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# PRICING OF ENERGY AND ECONOMIC DEVELOPMENT

Presentation to the Energy Policy Seminar
Energy Policy Foundation of Norway
on February 4, 1983

Ernest Stern, Senior Vice President, Operations
The World Bank

Since the dramatic change in energy prices which started in 1973 the world economy has been characterised by a degree of volatility and uncertainty which is exceptional. Neither forecasters nor nations were prepared to operate effectively in this new environment. A decade later we can look back and see the turmoil of these years as nations sought to adjust to the rapid changes in energy prices. Initially, the problem was seen as a financial one -- particularly for the developing counries. How were they to pay their import bill which had exploded with the increasing prices of oil and the rapidly escalating prices of manufactured goods. The increased borrowing made possible by a flexible international financial system seemed to solve the problem, helped by the boom in commodity prices, by inflation eroding the value of fixed-term debt, by interest rates which lagged behind inflation, by rapid growth in import demand for goods and services from oil exporting countries and by an expansion of foreign aid from Europe and the Middle East. But some of the flexibility went out of the international system in the mid-1970s and the further energy price increases of 1979 were not so easily digested.

Some countries had used borrowed funds, not to finance their adjustment and invest in new product lines but to maintain consumption. Debt grew but it now was incurred at high real interest rates; inflation, which had accelerated in many countries, became the central focus of policy in many industrialized countries which led to a slow-down of GNP growth. This in turn led to stagnation of world trade, which shrank the markets for the manufactured exports of the developing countries and caused a sharp drop in primary commodity prices -- to the lowest levels in 30 years -- severely eroding their export capacity and consequently their creditworthiness.

Throughout this period many of the developing countries made major adjustments, in development strategies, by reducing their investment programs, by improving their price and incentive structures and by reducing the growth of their budgets. But the recession in the industrialized countries has been deeper and longer than anyone expected and quick return to rapid growth in the OECD countries is not now foreseen. Consequently, international trade will remain relatively stagnant, protectionist pressures will be stronger and near term growth prospects for the developing countries will be lower. In this situation the further adjustments facing the developing countries are severe -- sometimes exceeding the capacities of their political systems or their decision-making processes.

It is against this background of the long-term adjustment process that I want to address three interrelated issues:

first, the adjustments in the energy sector;

second, the role of energy pricing in the domestic context; and

third, the financial requirements of future energy investment in the developing countries.

But let me start with our assumptions about global energy growth and prices. During the 1970s, global consumption of energy from all primary sources grew at an annual rate of about 3%, and at about 6% in the developing countries. But the very large increase in prices in real terms has significantly changed demand growth, consumption patterns and investment in energy.

The slowdown in the growth of global energy consumption has led to speculation about the delinking of energy consumption trends from the growth of income. The energy/GDP coefficient has dropped in the developed as well as in the developing countries. In the latter, commercial energy consumption used to grow about 1.2 to 1.4 times their growth of GNP. In the last few years this ratio has dropped to less than 1.0. Yet although it is too early to reach a definitive conclusion about this relationship we believe a permanent downward shift has been achieved. Therefore, we project that even with economic recovery in the developed countries and growth rates for developing countries comparable to the 1970s, global energy consumption will grow more slowly than in the past - at about 2.5% per annum through 1995.

The growth in oil consumption is projected to be even less than that - an annual growth rate of only 1% between 1980 and 1995, compared to 3% per year between 1970 and 1980. During the 1970s oil accounted for 43% of incremental consumption - in the next decade we believe it will constitute only a little over 10% of the increase in global energy consumption.

This factor and the current market situation raises the basic issue of what prices to expect in the longer term. Is the present situation a reversal of the trend towards high-cost energy in developing countries, or is it merely a temporary phenomenon. There is a wide range of views on this issue and the number of possible scenarios is endless. The problem of forecasting is compounded by the fact that so much depends on political developments and on an assessment of the cohesion of a cartel.

It is obvious therefore that judgements must be tentative. However, we believe that despite these uncertainties there are compelling reasons to think that over the next decade developing countries will continue to face high energy prices. Since, from the discussions in the

last two days I gather that this is a widely shared view here, let me merely state the three broad elements which underlie this conclusion:

-- economic recovery in the OECD will lead to increased growth in demand for energy, albeit at a slower pace than in the past because of the moderating effects of conservation and demand management policies;

-- the prospects of new discoveries of oilfields and other resources that could significantly alter the global balance between demand and supply in the coming decade are small;

-- the cost of energy converting and generating plant continues to be high as more expensive hydrosites are brought into operation and as the conversion from oil to coal continues.

