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COUNTRY ECONOMICS DEPARTMENT

Research, Policy Analysis, Technical Assistance, and Dissemination Activities

Annual Report
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Contents

Country Economics Department: Past and Future

This annual report highlights work in the Country Economics Department (CEC) for fiscal 1992. Although these highlights capture only a partial view of the year's work and work in progress, they indicate the range and depth of the department's research, policy, operational support, and dissemination activities.

CEC's mission

The Country Economics Department is responsible for:

- Conducting research and analysis of key development questions.
- Translating analytical and research findings into practical policy options and recommendations.
- Providing operational review, advice, and support to the Bank's regional departments.
- Providing technical assistance to the Bank's borrowers.
- Disseminating major research and policy outputs to the Bank and to external audiences.

Looking back

For the past several years the department has been concerned with analyzing country policies in the areas of finance and the financial sector, macroeconomic adjustment and growth, public finance, the development of public and private sector institutions, trade policy, and reform in economies in transition from socialism to market systems.

During fiscal 1992, the department moved beyond its traditional areas of concern in several new directions:

- *Poverty and labor issues*. Work began on a major report on old age security, to be completed in fiscal 1994. The initial steps were also taken for a program of work on labor issues.
- *Regionally focused initiatives*. Several regionally focused initiatives were begun in close coordination with the regional chief economists. Two of these initiatives will culminate in major reports: one on structural adjustment in Sub-Saharan Africa (to be completed in fiscal 1994) and one on lessons of the East Asian experience (due in fiscal 1993).
- *Dissemination*. The department launched *CEC Outreach*, a monthly note designed to communicate aspects of the Bank's research to operations staff and innovative approaches from the Bank's operational work to Bank staff across all regions.
- *Operational support*. To meet the greatly stepped-up demand for operational support for Eastern Europe and the states of the former Soviet Union, the department provided considerably more staff resources to operational support and technical assistance than planned.

Looking ahead

As part of the Bank's recent reorganization, the department has received an expanded research mandate. Responsibility for sectoral research, which was previously carried out by departments of the former Sector and Operations Policy Vice Presidency (OSP), has been shifted to the Chief Economist and Vice President, Development Economics (DEC). CEC will assume responsibility for both macroeconomic and sectoral research.

This shift in responsibility is reflected in several changes in the department's organization (see chart on next page). Three divisions in charge of macro-oriented research will remain in place: the Transition and Macro-Adjustment Divi-

including training and cross-support to the Economic Development Institute. This activity provides an opportunity to test and disseminate analytic approaches in an operational context, makes a direct contribution to operations and to the Bank's training and dissemination work, and provides operational and country-based experience for departmental staff.

In the sectoral area special attention will be given to ensuring that research complements and supports best-practices work and that economists in research benefit from collaboration with technical staff and economists in the new sector departments. The CEC department will seek cross-support or secondment of staff from outside the DEC vice presidency for research and high priority tasks, when appropriate. This support will be sought in particular for the major cross-cutting research studies (two of which currently involve substantial inputs from regional staff). Similarly, DEC staff will be encouraged to provide direct support for best-practices and other sectoral studies undertaken in the thematic vice presidential units, if their services are sought. The CEC department will continue to invite staff from outside DEC to spend six to eighteen months as CEC Fellows (internal sabbaticals), with full salary support.

The department will also continue to publish *CEC Outreach*, which is specifically targeted to regional staff; to prepare short nontechnical versions of research output in easily accessible booklet form; and to sponsor colloquiums on topical subjects for the Board of Executive Directors. The department will also continue its commitment to provide support to the Economic Development Institute and to collaborate in training programs designed to strengthen the technical expertise of Bank staff in economic analysis and advice.

The pages that follow show the breadth and depth of the department's work program, as well as an intensified focus on dissemination activities during the past year. The energy and resources devoted to dissemination are reflected in the unusually large number of conferences, publications, and training activities reported here. The department will continue to give high priority to active dissemination of findings both inside and, increasingly, outside the Bank, especially to policymakers in client countries.

Highlights of Fiscal 1992

During fiscal 1992 the department's work program was carried out by five divisions and one unit:

- Macroeconomics and Growth Division (CECMG)
- Financial Policy and Systems Division (CECFP)
- Public Economics Division (CECPE)
- Trade Policy Division (CECTP)
- Public Sector Management and Private Sector Development Division (CECPS)
- Socialist Economies Reform Unit (CECSE)

This section presents highlights of the work program. The following section describes the major themes of the work program for each division.

• Adjustment in the public sector has been substantial, but misallocation of resources is still a problem.

Fiscal 1992 also saw the completion of a research project on *adjustment, income distribution, and poverty,* undertaken jointly by the Trade Policy Division and the Development Center of the Organization for Economic Cooperation and Development. The project, directed by Jaime de Melo (CECTP), Francois Bourguignon, and Christian Morrisson, studied the effects of adjustment policies on income distribution in six countries and provided an analytical interpretation of how each economy had fared. With simulation exercises, the country studies explored how poverty and income distribution would have fared under alternative adjustment packages—or none at all.

The exercises show considerable diversity in the evolution of income distribution during adjustment. They also expose the fatal flaws of narrowly designed programs. Adjustment programs, whether focused on efficiency or welfare, will fail if they do not recognize the interdependence of the three criteria of efficiency, welfare, and political feasibility. Adjustment programs must also be carefully packaged to fit the circumstances of each country, taking political as well as economic conditions into account. The country studies and an overview piece were published in an issue of *World Development* that was devoted entirely to the study.

Poverty and public spending

Responding to an urgent need for more efficient antipoverty programs in a period of tight budgets almost everywhere, the Public Economics Division sponsored a conference on *Public Expenditures and the Poor: Incidence and Targeting*. Organized by Dominique van de Walle, Shankar Acharya, and Kimberly Nead, the conference was attended by some 250 researchers, policymakers, and others involved in designing and implementing antipoverty programs in developing countries. Papers explored the costs and benefits of various antipoverty programs and targeting mechanisms, as well as who benefits from them.

Among the findings highlighted in papers and discussion:

• Targeting is a policy instrument, not a goal, so its usefulness depends on the specific context and policy environment.

• The behavioral responses of participants and others involved can strongly influence the effectiveness of targeted programs in reducing poverty.

