionary fiscal policies, and an appreciation of the nominal and real exchange rates. The Malaysian government perceived the adverse commodity price movements in the early 1980s as being merely temporary. On the strength of high expected commodity revenues, the government aspired to counteract deflationary effects by embarking on an unprecedented fiscal expansion in 1981-82. This led to serious macro imbalances. Higher GDP growth (averaging 7.3 percent per annum over the period 1979 to 1984) was achieved at the cost of higher inflation and greater current account and fiscal deficits.\textsuperscript{20} Investment financing, which had largely depended on domestic savings in the first half of the 1970s, shifted to external borrowing after 1980. Foreign borrowing during the years 1981 to 1984 (accounting for 40 percent of federal deficit financing), led to the emergence of a significant debt overhang, the financing of which placed further strains on external balances (Demery and Demery 1992). The large inflows of external capital placed upward pressure on the nominal exchange rate, and combined with the fiscal expansion, caused a major appreciation in the real exchange rate (see

\textsuperscript{19} Schiff and Valdes estimate that agricultural producers were taxed at a rate of 49 percent in nominal terms over the period 1960 to 1982: 23.3 percent from exchange rate distortions; and 25.7 percent from direct trade, other tax and price-setting distortions. Exportables and importables received protection rates of -78 percent and 7 percent respectively, during 1976-82 (Demery 1994).

\textsuperscript{20} Inflation increased from 3.6 percent in 1979 to almost 10 percent in 1981, and the current account deteriorated from a surplus of 4.4 percent of GDP in 1979 to a deficit of over 13 percent in 1982. The government deficit increased from around 14 percent of GDP in the late 1970s to over 27 percent in 1981-82.
Moreover, government expenditures on non-tradables aggravated the RER appreciation, and had adverse effects on resource allocation during the period 1980 to 1984. The rate of growth in manufacturing real value added, which had averaged 12 percent between 1974 and 1979, declined to 8.5 percent during the years 1980 to 1984. Construction and services increased their respective growth rates from 8.2 percent and 9.6 percent between 1974 and 1979 to 11 percent and 12 percent during the period 1980 to 1984.

**Figure 11: Exchange Rate and Terms of Trade Movements in Malaysia**

![Graph showing exchange rate and terms of trade movements in Malaysia](image)


**Adjustment in Cote d'Ivoire and Malaysia**

The appropriateness of exchange rate policies proved to be a crucial factor in restoring competitiveness in both economies. In Cote d'Ivoire, the pegging of the CFA franc to the French franc constrained adjustment efforts in the 1980s. During the years 1980 to 1983, Cote d'Ivoire's RER depreciated due to improvements in the relative inflation rate, and the depreciation of the French franc. Since 1983, however, the strong appreciation of the French franc has driven the real exchange rate appreciation, undermining Cote d'Ivoire's competitiveness.\(^2\) Devaluations by trading partners, mainly Ghana and Nigeria, have also contributed to the adverse real exchange rate movement. The lack of policy instruments to respond to the deteriorating external environment in the latter half of the 1980s, forced the government to rely on

\(^2\) Cote d'Ivoire's relative price index moved in the right direction, (from 113.5 in 1983 to 86.1 in 1991), but this has not been sufficient to compensate for the strengthening French franc since 1983.
expenditure reduction in an attempt to restore competitiveness and export growth. In agriculture, a subsidy-cum-tariff scheme was used to mimic an exchange rate depreciation, but failed as fiscal constraints prevented the timely payment of export subsidies. Value added in agriculture, which grew at an annual rate of 3.8 percent between 1965 and 1980 (with the export crop sector growing by 6.5 percent annually), declined at an annual rate of 1.5 percent from 1980 to 1987 (with the export crop declining by 0.5 percent annually). Ivorian manufacturers in textiles, footwear, electronic equipment, appliances and vehicle industries were hurt as import controls were lifted during a phase when the real exchange rate was appreciating and competitors were devaluing. Over the period 1987-91, industrial growth declined at an annual rate of 6.3 percent, and manufacturing value added and exports fell at annual rates of 2.2 percent and 1.6 percent. Although contractionary fiscal policies combined with increased revenues from commodities during 1984-86 closed the fiscal deficit to 3 percent of GDP in 1986, given the declining terms of trade and commodity revenues since 1987, the fiscal deficit increased to 13.1 percent in 1991 (Demery 1994).

In Malaysia, the worsening terms of trade and the external debt position forced a change of policies in 1984. Fiscal contraction and an exchange rate depreciation were used to restore external balance and the competitiveness of the tradable sector. The significant reduction in capital inflows over the years between 1984 and 1986, and the moderation in domestic inflation inevitably led to almost a 30 percent real exchange rate depreciation over the period 1985 to 1987.22

The deterioration in Malaysia's competitiveness during the first half of the 1980s is attributed to two main factors: the appreciation of the real exchange rate, and the increase in domestic-currency unit labor costs. By the same token, the improvement in exports after 1986 was due to improved competitiveness of Malaysian manufacturing, arising from the same two factors -- a depreciation of the RER and a decline in unit labor costs (Demery and Demery 1992). Real wages grew at average annual rates of just under 2 percent during the 1970s, 6.6 percent during the period 1981 to 1984, and 6.0 percent in 1985 and 1986. In 1986-87, both nominal and real wages declined. A second round of market liberalization and more active promotion of private sector growth occurred in 1985 and 1986. The Promotion of Investment Act of 1986 provided a range of incentives for manufacturing, agriculture and tourism, and included small- and medium-scale enterprises. These reforms were rewarded by higher foreign direct investment (FDI) by a new wave of Asian newly industrialized economies (NIEs), particularly Taiwan, China.23 Taiwan, China's investments increased from a

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22 The nominal depreciation was about 25 percent over 1984-87 (Demery and Demery, 1992).

23 FDI had grown from 0.9 percent of GNP in 1968 to 6.3 percent in 1974 (and 19 percent of GDP). FDI dropped, however, to 3.9 percent in 1975, and continued to slide to 2.9 percent in 1979, during the push towards equity objectives and the Investment Coordination Act (ICA) in 1975.
scanty 0.3 percent of approved FDI in 1982 to 36.0 percent in 1990 (passing even Japan).

Malaysia's steady growth and industrialization are based on strategic thinking in agriculture, a flexible government and strong macroeconomic management. Judicious crop selection and agricultural research enabled Malaysia to diversify the export base in the very early stages of development, and increase agricultural productivity. Effective government policies, except for a lapse in fiscal management during 1981-82, have redirected commodity rents to investment in other tradables, and successfully transformed the economy along with a strong performance from agriculture. This is certainly a lesson for Cote d'Ivoire as well as other resource-rich commodity exporters.

Figure 12: Growth in Manufacturing Value Added

Source: Bank Economic and Social Data base (BESD), The World Bank.

The ICA aimed at controlling industrialization and enforcing the New Economic Policy goals (NEP-1971) (Salleh and Meyanathan 1993).

See box on Malaysia's Penang Free Trade Zone in Part III.
Figure 13: Real Growth in Manufactured Exports

Source: Bank Economic and Social Data base (BESD), The World Bank.
TANZANIA, GHANA AND THAILAND

Tanzania, Ghana and Thailand have a broad range of natural resources, including arable land, forests and minerals, and have traditionally depended on primary production and exports. In 1970, agriculture accounted for roughly 41 percent and 47 percent and 26 percent of GDP respectively. Commodity exports—mainly rice, rubber and palm oil in Thailand, cotton and coffee in Tanzania, and cocoa in Ghana—contributed respective shares of 92, 87 and 99 percent toward total merchandise export earnings. The service sector has played a prominent role in all three economies, and has remained the largest sector in Thailand and the second largest in Tanzania and Ghana.

GDP Growth

Figures 14 and 15 show GDP and per capita income growth. Thailand's rapid and consistent growth over the past three decades is attributed to macroeconomic stability, open trade and investment regimes, a dynamic private sector, and high rates of primary school enrollment. Tanzania's annual GDP growth averaged over 6 percent during the period 1961 to 1967, when economic policies were largely based on market forces. In 1967, the Arusha Declaration ushered in a long era of socialist policies, where the public sector was given a leading role and state control was extended throughout the economy. During the years 1967-73, GDP continued to grow at almost 5 percent annually and donor assistance increased rapidly. However, several underlying structural weaknesses emerged. Productivity of public investments and exports declined, domestic savings remained low, and government controls led to large parallel markets in goods and foreign exchange (Mans 1994). Tanzania was also affected by several external shocks, including a severe drought in 1973-1974 and the war with Uganda. Real GDP contracted each year from 1981 to 1984, and Tanzania embarked on reforms in 1986. Ghana's, annual GDP growth over the past three decades has averaged only 1.5 percent. During the early 1960s, Ghana emphasized industrialization at the expense of cocoa and mineral production. Several state-owned import-substitution industries were set up behind high tariffs, tax rebates and low interest charges. These industries performed poorly, and Ghana recorded negative GDP growth during the 1970s. The economy virtually collapsed before reforms were introduced in 1983.

Government policies toward private sector development differ markedly. In Thailand, the stable monetary environment and macroeconomic balance enabled the private sector to focus on productive investment, while in Tanzania and Ghana private

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25 The primary school enrollment rate was 83 percent even in 1960.
sector growth was actively discouraged. In Tanzania, government interventions and inefficient industrial parastatals undermined private sector development, and in Ghana, the private sector was almost destroyed by the proliferation of direct government controls, acute shortages of imported inputs, and financial imbalances. Since policy changes in the mid-1980s, however, the private sectors in Tanzania and Ghana have responded positively.

Figure 14: GDP Growth, Tanzania, Ghana and Thailand

Source: Bank Economic and Social Data base (BESD), The World Bank.

26 The growth of Thailand's private sector has, in turn, been fed by strong banks. Banks perform some of the functions of investment coordination that are undertaken by the state in most other developing countries (see Christensen and others. 1993).
Fiscal Policies and the Budget Deficit

During the decade prior to adjustment, both Tanzania and Ghana witnessed a decline in total government revenue/GDP. In Tanzania, poor economic performance especially during the period 1981 to 1984—when industrial output decreased by 15 percent a year and capacity utilization dropped to less than 25 percent—reduced revenues from sales taxes on local manufacturing. Total expenditure continued to rise, primarily due to the financing of parastatals. In Ghana, government intervention and price and distribution controls caused the expansion of unrecorded cross-border trade, causing a sharp decline in the tax base. Both countries financed the large fiscal deficit through increased domestic bank borrowing, which led to an acceleration in inflation and increasingly overvalued exchange rates.

Thailand, on the other hand, has exercised firm fiscal restraint. The rigidity of the budget process has effectively prevented politicians from responding to voter demands through development programs and public spending. Most governments have

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27 Taxes on international trade and transactions as a percentage of GDP declined from 8.1 percent in 1975 to 1.4 percent in 1980. By 1983, total tax revenues had declined to 4.6 percent of GDP—about one-third of its 1970 level. This compares with 21 percent for Africa and 14 percent for Sub-Saharan Africa (see Kapur and others 1991).

28 Inflation remained at over 30 percent per annum in Tanzania during 1981-85. In Ghana, inflation averaged 58 percent per annum during the years 1972 to 1983.
avoided raising tax rates (with the exception of customs tariff rates). Also, Thailand's budgetary law limits the deficit to no more than 20 percent of government expenditure. Following the second oil shock in 1979, the Thai government took several measures to cope with the deterioration in the fiscal and external accounts, including fiscal restraint and strong tax collection (Christensen and others 1993).

**Exchange Rate Policy**

Thailand has maintained a low and stable real exchange rate for almost four decades compared to significant appreciations in Tanzania and Ghana. In 1984, the Bank of Thailand started tying the baht to a basket of major currencies, not just the US dollar. This led to an immediate 14.8 percent devaluation of the RER (see Figure 16). It also gave the government more flexibility, as the basket was not precisely defined. In the latter half of the 1980s, when the US dollar fell against major East Asian currencies, the government allowed the dollar weight in the basket to increase, so that the baht was devalued significantly against the yen and the New Taiwan, China dollar. Between the years 1983 and 1991, the RER depreciated by nearly 30 percent. This boosted export incentives, and attracted direct foreign investment from the economies whose currencies had appreciated (Christensen and others 1993).

**Figure 16: Real Exchange Rates, Tanzania, Ghana and Thailand, 1979-93**

![Graph showing real exchange rates for Tanzania, Ghana, and Thailand from 1979 to 1993.](image)

Source: International Financial Statistics 1994, IMF.

The Tanzanian government resisted any devaluation even during the severe balance of payments crisis of the late 1970s to early 1980s. The RER appreciated significantly. The restrictive trade and exchange regimes led to a large parallel market for foreign exchange by 1984, with a prevailing exchange rate that was reportedly eight
times higher than the official rate (Mans 1994). In 1984-85, Tanzania finally devalued the exchange rate by one-third, representing a major shift in policy. Exchange rate adjustment continued under the economic recovery program, leading to a cumulative depreciation of the RER by more than 80 percent over the period 1986 to 1991. The premium in the parallel market was reduced substantially from its peak of 800 percent in 1985 to about 50 percent in 1991 (Mans 1994).

In Ghana, the exchange rate of the cedi was pegged to the US dollar and maintained at 2.75 from late 1978 until early 1983 (Kapur and others 1991). Since Ghana's inflation rate was substantially higher than those of its trading partners, the RER appreciated by 445 percent during this period. The differential between the official and parallel market rates (expressed as a percentage of the official rate) reached almost 2,100 percent in 1982 (Kapur and others 1991). The government addressed balance of payments difficulties by resorting to ad hoc restrictions on trade and payments, which fueled parallel market activities. As a central element of the recovery program, the cedi was devalued in several stages between 1983 and 1986, to correct the massive overvaluation.

Sectoral Policies, Growth and Export Performance

Agriculture

In all three economies, industrial and trade policies discriminated against agriculture, and hindered the sector's growth. In Thailand, rice exports were discouraged through significant export taxes, a multiple exchange rate system and a state monopoly which controlled exports. Although Thailand still has a low export tax on rice, this is more than counterbalanced by a variety of extension services to farmers, including (almost free) water supply, subsidized seeds and fertilizer. Beginning in 1975, the Thai government also stipulated a certain share of credit to agriculture, claiming that commercial banks were neglecting farmers. Banks were required to allocate 5 percent of their previous year's deposit base to agricultural lending. By 1987, this target reached 14 percent for direct lending to the rural sector, plus 6 percent for agribusiness. Shortfalls had to be deposited in the Bank for Agriculture and Agricultural Cooperatives (BAAC), a development bank for agriculture.

\[29\] Thailand's main agricultural activity is rice production, followed by rubber.

\[30\] In practice, commercial banks have exceeded the 6 percent target for lending to agribusiness, but their lending to agriculture has usually fallen short of the 14 percent target, requiring deposits in to the BAAC. The BAAC is quite efficient, with a recovery rate on loans of 82 percent in the late 1980s, compared to rates as low as 10 percent in many LDCs.
In Tanzania and Ghana, the increasingly interventionist role of the government hurt agricultural growth during the 1970s and early 1980s. In Tanzania, collectivization of the smallholder sector, nationalization of financial and trade concerns, and the lack of incentives for output and productivity growth contributed to the poor performance of real agricultural GDP. The decline in export crop production combined with the fall in international prices for traditional agricultural export crops caused the real value of Tanzania's merchandise exports to decrease at an average annual rate of 4.5 percent between the years 1965 to 1991. In Ghana, the continued overtaxation of cocoa farmers ruined the industry. In 1965, Ghana produced 34 percent of world cocoa output, and held a 36 percent share of world cocoa exports. During the 1970s and early 80s output fell precipitously, by 29 percent between the years 1965 to 1975 and a further 60 percent in the period 1975 to 1983. Ghana lost most of its world market share to Cote d'Ivoire, Indonesia and Malaysia. Today, Ghana's share of world cocoa output and exports is about 11 percent and 12 percent respectively.

Adjustment policies have had a positive effect on Tanzania's agriculture. Smallholders and the export sector have responded vigorously to the devaluation of the currency, the liberalization of farmgate prices, and the introduction of competition to export crop processing and marketing. The annual average real growth of export crops which was -2.8 percent from 1976 to 1980, and -7.9 percent from 1981 to 1985, showed a dramatic reversal, at 2.4 percent over the years 1986 to 91. In Ghana, however, agricultural reforms started only in the late-1980s and have been limited in extent. The performance of the sector has also been sluggish, despite evidence regarding price elasticities which suggests that Ghanaian farmers react promptly and significantly to price changes (Leechor 1994). The cocoa sector has fared better than the overall agricultural sector, as farmers have responded to reductions in the export tax and higher domestic prices by undertaking new plantings. Although the devaluation of the cedi has increased the share of world price received by cocoa farmers, the sharp descent in world cocoa prices since 1984 has, however, resulted in a fall in Ghana's producer price in real terms during the period 1988 to 1993.

31 During the period 1965 to 1983, Côte d'Ivoire's output increased rapidly, and its world market share rose from 13 percent to 30 percent. Ghanaian farmers received 15 percent -40 percent of the world price, while Ivorians received at least 66 percent. Ghana's Cocoa Marketing Board maintained a legal monopoly over domestic trade and exports, while in Côte d'Ivoire private companies traded and exported cocoa (Leechor 1994). Côte d'Ivoire's current share of world output and exports is 35 percent and 36 percent.
Table 7: Structure and Growth of Production in Tanzania, Ghana and Thailand

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(Average annual growth rate)

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<td>Ghana</td>
<td>-0.3 1.2</td>
<td>-1.0 4.0</td>
<td>-0.5 4.1</td>
<td>1.1 6.7</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Bank Economic and Social Data base (BESD), The World Bank.

Industry

Thailand's industrial policies during the 1960s and 1970s favored large-scale producers in capital-intensive, import-substituting industries. Capital-intensive manufactures, mainly textiles, automobiles and pharmaceuticals were heavily protected. This policy had a significant effect on the pattern of industrialization, and

Table 8: Structure of Merchandise Exports

<table>
<thead>
<tr>
<th>Fuels, minerals and metals</th>
<th>Other Primary Commodities</th>
<th>Manufactures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Thailand</td>
<td>15 2</td>
<td>77 32</td>
</tr>
<tr>
<td>Tanzania</td>
<td>7 4</td>
<td>80 81</td>
</tr>
<tr>
<td>Ghana</td>
<td>13 15</td>
<td>86 84</td>
</tr>
</tbody>
</table>

Source: Bank Economic and Social Data base (BESD), The World Bank.
helps to explain why industry's share of GDP rose steadily from 25 percent in 1970 to about 34 percent in 1988, while industry's share of the labor force increased only from 6 percent to 11 percent. In the 1980s, policies shifted in favor of exports, with traditional light manufacturing industries—garments and leather products—increasing their share of manufacturing value added from 20 percent to 23 percent, and heavy industries decreasing its share from 43 percent to 37 percent. Although Thailand has become a major exporter of manufactures, labor-intensive manufactures have not had the same effect on production and employment as it has had in other Southeast Asian economies.

**Figure 17: Growth in Merchandise Exports, Tanzania, Ghana and Thailand**

![Chart showing growth in merchandise exports for Tanzania, Ghana, and Thailand between 1970-1982.](image)

Source: Bank Economic and Social Data base (BESD), The World Bank.

In the 1970s, Tanzania's major import substitution drive led by state investment in parastatals had generated a 3.7 percent per annum growth rate in manufacturing. The years 1979 to 1986, however, were a period of rapid deindustrialization, due mainly to the shortage of imports. Capacity utilization in manufacturing fell from 75 percent to 25 percent over the period 1975 to 1985, and the share of manufactures in GDP declined from 12 percent to 6 percent between 1979 and 1986 (Mans 1994). Since 1986, the reduction in the anti-export bias and greater profitability in exports have led to an increase in Tanzania's manufacturing output and exports. The policy environment has also encouraged the entry and expansion of industrial firms, and discouraged inefficient producers. In Ghana, the fastest growing sectors since 1983 have been industry and services. Industrial activity has been boosted by the removal of

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32 A World Bank Survey indicates that competitive efficiency in the industrial sector has improved between 1985 and 1990. Inefficient firms (generating negative value added), which had survived and even expanded, with the assistance of protection from imports and subsidized credit, had contracted their output by 22 percent over the period 1985-90 (Mans 1994).
price distortions, the increased availability of foreign exchange and imported inputs, and foreign investment in mining. Between 1983 and 1990, the volume of gold and total mining production increased by over 60 percent, while manufacturing output increased by over 80 percent. The favorable macroeconomic climate also benefited the service sector, mainly transport and trade, which are crucial to the marketing of agricultural and manufacturing output, and employ a large part of the urban sector.

Thailand’s experience illustrates that a developing economy can do very well by emphasizing the fundamentals: macroeconomic stability, a strong private sector including an efficient financial system, outward orientation, and sustained investments in primary education and rural infrastructure. It is true that some of Thailand’s sectoral interventions have been poorly managed and ineffective, and that export success came relatively late with the pro-export exchange rate policies and friendly FDI framework. This case is an important lesson not only for Tanzania and Ghana, but also for other developing countries with insufficient bureaucratic and institutional capacities.
PART II. THE IMPORTANCE OF BASICS

The *East Asian Miracle* study (World Bank 1993a) describes an useful evaluative framework that may be adopted for the purposes of this study. It looks at the three important functions of economic management—accumulation, allocation and productivity change. It then associates policy choices (basics and selective interventions), instruments (market and non-market competitive disciplines), and outcomes (growth rates and equality) with these functions. Keeping this in view, the study turns to an examination of the basics.