The increased demand that is projected, joined with a careful review of likely supply responses, suggests a price increase of about 2% per year in real terms for crude oil through 1995. While prices are unlikely to rise smoothly, and while there is considerable uncertainty about the precise rate of the price increase over the next decade, it is very unlikely that the real price of oil will be below its current level by 1995. Developing countries must structure their investment plans and strategies for the energy sector to continue the process of transition to an era of high cost energy.

Adjustments in Energy Strategies

Although developing countries have made big strides in the last eight years in adjusting to higher energy prices much still needs to be done. And the role of energy pricing is vital to the adjustment process. It determines investment decisions, the relative economics of conservation and the structure and volume of consumer demand. Broadly speaking, the oil importing developing countries a) have raised the price of oil to more than international levels to reduce consumption and promote energy efficiency; b) invested heavily in alternative sources, wherever available; c) have expanded exploration activities, and d) have begun to integrate energy planning in overall planning.

As a result of these and other measures, the pattern of energy use is shifting, the growth in demand is less, and dependence on imported oil is reduced. We expect demand for energy in the developing countries to grow at about 5.0% per year for the next decade - less than in the 1970s, but almost three times the demand growth projected for the industrialized market economies. Consequently, the share of developing countries in total energy consumption will continue to grow - from about 20% in 1980 to about 27% by 1995. Although we expect the developing countries to reduce their rate of growth in demand for oil to less than 3% per year, their

share in world consumption will continue to rise and they will constitute a very large portion of incremental oil consumption through 1995.

The developing countries reliance on oil will drop - 25% of incremental energy consumption against the current share of about 50% but it will still constitute about 40% of their commercial energy consumption by 1995. Oil imports will grow from about 300 million tons to an estimated 400 million tons by 1995.

Aggregate projections for developing countries are strongly influenced by a few major ones. China alone accounts for about 30% of LDC commercial energy consumption. India, Brazil and Mexico account for a further 20% and the twelve largest commercial energy users account for almost two-thirds of all the energy consumed by 115 developing countries.

Not only are the overall projections influenced strongly by relatively few countries, these projections mask the great diversity among developing countries. Since energy consumption is highly correlated with per capita income the importance of energy also varies widely - from very low levels in Burundi and Nepal to levels approaching those of the OECD countries in Yugoslavia, Brazil and Mexico. The developing countries also vary in their dependence on imported oil. Eighteen are oil exporters, though some of them are marginal exporters who may lose their exportable surplus unless demand is curbed and expanded exploration efforts are successful. These include Egypt, Ecuador, Peru and, most importantly, China. Their problem, like that of the oil importers, is demand management and the development of additional indigenous energy resources. Of the other developing countries about half depend for more than 75% of their commercial energy consumption on imported oil. The import dependence, in turn, has a direct bearing on their import capacity for non-petroleum items. The ratio of oil imports to earnings from merchandise exports consequently also varies widely. For a sample of 32 major oil importing countries this ratio exceeded 50% in 6, was between 25% and 50% in 17 and below 25% in the remaining 9. They also vary immensely in terms of their known, and prospective, resource endowments and the availability of domestic, lower cost energy sources is one of the decisive factors that determine a country's adjustment process and energy strategy.

## Demand Management

An essential ingredient in the energy strategy of the developing countries is an effective program of demand management.

The goals of demand management are two-fold:

- a reduction of energy use per unit of output to conserve scarce energy and control the total cost of energy use, and

- to induce a shift from dependence on imported oil to domestic energy resources available at lower cost and which cannot easily be traded.

Price plays a crucial role in demand management and usually is the most effective means available to policymakers.

In many oil-importing developing countries, the principle of full and prompt pass-through of oil costs to final users has been widely adopted. For the six-year period 1975-81, the growth in domestic prices kept pace in real terms with the growth in international prices. However, as exchange rate changes have not fully corrected for higher domestic inflation rates, real petroleum prices rose by only 7.5% per year in local currencies. This substantial difference between local and dollar equivalent price movement indicates the importance of exchange rate policy for energy pricing and demand management.