• Broad targeting, or the universal provision of basic social services, has been a key part of successful strategies in countries such as Indonesia and Malaysia. Expanding such services often benefits the poor more than others.

• Narrowly limited programs that discriminate among beneficiaries can provide a crucial fallback for individuals in temporary crisis, as following a drought or other disaster, and for people chronically unable to provide adequately for themselves, such as the elderly and infirm.

Much still remains unknown about the true costs and benefits of narrowly targeted programs. A cautious approach is probably wise. A careful weighing of costs and benefits of specific programs would include consideration of several interrelated concerns: net benefits received by the poor, administrative costs and requirements, behavioral responses of beneficiaries and other participants, and political support and sustainability. Additional research on targeting and on who benefits, and more support for broad targeting appear to be activities with potentially large payoffs.

Financial reform

Intensive research and fieldwork on financial reform by the Financial Policy and Systems Division culminated in the completion of four products of major relevance to Bank lending and operations.

The findings of a research project on financial reform, managed by Gerard Caprio, were presented at a conference held at the Bank in April 1992. A book on the study is also being prepared (*The*

Other research and policy work

In addition to the work mentioned above, other major studies completed by CEC staff during fiscal 1992 include:

• Modeling the behavior of holdings of money and public debt, private consumption and investment, the trade balance, and the real exchange rate for a sample of ten developing countries to show *how financial markets, private spending, and the external sector react to fiscal policies*. The study found that the virtuous circle of growth and good fiscal management is one of the strongest arguments for a policy of low and stable fiscal deficits. An article by William Easterly and Klaus Schmidt-Hebbel (CECMG) detailing some of the findings will be published in a forthcoming issue of the *World Bank Research Observer*.

• The *design and implementation of tariff reforms*. Directed by Arvind Panagariya and Ramon Lopez (CECTP), the study found that conventional advice advocating uniform tariffs is right (for political reasons and as a reasonable rule of thumb), but not necessarily for the reasons usually given (that uniform tariffs minimize distortions—they don't always). Articles on the study have appeared in *American Economic Review*, *Journal of International Economics*, and *Economic Letters*.

• The *inflation process during price liberalization* in Eastern European countries. The study, directed by Fabrizio Coricelli (CECMG), found that price liberalization has, in many cases, been followed not only by an initial jump in prices, as expected, but by persistent inflation, due in large measure to weak market forces and undefined property rights. Findings have been reported in a symposium volume, an article in the *World Bank Economic Review*, and the EDI Seminar Series.

• *Reforms of fiscal incentives* in many developing countries, designed to foster industrial and technological development. The study, led by Anwar Shah (CECPE), recommends that the first step in an effective investment promotion strategy be to develop a climate of business confidence and eliminate tax and other disincentives. Well-targeted tax policy interventions could follow. Findings were presented in two books published by the Bank.

• The effectiveness of Bank-supported *adjustment programs in Sub-Saharan Africa*. Using adjustment lending as a proxy for adjustment, the study directed by Ibrahim Elbadawi (CECMG) found that adjustment lending contributed to significant improvements in export performance—increases in export competitiveness and the efficiency of investment—but that the improvements were not sufficient to counteract a decline in investment, a finding considered a useful point of departure for future research.

• Identification of innovative and *successful civil service management practices* in industrial countries that might serve as models for reform in developing countries. The study, managed by Barbara Nunberg (CECPS), found that traditional, centralized civil service management models provide the best starting point, that certain management functions such as recruitment should receive higher priority than others, and that the establishment of some form of senior executive service has important payoffs.

• Development of the RMSM-XX (Revised Minimum Standard Model) *macroeconomic simulation model and country applications* through the preparation of behavioral macroeconomic models for a few countries. The four RMSM-XX models developed so far (for Chile, Colombia, Philippines, and Zimbabwe) under the direction of Klaus Schmidt-Hebbel and Luis Serven (CECMG) have proved to be successful tools for sensible macroeconomic analysis involving the interaction of prices, asset returns, and quantities.

tation were prepared for Guatemala, Madagascar, Mali, Morocco, Poland, Uganda, and Uruguay. In fiscal 1992 the program, managed by John Nash (CECTP), provided technical assistance to Costa Rica, Czechoslovakia, Kenya, and Peru. A monitoring component has been added to the program in Phase II, to allow for more formal follow-up of recommendations from the country reports.

The program also sponsors the preparation of occasional papers. The papers draw on theory and the experience of many countries to give practical advice on such issues as export development and marketing organizations, the move from quantitative import controls to tariffs, and mechanisms for stabilizing export commodity prices.

The program was an important complement to research by the Bank aimed at distilling the lessons of trade reforms across countries and summarized in a volume by Vinod Thomas and John Nash, *Best Practices in Trade Policy*. The book is frequently used by operations staff in the design of trade reforms as part of adjustment lending operations.

The macroeconomic situation in Eastern Europe

June 4-5, 1992, Washington, D.C.
Official statistics show a precipitous fall in output across Central and Eastern Europe in the last few years. Special factors have been responsible for the biggest declines—in Albania, eastern Germany, much of the former Yugoslavia—but output has fallen by over 20 percent in other countries. The steepness of this fall and its persistence were not anticipated.

What caused the decline? How much influence did macroeconomic policies have, as opposed to structural and external shocks? What are the bottlenecks to sustained recovery? A two-day conference cosponsored by the World Bank and the International Monetary Fund and organized by Mario Blejer (CECMG) and Alan Gelb (CECSE) was held in June 1992 to address these topics. Approximately 70 people participated, including scholars, officials from Eastern European countries, and IMF and World Bank staff.

The most worrisome aspect of the output decline was not its magnitude—trade shocks and statistical mismeasurement played a role here—but rather that very little real restructuring accompanied the contraction, implying pessimistic prospects for its duration. The immaturity of financial markets—and their passivity in initiating bankruptcy proceedings—was singled out as a major impediment to rapid restructuring and recovery. Unresolved issues of ownership and control of state enterprises are another serious bottleneck. Labor markets seem to be adjusting more rapidly than financial markets: as industrial output fell at the end of 1991 to about 65 percent of 1989 levels in Czechoslovakia, Hungary, and Poland, the industrial labor force shrank by a quarter.

Four causes of the output decline were identified:

• Official statistics overstated the decline by failing to adequately capture the growing private sector and because of index number complexities. Estimates for Poland in 1990 put the actual decline at between 5 percent (measured from the demand side) and 9 percent (from the supply side), compared with official estimates of 12 percent. These estimates did not go unchallenged, but there seemed general agreement that measurement error accounted for up to one-third of the decline.