MACROECONOMIC STABILITY

The five pillars of macroeconomic stability in the East Asian late successes (the relevant comparators for this exercise) were: *pro-savings policies,* *maintenance of sustainable fiscal positions,* *low inflation,* *competitive exchange rates,* and *rapid corrective responses to macroeconomic disequilibria.* Clearly, these pillars are mutually reinforcing.

Pro-Savings Policies

Several instruments were used to raise domestic savings. Private savings range between 14 percent and 19 percent of GDP today, compared to an average of 9 percent in the SSA countries, with a range of -13 percent to 37 percent of GDP. Public savings have served to augment the domestic savings pool when needed. Thus, not only has there been an ability to finance much of investment out of domestic resources, it has also been possible to limit budget deficits to manageable levels.

There are two aspects to the private savings performance. *First,* savings (defined as private sector income less consumption) rose as a proportion of total income. This may be attributed to several factors—shifting demographics, trade restrictions on consumer goods, low inflation, high forced savings, and a rapid growth of incomes. *Second,* a larger proportion of the savings pool was held in financial assets in the domestic financial system, thereby facilitating their transfer to support productive activities in these economies. The common factors in stimulating both effects were the existence of low inflation and high forced savings. In addition, the financialization of savings was aided by policies that retained or enhanced the attractiveness of financial assets denominated in the domestic currency. Such policies included positive interest rates (even during periods when rates were administered), realistic exchange rates, and

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33 It should be noted, however, that for countries at the high end of the range, the private savings numbers contain a large component related to the savings of parastatal organizations misclassified in the private sector.
periodic interventions to reduce financial system risks (or the perception of such risks). In addition, the extended reach of existing institutional networks was utilized to make savings instruments available to all segments of the population at low private transactions costs.\(^3\) The deliberate pace at which the capital account of the balance of payments was liberalized in all East Asian countries (except Hong Kong and Indonesia) is also judged to be an important factor promoting the retention of savings in domestic financial assets.

**Sustainable Fiscal Positions**

Developing an absolute standard for the appropriate size of a fiscal deficit is impractical (and perhaps perilous). Even if the public sector is identified correctly, cross country comparisons become complex. Thus, for example, even by SSA standards (where the median size of central government deficits has been 9 percent of GDP over the past five years) Malaysia's fiscal deficit, which averaged 11 percent of GDP (reaching 17 percent of GDP during the period 1981 to 1983) is massive. Seen from the viewpoint of the public sector's draught on total resources, the East Asian economies have not been too far behind the socialist economies or the Nordic social democratic governments. The sum of taxation, seigniorage transfers, and domestic borrowing by the governments of the East Asian economies has been a significantly larger proportion of output than among most SSA countries.\(^5\) From the viewpoint of macroeconomic stabilization, rating the effect of a particular fiscal stance is a more complex matter than mere measurement of tax ratios, government savings, or the overall deficit.

Instead, the sustainability of a fiscal position is a key determinant of macroeconomic stability.\(^6\) The evidence on both central government and public sector

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\(^3\) The use of mobile banks by private intermediaries and active promotion of postal savings schemes by the government are two examples.

\(^5\) In addition to taxation, all of the public sector's access to resources at below market rates is relevant, not just the take from seigniorage, as it represents a non-transparent “tax” on the private sector. An important reason for the administrative management of interest rates in many economies has been to provide the public sector with access to cheap funds—for the same level of borrowing, the amount of “tax” transferred to the government because of below market interest rates is proportional to the degree of financial repression. With the exception of Indonesia since 1969, large volumes of resources were commandeered through this mechanism. Access to the government trust funds (for example, forced savings mechanisms such as the Employee Provident Fund in Malaysia) were important sources of noninflationary financing. Interest rates on savings in such institutions typically remained below even commercial bank deposit rates until the late 1980s.

\(^6\) It should be noted that all of the later successes, and even Korea, have at times acquired high levels of external debt. Pro-savings policies for the private sector and rapid growth in aggregate output
budget deficits in the East Asian economies shows that, except for brief episodes when budget deficits became excessively large, they were generally managed at sustainable levels. Several practical guidelines may be developed for SSA countries. First, the external debt problem (and increasingly domestic debt in many countries) looms larger in SSA macroeconomic policy-making than elsewhere among developing countries. It is reasonable, therefore, that in the first instance, rating the sustainability of a particular fiscal position should begin with the use of simple, but robust, measures developed in the context of the debt dynamics models. Second, given the low level of private savings, there is a need for greater attention being paid to government savings. A critical factor in achieving macroeconomic stability in East Asia has been the early focus on improved revenue effort and, perhaps more important, curbs on government consumption. Several East Asian economies ran budget surpluses for long periods. Third, continued attention to the sources of financing of the overall deficit is justified. However, in addition to evaluation of the inflationary consequences of alternative forms of financing, it would be useful to measure the total “take” of the government from the resource pool. Evidence from Latin America suggests that too large a “capture” by the government could have a severe effect on both savings and investment by the private sector.

Low Inflation

Despite some episodes of high inflation, control over inflation has played a key role in East Asian macroeconomic management. There are, however, few lessons in this area for most SSA countries. Inflationary financing of budget deficits is controlled under most Bank/IMF programs, although implementation has been poor in most cases. A key factor in the management of inflation, as seen in the high performance East Asian countries, is the consistency with which anti-inflation policies have been followed. Consequently, inflationary expectations were checked, with favorable effects on the behavior of economic actors. This is unfortunately not true of many SSA countries, which have demonstrated significant variations through time in fighting inflation. More important, perhaps, has been the slow response time of many SSA countries to episodes of imported or domestic price shocks. A significant feature of the East Asian experience has been the rapidity with which governments have reacted to such shocks, realigning domestic prices and exercising adequate monetary and fiscal control.

37 A preliminary estimate for SSA countries suggests that, despite recent reductions in the size of central government deficits in many economies, twenty-eight of thirty-three countries for which data are available have unsustainable fiscal positions.
Competitive Exchange Rates

The key to managing the real exchange rate in East Asia’s successes has been low inflation. Given low inflation, East Asia’s exchange rate management regimes have evolved over the long term in a generally similar pattern—pegging to a key currency, accompanied by quick adjustment to macroeconomic shocks when they occurred, followed by adjustable pegs, and finally managed floats. The remarkable stability in the real exchange rate has been a key factor in managing the incentive regime, promoting macroeconomic stability, and enhancing the attractiveness of domestic financial assets. This is in sharp contrast to the Latin American experience, unfortunately fed into SSA adjustment programs without much criticism, which relied on extraordinary innovations in nominal exchange rate management to obtain the necessary real exchange rate outcomes. In most cases it has been difficult to keep many of the macroeconomic fundamentals in line to produce desirable outcomes. So the real exchange rate has been very volatile for a number of SSA economies. As discussed in a number of recent studies, this may have had an adverse effect on the supply response in a number of SSA countries (Mustapha Rouis and others 1994).

GREATER OUTWARD ORIENTATION

As yet, just one of the three lessons (trade liberalization, manufactured export promotion, and openness to foreign technology and investment) from the outward orientation of the East Asian successes has been internalized in terms of practical guidelines for policymakers in SSA countries. The pattern of trade liberalization adopted by several SSA reformers is not dissimilar to that of East Asia—it is marked by gradualism, even in the removal of non-tariff barriers, although it could be argued that many import regimes in SSA continue to be less transparent than elsewhere. This is a critical difference. The persistence of non-tariff barriers in most of the early successes among the NIEs has drawn a lot of attention in the context of multilateral trade negotiations. What remains relatively unnoticed is the substantial prevalence of such barriers in the regimes of even the later successes, especially Indonesia. However, the rules tend to be transparent and in the public domain, including the application and removal of particular barriers. Moreover, tariff rates have been reduced gradually and duty exemptions are rare, limited chiefly to those bound by international agreements.

In addition to the favorable effects on government revenues, the effects of the trade regime have been to align relative prices closely with international prices (thereby promoting allocative efficiency), provide a level playing field for all importers, and apply constant, but firm, competitive pressure on domestic entrepreneurs to promote technical efficiency. In terms of policy, therefore, one of the most significant lessons from the second generation East Asian successes for trade liberalization in African economies is the need to abolish import licensing and enhance currency convertibility on the current account of the balance of payments. There is a vast body of evidence accumulating from surveys of private firms in SSA that access to import licenses and
foreign exchange are critical constraints on production and investment. This point has not been discussed adequately in our economic dialogue, focusing perhaps excessively on the exchange rate, rather than the unhampered availability of foreign exchange.

In a few instances, East Asian style manufactured export promotion efforts have been initiated in the SSA countries. In several countries—for example, Kenya, Ghana and Zimbabwe—programs have begun to provide free trade status to exporters, pre-shipment financing, and firm level assistance on technology and market penetration. (See Section III for a discussion of the specific results of these attempts.) Such polices have been supported by changes in the incentive regime, chiefly the real exchange rate. However, most efforts are still relatively uncoordinated, lacking the single-mindedness with which the export push was pursued in the East Asian successes. Clearly, the problem lies less with not knowing the elements of a successful export strategy, and more with the inability to implement such policies in economies that continue to be characterized by fundamental macroeconomic disequilibria.

While the ingredients of a manufactured export push are understood, but not implemented effectively, those for the acquisition and use of foreign technology and investment promotion seem neither to be understood nor implemented. Regarding the former, the central problem is foreign exchange controls. Without exception, SSA countries lack modernized technology policies. Instead, what is termed a technology policy is usually a modified exchange control policy that regulates purchases of technology, the terms of royalty payments and associated fees, and the use of expatriate technical personnel. Consequently, most countries are unable to avail themselves of relatively cheap off-the-shelf technologies for upgrading production, especially for export markets where quality standards are more demanding. Moreover, investment codes developed to regulate foreign investment do not in general show an appreciation for the burgeoning volume of cross border service, management and technology contracts that have been consummated elsewhere in recent years. One of the most significant elements of East Asian success has been the ability of governments and private firms to acquire the needed knowledge and expertise in a timely fashion. Policies have, in general, encouraged the search for and absorption of foreign technology. For SSA, there is a strong argument for rapid movement toward the elimination of exchange controls on current account transactions, as a necessary first step to designing improved and outward oriented technology policies for SSA.

Despite policy pronouncements to the contrary, there continues to be an aversion in most SSA countries to direct foreign investment. This, rather than lack of investor interest, may be the first order of problem that needs to be tackled. A survey of investment policies demonstrates a relatively greater emphasis on investment codes—that is, on regulatory mechanisms—than on investment promotion. Arguably, the greater need among most SSA countries is to increase the total volume of foreign investment. This is achieved best through an integrated program of macroeconomic and structural policy measures, as in the East Asian economies. Moreover, there is
clear synergy between policies to promote domestic and foreign investment, as links between foreign and domestic firms are the most important channels for investment and technology flows.

Investment codes, however, are intended to ensure a particular pattern of foreign investment. While useful, investment promotion tends to get sidelined in such codes, or are tied too closely to regulation of the pattern of investment than to the generic macroeconomic and structural changes under way. SSA investment codes place heavy reliance on outmoded fiscal and other incentives, despite evidence that points to their relative ineffectiveness (and high costs) in attracting foreign investment. Several initiatives are under consideration currently to forge stronger links between foreign and domestic firms. These include risk mitigation schemes for foreign investors, government mechanisms providing grant funding and information flows to build buyer-seller links, and equity funding mechanisms (for example, country funds) to tap small investor resources. The antecedents of some of these initiatives are to be found in the practices of Indonesia, Japan, Korea and Singapore.

INVESTMENT IN HUMAN CAPITAL

In nearly all the East Asian high performers, the growth and transformation of educational and training systems during the past three decades has been dramatic (World Bank 1993a). The quantity and quality of schooling, and training in the home improved simultaneously. Except for Thailand, the quantity of basic education provided to boys and girls of school age has been consistently higher in the high-performing Asian economies than in economies with similar levels of income. Singapore and Hong Kong achieved universal primary education in 1965. Indonesia, with its vast population, achieved a primary enrollment rate above 70 percent. By 1987, East Asia's superior education systems were evident at the secondary level. In school quality, often measured by the performance of children on tests of cognitive skills, standardized across economies, East Asian children tended to perform better than children from other developing countries, and even, recently, better than children from high-income economies (World Bank 1993a).

What accounts for East Asia's exceptional performance? Higher shares of national income devoted to education cannot fully explain the larger accumulation of human capital in the high-performing Asian economies. In both 1960 and 1989, public expenditures on education as a percentage of GNP was not much higher in East Asia than elsewhere. In 1960, the share was 2.2 percent for all developing countries, 2.4 percent for Sub-Saharan Africa, and 2.5 percent for East Asia. During the three decades that followed, governments in other regions as well as in East Asia increased the share of national output they invested in formal education. In fact, Sub-Saharan

38 This study does not deal in-depth with educational policy and investment in human capital. See East Asia Miracle for details on these topics. This section is drawn from the Miracle study.
Africa’s share of 4.1 percent was higher than East Asia’s 3.7 percent, and the rest of the developing world’s 3.6 percent. High income growth, early demographic transitions, and more equal income distribution were all enabling factors. However, the decisive factor in East Asia’s success was the allocation of public expenditure between basic and higher education. East Asia consistently allocated a higher share of public expenditure on education to basic education than elsewhere. The share of public funds allocated to tertiary education in East Asia has tended to be low, averaging roughly 15 percent during the past three decades, compared to Africa’s 24 percent (World Bank 1993 a:199). Asian governments stimulated the demand for higher education, while relying to a large extent on the private sector to satisfy that demand. In Africa, notably Kenya, low public funding of primary and secondary education resulted in poorly qualified children from low-income backgrounds being pushed entirely out of the educational system.

SELECTIVE INTERVENTIONS

The success of East Asia has been erroneously attributed to the selective strategic interventions that were undertaken by them to speed industrialization. However, a careful reading of their experience, especially of the later successes would suggest a different conclusion, and several practical guidelines for policymakers.

Initially, it is important to identify the nature of such interventions. Generally, they fall under the rubric of “industrial policy”—defined in one set of recent studies as “deliberate attempts to change a country’s industrial structure, usually to encourage the growth of capital intensive industries” (Leipziger and Thomas 1994). The evidence shows that a number of instruments were employed to reach industrial policy objectives—financial repression, tax/subsidy policies, public provision of goods and services, socialization of risks through public guarantees and bailouts, even restrictive labor regulations. Some lessons for countries in SSA are summarized below:

(a) All SSA countries are characterized by long periods of extensive intervention, with a significantly wider ambit than in any of the Asian successes. Such interventions have been justified by a multiplicity of goals—changes in ownership, correction of rural-urban imbalance, food security, and rapid industrialization. Although public policy is expected to serve a number of goals simultaneously, it is unclear whether an adequate distinction was made to match instruments to objectives, nor is it evident that the “rules of the game” were transparent and arbitrated impartially. Consequently, most economies are mired in often contradictory policies and programs, each offering high rents to selected segments of their populations. There is need for greater clarity of objectives, and a fuller understanding of the effects of particular instruments on specific and economy-wide outcomes.
(b) Not all East Asian economies have intervened with a heavy hand. By the end of the 1980s, even the early successes, noted for more interventionist strategies, relied almost entirely on the market-place and private initiative, rather than public intervention, to guide economic activity. More important, even during the interventionist phases, not all interventions were successful. The key success factors were:

- high levels of technical and administrative capacity, stability, and performance standards on the part of the bureaucracy involved in the implementation of industrial policy;

- clear understandings between firms, the general public, and the government about objectives and performance requirements;

- non-interference by the government in day-to-day operations and decision-making by private firms;

- use of international prices and demanding export performance criteria to measure efficiency and performance;

- extreme selectivity with regard to the amount, duration and form in which assistance was extended to firms; and

- early modification or reversal of policies when they resulted in adverse economy-wide effects or macroeconomic disequilibria.

As demonstrated by East Asia, industrial strategies governed by such considerations, and founded on a solid base of the economic fundamentals identified here, have a greater chance of success than the traditional pattern of interventions found in most of the SSA countries today. Many of the East Asian interventions cannot be replicated in today’s more restrictive international trading environment, nor can most be afforded by (human and financial) resource-strapped governments in Africa. Under these circumstances, a strong case may be made for public policy to concentrate on the basics, supplemented by appropriate actions to provide support for the construction of infrastructure, human resource development, international marketing, and the acquisition and use of technology.

The remainder of this paper considers the heterodox policies used as selective interventions to supplement the successful basic policies. As noted in Part I, these policies are at present only for consideration by that group of leading SSA countries that have made progress with the basics. However, as the ranks of such countries grow, they will increasingly ask what they can do to supplement these basic policies, given East Asia’s success.
PART III. THE HETERODOX APPROACHES OF EAST

AND SOUTHEAST ASIA

This part of the paper turns to those heterodox policies that a number of East Asian countries have pursued. It is not possible to cover all such policies, and nor would they all be relevant. Moreover, no claim is made to originality in that these issues have been considered many times. Indeed, there have been many attempts to apply some of these lessons in Africa. Rather, with the benefits of hindsight, this report attempts to draw out the practical lessons and the essence of these policies, in the hope that this will clarify the policy implications for today.

These policies are aimed primarily at the development of exports, especially manufactures. These policies would only be of relevance for Africa if its comparative advantage, at present or in the near future, were also to be in this area. There are those who contend this is misguided, given Africa's endowment in raw materials and agriculture. However, we are convinced more by the evidence that already exists of Africa's competitiveness in labor-intensive exports (Biggs et al., 1994). Moreover, the purpose of the comparisons in Part II was to show how Africa's comparative advantage is likely to evolve given favorable policies. Finally, given the need in most African countries to restrain or reduce domestic demand in order to maintain or achieve stabilization, increasing the demand for exports seems to us the only route to strong economic growth in Africa. Indeed, it is our view that the disappointing growth performance in Africa in the last fifteen years can be attributed in no small measure to the absence of an unequivocal commitment to exporting.

The policies considered are: industrial promotion policies, and especially the bureaucratic capacity required; public sector-private sector consultation fora, and the related creation of public-private trust; export development policies, and especially the use of duty-free import systems and credit mechanisms; free trade/export processing zones, and their potential role in stimulating the development of manufactured exports; the role of the state in the provision of industrial training to supplement basic education; and finally, in Part IV the role of managed exchange rates in the export development strategy. Part V of this paper looks at whether these considerations have operational implications for future interactions between the World Bank and Sub-Saharan Africa.

39 See, for example, the works of Bruton.

40 This paper does not attempt to develop a theory as to how such policies are translated into productivity gains, or even whether the growth associated with such policies is generated by such gains or by capital accumulation. Rather, we note the policies that were associated with growth, positing that appropriate adaptation of such policies in Africa could have similar results.
We should also note at the outset that this is a selective, rather than a comprehensive list of relevant policies. They are chosen not so much for their relevance to Africa, but rather because they are what distinguishes the East Asian experience, and whose relevance therefore needs to be assessed. There are a number of other constraints to export development in Africa -- labor market rigidities, the legal framework, entry/exit regulations, barriers to foreign direct investment, lack of business support services, access to working capital and technology, cash crops strangled by monopsonistic marketing boards -- that may be equally important if export development is to get under way. The correct mix of policies to address these constraints will be a matter for country-based analysis. Indeed, in many countries, the solution will not be to introduce more intervention via Asian-style policies, but rather to reduce intervention that discourages private sector activity. But in many cases, the following sections offer examples of policies that could contribute significantly to export incentives in Africa.

INDUSTRIAL PROMOTION AND POLICY

Among the heterodox approaches adopted by the East Asian high performing economies, industrial (promotion) policy has been the most controversial. Its proponents cite the concrete experiences of Japan, South Korea, and Taiwan, China as prima facie evidence for its effectiveness in speeding up economic development (Amsden 1989; Wade, 1990; Yamamura 1988). But while they have established the undeniable existence of a number of instruments that were available to and utilized by these countries for the purpose of promoting industrial change, they have still to show conclusively that industrial policy has made a significant difference. Lacking a counterfactual, such an exercise may prove to be undoable. "The question of whether measures designed by a well-meaning bureaucracy can achieve results superior to those which a more liberal market system would produce is impossible to answer conclusively; what would have happened in the absence of the intervention is always unknown (Wade 1990: 30)."

But the fact that the economies of Japan, South Korea, and Taiwan, China, have exhibited the most rapid economic change over the last thirty years suggests that the whole idea of industrial policy cannot be simply dismissed. To be sure, most developing countries have adopted some form of industrial policy. In the 1950s and 1960s, for instance, it was both fashionable and common among developing country governments to provide incentives to so-called pioneer industries. What distinguishes the three Northeast Asian countries from others is their use of industrial policy to alter

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41 For an overview of how important are these constraints to African enterprises, the reader is directed to the results of Regional Program for Enterprise Development (Biggs et al, 1995).
the structure of the manufacturing sector. That is, while industrial policies of most
developing countries have been functional in nature, i.e. industry neutral, policies in the
three countries have been targeted, i.e. biased towards promoting specific industries. It is this type of industrial policy that has caused extensive debate among scholars and practitioners.