• Trade shocks were another factor. Trade in the Council for Mutual Economic Assistance (CMEA) has contracted abruptly since 1989, mainly because 85 to 90 percent of trade with the former USSR disappeared. The shift to world prices also imposed large terms of trade losses, averaging 4 percent of GDP for Czechoslovakia, Poland, and Hungary. Estimates presented at the conference suggest that trade shocks reduced output by something like 8 percent of GDP for Czechoslovakia and Hungary and 4 percent for Poland—even more if a Keynesian multiplier higher than unity is assumed. A reasonable conclusion is that the trade shock was responsible for at least one-third of the fall in regional output.

• Macroeconomic policies also contributed to the output decline. The question is whether the big bang policies were too restrictive, in that hyperinflation could have been avoided at a lower cost in forgone output. Presentations suggested that this might have been the case for Poland and that macroeconomic imbalances in Czechoslovakia may have been exaggerated when the stabilization program was planned. In any case, it is clear that growth in real credit volumes did not signal recovery (except in Hungary, which followed a more gradual strategy) but rather a growth of arrears, and so no lessening of the credit squeeze on promising firms. The blame lies with underdeveloped financial markets and unsatisfactory resolution of ownership issues.

• Some of the output decline was also attributed to perverse behavior of enterprises in response to macroeconomic policies. Some microeconomic aspects of the adjustment were encouraging, such as the employment response to falling industrial output and the realignment of trade away from the CMEA. Less encouraging

Public expenditure and the poor: incidence and targeting

June 17-19, 1992, Washington, D.C.
Public expenditures are a key instrument for reducing poverty. With budgets being squeezed ever tighter, it becomes especially important that public programs to reduce poverty be effective and well directed. A World Bank conference in June 1992, organized by Dominique van de Walle, Shankar Acharya, and Kimberly Nead (CECPE), took stock of what we know about who benefits from public spending in developing countries, as well as the scope for better targeting of public programs. Participants included researchers, policymakers, and practitioners involved in the design and implementation of antipoverty programs. About 300 people attended the conference.

Among the points brought out in the discussion:

• It is important to be clear about the objective of poverty-reduction programs. Low income is not the only poverty indicator. Being deprived of basic nutrition, health, education, shelter, and dignity are other aspects of poverty. A clearer focus on objectives makes it more likely that programs will be targeted effectively.

• Experience shows that often the most effective way to benefit the poor is not through narrowly targeted programs (which try to distinguish individuals who are poor from those who are not) but through a strong program of basic social services for all. Expanding such programs usually benefits the poor more than others, and these programs are also easier to sustain because they have broad social and political support. Such broad targeting of public spending has played a key role in reducing poverty in countries such as Malaysia and Indonesia.

• In many situations narrowly targeted antipoverty programs provide vital safety nets. For example, rural workfare schemes in India and Africa have provided effective insurance for the poor in times of drought and other disasters.

• The cost-effectiveness of targeted programs has usually hinged on containing administrative costs and relying on self-selection rather than means-testing and other administratively demanding methods of reaching the poor. For example, rural relief work programs typically reach primarily the poor by paying low wages.

• The effectiveness of targeted programs also depends on the behavioral responses of participants and others. For example, in the Philippines, where private transfers from the better-off to poor relatives are common, research suggests that much of the benefit from introducing unemployment insurance and other public transfers for the poor could go to richer households, who would cut back their transfers to poor relatives.

• While narrowly targeted programs can be effective in reducing poverty, assessments need to consider whether programs actually reach the poor and not those who are better off, the administrative costs, the behavioral responses of beneficiaries and others, and the political sustainability of the program. These are the factors that determine the economic and social viability of targeted antipoverty programs.

Impact of financial reform

April 2-3, 1992, Washington, D.C.
Many countries have undertaken financial reform in recent years, often with World Bank support. A conference was held at the Bank in April 1992 to examine the results of financial reform in developing market economies and to find out what has worked best.

The principal conclusions of operational relevance:

• Financial reform is a process, not an event. Building up institutions and skills is central. There is generally a case for deliberate but gradual reform stretching over a period of years. The countries where success has been most evident, such as Korea and Malaysia, moved gradually, first reducing taxation of the financial sector and intervention in credit and interest rate decisions before deregulating interest rates completely.

• The management and speed of the reform process should depend on the

expand, and a safeguard against exploitation of consumers.

• The divestiture of even efficient firms can be advantageous to the economy, and partial divestiture can result in more than cosmetic changes.

• Successes, defined as economic gains to society as a whole, were greatest where enterprises had been relatively inefficient before divestiture, where the regulatory framework was well conceived and implemented, and where lack of public resources was a constraint to new investment and expansion of services.

• Gains stemmed primarily from higher investment, higher productivity, and higher output prices.

• Benefits were widely distributed: consumers often won, but not always; workers did not lose, and sometimes won; foreigners did well, and so did nationals; and buyers did well, and so did governments.

Among the policy lessons: adopt appropriate regulations before selling natural monopolies, divest some ownership if full divestiture cannot be pursued at once, and give no concessions to sweeten the deal.

The conference, which was preceded by a press conference, was reported on in *The Economist*, *Business Week*, the *Journal of Commerce*, and several European and Latin American journals.

Integrating Ukraine into the world economy

June 9-11, 1992, Kiev

With cofinancing from the Bank, the Trade Expansion Program organized a two-day seminar, under the direction of Jaime de Melo, John Nash, and David Tarr (CECTP), on trade integration for Ukraine and other states of the former Soviet Union and Eastern Europe. The seminar was attended by about fifty participants, including invitees from the Baltic States, Russia, Hungary, Poland, and Romania. Presentations covered best practices derived from experience with trade liberalization outside the former Soviet Union and first-hand experience with reforms in the Baltic states, Hungary, Moldova, Poland, and Ukraine.

Presentations on best practices highlighted issues of sequencing, other sectoral and regulatory policies, coordination of trade liberalization and stabilization measures, the need for comprehensive reform packages, and attention to the real exchange rate. Overall, the presentations emphasized that good trade policy matters.

Transitional trade and payments arrangements for the states of the former Soviet Union also received special attention. Among the key findings here:

• There seems little doubt that states of the former Soviet Union must turn their trade toward Western Europe over the long run. What must be avoided is too rapid a transition and the collapse of interstate trade in the short run. The search is for solutions that will encourage redirection over the long term while avoiding excessive contraction in the short run.

• The shift in terms of trade to the advantage of states exporting raw materials and energy products is unavoidable in the long run. Confrontational efforts to prevent the shift, say by charging short-run monopoly prices for services such as transportation, should be avoided since they will have counterproductive effects in the long run.

• Extensive controls on exports to convertible currency areas are counterproductive. Only export taxes for goods subject to price controls should be used, and the number of goods under price controls should be very limited.

• List trading—a holdover from the trade model of the Council for Mutual Economic Assistance—retains too much importance in interstate trade. This overregulation tends to preserve central planning, which is undesirable. Only products still under price controls should be subject to list trading. Despite their reluctance, non-Russian states should be willing to accept rubles for their exports, since they will be running ruble deficits in interstate trade; otherwise, other states (including Russia) may retaliate with export controls of their own.

Training

CEC divisions organized and conducted several training courses, seminars, and workshops for Bank staff, most of them arranged through the Bank training division. Among them:

• Three three-day courses on "Macroeconomic Adjustment and Growth," prepared by CECMG to help upgrade the skills of Bank economists in this area.

• Seven hands-on clinics, also sponsored by CECMG, to teach staff how to use the RSMS-X model.

• A three-day course on "Public Expenditure Analysis," conducted by CECPE.

• A training workshop on "Trade Policy Reform and Related Industrial Sector Issues," sponsored by CECTP.

• Seminars on "Bank Analysis," "Capital Flows," "Securities Markets Development," and "Financial Sector," sponsored by CECFP.

• Training on "Management of Public Expenditures," "Employee Ownership," and "Private Sector Delivery of Social Services" and courses directly related to Bank operational issues to promote the exchange of best practices across regions (how to do private sector assessments, civil service reform, privatization, and the like), offered by CECPS.

In addition, CEC staff also participated in several training courses and seminars sponsored and organized by the Economic Development Institute (EDI):

• Inderjit Singh (CECSE), Michael Finger (CECTP), and Gerard Caprio (CECFP) participated in an EDI seminar for senior officials in Viet Nam on "Reform in Transitional Socialist Economies."

• Christine Wallich (CECPE) contributed to another EDI seminar in Viet Nam on "Urban Finance and Management."

• Ahmed Galal (CECPS) participated in an EDI seminar on privatization, held in Washington, D.C.

• Brian Levy (CECPS) helped EDI design a regulatory reform seminar to examine the problems of regulatory failure where institutions are weak and politics intrusive.

• Diana NcNaughton (CECFP) was the lead speaker at an EDI training seminar for bankers held in Moscow in February 1992.

• Christine Wallich was a speaker at an EDI seminar on "Intergovernmental Fiscal Relations" in Russia.

• Mario Blejer (CECMG), Fabrizio Coricelli (CECMG), and Alan Gelb (CECSE) presented courses at the Moscow summer school for training economists.

• Dan Mozes (CECFP) was codirector of an EDI seminar on "Enterprises in Transition: Enterprise Management in the Ex-Socialist Economies," held in Poland.

• Kazi Matin (CECTP) participated in a joint UNITAR/EDI seminar on "International Development Issues" in New York in June 1992.

• With the logistical and administrative assistance of EDI and in conjunction with the Federal Reserve Board, CECFP staff conducted two seminars on bank supervision for senior bank supervisors of central banks, one held in Mexico, led by Joaquin Gutierrez (CECFP), and one in Washington, D.C., led by Andrew Sheng and David Scott (CECFP).

Work Program and Themes by Division

merger toward the end of fiscal 1992 of the division and the Socialist Economies Reform Unit. The merger should strengthen links between top-down macroeconomic research and bottom-up microeconomic research.

Carry-over research projects of the division include studies of currency substitution (dollarization), foreign exchange auctions in Africa, and books on private investment and advanced macroeconomic models. Ongoing research projects are examining:

• *The macroeconomics of public sector deficits*. Early results have been described in Policy Research Working Papers, and a book manuscript is under review. Large fiscal deficits were found to be a drag on growth, whatever the method of deficit financing. Fiscal deficits tend to be strongly associated with external deficits and with currency overvaluation.

• *The effects of national policies on long-term growth*. The study is quantifying the effects of macroeconomic and financial policies, direct foreign investment, education level, and other phenomena on growth in per capita output. Several distinguished consulting economists are associated with this project, and final papers are expected for a conference in February 1993.

• *The macroeconomics of foreign exchange markets in developing countries*. Based on eight country studies, this research confirms that macroeconomic variables such as the fiscal deficit and rate of monetary expansion determine the long-run real exchange rate. The spread between a parallel market rate and an official rate can be viewed as a measure of macroeconomic imbalance. A book manuscript is being prepared.

• *The political economy of structural adjustment in new democracies*. The study, to be completed in fiscal 1993, is examining eight countries that have undertaken political liberalization as well as structural adjustment. Fiscal, trade, and exchange rate reforms are scrutinized and related to political changes.

• *The political and institutional foundations and economic effects of central bank independence*. Legal structure is not the only determinant of central bank independence. This study takes numerous other factors into consideration, such as the method of appointment and length of tenure of central bank executives. Drawing on information for more than seventy countries, the research explores the correlation of inflation, or central bank accommodation to inflation, and institutional autonomy of action.

The division also has several ongoing collaborative research projects. One, a joint effort with the Europe and Central Asia Country Department III, is examining business and consumer services as a growth-promoting sector in the former Soviet Union. Rapid growth in such services could generate much-needed employment and improvements in social welfare. A paper is expected in fiscal 1993.

Another collaborative research project, jointly conducted with the Economic Development Institute, is on the labor market in transitional socialist economies. The study focuses on labor markets in Bulgaria, Czechoslovakia, Hungary, and Poland. The aim is to identify the effect of national incomes policies and labor market regulations on employment and real wage rates during the transition to free market capitalism.

Among several conferences convened by the division to disseminate its research findings was one on the "Macroeconomic Situation in Eastern Europe," organized jointly with the Socialist Economies Reform Unit and the International Monetary Fund and dealing with severe output declines in Albania, eastern Germany, and the former Yugoslavia. A conference volume will be produced in fiscal 1993. A conference on "The Capital Account and Macroeconomic Policies" focused on the recent resurgence of private capital flows to Latin America and considered macroeconomic policies to cope with them.