Part of the debate follows from the absence of an economic theory upon which
to establish the technical merits of industrial policy. The theory of late-late
industrializers is the closest thing to such a theory (Amsden 1989). Growth leads to
increased investment in plant and equipment (which necessarily embody foreign
technology), to greater demand for output (which speeds up the realization of scale
economies), and to a more rapid accumulation of experience with the imported
technology (which facilitates learning). Then, it necessarily feeds back into
productivity increases. Thus, for late-late industrializers, high speed growth through a
growth-productivity cycle is potentially achievable. This is essentially what the
experience of South Korea, the quintessential late-late industrializer, suggests.

However, this same experience also suggests that the task of achieving it is very
complex. For example, overvalued exchange rates are needed to facilitate the import
of foreign technology. At the same time, a properly valued, if not undervalued,
exchange rate is needed to spur industrial exports. Targeted industrial policy is
logically consistent with Amsden's theory: it creates price distortions that direct
investment towards specific, higher value added industries. Such industries facilitate
the infusion of foreign technology. While the theory provides some rationale for
pursuing targeted industrial policy, it does not offer a practical way of evaluating its
effectiveness.

References:

42 Some refer to this as creating if not picking winners.

43 Amsden argues that developing countries today, so-called late-late industrializers, face starkly
different circumstances than did the late industrializers, United States and Germany, during the
late 19th century and early to mid 20th centuries. England is considered the first industrialized
nation. The United States and Germany caught up with it and then, after the Second World War,
Japan. The economies of Korea and Taiwan, China appear to be well on their way to
emulating Japan, at even faster growth rates. Both dislodged England from economic supremacy
through technological innovations. Both were at the world technological frontier at the time of
their ascendancy. Consequently, productivity growth through technical change became the driving
force behind their economic growth. Developing countries today however fall far below the world
technological frontier. Hence, for them, economic growth must come from different sources.
"First, increases in productivity come from imports of foreign technology. Second, they come from
operating foreign technology on a scale sufficient to minimize costs. Third, they come from
learning how to use foreign technology imports efficiently" (Amsden 1989: 111).

44 What Amsden calls "getting the prices wrong", a necessary requirement according to this theory.
In the absence of such a measure, it is difficult to establish how and why such policies might help facilitate economic development in Sub-Saharan Africa. This issue therefore has to be tackled indirectly. A potentially fruitful approach is to examine the underlying prerequisites for the effective implementation of industrial policy, independent of its merits or demerits, and to determine whether the SSA countries meet those prerequisites. This approach of course would not be particularly useful if it is discovered that some of the countries do meet the prerequisites. But, if none do, then a strong argument can be made for discouraging the use of targeted industrial policy, at least at the current time.

Institutional Prerequisites Of Industrial Policy

The experience of the economies of Japan, Korea, and Taiwan, China, suggests that the first prerequisite for the proper conduct of targeted industrial policy is a stable macroeconomic environment. Table 9 lists the average inflation rates from 1961 to 1991 for the three economies and the average for each regional grouping of low- and middle-income countries. As indicated, the rates are considerably lower in these three economies. Even Korea, which has had the most serious bouts with inflation among East Asia's high performers, has had rates that fall substantially below all but one of the averages.45

The link between macroeconomic stability and targeted industrial policy has not been made explicit, but it is implicit in discussions of the experience of the three economies. In essence, prudent macroeconomic management is needed to prevent inefficiencies that could arise (through targeting) from getting out of hand. These inefficiencies generally impinge on macroeconomic variables such as the budget deficit and inflation, e.g. subsidies become burdensome. Unless there are institutional constraints that keep the deficit and inflation from exploding, the inefficiencies would continue and ultimately cause considerable harm to the economy.46 Such constraints effectively act as alarm bells for the government. Korea's retrenchment and redirection of its Heavy and Chemical Industry (HCI) Drive in the late 1970s and Malaysia's scaling down of its Heavy Industries Corporation (HICOM) in the mid-1980s are a

45 Being predominantly socialist in orientation, South Asian economies have historically had low inflation rates.

46 For example, in Japan, the Ministry of Finance has the legal authority to put limits on increases in the budget. During the early 1960s the ceiling (on increases) was placed at a generous 50 percent. But beginning in the mid-sixties, the ceiling has been progressively reduced. In the 1980s, the ceiling was set close to zero and in some years it has been negative, i.e. the budget was shrunk (Muramatsu and Pempel 1994). Other constraints could be informal, i.e. based on norms that have evolved over time.
testament to the importance of such constraints. Both occurred in response to burgeoning macroeconomic imbalances.47

<table>
<thead>
<tr>
<th>Table 9: Average Inflation Rates, 1961-91</th>
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<tbody>
<tr>
<td>Japan</td>
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<tr>
<td>Korea, Rep. of</td>
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<tr>
<td>Taiwan, China</td>
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<tr>
<td>All low-and middle-income economies</td>
</tr>
<tr>
<td>South Asia</td>
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<tr>
<td>Sub-Saharan Africa</td>
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<tr>
<td>Latin America and Caribbean</td>
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</tbody>
</table>

Note: Averages are unweighted.
Sources: World Bank data; World Bank (1992d); Taiwan, China (1992).

An important institutional prerequisite appears to be the establishment of a competent economic bureaucracy. The complexity and difficulty of managing targeted industrial policies places high demands on the economic bureaucracy. In the first place, targeted industrial policies require "getting the prices wrong". Targeted industries are given preferential treatment -- lower interest rates on loans, tax holidays, etc. -- which is analytically equivalent to offering the same commodity or service at different prices to different customers. The sad and often disastrous experience of many developing countries with import substitution, a milder form of industrial policy, testifies to the difficulty of properly managing this task. For many, this experiment resulted in wasteful rent-seeking and corruption. This brings us to the second point.

For targeted industrial policies to work, the economic bureaucracy must be able to balance financial support for targeted industries with penalties for non-performance. The various subsidies that targeted firms get are effectively rents: these are premiums which would not have materialized were it not for government intervention. Unless targeted firms understand that the awarding of these rents is contingent on meeting certain performance criteria and that failure to meet the criteria will result in severe penalties, they are likely to engage in activities that detract from policy objectives: the obtaining of subsidies, rather than the achievements of sound results, becomes the main

47 See for example Leipziger and Kim, 1993; Salleh and Meyanathan 1993.
aim. The economies of Japan, Korea, and Taiwan, China all had economic bureaucracies capable of imposing discipline on private industry.

These two prerequisites are only necessary conditions. Box 2 on the Korean HCI Drive and Box 3 on Malaysia's HICOM highlight this point. Both South Korea and Malaysia have had a long history of (relatively) stable macroeconomic management and both have reasonably competent economic bureaucracies (World Bank 1993a, and Part I of this paper). And yet one, Korea, has had guarded success with targeted industrial policy and the other, Malaysia, has met mostly with failure.

---

**Box 2: Korea's HCI Drive**

Korea's development of heavy and chemical industries is one of the success stories that proponents of targeted industrial policy often cite. In 1972, the government embarked on an ambitious program to build strategic upstream industries with the objective of moving the economy rapidly towards production of higher value added products capable of competing in international markets. The program covered five heavy and chemical industries -- shipbuilding, petrochemicals, iron and steel, machinery, non-ferrous metals -- as well as electronics and automobiles.

Considerable work has been done by various individuals and institutions to evaluate the success of the HCI program. Much of this work points to the heavy burden, i.e. cost, that the program imposed on the economy. Among the costs often cited are: the long delay in establishing an independent financial sector; efficiency losses due to the relative decline of the small and medium sized enterprise sector; and a slight worsening of income distribution. Juxtaposed against this however is the continued strong growth of the economy throughout the HCI period48 and the emergence of remarkable success stories in steel, automobile manufacturing, shipbuilding, and electronics (particularly in the production of semiconductors). An evaluation of the program by the World Bank was in fact rather balanced and mildly supportive. "The HCI drive was overambitious and resulted in serious misallocation of resources. Nevertheless . . . many of the goals of that policy were in fact achieved. Exports of HCI did not quite reach the target of 50% of total exports by 1980, but exceeded the target only a few years later and reached 56% in 1983 . . . In a comprehensive dynamic perspective, it is difficult to demonstrate that an alternative policy would have worked better" (World Bank 1987: 45). Given the numerous debates about the program and the absence of any counterfactual, it would be difficult to pass unequivocal judgment. But at the same time it would be difficult to call the program a failure.

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48 In fact, the country experienced among the highest annual GNP growth rates during the HCI period (1972-1979). The average for the period was in fact about 9.7% per year.
Box 3: The Heavy Industries Corporation of Malaysia (HICOM)

In 1980, the Malaysian government created HICOM, a public enterprise, with the express objective of pushing the country into the ranks of the so-called four tigers. This was part of an overall policy, the Look East Policy, which steered development strategy away from western economic models and toward the Japan Inc. model. The corporation was charged with the responsibility of establishing footholds in heavy industry including automobile manufacturing, fabricated metals, shipbuilding, petroleum refining, chemical products, and paper/paper products. Partly due to the collapse of oil prices and the world recession during the early 1980s, the corporation ran into severe problems almost immediately. "The best known of the HICOM ventures was the national car project, PROTON, a joint venture with Mitsubishi... PROTON had an initial plant capacity of 80,000 units with a plan to expand to 120,000 units in 1988... Production measured 100,000 in 1983, the year PROTON was established, and dropped to 70,000 in 1985 and 33,500 in 1987... In 1988, HICOM officials were replaced by managers from one of PROTON's foreign partner institutions" (Salleh and Meyanathan 1993: 14-15).

A look at the sources of growth over the period 1970 to 1990, which is summarized in Table 10, suggests how costly the HICOM project was to Malaysia. During the period 1981 to 1985, the overall growth rate declined. This could be attributed to the recession. But interestingly, the share of capital rose substantially to 61.1 percent from 34 percent in the preceding five year period and the share of total factor productivity, a measure of efficiency, fell to approximately zero from a share of 33 percent. This could not have been recession induced. In fact, the economy wide incremental capital output ratio increased "from 3.65 in 1971-1980 to 7.21 in 1981-1985 before dropping to 4.7 in 1986-1990. The ratio for the public sector increased from 6.75 in 1971-1980 to 15.51 in 1981-1985" (Salleh and Meyanathan 1993: 46). Gross inefficiencies had clearly emerged by 1985 and had began to impinge on growth. HICOM's operations were scaled down in 1986.

In short, running a set of successful industrial policies of the East Asian type requires a deep commitment to a stable macroeconomic framework, and an economic bureaucracy capable of running complex pricing policies, and objectively running public subsidy schemes. Do such conditions exist anywhere in Africa?

---

PROTON appears to have turned around in 1990 with its export of the Saga model, mostly to the U.K. It remains to be seen whether it can penetrate North American markets like the now successful Hyundai Excel.
Table 10: Sources of Malaysia's Growth (GDP at factor cost)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Output growth</td>
<td>6.5</td>
<td>7.72</td>
<td>5.71</td>
<td>5.93</td>
</tr>
<tr>
<td>Contribution by:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>capital</td>
<td>0.81</td>
<td>2.62</td>
<td>3.49</td>
<td>1.36</td>
</tr>
<tr>
<td>labor</td>
<td>2.52</td>
<td>2.44</td>
<td>2.47</td>
<td>2.57</td>
</tr>
<tr>
<td>(labor quality)</td>
<td>0.4</td>
<td>0.43</td>
<td>0.65</td>
<td>0.96</td>
</tr>
<tr>
<td>structural change</td>
<td>0.09</td>
<td>0.01</td>
<td>0.11</td>
<td>-0.07</td>
</tr>
<tr>
<td>residual (TFP)</td>
<td>3.03</td>
<td>2.56</td>
<td>-0.35</td>
<td>1.76</td>
</tr>
</tbody>
</table>

Source: Salleh and Meyanathan, 1993

Implications for Sub-Saharan Africa

Amongst the countries in Sub-Saharan Africa, Ghana has had the most success, however modest, with managing the macroeconomic environment. The World Bank (1994a) ranked the country highest in terms of macroeconomic policy stance. Table 11 presents the results of this ranking.

Given that prudent macroeconomic management is a prerequisite for the successful implementation of targeted industrial policies, Ghana would be the country with potential to succeed with such policies. However, Ghana would have to meet the second prerequisite: it must have a reasonably competent economic bureaucracy.

Evidence on public sector-private sector wage differentials suggest that the Ghanaian government may not be capable of recruiting and/or keeping competent individuals. Estimates of the differential for professional staff in Korea range from 57 percent to 69 percent (Campos and Root 1994), and in the economy of Taiwan, China, from 60 percent to 66 percent (World Bank 1993a). In Ghana, "median pay levels in the civil service range from 28% to 41% of private sector levels “(De Merode and Thomas 1993). But even if Ghana could indeed recruit competent personnel into its bureaucracy, other incentives are needed to make its bureaucrats perform their functions effectively.
Table 11: Countries Ranked by Overall Macroeconomic Policy Stance (1990-91)

<table>
<thead>
<tr>
<th>Adequate</th>
<th>Fair</th>
<th>Poor</th>
<th>Very Poor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ghana</td>
<td>Burundi</td>
<td>Central African Republic</td>
<td>Cote d'Ivoire</td>
</tr>
<tr>
<td></td>
<td>The Gambia</td>
<td>Niger</td>
<td>Cameroon</td>
</tr>
<tr>
<td>Madagascar</td>
<td>Benin</td>
<td>Congo</td>
<td></td>
</tr>
<tr>
<td>Malawi</td>
<td>Rwanda</td>
<td>Mozambique</td>
<td></td>
</tr>
<tr>
<td>Burkina Faso</td>
<td>Tanzania</td>
<td>Sierra Leone</td>
<td></td>
</tr>
<tr>
<td>Kenya</td>
<td>Zimbabwe</td>
<td>Zambia</td>
<td></td>
</tr>
<tr>
<td>Gabon</td>
<td>Mauritania</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nigeria</td>
<td>Senegal</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Togo</td>
<td>Mali</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Uganda</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: The World Bank 1994 p. 58 from Table 2.5.

Several indices based on surveys of businessmen regarding the quality of bureaucracies suggest that the Ghanaian bureaucracy may not be able to function effectively. ICRG (International Country Risk Guide) produces one of these surveys. Included in its annual survey are rankings of countries according to bureaucratic quality and corruption based on the subjective evaluations of businessmen.\(^5\) Scores range from zero to six with higher numbers indicating better quality and less corruption. The results for Japan, Korea, the economy of Taiwan, China and Ghana are presented in the first two columns of Table 12. Note that Ghana scores substantially below any of the other three economies on both dimensions. The last column of the table presents the results from another survey undertaken by BERI (Business Environment Risk Intelligence).\(^5\) Bureaucratic delay refers to the "speed and efficiency of the civil service including processing customs clearances, foreign exchange remittances and similar applications" and the rankings are based on scores ranging from one to four. As indicated Japan, and the economy of Taiwan, China have very close scores with Korea a half point lower. Very few African countries were included in the survey.

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50 Survey results are from 1982.

51 Survey results are for 1972.
Unfortunately, no scores were available for Ghana. However, the average for the three Sub-Saharan countries that were included -- Zaire, Kenya, and Nigeria -- was 1.27. It is therefore highly unlikely that Ghana would have scored higher than Korea.

Table 12: Evaluation of Bureaucratic Quality

<table>
<thead>
<tr>
<th>Country</th>
<th>Quality</th>
<th>Corruption</th>
<th>Delay</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan</td>
<td>6</td>
<td>6</td>
<td>2.6</td>
</tr>
<tr>
<td>Korea</td>
<td>3</td>
<td>3</td>
<td>2.1</td>
</tr>
<tr>
<td>Taiwan, China</td>
<td>5</td>
<td>5</td>
<td>2.7</td>
</tr>
<tr>
<td>Ghana</td>
<td>1</td>
<td>1</td>
<td>na</td>
</tr>
</tbody>
</table>

Source: International Country Risk Guide (ICRG) and Business Environment Risk Intelligence (BERI) surveys.

The bottom line then is that countries in Sub-Saharan Africa are unlikely to do well with targeted industrial policies. None of the countries can meet two necessary prerequisites -- the capability to properly manage the macroeconomy and competency of the economic bureaucracy. As the Malaysian experience suggests, difficulties with such policies are likely to be even more daunting for these countries because other factors come into play. As a matter of strategy, therefore, it is best that these countries stay away from adopting industrial policies. If they are to consider it at all, it would have to be long in the future and only if they can then meet the two prerequisites. Indeed, far from encouraging greater involvement of the state in Africa in directing industrial activity, the opposite is true in many African countries. Rather, the imperative is for African governments to develop more trust in private industry, focusing on removing barriers to its success, rather than on what the state thinks private industry should do.
GOVERNMENT BUSINESS RELATIONS

Conservative wisdom on government-business relations has it that, other than establishing and protecting property rights, the government should not interfere with private economic activity. While this might represent the extreme Anglo-American view, it has influenced the way many western governments have dealt with the business sector. On the other side, various forms of socialism, communism representing one extreme, has led many non-western governments toward a paranoiac view of private business: businessmen are concerned only with private gain, in whatever way it can be generated, and cannot be trusted to promote the overall welfare of society. In this view, private business activity has to be heavily controlled if not eliminated altogether. Hence, central planning becomes necessary. East Asia's high performers have turned both these views upside down. Cooperation and close collaboration between business and government has been one of the hallmarks of their success.

In a market system, information is transmitted primarily through price signals. However, because of various imperfections, prices often do not capture all the necessary information. East Asia's high performers addressed this problem by adopting a market system as the basis for its economy and then supplementing it with institutional arrangements that facilitated the flow of information between the public and private sector.

Formal institutions, called deliberation councils, have permeated the policymaking process in Japan, Korea, Malaysia, Singapore, and Thailand. These councils have performed the crucial role of facilitating interaction between government officials and private sector groups. Membership in a council generally consists of high-ranking government officials, representatives of the business community, and, in some cases, representatives of academia, consumer groups, and labor. A council serves as a forum through which government officials and private sector groups can interact repeatedly in the formulation of policies. It creates a basis for nurturing trust and for developing cooperative relations.

The main function of a council is to sift information that is needed to formulate policies that will enhance the performance of the private sector and the economy as a whole. Thus, a council helps ameliorate the informational problems inherent in real-world market systems. By implication, it helps the economic bureaucracy formulate better economic policies. But a council performs other roles as well. First, it helps minimize the deleterious effects of rent-seeking by converting "under-the-table" favor seeking or lobbying to more transparent processes of allocating rents (Campos and Lien 1994). The subsidies for exports arrangements between the Korean government and big business is the classic manifestation of this function (see Box 4). Second, it helps reduce the uncertainty that private business normally associates with respect to the policy environment and thus encourages private investment in long-term economic
activities. A council keeps policies (over which it deliberates) from being changed without prior consultation with and without prior consent of its members. And third, a council adds legitimacy to policies since the consent is sought from private parties whose fortunes may be affected by the policies (Campos and Root 1994). This makes implementation less costly since those who are to be affected have agreed to the rules that the policies embody.

Box 4: Reciprocal Performance in Korean Government-Business Relations

A striking characteristic of business-government relations in South Korea during its rapid growth phase (mid-1960s to the early 1980s) was the extent to which the government extracted good economic performance from the large business conglomerates, known as the chaebol. The government gave the chaebol considerable subsidies to undertake new activities. In return, however, it required that the chaebol meet certain performance criteria (Amsden 1989). The criteria were export based. Basically, firms had to export a certain proportion of their production and to continually increase this proportion over the years.

Continuation of the subsidies was contingent on meeting the export criteria. Failure meant withdrawal of subsidies and/or a particularly detailed audit of a chaebol's operations and finances (Haggard 1990). In effect, the government allocated rents, i.e. the subsidies, in a systematic and transparent (rule based) way and moreover did so in order to promote growth. The Monthly Economic Briefings and the Quarterly Trade Promotion Meetings, both manifestations of a deliberation council, were involved in the discussions of this arrangement and the monitoring of performance (Campos and Root 1994).

The Requisites of Deliberation Councils

Making a council system work has several requisites. First, the government must have a reasonably competent economic bureaucracy with a modicum of protection from political interference. Unless economic bureaucrats have the skills and the authority to formulate and implement good economic policies, businessmen are unlikely to take the deliberations seriously since the government has nothing much to bring to the bargaining table. Similarly, it would not make much sense for the government to initiate a deliberative process if there were no individuals in the private sector who have the requisite skills to run a business enterprise. Hence, countries with not particularly competent economic bureaucracies and/or with a scarcity of entrepreneurial skills are likely to bungle efforts at creating and institutionalizing deliberation councils.

In a related context, both bureaucrat and private sector members of a council must enjoy a high degree of respect amongst their peers. Otherwise, they will not be able to deliver on commitments made in the council. When dubious individuals act as
representatives doubts about impartiality make consensus difficult to achieve. In East Asia's councils, well-respected individuals represented their respective sectors.