Fiscal 1993 will yield substantial outputs—articles, books, conferences—from earlier and ongoing work in the division. With solid products in hand, the newly configured division will be well set to disseminate its findings with an eye to maximizing policy impact.

• A study examining financial sector developments in successful East Asian economies to develop models of best practices for possible application elsewhere.

• A major research study on the effectiveness of credit policies in East Asia, jointly funded by CEC and the Japanese government, examining the theoretical framework for targeted credit programs. The study is assessing whether Japan's experience can be replicated in developing countries. Case studies of targeted credit programs in selected countries will compare and contrast experiences.

Restructuring financial systems in distress. Restructuring insolvent banks is one of the most pressing challenges facing financial reformers in developing countries. A major project on bank restructuring examined the experience of countries facing financial distress in the 1980s. A book is being completed on the project, detailing the mechanisms the countries employed in restructuring their banks and the lessons learned. The division has also taken a leading role in improving supervisory standards for banks and laying the foundations for strong and efficient financial institutions.

Building sound and efficient banks. A two-volume study, *Banking Institutions in Developing Markets,* responds to the need to appraise, build, and manage banking institutions in developing countries. The books constitute the main reference material for Bank staff training courses and seminars in borrowing countries. The two volumes cover financial analysis and institutional diagnosis as well as the strengthening of management and institutions. The books have been translated into several languages, including a Russian translation being prepared by the State Finance Academy. Other work on building sound banks includes a paper on measuring bank efficiency. A major project is also under way on the scope, benefits, and mechanics of bank privatization and the role of banks in private sector development.

Impact on operational work

The division's research has had a substantial impact on the Bank's operations. Research outputs of the division were major inputs to *World Development Report 1989* on financial systems and development and to the deliberations leading to the "Report of the Task Force on Financial Sector Operations" (the Levy Report) and "Operational Directive on Financial Sector Operations" (OD 8.30). "Financial Sector Adjustment Lending: A Preliminary Assessment" was particularly well received in operations. The seminar and book on *Monetary Policy Instruments for Developing Countries* and the research paper on "Financial Policy and Private Investment" met the demand for better information about how financial policy can encourage private investment and support Bank operations and policy discussions with client countries. Research outputs on banking institutions in developing countries, contractual savings, and securities markets are already being used extensively for operational and training purposes.

the influence of the composition of public expenditure on economic growth and efficiency. The goal is to provide guidance about where countries should prune their overall expenditure programs at least cost to efficiency.

Two initiatives were launched in the area of military expenditure. As part of a search for rough norms in this contentious field, a small exploratory study is using cross-country data to test hypotheses about the determinants of military expenditure. Another study was begun in late fiscal 1992 to look at transitions from civil war to peace in contemporary Africa, to shed some light on economic management issues, especially fiscal policy, in such contexts.

Fiscal decentralization. The division led a major study of intergovernmental fiscal relations in Russia as part of the Russia Technical Cooperation program. For a number of other countries, including Hungary and Romania, issues of expenditure and tax assignment among different levels of government and the design of intergovernmental transfers were also examined as part of operational support and technical assistance activities. Operationally oriented studies of fiscal decentralization are planned for Indonesia and Pakistan in fiscal 1993, leading to a more research-oriented volume on the subject the following year.

Special features of the work program

The division's work program emphasizes close cooperation with other units of the Bank. Cooperation with other divisions of CEC in fiscal 1992 included work on public expenditure for the third report on adjustment lending, in cooperation with the Macroeconomics and Growth Division, and participation in the old age security study, with the Public Sector Management and Private Sector Development Division. The research project on the environment and fiscal policy instruments and the recent conference on public expenditure, benefits, and targeting reflect joint work with sector and operations policy units. The division also made significant contributions to *World Development Report 1992*.

Another notable feature of the fiscal 1992 work program was the sharp expansion in operational support—from 111 staff-weeks in fiscal 1991 to about 162 in fiscal 1992, not counting 18 staff-weeks of work under the Russia Technical Cooperation agreement. Most of the operational support was closely tied to the division's research clusters, with much of it directed toward new and newly activated members, such as the new states of the former Soviet Union, South Africa, Cambodia, and Viet Nam.

looking at the common property rights system to see whether it results in overexploitation of the natural biomass stock and excessive land clearing. Data from household surveys and satellite remote-sensing techniques have been merged to address the empirical importance of these effects. A pilot study found that a shrinking biomass stock explains a large part of the fall in agricultural productivity and that too much land is cultivated because farmers internalize less than 30 percent of the social cost of using the biomass. Less cultivation would raise villagers' social income.

Socialist economies in transition. The division has responded in a number of ways to needs for assistance on issues of importance to socialist economies in transition. Staff have participated in operational missions in several countries in Eastern Europe and the former Soviet Union. The division also contributed suggestions for the design of trade and payments arrangements for the states of the former Soviet Union, to facilitate the transition from a single country to separate countries successfully integrated into the international trading community. Policies were suggested for avoiding a costly collapse of interstate trade, without unduly impeding the transition. With the International Economics Department, we plan to build an integrated set of social accounting matrices (SAMs) for a handful of countries in the region.

Work under the Trade Expansion Program is also concentrating on socialist economies in transition. Country reports giving advice on trade policy reform are planned for Mongolia, Romania, and Viet Nam. A regional conference was recently held in Kiev, on integrating Ukraine with the world economy. Another conference is tentatively planned for 1993, focusing on Asian socialist economies in transition.

Other concerns

Africa. The division's work program incorporates a good deal of work on another priority region, Sub-Saharan Africa. Kenya, Madagascar, Mali, and Uganda received technical assistance under Phase I of the Trade Expansion Program, and Mauritius was one of the first countries to receive assistance under Phase II.

Also under the auspices of the Trade Expansion Program the division is researching the question of whether, as is widely believed, Sub-Saharan Africa has trailed the rest of the world in reforming trade policy, and if so, what can be done about it. In related work, the division is initiating research addressing critical connections between trade policy and human development issues.