It is also important for the (current) political regime to have some reasonable degree of longevity. The value of cooperation to the private sector depends in part on prospects of the regime continuing in power over the long term. If private sector agents, in particular, businessmen, expect the regime to be replaced in the near term, they are likely to discount the value of collaborative efforts quite heavily and thus will be much less willing to participate seriously in any deliberative process. This implies that, in countries where political turnover is high, councils may not be very useful.

Finally, for cooperation to emerge, there has to be a minimum level of trust between the government and the private sector. If government officials and private sector agents are mutually suspicious of each other, then it becomes very difficult to carry on fruitful discussions. Each party must be willing to give the other the benefit of the doubt. And this is unlikely when each suspects the other of devious motives. The nature of trust between the two parties depends for the most part on historical factors. In some African countries, government officials have come to view private business as the main source of inequity and corruption leading them to harass if not outlaw private business. Private business, in turn, came to view government as an expropriator of private property.

**Implications for Sub-Saharan Africa**

Given the above requisites, full-blown East Asian type government-business relations may not be feasible immediately in Sub-Saharan Africa, although steps can be taken to move in this direction.\(^5\)\(^2\) A comparison between Thailand and countries in Sub-Saharan Africa for which the relevant data is available should highlight the differences. Thailand has only recently engaged in deliberation council type relations with the creation of the Joint Private Sector-Public Sector Consultative Committee (JPPCC) in 1981 and, with the exception of Indonesia, has the least responsive bureaucracy among the high performers (World Bank 1993a). Moreover, it is the poorest among the high performers that have used deliberation councils. In other words, it likely reflects the minimum necessary requisite for deliberation councils to work and thus would make a good comparator.

\(^5\)\(^2\) South Africa, for example, has a relatively reputable economic bureaucracy and a large class of entrepreneurs. The new regime can conceivably continue to rule for a long time -- there may be different presidents but the same party is likely to dominate. And the degree of mistrust between the newly installed black controlled government and the white dominated private sector may not be as difficult to overcome particularly because many white Afrikaners have been retained in the economic bureaucracy.
Indices for bureaucratic quality, corruption, the risk of expropriation, and the risk of contract repudiation based on responses of businessmen are indicated in Table 13. The first two reflect the competence and relative political independence of the bureaucracy and the latter two the level of confidence that businessmen have in the government's predisposition to keep its promises, i.e. a trust index. The higher the indices, the higher the relative ranking of a country. As indicated, on average, the SSA countries rank below Thailand in all of the indices. This tends to be supported by whatever data is available on private investment trends. Box 5 offers a stark comparison between Thailand and Ghana.

Table 13: Survey Rankings

<table>
<thead>
<tr>
<th></th>
<th>Absence of corruption</th>
<th>Bureaucratic Quality</th>
<th>Risk of Expropriation</th>
<th>Risk of Repudiation of Government Contracts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Thailand</td>
<td>4</td>
<td>3</td>
<td>7.2</td>
<td>7</td>
</tr>
<tr>
<td>SSA Average</td>
<td>2.43</td>
<td>2.07</td>
<td>5.06</td>
<td>4.86</td>
</tr>
<tr>
<td>Std. deviation</td>
<td>1.20</td>
<td>1.05</td>
<td>1.38</td>
<td>1.02</td>
</tr>
</tbody>
</table>


This evidence suggests that, for most countries in Sub-Saharan Africa, the use of deliberation councils to facilitate business-government relations may require a lot of initial groundwork. The level of mistrust between the government and the private sector tends to be much greater than that in Thailand (and for that matter greater than in any of East Asia's high performers with the possible exception of Indonesia). Hence, any initial foray into an East Asian-type consultative process will have to focus on reducing the level of mistrust. This implies a strategy that first engages government officials and private sector representatives in repeated dialogues that attempt to solve relatively simple problems. The simpler the issues addressed, the better able each side is of delivering on its end of the bargain. As each side gains experience and as mutual confidence builds, then consultations can move on to more difficult issues, and more authority can be vested in such arrangements.

Ghana's experience with the formation of the Private Sector Advisory Group (PSAG) is consistent with this observation. The initial consultations of members of the PSAG produced a set of recommendations most of which the government was capable of implementing and which it did. Moreover, the recommendations covered policy changes that benefited large sections of the private sector and thus avoided potential charges of favoritism that more contentious and narrowly specified change might have engendered (Gupta 1993). The PSAG has been expanded into a larger
business roundtable to tackle more difficult issues. This has proven to be less promising than expected, partly because more potentially divisive problems that are also more technically demanding have been foisted on the roundtable.

**Box 5: Private Investment and Business Confidence in Ghana**

Direct objective-based measures of the lack of business confidence are difficult to obtain. But Table 14 offers some indirect evidence. The table compares Ghana to Thailand in terms of the ratio of private investment to GDP. Periods were chosen to control for the level of development, i.e. when Thailand had approximately the same per capita GNP as Ghana today. As indicated in the table, the ratio of private investment to GDP has been significantly lower in Ghana during periods when Thailand was at the same level of development. The ratio in the latter is more than quadruple that in Ghana suggesting that mistrust of both domestic and foreign investors in the Ghanaian government must be rather high. The table also compares Ghana with Thailand in terms of the distribution of GDP among the agricultural, industrial, and the service sectors. Again, periods were chosen to control for the level of development. Note that the distribution in Ghana today is drastically different from Thailand. In particular, the share of agriculture and services in Ghana during the last half of the 1980s has on average been 49.9 percent and 33.8 percent of GDP respectively while the shares for Thailand during the comparison period were 22.4 percent and 45.9 percent for services. Or alternatively, the share of industry in Ghana has been much smaller, at 16.3 percent compared to 31.7 percent in Thailand. The period during which Thailand had the same per capita GDP corresponds roughly to the period of transition from an agriculturally based economy to one based on industry (see Oshima 1993). This transition requires significant increases in private investment, in particular physical infrastructure, e.g. factories, and equipment. The significant differential in industry's share between Ghana and Thailand thus suggests that the requisite investment needed by Ghana to begin the agroindustrial transition has been absent. This is an indication of a lack of business confidence in the country's system of property rights.

Oshima (1993) shows that there is a marked jump in the share of construction and equipment in GDP during the agroindustrial transition of East Asian and Southeast Asian countries.

It should also be noted that a study of the growth of manufacturing firms in Ghana based on a panel survey of firms (Baah-Nuakoh and Teal 1993) indicates that "the Ghanaian manufacturing sector is proceeding in exactly the opposite fashion to that experienced by rapidly growing economies, in particular, Korea and Taiwan, China (p. 80). Little, Mazumdar, and Page (1988) have shown that both Taiwan, China and Korea exhibited similar patterns in the growth of their manufacturing sectors -- as manufacturing grew, the output share of small firms fell and the share of large firms increased. In Ghana, the share of the small firms has been increasing and the share of large firms falling. The panel survey also indicated that, among a long list of constraints to firm expansion including availability of credit, adequacy of demand, adequacy of infrastructure, government regulations, etc., the category labeled "Other" was mentioned as frequently by large firms as the availability of credit as a binding constraint, both exhibiting the highest percentages. These findings are consistent with the hypothesis that the business community lacks confidence in the overall business environment."
Table 14: Private Investment in Thailand and Ghana

<table>
<thead>
<tr>
<th></th>
<th>Ave. GNP/Cap</th>
<th>Priv. Inv. Share of GDP (%)</th>
<th>Share of GDP (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Thailand</strong></td>
<td>412</td>
<td>18.4</td>
<td>22.38</td>
</tr>
<tr>
<td>(1974-78)</td>
<td></td>
<td></td>
<td>31.67</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>45.95</td>
</tr>
<tr>
<td><strong>Ghana</strong></td>
<td>390</td>
<td>4.18</td>
<td>49.90</td>
</tr>
<tr>
<td>(1986-90)</td>
<td></td>
<td></td>
<td>6.26</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>33.84</td>
</tr>
</tbody>
</table>

Source: World Bank, various years.

The Thai experience further supports this point. The JPPCC was successful in helping move the Thai economy from an inward orientation based on import substitution to an outward orientation based on the export of manufactured products. But the JPPCC has not been able to move as effectively on labor policies, unlike the councils in Singapore and Japan, or on sectoral policies, as in Korea, Malaysia, and Japan (Campos and Root, 1994). Both issues are potentially divisive and require a greater level of trust among government officials and private sector groups. They also require greater bureaucratic capability.

Conclusions

The conditions under which East Asian countries were able to vest considerable powers in deliberations councils are similar to those required for the use of industrial policies. However, the consequences of failure with industrial policies are extremely high, while the use of such councils may pose less danger of costly failure.

This report’s conclusion is one that will recur throughout this section. The experience can be borrowed, but should be applied with simplicity. Councils should be created and charged with initially more straightforward tasks (FDI promotion strategies, legal and bureaucratic obstacles) before moving on to more complex (sector strategies) or more sensitive (privatization approaches, tariff reforms) issues. This requires a careful approach to terms of references and to selection, but a modest attempt seems preferable either to a “hands-off” approach or to the present situation of mistrust.
EXPORT DEVELOPMENT POLICIES

Of all the policies pursued in East Asia, "export promotion" is the most-often referred to. While this encompasses a whole range of instruments—and above all, an attitude in East Asia that put export development at the very top of the policymakers' agenda—the report focuses here on a few selected instruments that were used to encourage exports. This starts from a basic precept in international economics, that any tax on imports is a tax on exports, either through raising the cost of export production, or making the domestic market more attractive. In East Asia, one the apparent hallmarks of success has been the maintenance and encouragement of export competitiveness, while retaining some degree of domestic protection.

The key components of a rational export regime include assuring equal footing with foreign competitors in access to inputs at world market prices and to trade financing, as well as maintaining realistic exchange rates. East and Southeast Asia, in addition to maintaining realistic exchange rates, and reducing the average level of protection and its variance, pursued policies directly in support of exports, with the fundamental objective of achieving such free trade status for all export activities. Free trade—with no tariffs, taxes, import or foreign exchange restrictions—is the ideal policy goal. However, due to political and institutional rigidities, the removal of protective barriers cannot be carried out in a single step. Immediate liberalization would allow imports to displace domestic production, including infant industries that could otherwise become competitive. If not fully "compensated for" by exchange rate adjustments, immediate across-the-board liberalization would also increase balance of payment deficits and worsen the external debt burden. Therefore, granting free trade status to exporters plays a transitional role in offsetting disincentives to exports, while import protection is gradually reduced (Bhattacharya and Linn 1988: p. 76).

Free trade status for export activities can be achieved through: (i) fenced private or public free trade zones (FTZs); (ii) nonfenced FTZs; (iii) bonded manufacturing warehouses (BMWs); (iv) duty exemptions; and (v) duty drawbacks/rebates. The first three are specialized schemes, which have been widely and effectively used in countries at the early stages of development. These are considered in detail in the next section. Duty exemptions and drawbacks are economy-wide schemes that are desirable complementary systems, used especially as development advances (Rhee 1994). A duty exemption system exempts exporters from paying duties or indirect taxes on imports used in export production. The exemptions are granted at the time of importation. A duty drawback system refunds duties and indirect taxes exporters have paid on imported inputs, after they complete the exports. There are two ways of making such refunds: an individual drawback system refunds the

55 The issue of exchange rate policies is discussed in Part IV.
duties and indirect taxes paid by firms on a case by case basis; a fixed drawback system refunds the estimated duties and indirect taxes that enter into the cost of producing exports, according to a preset schedule. Specialized and economy-wide schemes should be offered in parallel, as in the economies of the Republic of Korea and Taiwan, China, so that foreign and domestic firms can choose depending on their particular needs and the relative effectiveness of the schemes (Rhee 1994). However, development experience suggests that in many low-income countries, the implementation of economy-wide schemes has been flawed, due to inadequate development of the necessary instruments, institutions, and mechanisms.

Amongst the successful East Asian exporters, the economies of Korea and Taiwan, China maintained protective import regimes until the mid-1980s, while encouraging strong export growth through a combination of policies. Exempting export inputs from the protection system was a central part of the trade regimes of both countries. Awareness of the need for such access has spread to other parts of the world, and Southeast Asia, China and Latin America have sought to emulate the Korean and Taiwanese systems (Wade 1991). In Sub-Saharan Africa, Mauritius, Madagascar, Kenya, Zimbabwe and Nigeria are among some of the countries that have tried duty exemptions and drawback schemes. While it may be difficult to precisely copy the Korean and Taiwanese systems in Africa and elsewhere, the latter can learn from these successful policies and their administration, as also from past attempts in SSA.

East Asia’s Duty Drawback and Exemption Schemes

The fundamental features of Korea’s pioneering export promotion drive were the duty drawback scheme, implemented through the domestic letter of credit (DL/C), and the export finance system. In addition, the exchange rate was managed so as to maintain Korea’s competitive position, and the entire governmental machinery was oriented towards the achievement of ambitious export targets. According to estimates, excluding exchange rate effects, Korea’s export incentives as a percentage of export value in terms of domestic currency increased from 12.8 percent in 1965 to 30.3 percent in 1971. In addition, the real effective exchange rate depreciated by 29 percent between 1965 and 1973 (Bhattacharya and Linn 1988).\footnote{The instruments selected for Korea’s export drive were comprehensive and far-reaching. They included the provision of income tax deductions, import duty exemptions and drawbacks, liberal access to pre- and postshipment and investment finance at preferential rates, export finance guarantees and credit insurance, preferential rates for electricity and rail transport, and supportive infrastructure investments, such as the provision of free trade zones.}

\footnote{In the early 1970s, however, the government’s drive in favor of heavy and chemical industries (HCl) and thus import substitution, reduced the value of export incentives to 16.5 percent of export value by 1979.}
The proper identification of indirect exporters, and the provision of inputs at world prices to indirect as well as direct exporters, were key factors in Korea's unusually successful duty exemption and drawback schemes. Input-supplying indirect exporters are critical for establishing backward linkages from exports, while output-supplying indirect exporters are critical for developing trading companies that specialize in overseas marketing. In many developing countries, export systems have failed to adequately identify indirect export activities, and pass on the benefits of export incentives to indirect exporters, particularly smaller ones. In Korea, the Input Coefficient Administration, which estimates and publishes detailed input-output coefficients, the fixed and individual drawback schemes, and the back-to-back credit system offered through Domestic Letters of Credit (DL/Cs), have been efficiently combined to provide tax free inputs and ready access to working capital finance to direct and indirect exporters. A good system of input-output coefficients allows a country to identify and assist domestic input and intermediate industries. For most Sub-Saharan African countries, where intermediate industries hardly exist, precise input-output coefficients are neither available nor perhaps necessary. However, Korea's export policies and their administration offer several lessons for countries in the early stages of export development.

Taiwan, China's duty rebate system works rather differently from Korea's, suggesting that there is more than one way to effectively organize such schemes. The three main differences between the two schemes are: (i) in Korea, the procedures start with evidence of export orders, specifically with the export L/C, while in Taiwan, China, it starts with evidence of actual exports. Even in the case of regular exporters, where the duty is put 'on account', evidence of actual exports corresponding to the 'on account' amount of imports is required; (ii) in Korea, the procedures for claiming the rebate are tightly linked with the procedures for claiming export credit, both being done through the export and domestic L/C. In Taiwan, China, these procedures are quite separate. The domestic L/C is not used. Even the export L/C does not count as a fully secure form of payment, as local banks place much weight on the fact that the foreign bank guarantees payment only if the exporter meets the terms of the contract, and hence the local banks will not normally lend against the full value of the export L/C, unless to a big company.

Indirect exporters are those who generate export value added but do not export directly. There are two types of indirect exporters: (i) input-supplying indirect exporters—who supply intermediate inputs to final stage (or next stage) export manufacturers—and (ii) output-supplying indirect exporters—who supply finished export products to trading companies that export directly (or sell to other trading companies).
Rhee (1985) states that a major factor contributing to Korea's successful export system is the pragmatic, speedy, flexible policy-making and administrative approach that is not so much a deliberate one of careful long-range planning, but more one of getting started, observing results, adjusting policy and repeating the process until the appropriate mix is found. Until the mid-1970s, Korea used a duty and indirect tax exemption system. The successful aspects of the system were the following. It assured unrestricted choice between imported and domestically produced inputs, while treating indirect exporters equally with direct exporters in assuring access to duty-free imports and other export incentives. This policy successfully extended free trade status to indirect exporters and resulted in efficient backward linkages. Administrative efficiency was achieved through two major instruments: (i) pre-tabulated and published physical input-output coefficients; and (ii) the use of trade financing procedures and documents for duty-free imports. When balance of payments problems worsened following the first oil crisis, the government switched to a drawback system, with an intention of instituting a fixed drawback system in the middle of 1975. That was a threat to free trade status in the name of administrative convenience, and when exporters expressed concern, the government introduced measures to guarantee tariff-free status. Importers of intermediate inputs used in exports have in most cases been allowed to defer paying tariffs for considerable periods. In turn, the fixed drawback system was modified by combining it with an individual drawback system. Only about 20 percent of Korea's exports had been subject to the fixed drawback system by 1980. On the basis of a complete review of its drawback system during the period 1975 to 1980, the Korean government implemented a new drawback schedule in 1981. Exporters rely on individual drawbacks for major imported input items for each export product, based on input-output coefficients listed in a drawback schedule published every six months. Fixed drawbacks are applied only to miscellaneous imported items. This new system appears to have a good balance: providing a tariff-free status is given the highest priority when major imported items are involved, while administrative simplicity is given the highest priority in the case of miscellaneous imported items.

Korea has also made continuing efforts to streamline its Input Coefficient Administration. This Administration—embracing banks, provincial governments, and the Office of Industrial Promotion in the Ministry of Commerce and Industry—estimates, updates, publishes, and administers input coefficients for most export commodities. At the end of 1982, the Administration published six volumes consolidating all the technical input-output information.

Source: Rhee 1985, pp. 83-84

Duty rebates are claimed on the basis of customs documents of exports and imports. Export credit (through banks) is much less significant, as a proportion of export value, than in Korea. More of the credit comes through suppliers credit (in the form of post-dated cheques), or buyers' credit (mainly from Japanese trading companies which
account for an estimated 30 to 50 percent of Taiwan, China’s exports). Indirect exporters cannot get export credit on the basis of documentary proof of their production for an export orders. (iii) Finally, Korea’s system differs from that of Taiwan, China’s in the area of input coefficients. For many products they have been set more generously in Korea, so as to give more of a subsidy to exports through an extra large amount of rebate (Wade 1991).

Indonesia, Malaysia and Thailand also applied export support instruments including tax incentives, duty drawbacks and exemptions, and export and investment finance. These initiatives started only in the early 1970s, and in the case of Indonesia, only in the early 1980s. In most respects, the more intensive efforts were initiated only in the early 1980s (Bhattacharya and Linn 1988). The experience with administering exemptions and drawbacks has been unsatisfactory, because of limited access (especially by small and indirect exporters) and slow and cumbersome procedures. Compared to Korea, the Southeast Asian systems have not been as comprehensive in coverage and as automatic in access. It is thus of interest that the South-East Asian countries have experienced strong export growth despite unsatisfactory rebate systems. This reflects the strength of their interventions in other areas, such as exchange rate management and training. However, those countries are still striving to eliminate the inefficiencies of their rebate mechanisms.

Indonesia introduced an export certificate system as part of its 1982 Export Policy. Misuse of the system, however, led to the government’s decision to abolish it in 1986, and establish a duty exemption (DE) and duty drawback (DD) scheme administered by the agency, BAPEKSTA. The DE system consists of preshipment inspection and clearance of imported inputs and exports, and duty and indirect tax exemptions. Input-output coefficient administration is essentially based on the “self-declared” approach, and not on “pre-tabulated standard coefficients”, and hence relies on exporters’ technical knowledge and honesty. Since 1986, Indonesia’s export system has gone through three phases: from self-declaration (May 1986 - September 1992) to prior screening of self-declared coefficients (October 1992-September 1993), and finally to post-monitoring/auditing of self-declared coefficients. The switch to the second phase implied that Indonesian authorities’ basic premise (to fully trust exporters) was proven wrong (Malik 1995). The switch to the third phase was in response to long delays caused by prior inspection and clearance.

Indonesia’s current exemption system does not extend to cover indirect exporters. Hence, backward linkages that enhance export value added are not realized. BAPEKSTA is now considering an approach based on a sales contract between the direct exporter and the indirect exporter. However, in the absence of an effective way to verify the actual delivery and quantity of the indirect export item, other than physical checking at the factory by a surveyor, the proposed mechanism is unlikely to be effective in meeting the needs of indirect exporters for speedy access to duty free imports (Malik 1995).
Box 7: Duty Rebates in Taiwan, China

Since 1955, Taiwan, China has had an import duty and indirect tax rebate scheme to assist producers of manufactured exports. A firm that is a major manufacturer-exporter is allowed to put its duty liabilities “on account”, to be canceled against evidence of subsequent exports. Firms must provide a bank guarantee that the duty plus penalties will be paid if the exports are not produced within eighteen months. The duties are reimbursed or canceled for exporters by the customs administration following presentation of documentation showing completed exports, and appropriate disposition of foreign exchange proceeds. The customs administration handles more than half a million rebate applications a year with a staff of about 200.