Advice on policy reform is commonly country specific—usually an appropriate and adequate approach. But there are exceptions. Trade policy for commodity exports such as coffee, cocoa, and tea in Sub-Saharan Africa and elsewhere is one. Policy reform in one producing country may benefit that country but harm others. And simultaneous reform in all producing countries may lead to losses for all. Initial research findings indicate the possibility of losses in export revenue, government revenue, and welfare. Continuing research on a few commodities is seeking to identify trade policies that would maximize welfare or government revenue, taking into account interaction between policies and outcomes for various countries.

Regional economic integration. Foot-dragging at the Uruguay Round of the GATT has generated new interest in regional economic integration. Regional arrangements involve policy issues of enormous importance to all countries and have the potential for dramatically changing the economic map of the world.

To address these issues, the division brought together leading scholars on the subject at a conference. Twelve papers were presented. The paper by Jagdish Bhagwati was covered by *The Economist* and *Financial Times*, and the conference was reported on in the IMF *Survey*. A compilation of the conference papers will be published by Cambridge University Press in 1993. A booklet summarizing the main messages was published by the Bank and covered in *The Economist*. An article is also due to appear in *Finance and Development*.

Region, and the two units are working closely on this effort.

• *Private delivery of core government services*. We will research the effects of private delivery of social services on efficiency and on the poor.

• *Social security*. Can it be made affordable, equitable, and sensible? What are the pros and cons of different designs, and what are the merits of a multi-pillared approach?

Approach

Sensitive to the risks of fuzzy thinking and too much prescription relative to description in the institutional area, the division seeks to ground its work in the practical through substantial involvement in operational support and best-practices analysis. Such activities allow for a more accurate gauging of demand and the identification of institutional issues that combine operational relevance and a need for analytical rigor. The private sector surveys, analysis of the experience of front runners in privatization, and work on public sector management in states of the former Soviet Union are all major operational support tasks with a research output.

The division recently completed a cycle of best-practices and policy papers on all three issues. Work is now focusing on pushing out the frontiers of our knowledge through research and on turning policy into practice through operational support and dissemination.

Support to the Economic Development Institute (EDI) is an integral part of the division's dissemination program. Our book on public enterprise reform and privatization was published by EDI and has been translated into French, Russian, and Spanish. Division staff are participating in EDI seminars on privatization in most of the states of the former Soviet Union and Eastern Europe. The division is helping EDI design a regulatory reform seminar to examine problems of regulatory failure where institutions are weak and politics intrusive. The seminar will provide more realistic advice to policymakers than traditional approaches focusing on regulatory policy alone.

Other dissemination activities include a series of lectures to outside groups on the division's privatization work and a planned second conference on privatization research in the Latin America and Caribbean region.

Research findings are also disseminated through Bank staff training. The division has prepared training on topics that are cutting edge (private delivery of public services, regulatory reform) as well as courses directly relevant to Bank operational issues that promote the exchange of best practices across regions (how to do private sector assessments, civil service reform, privatization). The division's yearly symposium on public sector management in September 1992 focused on cutting-edge issues and innovation.

Links with the past

Much of the division's work builds on past initiatives, especially in the case of mature themes such as privatization and public expenditure management. The privatization work in particular has led to a number of follow-up research assignments, some of them in other divisions (differential impacts of public and private enterprises on the environment, to name one). In private sector development, past tasks focused especially on developing the Bank's action program and reporting on progress to management and the Board. This reporting helped the division pinpoint issues for research and led to an operational tool—private sector assessments—with a potential research payoff.

Publications

Highlights

G.A. Calvo and Fabrizio Coricelli. "Stabilizing a Previously Centrally Planned Economy: Poland 1990." *Economic Policy* 14 (April 1992): 176-226.

The article examines the dynamics of the January 1990 stabilization program in Poland, focusing on the substantial and sudden collapse in industrial output and the persistence of inflation. Three not mutually exclusive explanations of these phenomena are presented: excessive initial inventories, an exogenous fall in household demand, and tight credit. Calvo and Coricelli conjecture that tight credit was at the center of the action: it magnified the fall in output and helped coordinate the fall across sectors.

That conjecture is based on the substantial segmentation of the credit market and underdevelopment of private credit markets. The weak private credit markets may explain the substantial shrinkage of interenterprise credit, which compounded the initial contraction of bank credit. The authors argue that credit tightness is reflected in firms offering wages below the ceiling rates of the stabilization program—especially considering that firms are controlled by workers councils not generally given to squeezing wages. Indeed, as credit expanded during the year, wages increased and even exceeded the program's ceilings. The authors further argue that the wage hike may be one of the reasons inflation persisted and credit expansion did not lead to a major economic recovery.

Vittorio Corbo and Klaus Schmidt-Hebbel. "Public Policies and Saving in Developing Countries." *Journal of Development Economics* 36 (July 1991): 89-115.

This article analyzes the effects of public policies on national saving, drawing from estimations of consumption functions for thirteen developing countries. The consumption specification applied nests three alternative explanations for consumer behavior: Keynesian, permanent-income, and Ricardian/direct-crowding-out hypotheses. The evidence is based on estimations using 1980-87 country panel data—the first use of data on consolidated operational nonfinancial public sector deficits. The article shows that a permanent cut in public expenditure of $1 reduces private saving by 47 to 50 cents, while a permanent tax increase of $1 reduces private saving by only 23 to 26 cents. Fiscal adjustment policies designed to boost public saving are therefore the most effective policy tool for increasing national saving levels in developing countries.

Miguel A. Kiguel and Nissan Liviatan. "When Do Heterodox Stabilization Programs Work? Lessons From Experience." *World Bank Research Observer* 7 (January 1992): 35-57.

What advantages and disadvantages does the heterodox strategy offer stabilization programs in countries with chronic high inflation? Heterodox stabilization programs, by the authors' definition, are those that support orthodox policies—tight fiscal policy and a fixed exchange rate—and the initial temporary use of wage and price controls. (With orthodox methods, inflation reduction is usually slow, and its costs in terms of unemployment are high. Heterodox tactics were devised to circumvent these difficulties.)

This evaluation, based on several heterodox programs, successful and unsuccessful, from the 1960s and 1980s in Latin American countries and Israel, offers four principal lessons:

This section covers fiscal 1992 publications by CEC department staff and consultants on CEC-managed research.

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Marilou Uy, Senior Economist
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Melanie Johnson
Anita Schwarz
Bo Wang

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Of the estimated 7 million poor in 1988, about 3.1 million were the new poor—people who lived above the poverty level before the crisis and have since fallen below it. More than nine-tenths of the new poor live in urban areas. Incomes in rural areas that were equal to or higher than those in urban areas reduced rural-urban migration, although it was still positive.

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market-completing programs are suggested to supplement laissez-faire policies in soft states, with less risk of doing harm.

A. Gelb, J. B. Knight, and R. Sabot. "Public Sector Employment, Rent Seeking and Economic Growth." ***The Journal of the Royal Economic Society*** **101 (September 1991): 1186-99.**
Surplus labor in the public sector is a characteristic of many developing countries. Consistent with theories of rent-seeking behavior, this article views public sector surplus labor as the consequence of lobbying for more high-wage (and high-rent) employment in the modern sector, especially for public jobs. Evidence of such surplus labor is presented, drawing on country studies and data on the relative growth of public employment in a number of developing countries. Public choice theory is then applied to explain the phenomenon.

A simple computable general equilibrium model with a segmented labor market and endogenous government hiring in response to unemployment is used to show how this policy can give rise to dynamic social costs; it is also used to quantify those costs. The model endogenizes labor absorption and investments in a public sector "sink" that must be financed by taxes on the two productive sectors (traditional and productive-modern). Simulations are run to assess the effect of stronger or weaker pressures to employ labor and of the need to invest more or less for "sink" labor to appear employed.

A comparison of the outcomes of simulations with the degree of labor redundancy suggested by the empirical studies shows that the surplus labor in the public sector has a potentially large effect on economic growth. Indeed, efforts to absorb labor can rob a reasonably performing economy of most of its growth vitality. In addition, the government's attempt to reduce unemployment is shown to be futile—essentially because temporarily reducing unemployment and expanding the modern sector in the process increases the incentive to migrate from the traditional sector. Unlike the Lewis model, which emphasizes the absorption of surplus labor from the traditional sector, this analysis emphasizes the effects—and high cost—of a development path that creates surplus labor in the modern sector.

A. Gelb and S. Fischer. "The Process of Socialist Economic Transformation." ***Journal of Economic Perspectives*** **5 (Fall 1991): 91-105.**
In the metaphor of Vaclav Klaus, then finance minister of Czechoslovakia: "I like to compare the transformation process with chess playing. When we want to play chess, we must know how to play. We must know how to move various pieces on the chessboard. We must know the basic opening strategies. But it's not possible to know the situation on the chessboard after the fifteenth or twenty-fifth move." This paper considers the reform process in the Central and Eastern European countries that have made the decision to move from a planned socialist system to a private market economy. Because the reform process is both complex and intertwined with political factors—especially the shift toward representative democracy—and because there are substantial differences among the reforming countries, no single detailed road map can guide the way to the new systems. The article therefore sets out general considerations that provide a framework for reform and relates the choices to some initial conditions in the reforming countries.

The organizing principle of the framework is a classification of policies into four broad groups: those concerned with establishing and maintaining macroeconomic stability, those aimed at broadening market mechanisms (for both goods and factors), those involving restructuring and property rights, and those needed to change the role of the state—in particular, to create a suitable legal infrastructure for the market and to establish a social safety net. The paper also considers the phasing of these reforms, recognizing that many will need to be implemented simultaneously, but that not everything can be done at

also depended on how well the interconnections with other macroeconomic and sectoral policies were addressed in the overall adjustment package.

The research finds that well-designed trade policy reforms do not conflict with other priorities except in special cases. Trade policy reforms, in view of their economywide effects, should continue to have a central place in adjustment efforts. Three issues deserve greater attention, however. First, more substantial reductions in both quantitative restrictions and tariffs are needed to strengthen competition. Second, more weight ought to be given to the effect of reforms on the budget and macroeconomic stability. When the inflation rate is very high and variable, stabilization efforts should precede other reforms. Third, trade reform often needs to be accompanied by domestic deregulation and a strengthening of infrastructural and institutional complements.

J. Michael Finger. "Dumping and Antidumping: The Rhetoric and the Reality of Protection in Industrial Countries." ***World Bank Research Observer*** **7 (July 1992): 121-43.**
A wide gap separates the rhetoric from the reality of protection in industrial countries. Antidumping is the current reality of that protection. Protectionist interests stretch the definition of dumping as far as they may to shelter actions against imports under the antidumping umbrella.

This article reviews the history of antidumping regulation and its evolution under the GATT system into an important instrument of protection. Its thesis is straightforward: antidumping is the fox put in charge of the henhouse—ordinary protection with a good public relations program. There is little in the history of antidumping to suggest that the scope of antidumping ever extended beyond protecting home producers from import competition, and much to suggest that such protection was its intended scope.

Maurice Schiff and Alberto Valdes. ***The Political Economy of Agricultural Pricing Policy.*** **Volume 4,** ***Synthesis: The Economics in Developing Countries.*** **Baltimore, Md.: Johns Hopkins University Press, 1992.**
This synthesis of research on agricultural price policy in eighteen countries found that the indirect tax on agriculture from industrial protection and macroeconomic policies was about 22 percent on average during 1960-85—nearly three times the direct tax from agricultural pricing policies (about 8 percent). Total taxation (direct plus indirect) was thus 30 percent. Industrial protection policies taxed agriculture more than did overvaluation of the exchange rate. High taxation of agriculture was associated with low growth in agriculture—and low growth in the economy.

Surprisingly, most countries protected importables at an average direct protection rate of about 18 percent. The average effect on the price of importables relative to that of exportables was about 40 percent. These distortions in agricultural prices increased between the early 1960s and the mid-1980s. Direct price policies stabilized domestic agricultural prices relative to world prices, with an average reduction in price variability of 25 percent. Indirect polices contributed little, if anything, to price stability.

The effect of removing agricultural price interventions is not regressive. In most countries, removing interventions changed the real incomes of the poorer urban and rural groups by less than 5 percent (up or down). More often than not, the rural poor gained. Finally, public investment in agriculture did not compensate for the adverse price policies. And despite the high cost to agriculture of direct and indirect government price interventions, the contribution of agriculture to fiscal revenues has fallen over time and is, on average, small.