Either the direct exporter or one indirect exporter collects the entire rebate. The indirect exporter can collect the rebate only if the direct exporter signs over the necessary documents. Often, a large supplier of inputs that is dependent on imported raw materials systematically acquires these documents from its small exporter customers and collects the rebates. Typically, it sells to direct exporters (or extends them credit by accepting postdated cheques) at a duty free price, but it also requires a postdated check covering the duty. This check is returned uncashed once the exporting firm signs over its documents. Rebates on new products are calculated on a case-by-case basis, whereas rebates for established products are determined on the basis of published fixed rates. Both methods involve the systematic application by customs rebate officials of pre-established input-output coefficients.

To export a product not previously exported, an exporter must obtain an export license and a list of the product’s physical input-output coefficients. To work out the coefficients, government staff or consultants visit the factory, inspect its records, and examine or test the product. The list is then certified and supplied to the customs administration within a month of the exporter’s application. To get a rebate, the exporter must then provide evidence on the source and quantity of all imported and dutiable inputs used. To save administrative time, any input valued at less than 1 percent of the value (FOB) of the exported product is dropped from the calculation of the rebate. Once a product has had a long enough production history for its input and output coefficients to be fairly stable, it is switched over to the fixed-rate method. To work out the fixed rebate, the customs administration calculates the duties rebated on all inputs (direct or indirect) into the product over the previous twelve months compared with the combined value or volume of the corresponding exports for all makers of the product. The result is a standard rate based on value or a physical unit such as weight. Where technical processes and input coefficients of different firms vary widely, their exports are defined as different products with their own fixed rates. Fixed rates on about 6,000 products are published each July, reflecting changes since the previous year in prices, duties, and sources of inputs.

Once a fixed rate is in effect, exporters receive the stipulated amount of rebate only after providing evidence that they have paid (directly or indirectly) duties and indirect taxes equal to that amount. Otherwise, they receive rebates equal only to the amount they actually paid. However, details are no longer examined. If an exporting firm shows that its actual payments were more than 20 percent higher than the standard rebate, and it can give good reasons why it needs these extra imported inputs, it can apply to an interagency committee for a redefinition of its export as a separate product eligible for a higher rebate. Taiwan, China partly dismantled this system, along with protective tariffs, after the mid-1980s.

The DD system also lacks an effective transparent criteria (pre-tabulated input coefficients) for post-auditing, and mechanisms for indirect exporters. Duty drawbacks to output supplying indirect exporters are given only after the direct exporter (the trading company) succeeds in obtaining a waiver form from the indirect exporter documenting that duties have been paid. In practice, this applies to only those transactions that take place between a firm and its subsidiary companies. There is also no provision for DD for the input-supplying indirect exporter. The lack of use made of the domestic L/C system makes it difficult for BAPEKSTA to provide DE for indirect exporters. Drawback is implemented on a case-by-case basis and not only requires full documentation and delays in getting refunds, but is also expensive since the exporter has to bear interest costs compared to the lower cost of a bank guarantee under the exemption scheme (Malik 1995).

Malaysia’s prior exemption and duty drawback schemes have proved to be cumbersome and time consuming, and not accessible to indirect exporters. The “domestic availability test” and the need to obtain import licenses for commodities under quotas further limited access to imports for exporters. Also, limited monitoring provided insufficient deterrent for abuse of these schemes. In Thailand, prior exemption and individual drawbacks were available through the Customs Department; fixed drawbacks were available through the Fiscal Policy office. Both systems were time consuming, lacked convenience and did not reach indirect exporters. Thus, they were used only by a fraction of potential beneficiaries. The fixed drawback system was based on input-output value relationships derived from a highly aggregate input-output tables.

**Assuring Easy Access to Trade Financing**

In most developing countries, where money and financial markets are not well developed and are highly segmented, exporters cannot enjoy neutral status without a special export financing system. Even in countries where financial markets are developing, they typically favor large firms over small ones, and demand physical collateral that often cannot be provided by exporters. These place exporters in developing countries at a disadvantage compared to both foreign competitors and local beneficiaries of credit rationing, and make it harder to exploit the export capabilities of developing countries. Assuring easy access to financing at uniform interest rates for all activities that generate export value added is therefore critical, providing neutral status for export activities until the time arrives when competitive money and financial markets have been developed.

There are four main methods of financing trade: (i) company credit; (ii) bank credit; (iii) bank loans; and (iv) self-financing. In most developing countries, exporters cannot meet their trade financing needs through company credit or bank credit because

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59 This section is based on Rhee (1985) and Rhee (1989).
they lack modern banks and trading companies that can internalize the risk-taking. Therefore, the immediate objective of assuring access to trade financing must be met through bank loans (Rhee 1989).

The three instruments and institutions for the bank loan-based trade financing system are: (i) transaction-based, self-liquidating mechanisms for trade financing (including rediscount mechanisms of the central bank); (ii) institutions to deal with exporters' non-performance risk (i.e. preshipment export finance guarantees (PEFG)); and (iii) institutions to deal with overseas buyers' non-payment risk (i.e. export credit insurance and guarantees (ECI/G)).

In the early stages of export development, the first requirement is to produce export commodities at internationally competitive costs. Therefore, the highest priority is given to preshipment working capital loans, designed to meet financing needs for production or sales activities from the time an export order is received to the time the order is shipped. Normally, the loan period is less than 90 days, during which time the preshipment export loan becomes the critical factor in realizing a supply response. Postshipment finance (granted for up to 180 days), covers financing needs for export sales on credit from time of shipment of commodities to the time of payment. While these facilities are usually offered alongside preshipment finance, they are less important for export development in LDCs. Financial systems in the importing countries are generally well developed, and for the types of manufactured exports shipped from developing countries, exporter financing tends to be a lesser factor in buyer decisions than the quality and price of the product. Only where capital goods exports take on significant shares of exports, as in the case of Korea, will postshipment credit become significant.

Korea's trade financing system was composed of: (i) the Bank of Korea's trade transaction-based, self-liquidating trade financing disbursement/liquidation mechanisms (together with its rediscount system); (ii) the Korea Credit Guarantee Funds' PEFG; and (iii) the Korea Export-Import Bank's ECI/G. The Bank of Korea's trade financing mechanisms have been a particularly good example of successful bank loan-based trade financing. Rhee (1989) states that they made a more critical contribution to the effective implementation of the outward-oriented development strategy than did any other export policy instrument.

It is therefore not surprising that several African countries have attempted to replicate such schemes, often with explicit World Bank support. Evidently, these have yet to generate similar results to those in Korea and Taiwan, China. Why should this be so?
Box 8: The Domestic Letter of Credit and how it works

The DL/C system has been the most effective administrative tool for assuring automatic availability of export loans and free trade status to Korea's indirect exporters. The principle of a DL/C is the creation of "back-to-back credit," a vehicle through which the beneficiary of an export L/C (or other export order) can take advantage of the creditworthiness of the importer (and the availability of export incentives tied to an export order). When an exporter has an irrevocable L/C in his favor, the existence of the L/C enables the concerned bank to open a second, similar credit account on behalf of the exporter, with the input-supplying indirect exporter or output-supplying indirect exporter as the beneficiary. Thus, the indirect exporter gains access to all export incentives based on the receipt of the domestic L/C, just as the final exporter gains such access based on the receipt of an export L/C.

A DL/C is a document created by a bank that declares to the indirect exporter that the bank will pay, on behalf of the final exporter, a draft drawn on it when the indirect exporter submits, together with the draft, a receipt that the commodities have been delivered to the final exporter. Therefore, the DL/C is the most reliable and automatic instrument for verifying the transaction between the final exporter and the indirect exporter as a basis for providing duty-free access to imports destined for export production. In addition to giving access to duty-free inputs, there will be an encouragement to use the DL/C as long as the final exporter gains access to export loans for purchasing domestic inputs or finished export commodities based on the DL/C he issues, and as long as the indirect exporter can use the DL/C to gain approval for his production loans. For this mechanism to operate, it is essential that the export financing system be modernized to provide export financing along these lines.

Since the DL/C is handled by commercial banks, it also offers the advantage of delegating much of the authority for export incentive administration to the commercial banks, which generally offer greater administrative efficiency than government can provide.

Source: Bhattacharya and Linn 1988, p. 85.

Africa's Experience with Export Development Measures

Kenya

The formation of the East African Community provided an opportunity for Kenya's import substituting industrialization as well as for growth in manufactured goods exports to its neighbors. As the most industrialized country in the Community, preferential trade arrangements enabled Kenya to broaden the industrial base and increase such exports without the need for targeted trade development programs. The main form of government assistance in this period was subsidized credit through specialized financial institutions and the commercial banks.
However, the collapse of the Community and Kenya's increasing structural problems required a shift in strategy toward proactive trade development policy. After desultory attempts at reform in 1980 and 1982, and major reversals in policies thereafter, Kenya embarked, in 1988, on a process that has resulted in the progressive liberalization of imports, concrete export promotion measures, and removal of most exchange controls on current account transactions. Today, it has one of the most progressive trade and external payments regimes in Sub-Saharan Africa.

Kenya's direct and indirect export support measures draw largely on the East Asian models. Specifically, while import liberalization was introduced gradually to protect government revenues, the authorities decided in 1990 to accelerate direct and indirect export support. Until 1989, the only duty free import scheme in Kenya was the Export Compensation scheme, which provided a uniform refund of 20 percent of the export value for all listed export products. This system did not include actual duty payments as a proportion of the associated export value, and therefore represented an excessive benefit for some firms and a very inadequate one for others. In 1989, the Manufacturing Under Bond (MUB) scheme was introduced, followed by the Export Promotion Zone (EPZ) law in 1990. Finally, an Import Duty/VAT Exemption scheme, directed at exporters who were not using the Export Compensation scheme, was introduced (see Box 9).

**Zimbabwe**

In 1993, Zimbabwe had about 1,500 exporters, of which roughly 80 percent were in the manufacturing sector. Manufactured exports amounted to approximately US$ 600 million that same year. One may misinterpret this to indicate that if Zimbabwe's manufactured exports are dominated by SMEs. Rather, this suggests that export shares of most large firms--MNCs and large white enterprises--are almost negligible, reflecting the long history of inward-orientation. It appears that about 300 exporters, with the majority in primary exports, dominate Zimbabwe's exports in terms of value, access to trade and investment finance, and access to duty-free imports (Rhee 1995).

Two instruments used to encourage Zimbabwe's exports include the inward processing rebate scheme (IPR), which is a duty exemption scheme for manufactured exporters, and the individual duty drawback scheme (see Box 10). Despite the popularity of the IPR scheme, only a limited number of exporters use it compared to the duty drawback scheme. Only established direct exporters with more than one year's export performance are eligible to apply for IPR licenses to the main Customs office. The handling of input-output coefficients, known as "formulae" or "rating" in Zimbabwe, is piecemeal and non-transparent.

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60 The section on Zimbabwe, including Box 5, is drawn from Rhee 1995.
Box 9: Kenya's Export Development Policies

The early phase of Kenya’s reforms focused on correcting the overvalued real exchange rate and promoting factory-based free trade status through the Manufacturing Under Bond (MUB) schemes. The MUB scheme was subsequently modified to allow firms to sell rejects in the domestic market, and extended to new urban centers. The MUB scheme is meant only for 100 percent exporters, and has in practice been taken up primarily by local investors, with foreigners opting for the EPZ scheme. Presently, there are about forty factories in operation under the scheme, most of them garment assemblers. The system still operates on the traditional basis of having two locks on all storage areas, so that the Customs officer, who is posted full-time to an individual factory, can authorize, and physically supervise, all movements of stock, using his second lock. This procedure is, however, cumbersome, outdated, and vulnerable to abuse. The treatment of local sales in the MUB scheme is another problem. In most countries, factories are typically allowed to sell up to 5 percent of their output--genuine offcuts and seconds--in the domestic market. In Kenya’s MUB scheme arrangements for local sales appear discretionary, and of dubious fairness (Kenya Export Development Project, 1995).

The Duty Exemption scheme is operated by the Export Promotion Programmes Office (EPPO) within the Ministry of Treasury, and currently services about 140 firms. Exemptions are based on postshipment audits carried out by external audit agencies, and do not rely on customs administration. According to an evaluation in 1993, the scheme has made a commendable start at achieving duty and tax-free status for firms exporting less than 100 percent of output, as well as indirect exporters and the original beneficiaries (firms that produced 100 percent of their output directly for export). Several problems that plagued the scheme in the past, such as delays in payments through the Central Bank and associated implications for working capital needs, have improved (RPED 1993-95, Kenya Background Paper). However, the EPPO Audit Unit, which verifies ex-post that individual firms have complied with the terms of the scheme, has accumulated an extensive backlog. The scheme as a whole is still basic and unwieldy, and it has been recommended that the Treasury start to bring it in line with best practice elsewhere in the world (Kenya Export Development Project, 1995).

To meet the working capital needs of exporters, the Government of Kenya reactivated the Central Bank’s facility for rediscounting private financial paper. The facility allowed commercial banks which granted preshipment loans to exporters (against confirmed and irrevocable L/Cs or confirmed and verified export contracts) to rediscount with the Central Bank the accommodation bill created as a result of that transaction. This feature was severely abused, and turned into a financial scandal. Reportedly, instead of ensuring that pre-shipment loans be confined to confirmed and irrevocable L/Cs, the scheme as implemented allowed loans to be made to some individuals against unverified export orders.61 The export financing scheme was closed at the request of the World Bank in April 1993.

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61 These individuals presented export orders for, most often, “gold bars”. First, they received pre-shipment financing loans, denominated in Kenya Shillings, capable of being exchanged into hard currency at the official exchange rate. They then changed the hard currency back into Shillings at the higher inter-bank rate, repaid their preshipment loan, and pocketed the profits without exporting anything. The real value of alleged gold exports was so high that it was blamed for significantly affecting Kenya’s monetary growth and inflation rate (Kenya Export Development Project, 1995).
Due to the Custom's mistrust of exporters' honesty and technical competence, coefficients submitted by exporters are examined on a case-by-case basis. Furthermore, no systematic attempt is made to share the input-output coefficient information between the Drawback section and the IPR section of the Customs. Under the duty drawback scheme, while the manual checking of input-output coefficients takes three to four months to complete once an application is received at the main office, the average time to obtain drawbacks is approximately eight months. Sample data on 49 exporters who had applied for duty drawbacks indicate that the delays in receiving the drawback range from 2 to 24 months (RPED 1993-95, the Wave One Panel Survey, Zimbabwe, May 1993). Some of the main complaints of Zimbabwe's exporters include the complex procedures and the long delays in getting drawbacks.

\textsuperscript{62} Under the RPED Wave One Panel Survey in Zimbabwe, forty-nine exporters were asked about the typical delay their firm had experienced in receiving the drawback. The number of firms experiencing delays of nine, twelve, eighteen, and twenty-four months were eight, eight, three and one. Only nine firms received the drawback in less than six months.
Zimbabwe’s IPR scheme has been in operation since 1992. The scheme is similar to the Inward Processing Relief (IPR) scheme of the European Union, but its operation is similar to the special bonded manufacturing warehouse (SBMW) schemes in some developing countries, as for example, Bangladesh’s SBMWs for garment exports. The use of the IPR scheme is limited, with the total number of licenses issued so far amounting to only forty-one (twenty-seven in Harare Customs jurisdiction). Only established direct exporters with more than one year’s experience can apply for IPR licenses, despite the bonding requirements that should prevent new exporters or SME exporters from misusing the scheme. An IPR factory must be equipped with two warehouses for the storage of duty-free imported materials (i.e. Inward Processing Store) and manufactured goods to be exported (i.e. Compensating Products Store) respectively. IPR license holders must put security bonds covering at least twelve months’ export-related import duty and other import tax liabilities.

The duty drawback scheme refunds custom duties, surtaxes, and import taxes paid when exporters import raw materials and intermediate inputs, after they complete the compensating exports. Under both schemes, the Customs must approve input-output coefficients on a case-by-case basis, because they do not adopt a systematic approach of relying on pre-tabulated input-output coefficients applied uniformly for all exporters. In determining the quantity input-output coefficients to be used for drawback calculations, the Customs follow several steps. First, the Regional Customs screen the coefficients through factory visits that occur in response to exporters’ requests after importation of inputs. Second, staff at the main office manually screen drawback applications including the coefficients submitted by the Regional Customs. Although the main office checking of coefficients has been recently replaced by post-auditing in order to speed processing times, it is unclear whether the change is temporary and how the post-auditing will be carried out. The Customs officials lack the requisite technical expertise, and do not tabulate the coefficients systematically using computers, which would help to avoid approving, for example, the five separate coefficients for the identical export item of the five different applications.

Drawback claims must be filed within thirty days of acceptance of export documentations, i.e. within thirty days of the time the export bill of entry is processed. Since most exporters do the export bill of entry paperwork in advance of shipping the goods in order to avoid the congestion in doing the paperwork, frequently it is too tight to meet the thirty day deadline. There is no logical reason why the claims filing deadline should be so tight, while, in principle, duty drawbacks are allowed as long as the compensating exports occur within two years of importation (Rhee 1995).
Cote d'Ivoire's duty drawback system does not function because the administration cannot find a simple system to reimburse prepayments. The Ivorian administration's financial difficulties have also made it hard to guarantee repayment of prepaid duties. Without an effective drawback system, Cote d'Ivoire's customs suspension regime under the temporary admission system has become crucial. A major difficulty with this latter system is that exporters seeking to take advantage of benefits may use only bank guarantees if their private customs commissioner (transitaire) has no credits left with the Customs administration (Competitiveness and Regulatory Reform Adjustment Program, Implementation Completion Report, June, 1995).

In Senegal, there are five categories of duty relief arrangements in addition to the industrial free zones program. These are: (i) the drawback procedure, which permits the total, partial or lump-sum repayment of duties and taxes levied on products used in the manufacture of exports; (ii) the bonded industrial warehouse system, which is an establishment under customs control where companies working for export and/or the domestic market enjoy tax-free imports; (iii) the bonded storage warehouse system, where goods are stored under customs control, free of taxes, duties and prohibitions; (iv) temporary admissions; and (v) special temporary admissions. Under (iv) and (v), goods, contractor's equipment for the use of public works, and industrial equipment for leasing, may be imported subject to complete or partial suspension of duties and taxes. All these procedures are satisfactorily designed for the objectives for which they were set up. However, the systems are difficult for the public to cope with and are cumbersome in application, not only for the public in terms of access, but also for the customs authorities themselves. Importers bringing materials or merchandise to Senegal do not know whether they are going to pay at normal customs rates or if a reduction or exemption from existing regimes will apply in their case and, if so, which will apply (Senegal, Diagnostic Study and Recommendations on Customs Systems and Procedures, FIAS, January, 1995).

All the administrative work, apart from the establishment of the temporary admission accounts, is performed manually. Even the computer system for setting up the accounts is inadequate and painfully slow. The design of the procedures, and the fact that goods are examined at a rate of mostly 100 percent resulting in delivery delays of the goods, are the biggest irritants for businesses.

Conclusions

Export development policies have been a critical part of East Asia's success and merit consideration. These schemes, mainly duty exemption and drawback systems, have failed in Sub-Saharan Africa for reasons of trust and capacity, cumbersome procedures, and because the costs from delays and paperwork outweigh the reductions in duty. In the case of drawback schemes, administrations are often unable to repay duties prepaid by exporters. In order to improve Africa's competitiveness in manufactured exports, governments must take a new initiative to widen the use of these
schemes and assure speedy access to exemptions and drawbacks for all exporters, through modernized administrative mechanisms. This report’s review of experience in East Asia and Africa suggests that simple exemption schemes focusing on the direct exporter are the highest priority for early attention, and that these exemption schemes are more likely to be sustainable and attractive to the private sector than drawback mechanisms.

One of the key elements of a modernized scheme in Africa should be the development of a system of pretabulated and published input-output coefficients. The work of pretabulating the quantity or value coefficients should be carried out by qualified engineers, entirely separated from the Customs, while the Customs focus on the implementation of exemptions and drawbacks based on the pretabulated and published coefficients (Rhee, BTO Report, 1995). This is based on the experience of (a) Korea and the economy of Taiwan, China, (b) recent experiences of developing countries such as India and Bangladesh; (c) almost fifty World Bank projects (during the period 1980-90), most of which have failed in the implementations of the duty-free import administration reforms primarily due to the mishandling of the input-output coefficient administration; and (d) the new GATT rules on export subsidies that require the systematic documentation of the input-output coefficients (Rhee 1995).

The other key element of export support has been the assurance of export credit supply for exporters, especially for preshipment finance. This is clearly an area where it is easier to reach a general conclusion than to find specific solutions, for the weakness of the financial sector in many SSA countries raises doubts about implementation capacity. Moreover, this is an area where the creation of new institutions should be avoided. However, much effort is being put in Africa into the restructuring and strengthening of the financial sector. Where these efforts result in sounder financial systems, the assurance of export credit should become a major priority.

A final consideration in Africa is the weakness of Customs Administrations, which contributes to the difficulties facing exports. Not only does this come in the form of slow or nonexistent rebates, but also in negative effective protection as exporters face duties on inputs but final goods are smuggled. Given the relative lack of intermediate goods industries in Africa, and their unlikeliness in terms of comparative advantage, an alternative solution that merits consideration would be zero tariffs on imported raw materials and intermediates, coupled with increased reliance for revenue purposes on domestic indirect taxes, such as VAT.
Free Trade Zones (FTZs) became popular as an instrument for attracting foreign investment for export development in the early 1970s. For countries which lack the financial and institutional infrastructure necessary to support economy-wide export activities, FTZs, if well administered, ensure the quickest access to free trade status within designated areas. Malaysia, Indonesia, Mauritius, Sri Lanka, and the Dominican Republic are examples of countries that used FTZs and bonded manufacturing warehouses (BMWs) in the early stages of manufacturing for export, in an attempt to initiate entry into the world market. China, through its Special Economic Zones (SEZs), granted a limited opening for international economic and technical cooperation in the 1980s. Korea and the economy of Taiwan, China, on the other hand, already had considerable capacity for exporting manufactured goods, and established FTZs as part of an equal footing export policy. Recently, FTZs have been advocated in Africa, and many countries including Senegal, Liberia, Kenya, Madagascar, Togo and Cameroon, have established FTZs following their success in Asia, and influenced by Africa's star performer, Mauritius. Several of Africa's zones, however, have not performed well. Global experience with FTZs suggests that their success hinges on the presence of certain complementary factors, such as macroeconomic stability and a realistic exchange rate, low political risk, an outward-oriented trade regime, basic infrastructure at market prices, and domestic entrepreneurial capacity. Failure to ensure these ingredients dampens foreign investment in LDC export activities, aside from the viability of FTZs (Rhee, Katterbach and White 1990).

Malaysia is one of the leading countries where FTZs have played a significant role in the growth of industrial exports (see Box 12). Within ten years, FTZ exports accounted for 51 percent of total manufactured exports, and 14 percent of merchandise exports (Rhee, Katterbach and White, 1990). Excellent infrastructure, macroeconomic and political stability, and outward-oriented strategies adopted in the 1970s made Malaysia attractive to foreign investors. The Malaysian government, in turn, actively promoted foreign investment to develop labor-intensive industries as part of its export-led growth approach. Forward thinking and the collective effort by the government, the Malaysian Industrial Development Authority (MIDA) and the Penang Skills Development Center (PSDC)--a public-private sector joint venture--were key to the success of the Penang FTZ.

Although in the first fifteen years (from 1972 to 1987) Malaysia segregated its FTZs and ignored backward linkages, in 1987, with the new industrial strategy, successful FTZs and their import requirements served as growth poles. FTZs were better integrated with the rest of the economy, which provided inputs from foreign-owned plants and joint ventures. Artificial barriers were dismantled, and a Korean-type
of export-financing scheme with pre-shipment export finance for backward-integrated suppliers was established as part of the strategy (World Bank 1992b).

**Box 12: Malaysia's Penang Free Trade Zone**

FTZs and Licensed Manufacturing Warehouses, which were designed to attract direct foreign investment (DFI), played a major role in the shift from import substitution to export-oriented manufacturing during the 1970s. DFI grew from 0.9 percent of GNP in 1968 to 6.3 percent of GNP (and 19 percent of GDP) in 1974. FTZ exports increased from 14 percent of total exports in 1982 to about 24 percent in 1990. Today, Malaysia has twelve zones directly employing about 104,000 people, and accounting for annual exports of US $1.6 billion (Lindauer and Roemer 1994).

FTZs in Malaysia were a success from the beginning because of good infrastructure and a favorable business and political environment. Beyond the general incentives to foreign investment, electronics—the dominant industry in Penang—was singled out. It had taken a foothold in Malaysia in 1967, when a Japanese multinational established a consumer electronics plant to take advantage of the domestic market (Salleh and Meyanathan 1993). In the 1970s, when U.S. semiconductor makers were relocating their labor-intensive assembly operations in LDCs, MIDA coordinated investment missions to attract their attention. During the 1980s, when U.S. investment slowed following the recession, Malaysia successfully targeted the newly industrialized countries. Small and medium enterprises producing electronics components in the economy of Taiwan, China have driven Malaysia's exports more recently. Electronics has been transformed into a highly capital and technology-intensive industry with forward and backward linkages. This has also assisted in initiating local research capabilities. PSDC has provided training to the industry, as well as to the entire manufacturing sector, and emerged as one of the leading training institutes in Malaysia.

The establishment and operating costs of Malaysia's FTZs are relatively low (Warr, 1989). The internal rate of return on the Penang FTZ is 28 percent, compared to rates of 26 percent, 15 percent and -3 percent respectively, for the largest zones in Indonesia, Korea and the Philippines. Employment and foreign exchange earnings provide the major sources of gain in the Penang zone, and account for 46 percent and 39 percent of the gross benefits. The benefits from greater local raw material purchases by FTZ firms, and the possible transfer of technology to domestic firms, are relatively small. Local raw materials and capital equipment constitute 4 percent and 10 percent of the total raw materials and local capital equipment used. The low administrative costs (-2 percent) and infrastructure costs (-18 percent) relative to other zones are striking. The cost of subsidized electricity (-22 percent), however, effectively outweighs the combined benefits from the use of local raw material and capital equipment, and all tax revenues raised from FTZ firms (Warr 1987).

The new wave of investors, mainly Taiwan, Chinese, setting up small and medium enterprises in component industries, has had a significant impact on exports. Today, Malaysia is the world's leading exporter of semiconductors, has one of the
world's largest installed semiconductor assembly capacities in the world, and is the third largest producer after Japan and the U.S. (Salleh and Meyanathan 1993).

Malaysia's FTZs have provided an important step towards a more liberal overall economic environment. In recent years, some of the duty-free and other benefits received by FTZ firms have been extended to firms producing for export outside the zones.

The Bataan EPZ, the largest and longest operating in the Philippines, has not been successful compared to other zones in the Philippines and Asia (see Box 13). Bataan was established in Mariveles--an isolated area located 100 miles from Manila, primarily to absorb abundant labor. The choice of location and policies granting EPZ firms preferential access to the Philippines' capital market at suppressed interest rates, and with government guarantees of loans, have proved extremely costly. Only some of the anticipated benefits from the EPZ--employment creation and foreign exchange earnings--have been achieved. Transfer pricing by multinationals has reduced tax revenues from the FTZ. The Philippine experience also suggests that tax holidays are less important than they appear (Warr 1989).

The Philippine experience shows that although the gains from employment generation are large, FTZs should not be used primarily as an outlet for abundant labor, while overlooking other necessary factors. The poor location of Bataan and policy-induced factor market distortions reduced economic welfare and diverted scarce public and private sector capital from alternative investments.

China's early experiment with market forces was in 1979, through four Special Economic Zones (SEZs) in Shenzhen, Zhuhai, Shantou and Xiamen. The location of the zones was essentially to exploit connections with overseas Chinese, and had little other economic logic (Wall, 1993). The remarkable success of market-based reforms and the SEZs spurred the opening up of trade and investment all across China, and has had a dramatic effect on inflows of foreign investment, industrial output and exports, and the integration of the Chinese economy into the world economy. Today, China has very few areas not open to foreign investors. In some respects, China's SEZs break the rules for the success of an FTZ: they were not created against the background of an overall favorable regime for foreign investment. However, they did create expectations that such a framework would exist, and that those already in the zone would be best equipped to exploit the potential of China's huge domestic market once it was opened up. Moreover, the contiguous geographic location with Hong Kong, and its common ethnic background render it somewhat sui generis. Perhaps the most important factor at the end of the day was that the zone was open to investors from the mainland, and very "leaky" in terms of trade with the mainland, and that its presence forced the rapid opening up of the rest of the country.
Box 13: The Philippines Bataan Export Processing Zones

The Bataan EPZ is rated poorly despite significant benefits through employment and foreign exchange earnings. Compared to industrial zones in Asia, Latin America, the Middle East and Africa, the Bataan zone has two striking features: (i) the enormous infrastructure costs necessitated by the choice of location; and (ii) the heavy cost of granting EPZ firms subsidized access to the local capital market. These two components outweigh the sum of all benefits from the zone, thus generating a negative net present value.

EPZ firms are offered a very favorable incentive package, including exemption from import and export duties, and municipal and provincial taxes, freedom to employ foreign nationals without Philippine personal income tax obligations, and unrestricted degree of foreign ownership. Unlike other Asian countries, the Philippines does not offer company income tax "holidays" to firms. Instead, it offers a generous schedule of deductions from taxable income. Little tax revenue has been raised as two-thirds of firms declare trading losses. Some firms have declared losses for more than a decade, while still producing and expanding. Government efforts to monitor transfer pricing have been futile.

EPZ firms are served by a separate administrative branch of government, the Export Promotion Zone Authority (EPZA). It has considerable autonomy within the zone, acts as an intermediary between firms and the government, and provides simplified export and import documentation. EPZ firms are also eligible for government assistance in local manpower training and foreign market development. The value of some of these advantages is reduced, however, by the location of the zone, especially due to the unreliable communications between the zone and Manila, and the outside world.

Costs, Benefits and Economic Performance: Employment grew through the mid-1970s to about 21,000 in 1980, but reduced to 16,554 in 1986 and 13,631 in 1990 (World Bank, 1992b). Garment manufacturers were the largest employers, followed by electronics firms. The highest benefit is from "declared" foreign exchange earnings, while those from technology transfer and domestic raw material use are disappointing. Since most firms are involved in labor-intensive production, little new technical knowledge is transferred. Firms which do have unique technological advantages (such as the few electronics firms) guard this knowledge carefully. Although firms receive a rebate for the use of domestic raw materials, the net gain to the Philippines from the use of domestic materials is about 3.7 percent of the value of raw materials used in the EPZ (Warr 1987).

Public infrastructure investments and domestic borrowings costs are very large. Setting up an industrial center in an isolated and mountainous coastal area involved the construction of an expensive dam, and the provision of basic housing, water and electricity facilities. Some infrastructure expenditures such as upgrading the port and constructing large office buildings proved to be unnecessary. Although the zone was expected to generate an inflow of foreign investment, most of the private capital invested was raised domestically. Of the approximately US$210 million (at 1977 exchange rates) invested in the zone up to 1977, 6.4 percent was equity and 93.6 percent borrowings. Of the equity, 74 percent was domestic and 26 percent foreign, and of the borrowings, 92 percent was domestic and 8 percent foreign. That is, about 91 percent of the total capital invested was raised domestically, and domestic borrowings accounted for 95 percent of these domestically raised funds. The cost of domestic borrowings is itself large enough to cancel all but 2 percent of the total gain from employment generation and foreign exchange earnings (Warr 1987).
Box 14: China's Shenzhen Special Economic Zone

The Shenzhen SEZ is situated in a remote fishing village, and by virtue of sharing borders with Hong Kong, benefits from its urban market. The initial impetus for the zone came from a Hong Kong multinational (owned by the Chinese government), which wished to establish an industrial park across the border, and form joint ventures with foreign companies in order to capitalize on China's large domestic market (Wall 1993). More than 80 percent of the foreign investors in the Shenzhen SEZ are from Hong Kong, and the proximity implies a natural partnership.

China's five SEZs have achieved their objectives of earning foreign exchange and creating jobs. The government, in turn, has made substantial investments in infrastructure, and provided a variety of subsidies and tax allowances to zone firms. Shenzhen's total industrial output, which grew at an annual rate of about 50 percent, stood at US$ 1.6 billion in 1987 (Chen 1993). Since 1985, its industrial structure has shifted from processing with supplied materials, to labor-intensive manufacturing for export in electronics, textiles and light industry. In 1987, there were 1,500 foreign firms in Shenzhen, and their exports accounted for 3.5 percent of China's total exports, rising to 13 percent in 1991. In 1988, FDI was approximately US$ 260 million; 90 percent in joint ventures and 42 percent in manufacturing. The incentives offered to zone firms are similar to those in other countries, except that the tax holiday is shorter (one to five years), and firms bringing new technology, larger investments and providing internal economic linkages are granted more favorable terms.

The private rate of return on investment for firms in the zone is estimated at 23 percent. Net social benefits were negative from 1979 to 1986. The greatest social benefits of Shenzhen are derived from tax revenues and insurance premiums, foreign exchange earnings, and employment. Tax revenues increased sharply after 1983, following the initial one to five year tax holiday, and by 1985, surpassed the gains from foreign exchange and employment. This deviates sharply from the experience of the Philippines' Bataan zone, where transfer pricing has resulted in very little tax revenues for the government. Chen's analysis suggests that given the actual situation in China, the internal rate of return of the Shenzhen SEZ project is 10.7 percent.

China's willingness to experiment and learn from experiments such as the Shenzhen SEZ has been unique. The zone has generated enormous welfare gains and demonstration effects. Once China recognized the benefits from foreign investment, city after city and province after province have been quickly opened up to foreign investment and trade (Wall 1993). Foreign investors have also been quick to capitalize on China's relatively cheap labor and other factors of production, and the extensive domestic market.

Among Sub-Saharan Africa's FTZs, the Mauritius EPZ has met with remarkable success, while the experience with Senegal's Industrial Free Zone of Dakar (IFZD) has been quite the opposite. In Mauritius, macroeconomic balance, a politically stable democratic system of government, open trade policies, a dynamic local business
community, combined with strong government support have contributed to the zone's accomplishments. Growth of manufacturing exports have been the fundamental basis for the transformation of the economy, which in the early 1980s was characterized by high unemployment, inflation and a substantial balance of payments deficit. Foreign exchange earnings from sugar exports to the EC (under the Lome Convention) have played a major role in underpinning the expansion of the manufacturing sector. The Mauritius economy has recently attained its 'natural' rate of unemployment, and the average real wage has risen nearly 10 percent over the last two years (Rhee 1990). This has diverted some foreign investment into a more recently-established EPZ in Madagascar.

The Mauritius EPZ has succeeded in attracting a major financial commitment from its investors. The share of equity capital from Hong Kong has risen from 33 percent during 1970-76 to 86 percent in the period 1983-85. Hong Kong investors have preferred controlling equity interest, and their share has usually been between 80 percent and 100 percent of the total. French investors have preferred joint ventures with shares of between 35 percent and 80 percent. EPZ firms have also been able to raise funds in the local market. During the period 1970-84, 44 percent of the local equity capital has come from the sugar industry.

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63 Unemployment exceeded 20 percent and the inflation rate rose to over 30 percent per annum (Overseas Development Institute 1990).
Box 15: The Mauritius Export Promotion Zone

Mauritius has built a large and competitive clothing industry within its EPZ in virtually seven years (ODI, 1990). The Mauritius EPZ regime differs from other LDCs FTZs in that it is not a 'zone' physically separated from the rest of the economy, but a system of incentives granted to firms exporting 100 percent of their output (with certain minor exceptions). Firms anywhere on the island enjoy equal footing export policies including free trade status based on the duty (and indirect tax) exemption system.

The zone evolved in three distinct stages. From 1970 to 1976 it grew rapidly, and by the end of 1976 the FTZ had eighty-four units operating mainly in the textile industry. The years 1977 to 1982 were ones of slow growth due to the global recession. Rapid growth began in 1983, reinforced by trade liberalization, and the government's carefully prepared and implemented integrated strategies. EPZ employment and exports 'exploded' between 1983-87 (Rhee, Katterbach and White 1990; ODA Working Paper 1990).

"Integrated strategies guaranteed equal footing export policies and infrastructure for all export activities. These were implemented through the Mauritius Export Development and Investment Authority, the Development Bank of Mauritius, the Export Credit Guarantee Scheme, and the Export Credit Insurance Scheme. The government also encouraged private sector initiatives in FTZ development and management through measures such as the Industrial Building Investment Scheme. Attempts were made to maximize the gains from foreign collaboration and upgrade the industrial structure in a diversified and more skill-intensive direction. For example, the Export Services Zone Scheme of 1981 and a recent offshore banking center were designed to diversify FTZ export industries. The new Industrial Training Strategy aims at speeding up industrial skill acquisition (Rhee 1990)."

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64 Taiwan, China and Korea also have this status for 100 percent and non-100 percent exporters. (Rhee, Katterbach and White).
Box 16: The Industrial Free Regime in Senegal

Twenty years after its inception, the industrial free zone of Dakar (IFZD), which offers an attractive package of incentives, has only eight remaining enterprises. Of these, five are in operation with a total labor force of 520. Since the establishment of the IFZD in 1974, only fifteen enterprises have been installed in the free-zone regime (FZR), (including points francs, or single factory zones since 1991). Several companies that received approval to establish operations did not realize their investments due to the difficulties faced by already settled firms. Several firms have left the zone, and no new company has been established since 1986 (FIAS 1994). Exports from the IFZD have declined from CFAF 5,307 million in 1989 to CFAF 3,762 million in 1993. Net exports in 1993 were only CFAF 1,089 million. IFZD exports for the period 1977-92 have accounted for a mere 0.6 percent of Senegal's total exports.

The failure of Senegal's IFZ scheme is largely due to the high factor costs of labor, utilities and shipping. The inability to provide efficient customs and tax administration, cumbersome pre-investment formalities, and the lack of clear statements with respect to property ownership in the IFZ law, have also hindered firms. Although the devaluation of the CFAF has eased the steep factor costs, they still remain amongst the highest of all countries with EPZ programs (FIAS 1994).

Senegal offers a very generous set of investment incentives. IFZ and SFZ firms enjoy full exemption from all taxes (including income taxes), for the twenty-five year periods 1974-1999, and 1991-2016 respectively. Most countries with EPZs offer income tax holidays for five to fifteen years, often followed by a reduced income tax rate. Firms in Senegal's FZR are permitted to sell 40 percent of production in the domestic market. The norm for other EPZs is typically up to 20 percent. FZR firms are also entitled to an employment subsidy in the amount of a 11 percent tax on salaries withheld from employees. However, given the relatively high cost of doing business in Senegal, these incentives have not attracted foreign or domestic firms.

Extensive state controls are cited as the single greatest obstacle to private sector development (FIAS 1994). The investment response to the devaluation of the CFAF may be discouraging, as long as these government controls remain. Senegal's credibility has been further threatened by the implicit suspension of FZR approvals since 1992, due to a lack of consensus over the appropriate incentive package and concerns about effective customs supervision.

Mauritius taxes EPZ companies at a low rate of 15 percent, while Hong Kong and Lesotho charges all taxpayers 17 percent and 15 percent respectively (FIAS 1994, p.13). Warr analyzes the social costs and benefits of the four largest FTZs in Malaysia, Indonesia, Korea and the Philippines, using the "enclave model". He calculates the welfare impact on the domestic economy by comparing the observed situation with the hypothetical case of not having a zone.
Conclusions

Free Trade Zones are not a magic tool for attracting foreign investors. They have generally been successful only in the presence of other necessary factors such as a stable macroeconomy, low political risk, equal footing export policies, adequate infrastructure, a business-friendly environment, and local entrepreneurial capabilities. Senegal illustrates the fact that even the most appealing fiscal concessions do not attract foreign investment nor ensure the success of a FTZ in the absence of a good business climate. In Africa, the economic benefits of FTZs as a tool of export promotion need to be carefully evaluated. It is clear for many African countries that any attempt to use this mechanism instead of promoting general reform is most unlikely to succeed. Four broad conclusions can therefore be drawn:

- Where the general economic climate is reasonable, or becoming so, the development of FTZs can be a useful encouragement to the development of export-oriented industry, as it can lower initial investment costs for investors, and encourage economies of agglomeration.

- FTZs should be a component of a broader outward-oriented development strategy, rather than a substitute for such a strategy, or an excuse to delay needed economy-wide trade reforms.

- The benefits from FTZs in terms of foreign exchange earnings, employment, technology transfer and linkages with domestic markets may be limited, unless accompanied by an appropriate policy framework and human capital development for sustained export development.

- While accepting that market failure justifies a potential role for the public sector in this area, the pricing of space in such zones should not be subsidized. Moreover, correct pricing should enable an early move to privatize such industrial estates once they are functioning. Similarly, as part of a general program to promote foreign investment, governments should be sure to remain open to the private development of such industrial estates, as is occurring in Malawi and Kenya."
INDUSTRIAL TRAINING

There can be little doubt that investment in human capital—and in basic education in particular—is critical to development success. This is as true in East Asia as anywhere. The key public policy question is whether the provision of basic education service should be supplemented by the public provision of industrial vocational training, or by specific incentives to employers to provide such training. If so, the conditions under which such training pays off and the depth to which it should go, i.e. general electronics compared to specific circuitry, becomes the issue.

An educated, skilled workforce is a critical input in economic growth. Training complements education in providing workers with job-related skills, to use equipment and existing technologies more efficiently, and to upgrade their skills to work with new technologies. Training can thus have beneficial impacts on firm-level productivity and individual welfare, and on technological progress, through workers’ enhanced ability to apply and adapt existing knowledge and processes as well as new technologies. The productivity-enhancing effects of training is supported by studies of the returns to worker training (World Bank 1993) and by firm-level production function studies from a broad cross-section of countries, including several countries in Africa—Zimbabwe and Kenya (Tan and Batra, 1995; Biggs, Shah and Srivastava, 1995). The evidence also suggests that while training by employers is typically more cost-efficient than others, most modes of training—from either public or private providers—can yield good returns when the jobs for graduates are available, and training is closely linked to employer demand.