Estelle James and Nancy Birdsall. "Public Versus Private Provision of Social Services: Is There an Efficiency-Equity Tradeoff?" In K. McCarthy, V. Hodgkinson, and R. Sumariwalla, eds., ***The Nonprofit Sector in the Global***

performance in the 1980s. They base their assessment on comparisons of members' performance indicators with indicators for other countries in Sub-Saharan Africa, other low- and middle-income countries, and other exporters of fuel and primary goods. Performance indicators for members of the CFA zone deteriorated more than indicators for other groups, especially in the second half of the decade. Growth and investment rates, in particular, fell more for CFA countries. The fall is attributed to the CFA members' declining competitiveness as other countries undertook adjustment programs that emphasized depreciation of the real exchange rate.

Controlling for changes in the external environment, Devarajan and de Melo show that CFA countries adjusted less than comparator countries during the 1980s. And the burden of their adjustment appears to have fallen disproportionately on reduced spending, particularly reduced investment—an ominous sign for future growth.

S. Devarajan, G. Kambou, and M. Over. "The Economic Impact of AIDS in an African Country: Simulations with a General Equilibrium Model of Cameroon." ***Journal of African Economies*** **1 (March 1992): 109-30.**

A multisectoral, computable general equilibrium model that captures the disaggregated structure of the economy and the behavior of its major macroeconomic variables provides a theoretically consistent method for measuring the sectoral and economywide effects of AIDS on resource-poor developing countries.

Applied to Cameroon, the model shows that the macroeconomic effects of AIDS are large, primarily because of the disproportionate incidence of AIDS among urban, skilled workers. Using reasonable estimates for the size of the epidemic, the authors find that if it is distributed evenly across the population, AIDS cuts the economy's average annual growth rate in half. Most of this loss is due to the loss in urban, skilled labor, as is shown by the counterfactual simulation of AIDS affecting only that segment of the labor force.

Jaime de Melo and David Tarr. ***A General Equilibrium Analysis of U.S. Foreign Trade Policy.*** **Cambridge, Mass.: MIT Press.**

The authors develop a general equilibrium model of the United States to analyze the impact of voluntary export restraints or quotas in textiles and apparel, automobiles, and steel. The combined cost of such quotas to the U.S. consumer is estimated at $21 billion (in 1984 dollars). Imposing an equivalent cost through tariffs would require raising tariffs from their current 3.5 percent average to more than 23 percent—a rate not seen in the United States since before World War II. That means that quotas have more than reversed the cumulative effects of tariff reductions through all the postwar rounds of multinational trade negotiations. And because the quotas transfer rents to foreigners, it is estimated that if tariffs were used instead, U.S. industries could receive the same level of protection with only about a quarter of the cost to U.S. consumers.

Protection through voluntary export restraints and quotas saves adjustment costs of workers who would otherwise be displaced as industries adjust. But for every dollar of worker adjustment costs saved on average, the economy loses an estimated $28. In the framework of imperfect factor and product markets, "strategic" trade policies (such as policies aimed at attracting workers to high-wage industries or shifting demand to sectors with economies of scale) are shown to be generally counterproductive.

James Tybout. "Linking Trade and Productivity: New Research Directions." ***World Bank Economic Review*** **6 (May 1992): 189-211.**

It is a mistake to think of productivity growth as an orderly shift in technology. What matters are the gradual processes of learning, innovation, investment, and the displacement of inefficient plants with efficient ones. Trade orientation affects these processes through many channels, often by influencing the ability of entrepreneurs to monitor new technological devel-

• The rapid reduction in inflation at the beginning of heterodox programs is the easy part; the problem is to maintain price stability over time.

• Incomes policies in heterodox stabilization programs are justified only in countries with high chronic inflation, where persistent inflation is pervasive and problematic.

• There is a case for a bigger fiscal adjustment in heterodox than in orthodox programs because of the risk that a program with price controls may be misperceived as a populist device for achieving price stability without adjusting.

• The failure of a heterodox program is more likely to destabilize inflation than is the failure of an orthodox program.

James Tybout, Jaime de Melo, and Vittorio Corbo. "Effects of Trade Reforms on Scale and Technical Efficiency: New Evidence from Chile." ***Journal of International Economics*** **31 (November 1991): 231-50.**

This article analyzes the changes in industrial structure and performance that accompanied Chile's dramatic trade liberalization in the 1970s. Comparisons of the manufacturing censuses of 1967 and 1979 indicate that little productivity improvement took place overall. However, this finding alone does not distinguish the effects of trade liberalization from those of recession, high interest rates, and real appreciation.

To isolate the effects of liberalization, industries undergoing relatively large reductions in protection are compared with others. In industries undergoing large reductions in effective protection, there were relatively large improvements in average productivity and relatively dramatic reductions in the dispersion in productivity between different enterprises.

These results support the view that foreign competition forces all firms toward common, higher levels of productivity. Taken together, the results support the received wisdom that the intraindustry effects of trade exposure are significant.

Gerard Caprio, Jr., and Patrick Honohan, eds. ***Monetary Policy Instruments for Developing Countries.*** **Washington, D.C.: World Bank, 1991.**

Many industrial and middle-income countries in the 1970s and 1980s adopted sweeping reforms of their systems of monetary control, dismantling bank-by-bank credit ceilings and sectoral credit allocation programs. Such direct controls can succeed in the short run, but eventually nonbank financial institutions arise to escape credit limits, and banks have every incentive to evade controls. Credit ceilings limit competition, and by choking off innovation and prompting excessive holdings of liquidity, they can curtail growth in the financial sector and the economy overall.

This volume summarizes the lessons of recent experience with indirect methods of monetary control, which can be expected to be of interest to monetary authorities in many developing economies:

• Indirect methods of monetary control require some degree of interest rate volatility.

• The successful central bank listens to the market as well as guides it.

• The stability of money demand relationships cannot be relied on in developing countries, partly because of insufficient historical experience with liberal markets on which to base forecasts. Developing countries may need to concentrate on direct targeting of foreign exchange reserves, rather than relying on an intermediate target such as the quantity of money.

• Optimal functioning of indirect methods requires the development of new markets, which in turn improve the efficiency of financial markets and their ability to serve the economy, including its investment needs.

• Emergencies can arise that require old-fashioned non-market-clearing solutions.

Ross Levine. "Stock Markets, Growth, and Tax Policy." ***Journal of Finance*** **46 (September 1991): 1445-65.**

This article constructs an endogenous growth model in which a stock market emerges to allocate risk and explores how the stock market alters investment incen-

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