Training is a form of investment in human capital, involving current outlays in materials, time, and foregone production in return for future gains in worker and firm-level productivity and in wages. As such, incentives to train are sensitive to many of the same factors that shape private capital investments. Employer incentives to provide or sponsor training are greater where existing education and skills of workers are higher, since educated workers benefit more from training; in larger firms, since the fixed costs of training can be spread across many trainees; when external public or private training providers are able to deliver relevant training at low cost; in competitive markets, where firms have incentives to raise productivity and adopt new technology to stay competitive; and when opportunities for expansion and growth are strong, since payoffs to investments in physical and human capital are higher.

In the high-performing East Asian economies, conditions conducive to worker training were abundantly present—good macroeconomic management, market-friendly and export-oriented policies, and early attainment of near universal primary education, as presented in Part I of this paper. Firms, building on a well-educated workforce, invested heavily in training. The economic growth that resulted created a virtuous circle in which rising demand led to further rounds of retraining and skills upgrading, in
turn facilitating the adoption of new technologies which created more growth. In Japan, rapid economic growth in the 1960s and 1970s was accompanied by dramatic increases in employer training, especially among the smaller, and typically less productive, firms. Between 1967 and 1984, the incidence of training in large firms with over 1,000 employees rose from 95 percent to 100 percent; for firms with thirty to ninety-nine employees, training incidence nearly doubled—from 43 percent to 79 percent—over this period. Similarly, economic growth in both the economy of Taiwan, China, and in Singapore was accompanied by a significant upgrading of the training and skills of workers in smaller firms.

In contrast, conditions in Sub-Saharan Africa were, at least until recently, less favorable to training (World Bank 1994). Relatively poor macroeconomic policies and high levels of regulation lowered the expected returns to investments in both physical and human capital, while protected markets diminished employer incentives to compete by upgrading plant and equipment and worker skills. The incentives of employers to provide training were further reduced by an aging capital stock, which required only rudimentary kinds of training, and by a poorly educated workforce, with limited capabilities either to benefit from training or to adopt and use new technologies effectively. The evidence indicates that African firms are less likely to train their employees than their East Asian counterparts. Though not strictly comparable, recent firm-level industrial surveys conducted in Kenya, Zimbabwe, and Malaysia (a high-performing East Asian country) revealed that a lower proportion of firms in these Sub-Saharan countries sponsored training for employees than their Malaysian counterparts (see Box 17).

What can policymakers do to encourage more, and better, training in Sub-Saharan Africa? Continuation of reforms begun in the late 1980s—better macroeconomic policies, increased competition, and removal of regulatory constraints in markets—will improve the economic environment and employer incentives to invest in new plant and technologies, and in requisite skills. On the supply side, expanding and improving general education will increase the supply of an educated and adaptable workforce, and reduce the costs to employers of training workers to satisfactory skill levels. Policy interventions to address several supply-side constraints will accelerate employers' training responses to market signals. These supply-side factors include weak training capacity of firms; imperfect knowledge about the value of training, new technologies and their skill requirements; high fixed cost of in-house training in small firms; undeveloped training markets; and poorly organized industrial associations. Concerns about poaching of skilled personnel may also lead to under-investment in training if employers cannot shift part of the training costs to workers, since job mobility prevents them from recouping their training investments.
Recent firm-level surveys provide insights into the incidence of training in the manufacturing sectors of Zimbabwe, Kenya, and Malaysia. In the two African countries, worker responses to questions about current training experiences were used to classify firms as being training or non-training firms. The questions did not distinguish between structured formal training and informal on-the-job training provided by co-workers and supervisors, so the presumption is that both types of training were provided by employers. In Malaysia, by contrast, employers were asked about both types of training. With these caveats, training responses in the three surveys are tabulated by firm size to show the incidence of ANY training (formal and informal), disaggregated further in Malaysia for formal training alone.

<table>
<thead>
<tr>
<th>Firm Size</th>
<th>Zimbabwe</th>
<th>Kenya</th>
<th>Malaysia</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>ANY</td>
<td>ANY</td>
<td>FORMAL</td>
</tr>
<tr>
<td>10-49 EMPLOYEES</td>
<td>38.2</td>
<td>28.6</td>
<td>16.4</td>
</tr>
<tr>
<td>50-99 EMPLOYEES</td>
<td>58.1</td>
<td>37.8</td>
<td>33.5</td>
</tr>
<tr>
<td>100-250 EMPLOYEES</td>
<td>73.3</td>
<td>56.1</td>
<td>50.9</td>
</tr>
</tbody>
</table>


In all three countries, the incidence of training rises with firm size. Of the two African countries, a higher proportion of employers in Zimbabwe provide formal and informal training as compared to Kenya—the figures range from 38 percent to 73 percent in Zimbabwe, and from 29 percent to 56 percent in Kenya. The proportion of firms providing any training in these two countries is considerably lower than in Malaysia, where the comparable figures range from 80 percent to 95 percent. The figures for formal training alone in Malaysia is roughly the same magnitude as formal and informal training combined in Kenya.

Developing countries have used different training policies to address these supply-side shortcomings. In general, most modes of training can be cost-effective when the training institution—public or private— is well linked to employers, efficiently organized, and sufficiently flexible to adjust the content and quantity of training when the demands of employers change. When training is provided through public training centers, the design challenge is how to provide incentives for these institutions to deliver relevant and responsive training to enterprises. When training is provided or sponsored by employers, the issue of matching training supply and demand does not arise. Firms train only for needed skills. And because most new technologies enter developing countries through enterprises, employers have the equipment and technical information needed to determine what skills are needed. Furthermore, in most countries, the largest share of training is provided by employers during employment, either in-house or from external training institutions, equipment suppliers, industry associations, and joint-venture partners (Tan and Batra 1995a). To the extent that enterprises can be encouraged to train, they offer an important means to expand the resources available for skills development in the country.
Several East Asian economies have effectively used direct reimbursement of approved training expenses, funded out of payroll levies, to encourage firms to train their employees. Successful schemes--such as those in Taiwan, China and Singapore--are flexible, demand-driven, and often accompanied by an information campaign and a program of technical assistance to smaller firms (see Box 18). The introduction of such a scheme in Taiwan, China led to dramatic increases in the volume of training, which continued even after the program was terminated in the 1970s. Singapore uses a levy on the wages of unskilled workers to upgrade worker skills through the Skills Development Fund, and the Fund's aggressive efforts--to raise awareness of training among firms, to support development of company training plans, and to provide assistance through industry associations--have led to a steady rise in the incidence of training, especially amongst smaller firms. However, such schemes, when administered rigidly, can also create disincentives to train. In Korea, the requirement that firms give training lasting a minimum of six months or pay a fine, led many firms to pay the penalty rather than train to this standard.

**Box 18: Well-Designed Levy-Grant Schemes Can Induce Firms to Train**

Malaysia's Human Resource Development Fund is an example of a flexible, demand-driven training scheme. A payroll levy is used for partial reimbursement of approved training expenses. Depending on their training needs, firms can choose flexibly from among several programs: (i) approved training courses provided by registered external institutions; (ii) ad hoc in-plant or external training courses on a as-needed basis; and (iii) annual training programs. Prior approval of training courses under the second and third programs is required from the HRD council. However, the council's overhead costs are kept low, and filing burden on firms are reduced, by automatic approval of courses under the first program, by using registered training institutions as collection agents of the council, and by giving firms with well-developed training plans the option of filing under the annual program. In addition, the HRDF provides firms with grants for developing training plans, organizes regional courses on training need assessments, and administers a variety of subsidized programs targeting small enterprises.

Many developing countries have also used training subsidies or tax write-offs of training expenses to encourage firms to train, including Asian countries such as Malaysia, Pakistan, and the Philippines. The limited evidence suggests that they often needlessly subsidize well-run firms that already train, while poorly-managed firms either do not respond or respond by establishing training programs that are designed more to maximize financial gains than to develop needed skills (see Box 19). Thus, these tax incentives often represent a windfall gain to the firm and a loss of revenue to the treasury. Evaluations of these programs indicate that the main beneficiaries are large firms in the most dynamic sectors of the economy. Smaller firms--who provide the least structured training and who would most benefit from training--are seldom induced to train by such tax incentives. Few are profitable enough to find these tax incentives attractive, and many have weak training and management capabilities and limited skill needs.
The weak capabilities of small firms can be addressed directly through public programs of technical assistance to build enterprise capacities. Public-supported industrial extension to small and medium enterprises (SMEs) have been in place in a number of East Asian economies--most successfully in Japan, Taiwan, China, and Singapore--providing productivity consulting, training need assessments, and assistance in acquiring and using advanced technology and quality control methods. Successful examples of such SME programs are not limited to East Asia.

Mexico's CIMO program of training and technical assistance has yielded significant productivity increases in SMEs served. Operating through a national network of small offices to better reach their target population, CIMO staff work closely with SMEs, providing them with a range of low-cost services made possible, in part by public subsidy, and in part by group provision of training and technical assistance.

Finally, governments can also act as a catalyst in creating privately-run, and demand-driven training centers to serve firms in different industries or regions. Coordination failure--when industry associations are poorly developed and skill needs vary--can hamper the creation of industry-based or regionally-based training centers to serve the skill needs of groups of firms. The Penang Skills Development Center in Malaysia is a successful example of the catalytic role of a local government in developing demand-driven, privately funded and managed, training programs for regionally-based industry (see Box 20). The key to its success was the active involvement of the private sector in the planning and management of the training center.

### Box 19: Tax Incentives to Encourage Training are Seldom Effective

In 1987, Malaysia introduced a scheme to encourage training by allowing firms to deduct double the amount of eligible training expenses from taxes. Take-up of the scheme was uneven--concentrated primarily in large, modern firms that were already doing a great deal of training, and heavily used by multinationals that would train even without the tax incentive. In the domestic-oriented sectors and in small firms, where education and skill levels are generally lower, the scheme was ineffective in encouraging firms to train. The tax incentive was not attractive to small firms because (i) many operate close to the break-even point, and have no taxable income to shelter; (ii) firms have weak training and management capabilities; (iii) fixed costs of training and applying for benefits is high, given their small firm size; and (iv) many small firms operate in the informal sector, and prefer to forgo benefits rather than invite closer government regulation of their activities.
Box 20: Public-Private Collaboration in Training Provision

The Penang Skills Development Center (PSDC) in Malaysia is a successful example of how public-private cooperation can be harnessed to provide demand-driven training programs for regionally-based industry. Established in 1989 as a tax-exempt institution on the joint initiative of the Penang state government and major manufacturing firms (primarily MNCs), the PSDC is funded by corporate contributions and training fees, and by the state government which provides PSDC with subsidized facilities. Its strategic location in the Bayan Lepas Free Trade Zone provides workers with easy access to training, which they attend either full-time or on a part-time basis. Training programs and course content are determined by a training committee on the basis of semi-annual needs assessments of firms, and approved by the PSDC council representing the state government, corporate members, the local university, and the national standards agency. Training courses are taught by staff from external training institutions, the local university, and the firms themselves. Firms have several incentives to join and work with PSDC: they help shape the training agenda; they pay relatively low training fees because of economies of scale; they have access to classrooms and recent vintage training equipment; equipment donations to PSDC are tax-deductible and, as donors, they receive preferential access to the equipment for running their own training courses.

The Malaysian government has sought to replicate the PSDC model in other states by providing grants to complement contributions of land and training facilities by state governments. Early experience with these SDCs has been mixed. The most dynamic SDCs had several characteristics—they brought private sector firms into the planning process from the very beginning; training need assessments were conducted of firms in the region to be served; machinery suppliers were persuaded to donate equipment for training; and training facilities were located close to firms. Some SDCs were less successful, in some cases because of poor location of training centers (location decisions were shaped by a policy of decentralizing industry from congested areas), in other cases because the training provided was supply-driven (planning focused more on assessments of the training capabilities of existing providers than on the training needs of firms).

Conclusions

In several Asian countries, the state has played a useful role in stimulating the provision of industrial training, with a positive impact on industrial development. As with all industrial policies, however, this has worked best where the state has worked to stimulate and support the role of the market, rather than to fight market forces. i.e. where it has reinforced comparative advantage, rather than attempting to create it artificially. It appears that relatively little attention has been paid to these issues in Africa to date. Such mechanisms appear to work best when they adopt the following features:

- They are flexible and market-driven, with a strong role for the private sector in determining the scope, size and content of the publicly-provided training.
• With respect to the financing of training provided by firms themselves, it appears to be more appropriate to use payroll taxes to finance programs directly, rather than offering general industrial subsidies or tax rebates.

• In addition to the provision of general industrial training for workers, there appears to be a role for the state in the provision of specific services to enterprises and enterprise managers in particular, such as technology searches or funding of participation in trade fairs.
PART IV. EXCHANGE RATE POLICIES FOR TRADE PROMOTION

Throughout this paper, maintenance of competitive exchange rates has emerged repeatedly as a key issue. This is both from the perspective of its role in East Asia in promoting exports, as well as (implicitly) the absence of such a role in Africa for much of the period under consideration. However, this is an area where much progress has been made in recent years in Africa, with the introduction of foreign exchange markets and removal of exchange restrictions in many countries (Kenya, Uganda, Tanzania, Zambia, Ghana) and with the 50 percent devaluation of the CFA Franc in January 1994 (Bouton, Jones and Kiguel 1994). Indeed, it can truly be said that in many SSA countries, the exchange rate is now determined by the total demand for and total supply of foreign exchange.

However, this section poses two questions:

i. In East Asia, it appears that the policy was to maintain an undervalued exchange rate, in order to ensure a strong export incentive, and simultaneously protect domestic industry. Why is this policy apparently discarded in Africa?

ii. In East Asia, foreign aid flows were relatively unimportant, and were largely for projects. In Africa, in contrast, substantial flows of balance of payments assistance have been generated, and increasingly directed to the emerging foreign exchange markets. Is this compatible with maintaining a competitive exchange rate to promote exports while liberalizing import regimes?

East Asian Policies

There are two fundamental aspects to exchange rate policies in East Asia, each of which were vital. First, as seen in the country case studies for Indonesia, Malaysia and particularly Thailand, exchange rates were remarkably stable because of the general avoidance of severe macroeconomic distortions. Thus, it was not just the case that exchange rates were not out of line at two end points, but that constant attention, and avoidance of bouts of inflation kept rates in line and stable. The East Asia Miracle Study published an “appreciation index” (see Table 15) which illustrated this vividly:

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66 It is to be re-emphasized that the views expressed in this section in particular are those of the authors and do not represent the views of the World Bank. These views are put forward to promote debate on these issues, rather than being specific proposals for implementation

67 For a recent discussion of this, see Lawrence Bouton, Christine Jones, and Miguel Kiguel, 1994.
Table 15: Average Appreciation Index 1978-80

<table>
<thead>
<tr>
<th>Country</th>
<th>Index</th>
<th>Percentage Rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>98</td>
<td>25</td>
</tr>
<tr>
<td>Malaysia</td>
<td>80</td>
<td>12</td>
</tr>
<tr>
<td>Thailand</td>
<td>75</td>
<td>5</td>
</tr>
<tr>
<td>Cote d'Ivoire</td>
<td>185</td>
<td>90</td>
</tr>
<tr>
<td>Ghana</td>
<td>248</td>
<td>99</td>
</tr>
<tr>
<td>Nigeria</td>
<td>277</td>
<td>100</td>
</tr>
</tbody>
</table>

a. 100 means most appreciated, 0 means least.

Source: World Bank, 1993a, Table 3.4, p. 114.

Thus, the Southeast Asian countries had among the least appreciated (or most undervalued) currencies in the world during this time, and three of this study's comparator countries had among the most appreciated currencies.

Moreover, each of the comparators illustrated the fact that periods of export growth were associated with periods of high competitiveness. The Indonesian export diversification program, which gained such momentum in the early to mid-1980s, was associated with a steady decline in the real effective exchange rates during the period 1981 to 1986 (from 100 in 1981 (1980=100) down to 50 (1980=100) in 1986 and constant thereafter). It was in this period of stable, highly competitive rates from 1986 to 1992 that manufactured exports expanded from 13 percent to 48 percent of total exports. Simultaneously, in Malaysia, the real effective exchange rate index fell steadily from a peak of 118 in 1984 (1980=100) to 80 during the period 1988 to 1993. It was in this same period that exports grew by an average real annual rate of nearly 35 percent per annum. There can be little doubt, therefore, that these were associated phenomena. Not only have such exchange rate policies encouraged the development of exports, they have also afforded moderate, even protection (by not undervaluing imports) that has fostered the development of indigenous enterprises. There are legitimate concerns in Africa that trade reforms in conjunction with overvalued exchange rates may have done the opposite.

Indonesia, Malaysia and Thailand did not leave this to market forces. Rather, their regimes generally moved through three phases: from fixed rates, to fixed rates with occasional sharp devaluations, to managed floats (Indonesia, Thailand) or market systems with strong central bank intervention (Korea and Taiwan, China). Such intervention was associated in both economies with large accumulation of foreign exchange reserves and with high current account surpluses (8 percent to 20 percent of GDP). But in all economies, in order to ensure maintenance of competitiveness, the system has now settled to a managed float with continuous minor adjustment to maintain real rates in the light of domestic conditions and movements of other currencies.
African Exchange Rate Policy

This study has already made note of the “appreciation” index. Further, the “Adjustment in Africa” study assembled vital information on parallel market exchange rate premia in Africa (Bouton, Jones and Keiguel 1994; Tables A5, A6). The average premium during the period 1981-86 was 59.7 percent, but this had declined to 24.6 percent in 1990-1991. Some such premia were remarkable, as was their decline. This is shown in Table 16. It should be noted that there are several examples in which dramatic movement was made in the right direction (Tanzania, Nigeria) but where huge distortions (as measured by premia) remained.

Table 16: Foreign Exchange Market Premia and REERs in Africa

<table>
<thead>
<tr>
<th></th>
<th>Parallel Market Premium</th>
<th>Change in Real Effective Exchange Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1981-86 (%)</td>
<td>1990-91 (%)</td>
</tr>
<tr>
<td>Ghana</td>
<td>1098.2</td>
<td>3.4</td>
</tr>
<tr>
<td>Tanzania</td>
<td>248.8</td>
<td>74.5</td>
</tr>
<tr>
<td>Nigeria</td>
<td>232.7</td>
<td>25.1</td>
</tr>
<tr>
<td>Mozambique</td>
<td>2110.8</td>
<td>62.6</td>
</tr>
<tr>
<td>Sierra Leone</td>
<td>49.4</td>
<td>104.4</td>
</tr>
</tbody>
</table>

Source: Adjustment in Africa: Tables A5, A6.

One group of countries, the CFA zone, maintained a fixed exchange rate regime throughout the adjustment period with one major adjustment in 1994. Given the regime that existed, with full convertibility backed by France, it was not possible to equate uncompetitiveness with a parallel market and other measures had to be created (Devarajan and Walton 1994).

For most other countries, the solution has either been a large devaluation, followed by the creation of some form of inter-bank foreign exchange market, or the installation of a foreign exchange auction market (Nigeria, Uganda, Zambia) in some cases followed by the creation of unified markets (Aron and Elbadawi 1994). In summary, the markets in Ghana and Uganda have tended to generate unified, stable allocation, while the experience of Nigeria and Zambia has been much less satisfactory. Moreover, with the developments in coffee prices in 1994, Kenya and Tanzania have demonstrated how volatile such markets can be in the absence of exchange rate targets.
However, it must be noted that there is a general sense in the international institutions that the determination of exchange rates and foreign exchange markets are, essentially, a solved problem in Africa, and a distinct achievement of the adjustment period. And yet, in Africa, this dramatic reduction in exchange rate distortions has not been followed by the sort of rapid export response seen in East Asia. This may, as many would say, reflect structural problems in Africa that the earlier policy discussions in this section of the paper are designed to address. Alternatively, it may reflect the fact that, while rates have been sharply depreciated, this process has not yet gone far enough to restore competitiveness.

**Trade Policy, Exchange Rates and the “Dollar Index”**

Table 16 has illustrated the use by the *East Asian Miracle* Study of a measure of overvaluation. This is the so called “Dollar Index”, named for its author (Dollar 1992). This index is important, as it attempts to measure outward-orientation rather than exchange rate misalignment. An exchange rate can be quite stable, and clear the effective market, if that market is constrained by a sufficiently large volume of protective trade restrictions. Indeed, this probably was the case for many African countries for a long period of time, although this spilled over into informal markets, has been seen. Dollar develops his index based on the Summers and Heston international price comparisons projects, arguing that the comparable price level is the only true measure of correct exchange rate alignment.

In most developing countries, prices for non-tradables (especially human services) would be expected to be below international levels. For most countries, therefore, it is expected that the overall international price level would rise with income. Indeed, for all regions of the world except one this is true: with the US=100; Asia’s level is 46.5; and industrial countries are 107.0. The exception is Africa, whose level is the highest among LDC groups, at 68.6. The price indices are then combined with factor endowments to produce an index of real exchange rate distortion.

The African region is the most distorted, i.e. inward-oriented, according to this measure. Note that the measure cannot identify the source of overvaluation, and separate it between the exchange system and trade restrictions. However, as noted earlier, the stability of a rate is quite compatible with inward-orientation if combined with trade restrictions. Many African countries are found to have stable exchange rates, in terms of variation around averages. Dollar combines those two measures - overvaluation and stability - into an “outward-orientation ranking”. While Thailand, Malaysia, Singapore, and Hong Kong are in the top 25 percent, Tanzania, Uganda, Ghana and Nigeria are in the bottom 25 percent. Cote d’Ivoire and Senegal are in the middle, below Indonesia, because of higher real exchange rates but with very low variability.
Table 17: Dollar Indices and Exchange Rate Variation

<table>
<thead>
<tr>
<th></th>
<th>Real Exchange Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Distribution</td>
</tr>
<tr>
<td></td>
<td>(100=zero distortion)</td>
</tr>
<tr>
<td>Burkina Faso</td>
<td>130</td>
</tr>
<tr>
<td>Cote d'Ivoire</td>
<td>185</td>
</tr>
<tr>
<td>Ghana</td>
<td>248</td>
</tr>
<tr>
<td>Nigeria</td>
<td>277</td>
</tr>
<tr>
<td>Senegal</td>
<td>146</td>
</tr>
<tr>
<td>Sierra Leone</td>
<td>201</td>
</tr>
<tr>
<td>Tanzania</td>
<td>216</td>
</tr>
<tr>
<td>Uganda</td>
<td>155</td>
</tr>
<tr>
<td>Zambia</td>
<td>206</td>
</tr>
<tr>
<td>Malaysia</td>
<td>88</td>
</tr>
<tr>
<td>Indonesia</td>
<td>98</td>
</tr>
<tr>
<td>Thailand</td>
<td>75</td>
</tr>
<tr>
<td><strong>Africa</strong></td>
<td><strong>160</strong></td>
</tr>
<tr>
<td><strong>Asia</strong></td>
<td><strong>86</strong></td>
</tr>
</tbody>
</table>

Source: Dollar 1992, Table A1.

Why does this matter? Dollar goes on to calculate the relationship between these measures of outward orientation and economic growth. This is found not only to be statistically significant but economically important. For all developing countries, the resulting coefficients would imply that reducing overvaluation to the real level of Asia would raise average growth by 1.8 percent in Africa, and reducing exchange rate volatility to the Asian level would raise it further to a total of 2.1 percent. If the same calculations are done only for the poorest countries, the relationship between the exchange rate and growth is even stronger. It is interesting to note the predictive power of the calculation: for Ghana, for example, it predicts a turnaround of 5 percentage points, which is not far from the result achieved. The results “strongly imply that trade liberalization, devaluation of the real exchange rate, and maintenance of a stable real exchange rate could dramatically improve growth performance in many poor countries” (Dollar 1992, p. 540). 68

This is therefore strong econometric evidence to accompany what has been observed in the earlier country comparisons. The extent of trade restrictions and exchange rate misalignment have reduced sharply in recent years under structural

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68 Dani Rodrik, in his critique of the Dollar Index, claims that Dollar’s cross-country evidence is insufficient to conclude anything about the consequences of trade restrictions or of openness proper. Rodrik, however, agrees that exchange rate mismanagement and overvalued currencies appear to have been detrimental to long-run economic performance.
adjustment. The evidence of both this work and this study's observations indicate therefore that this was the right way to proceed. The question then is whether the current "policy package" can get to the final goal of approaching Asia's level of outward orientation.

The Africa Difference

The *Adjustment in Africa* study and other recent trade analyses suggest that Africa has made significant progress in reducing non-tariff barriers and exchange rate distortions, although much less in terms of tariff reform (Dean, Desai and Riedel 1994). The current model suggests a four-element strategy for trade reform in Africa.

i. Rapidly eliminate non-tariff barriers, replacing them with tariffs where necessary.

ii. Adjust through an auction mechanism to a market-determined exchange system, rapidly eliminating restrictions on current account transactions.

iii. Gradually, over a four- to six-year period, reduce average tariffs to 15 percent to 20 percent, with about four rates and a maximum rate of around 25 percent.

iv. During this period of structural adjustment, receive balance of payments assistance equivalent to 20 percent to 50 percent of exports earnings.

The African difference is the final element: that Africa is much more heavily dependent on external assistance than is any other developing region. For project assistance, there can be legitimate concerns about savings rates, but it can be safely assumed with reasonable certainty that the external assistance finances programs, or makes possible, the financing of programs that would otherwise not have been carried out, and that it therefore raises the investment rate.

The case of balance of payments assistance is different. The incremental flow of foreign exchange to foreign exchange markets in Africa could mean that the overall supply of foreign exchange is higher by precisely this amount, and that this therefore results in a lower exchange rate than would otherwise prevail. Indeed, the justification for such assistance is to reduce the pain of the adjustment measures. But if the result is an under-depreciated exchange rate, the result will be lower export growth, lower GNP growth, and faster elimination of inefficient import substitution industries.

In Ghana, aid flows increased from about 3 percent of GDP before the Economic Recovery Program (ERP) began to 7 percent of GDP in 1987, four years later (Younger 1992). These capital inflows, which are likely to endure for a considerable time, have caused "Dutch Disease" problems for the macroeconomic management of the economy. Younger points out that the Ghanaian authorities'
response to these problems has been limited by Ghana's agreements with the international lending institutions. First, the government faces ceilings on growth in the money supply imposed by its agreement with the IMF, so it must contract domestic credit to offset the growth in foreign exchange reserves. One way the government has done this is by imposing tight credit ceilings on commercial banks' loan portfolios, making credit to the private sector very scarce. This partly explains why private sector development has remained low despite market-oriented reforms. Despite tight domestic credit, Ghana has been faced with persistent inflation. Younger lays out the policy options the Ghanaian government and its international creditors could follow, in order to better handle the strong capital inflows.

To examine the potential impact, this study has taken for the three comparators of Cote d'Ivoire, Tanzania, and Ghana the levels of balance of payments assistance received during "SPA2". It has then taken the straightforward approach of asking "Given a range of elasticities for imports and exports in Africa, how much would the exchange rate have had to adjust in order to compensate for such balance of payments assistance if it had not been supplied?" Though in reality, arrears would have emerged and reforms may not have occurred, that is not the point -- the study is trying to assess whether there is a contradiction in the paradigm.

The methodology and results are shown in Box 21 and Figure 18 below. As can be seen, these are rather invariable to the range of elasticities shown. If anything, these elasticities are on the high side, and would tend to under-estimate the degree of overvaluation. The results show that the balance of payments assistance results in an overvaluation of the exchange rate of at least 15 percent in Tanzania, and almost 10 percent in Ghana and Cote d'Ivoire.

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69 The Special Program of Assistance is a multi-donor program to raise finance for structural adjustment in Africa. SPA2 covered the period 1991-1994.

70 The five elasticity pairs for import demand/export supply are: (a) 1.0, 1; (b) 0.8, 1.0; (c) 0.8, 1.0; (d) 0.9, 1.2; and (e) 0.9, 1.5.
Figure 18: Overvaluation Due to Balance of Payments Assistance

Box 21: Calculation of Exchange Rate Overvaluation Due to Balance of Payments Assistance

Example: Ghana for the year 1993:

Ghana’s imports of goods and non-interest services (US$ million 2,180) less project financing (US$ million 693) equals US$ million 1,487. Exports of goods and all services is US$ million 1,203. If we assume that import demand and export supply elasticities are -0.9 and 1.0 respectively, and the financing gap before SPA (before debt relief and adjustment support) is US$ million 348, then,

\[
348 / (1,487 \times 0.9) + (1,203 \times 1.0) = 13.7\%
\]

The overvaluation is: (113.7-100)/113.7 = 12.0%

While such numbers may have been unimportant during periods of extreme overvaluation and high protection, they become critical after reform. Average protection needs to be reduced to about 15 percent through import tariffs. Uganda and Ghana are close to this figure, and yet this level of assistance would reduce that to zero or negative levels. Moreover, a 15 percent tax on exports (which the overvaluation represents) would be considered devastating and, if explicit, would be the immediate target of policy reform. Therefore, this study regards this as an aspect of policy that is Africa-specific, and is being neglected in the application to Africa of lessons learned elsewhere.

Conclusions

The argumentation of this section can be rapidly summarized. The lessons from East Asia for outward orientation are clear. It also appears to be the case that the extent to which Africa was inward oriented prior to reform rightly put this at the head of the reform agenda. This meant a combination of exchange rate reforms to re-establish competitiveness and trade reforms both to eliminate the anti-export bias, and to ensure true exchange rate alignment. Substantial progress has been achieved in this regard in Africa. However, the lesson from East Asia must also be the correct use of the exchange rate during the process of trade liberalization. While much of the argument has been understood, this study has argued that the use of markets to determine exchange rates results in under-shooting the necessary exchange rate because of huge flows of balance of payments assistance. Further, the study argues that this:

i. Reduces the positive impact on exports, explaining some of the disappointing export performance in response to the adjustment programs.

ii. Could have exacerbated the impact of liberalization programs by over-reducing protection, or by generating back-door reintroduction of non-tariff barriers.

This suggests two recommended courses of action that deserve consideration:

i. That the flows of assistance to Africa are necessary in terms of supplementing domestic savings. However, they should increasingly be used in ways which do not artificially reduce exchange rates. This would suggest that assistance should flow less for the financing of general imports, and more to finance development-related expenditures, either by the state or private sector. This, in turn, implies much higher targets for balance of payments surpluses, accompanied by programs either of reserves accumulation or of debt pre-payment.
ii. That exchange rate determination be more a matter of policy and less a matter of determination in distorted markets. Auctions and markets have eliminated the worst distortions. Now African countries need to consider pro-export exchange regimes. The correct exchange rate is not, in this view, the one that clears the (distorted) market: it is the exchange rate that achieves the targeted rate of export and GDP growth.

This said, it is fully recognized that this is too simplistic an analysis on which to base firm conclusions at this stage. The impact of different forms of aid on import demand is not unambiguous, depending on their relationship to the structure of the budget. Moreover, the impact of aid flows on the equilibrium exchange rate also depends on the extent to which private capital inflows will later replace the extraordinary balance of payments assistance following economic reforms. Moreover, the correct exchange rate policy cannot be divorced from the maintenance of sound fiscal and monetary policies, as the South-East Asian experience amply demonstrates. However, these considerations do, in overview, suggest the need for more discussion of how to manage exchange rates at this stage in Sub-Saharan Africa's reform and development.
PART V. OPERATIONAL IMPLICATIONS

This final section of the report attempts to bring out some of the operational implications of the East Asian experiences, especially with respect to industrial and trade policies. However, these must start from a restatement of the most important conclusion that emerge from any review of the East Asian experience, and especially the recent experience of the Southeast Asian economies that have been the focus of much of this study's attention: that attention to the basics is largely responsible for their success. In this case, the basics refer to three key elements of economic policy: the maintenance of macroeconomic stability; the encouragement of savings; and public investment in human capital to ensure wide enjoyment of the benefits of economic growth. It must be clearly understood, however, that any recommendations for Sub-Saharan Africa with respect to the operational implications of East Asian policies assumes that any such industrial or trade policy initiatives would take place within a context where the three basic elements are being addressed satisfactorily. The absence of such a context would almost certainly result in the failure of such interventions.

These following implications are divided into two types: policy issues, and project/technical assistance issues. The audience for such observations is two-fold: African policymakers, and World Bank staff dealing with African economies, especially those countries under or emerging from adjustment. It is assumed that the main conduit for the transmittal of these messages will indeed be the Bank country staff, and this is why one aspect of these implications is concerned explicitly with project possibilities. In terms of policy issues, these are questions that will need to be considered in the context of policy framework papers and possibly in the context of future adjustment programs.

However, there are two aspects of the implications of East Asian experience that do not neatly translate into one of these categories, nor are they something that can be introduced or induced into African societies: the attitude towards the private sector, and the role of the export sector in economic strategy.

- In terms of the role of the private sector, East Asian governments have explicitly taken the attitude that what is good for the private sector is also good for them (in terms of taxes, public welfare, economic growth, etc.). Therefore, the role of the state with respect to the private sector is to do everything necessary to ensure the sector’s success, and to work with the representatives of the private

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71 This study does not deal with educational policy and investment in human capital. See The East Asian Miracle, World Bank, 1993a for further analysis of these topics.
sector to design government policies accordingly. When governments see their own survival in these terms, the approach to the private sector is quite different. This cannot be imposed on or required of African governments. It can merely be pointed out that this is the situation in successful countries elsewhere.

- In terms of export development strategy, it is not simply a question of reluctantly removing barriers to trade, or grudgingly handing over tax rebates. The East Asian countries put the development of exports as the central economic strategy, in the belief that this would be the source of economic success in other spheres. Thus, as observed earlier, exchange rate strategy was not about national pride, or about retaining the goodwill of an import-dependent elite. It was about finding the right rate for the promotion of exports. An export credit scheme in Korea assumed the exporter was truthful, as this was the case most of the time, and the costs of assuming they were trying to cheat would have been too high.

These two key factors permeated the approach of the East Asian governments, especially in Korea, and later in the Southeast Asian comparators of Indonesia, Malaysia, and Thailand. What this amounts to is that East Asian governments developed a long term vision for their economies and societies and set out with determination to design and implement policies to realize this vision. It is a lack of this sort of vision and commitment that has contributed to Africa’s lack of development success. The greater commitment to development of many African governments that have come to power in recent times-- in Malawi, Ghana, Cote d’Ivoire, Zambia and Benin to name a few -- lends hope that such a vision can now be developed. While these attitudes cannot be conditions in structural adjustment loans, the results of these approaches can be pointed out, as fundamental explanatory factors behind the East Asian success story.

POLICY APPROACHES TO BE CONSIDERED

This section deals with the broad policy conclusions that need to be considered in the light of this experience, and whether there are lessons that need to be applied in considering these questions. The discussion leads to four broad issues in this regard:

i. Macroeconomic stability as the starting point. Much of the dialogue between the World Bank and African economies has been concerned with the achievement and maintenance of macroeconomic stability. The World Bank’s recently issued revised strategy statement for Africa (World Bank 1995) reaffirms the achievement of basic macroeconomic stability as the basis of the Bank’s approach in Africa.
It also concludes that in many respects this is the area where most progress was seen in the early 1990s, and that it is in the accompanying sectoral policy areas that most remains to be achieved. The conclusions of this paper firmly endorse this approach, both in terms of the fundamental importance of the macro framework, and stability in particular, and also in terms of the need to look beyond this basic aspect.

ii. **Exchange rate policies to be targeted to serve the export sector.** This study has made the case that Africa is different when it comes to exchange rate policies because of its extraordinary dependence on external assistance. This means that a policy that fixes the rate according to market clearing, instead of according to the fulfillment of export targets will be intrinsically anti-export. Thus, a critical lesson from Southeast Asia in particular is that exchange rates should be determined from an external competitiveness and export development perspective, and that this approach deserves to be discussed and considered both with African governments as well as with the International Monetary Fund.

iii. **Africa is not yet ready for industrial targeting and directed credit.** This review has not attempted to deny the importance of some aspects of industrial targeting and of selective credit policies. Rather, it has noted that they existed and that many observers have considered them important in East Asian development, although, significantly, they were much less important in Southeast Asia, the main comparator. Rather, the question is, what are the necessary institutional conditions to operate such policies? Here, the conclusion is that even in the most advanced reformers the conditions are not yet ripe, and therefore these policies do not yet merit a place at the policy table. Perhaps by the time the conditions are right, the policy debate on whether such policies are indeed critical will have matured further, but at present that debate is simply, in this study’s view, not of relevance for Africa.

iv. **Consultation mechanisms should be developed, but cautiously.** A fundamental aspect of the East Asian approach is the extent to which institutions such as deliberation councils have been used. In effect, much policy setting is delegated to such councils in East Asia, and this has proved very valuable in ensuring the effectiveness of policy initiatives. The principles of such mechanisms are undeniable, and of course the development of such consultation systems must be encouraged. However, the brief review of this topic suggests that caution should be exercised in vesting excessively complex tasks to such
councils initially. Rather, their role should be built up gradually, starting from simpler demands, such as the identification of obstacles to investment. The danger is that initial failure from being over-ambitious could undermine the confidence of both sides in such mechanisms. The ultimate goal of such organizations is not so much the specific polices and programs they develop, but rather the mutual confidence that they engender in the various participants.

PROJECT DESIGN IMPLICATIONS

In addition to the broad policy conclusions, there are several issues that have emerged from this review that would suggest how the process of export-oriented industrialization in Africa could be assisted through lending and technical assistance. It has not been “fashionable” of late to promote industrial projects in Africa, not least because in a historical perspective, many such projects were probably in violation of this study’s considerations about industrial policy and selective credit. Moreover, such policies were either pursued in the absence of a sound macroeconomic framework, or else by the importation of an excessively complex design. However, this review of the polices of East Asia leads to the conclusion that there are six elements that should be pursued in industrial lending, and that simple design could overcome some of the problems that past attempts have faced. The study recognizes that there are in addition a wide number of supplementary issues that could also be considered, but is concerned here with the primary directions that seem to offer the most scope for further examination in individual country circumstances.

Technical Assistance Aspects

There are three types of institutional support that should be considered, in order to develop the capacity of African governments to lend support to the development of the export sector in Africa.\textsuperscript{72}

i. The development of training financing mechanisms. The study concluded quite strongly that the most successful approaches to the encouragement of training mechanisms had been through the refund of payroll taxes, rather than through subsidy mechanisms or general tax rebate mechanisms. There was a role for the state in encouraging enterprises to increase their training efforts, and the study did find that

\textsuperscript{72} This study does not in this regard consider explicitly the issues of developing domestic industry or the service sector, and nor does it concern itself explicitly with the development of industrial opportunities for the poor. Therefore, it is not explicitly concerned in these considerations with the development of microenterprises or the informal sector.
African enterprises were pursuing training less vigorously. Therefore, governments should be assisted in the design and implementation of such schemes.

**ii. Technical assistance programs for enterprises.** Many firms in Africa have difficulty in accessing technology or design skills, and need support of various kinds for the development of external markets, for participation in trade fairs etc. While much can go wrong in such schemes if they become too supply-driven, the evidence from East Asia appears to support the view that such schemes can work in Africa, and deserve to be assisted, if well-designed.

**iii. Development of simple duty exemption schemes for Africa.** The ability of exporters to have access to duty-free inputs is critical to export competitiveness. The experience of these schemes in East Asia is highly successful as compared to Africa. One design problem relates to the indirect exporter, and the conclusion is that at Africa's stage of development, this problem should be secondary to establishing simplicity and effectiveness in the basic mechanism. Further, exemption schemes are likely to be more successful in Africa than rebate schemes, although zero tariffs for raw materials and intermediates imports could be an alternative to be considered in some cases. Finally, the study concluded that transparency is key to the whole process. Introduction of such mechanisms is often a requirement of structural adjustment programs, but less attention has been paid to the design details. Technical assistance should be provided for the design implementation and operation of these simple mechanisms, and no effort should be spared in what has to date been a dismal record in Africa in an area of critical importance.

**Implications for Lending Operations**

In addition to technical assistance, there are three possible elements of development projects that this review of East Asia would suggest as being worthy of consideration. As noted, in response to problems with industrial credit projects, these aspects have largely disappeared from practice in World Bank-supported projects. This review suggests that while abandonment of such projects was probably a sound judgment, this should not have implied the abandonment of all industrial lending initiatives. Three avenues seem to merit attention in particular.

**i. Export credit support mechanisms.** The provision of automatic credit to exporters, especially for preshipment finance, is one form of directed credit that appears entirely justified. Moreover, the study concluded that the ready availability of such credit in East Asia was a
significant explanatory factor. If one considers that credit should be set aside by central banks for the provision of a rediscount facility for such lending, then it seems quite reasonable that in Africa the World Bank or other development agencies should be prepared to provide countries with financing for such facilities.

ii. **Public-private training institutions.** The public provision of industrial training, in the right circumstances, could be a useful supplement to the direct provision of training by enterprises. The key is that the public training is for generic industrial skills, and that the private sector be given an absolutely central role in the development of the course selection and curriculum, as well as in determining the level of demand for various skills. It is clear that when these conditions are met, such training centers can be very helpful, but that when these become supply-driven exercises divorced from the potential employers, then they have little chance of succeeding. However, it again seems quite reasonable to support through project lending the development of such centers when they are designed in the way that is more likely to succeed.

iii. **Development of Industrial Parks and Zones.** Finally, and perhaps more controversially, the review of the experience of industrial zones and EPZs suggests that in the right circumstances, these zones can indeed influence the pace of industrial development. Broadly speaking, these circumstances are when the natural advantages of a location or environment would suggest that industrial development is likely. For example, the hinterland of a good port in a country with generally stable conditions. It can be argued that in such circumstances, the private sector ought to be willing to develop such parks. However, these are long-term investments, with high initial costs, and there is good reason to expect market failure. More fundamentally, one is convinced that there is a good prospect of such a park or zone succeeding, and sure that the state would not be pre-empting a private investor, there should be no objection to assisting a government with such a project, ensuring an appropriate pricing policy, and a commitment to eventual privatization. Lowering of initial capital costs could be a significant initial attraction, especially for potential local enterprises.
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