Passing along changes in international oil prices is important but it is not enough, since the general price increases came on top of a varied price structure for petroleum products -- some of which, such as kerosene or diesel, tended to be highly subsidized. Not only did the overall price level have to be adjusted, but the relative prices of petroleum products had to be changed. Subsidies which were bearable at $2 per barrel oil were ruinous at $30 per barrel. Moreover, inter-product price anomalies led to distortions in current use and in investment decisions. During the second half of the 1970s, diesel prices in the oil-importing developing countries rose in relative terms from 38% of gasoline prices to 61%, reflecting a policy to reduce domestic diesel subsidies. In the same way, many countries are beginning to remove subsidies on kerosene to avoid the diversion of this fuel from residential to other uses because of its low price. These absolute and relative price changes have been quite substantial in real terms in many instances: the real domestic price increase of petroleum products in terms of local currency between 1975 and 1980 amounted to about 100% in Brazil, 200% in Colombia, and about 100% in Yugoslavia. On the other hand, there has been a decline in real terms in Argentina and Egypt, and an increase of only about 20% in India. The pattern of consumption of petroleum products has responded to relative price changes: while Pakistan's diesel consumption decreased from about 550% to about 300% of gasoline consumption within five years, Brazil's decrease in the diesel price relative to that of gasoline, led to an increase of diesel use from 90% to about 150% of gasoline use during the same period.

The experience overall clearly shows that energy use - at least in the developing countries - is highly and quickly responsive to price. The high energy intensity of certain countries - Romania, China, India, Egypt - is testimony to the long-term impact of maintaining energy prices at artificially low levels. Egypt might not have developed such energy

intensive industries as aluminum smelting if power prices had reflected costs and its demand for petroleum products would no doubt grow more moderately if its average prices were higher than a mere 11% of the international price.

Appropriate pricing signals in the electricity sector must proceed in parallel if demand for power is not to be seen as a cheap substitute for oil with a consequent surge in demand which can not be met quickly and which requires heavy investments. In recent years, power utilities in several countries, among them Kenya, Nigeria, Indonesia, Sri Lanka and Bangladesh, have committed themselves to taking economic cost of supply considerations into account in their tariff setting. The concept of long-run marginal cost, applied to electricity tariffs, ensures that tariff levels as well as structure reflect the cost of power system expansion. However, action to raise electricity prices often encounters political and social obstacles, and most developing countries' tariffs are still below those required to cover economic cost in the long run. Of 33 countries surveyed recently, only seven have electricity tariffs that are equal to or exceed long-run marginal cost. However, 13 other countries have increased their tariffs in real terms since 1974, and thus are likely to approach economic cost gradually. Among these, increases in real terms have ranged from 50-100% between 1975 and 1980.

An important reason for pricing all forms of energy at their economic cost of supply is that otherwise many economically viable investments in improving efficiency may not be undertaken because there is no financial incentive to do so. And yet conservation in the developing countries is important. Some years ago it was believed that energy conservation would be relevant primarily in industrial countries. But careful analysis has shown otherwise.

Although energy intensity in most developing countries is below that of the industrialized countries, the middle income countries are generally at least as energy intensive, some developing countries such as India, Korea and Yugoslavia are close to, and some, such as China and Romania, are well above the level of the most energy intensive industrialized countries. Many industrial plants in developing countries have been found to consume 10-30% more energy per unit of output than the best international practice and sometimes much more. For instance, the production of crude steel in both India and China uses twice the amount of energy per ton as in Japan (and 50% more than in the U.S.). Power system improvements could reduce losses by half (from 15% to 8% of all generation) and savings are feasible in transport and other sectors with relatively small investments.

It has been our experience that relative pricing problems are becoming less of an issue in developing countries, as awareness about the importance of pricing in economic development grows. Of 18 countries

where joint UNDP/World Bank energy sector assessments have been carried out there were only five where the price of one or more energy products was so distorted as to be causing major efficiency problems in the allocation of resources. In these countries, it is either the artificial distortion among petroleum product prices, or the distorted relation between electricity and petroleum prices that combine to limit the incentive for economic fuel substitution.

Financing Energy Investment

The transition from a low price oil based energy economy to a higher cost energy mix, comprising other sources as well as oil, imposes a three-fold burden:

- investments needed to explore for and develop indigenous sources of energy;
- conversion of existing plants to use cheaper fuels or to use energy more efficiently;
- paying for imported oil until the new investments bear fruit.

These factors have led to a considerable increase in energy investments in the past decade. Since the investments are classified in several sectors in the national accounts it is difficult to compile global data on trends in energy investments. However, studies of individual countries show that energy investment as a percent of total investment has doubled since 1973 and now represents between 15 and 20% of the total. For instance, in Turkey investment in energy in terms of 1980 dollars rose from US$780 million in 1973 to US$2.2 billion in 1980. In India, the investment in oil and gas in 1980 dollars rose from about US$330 million to about US$1.3 billion between 1975 and 1981, an average annual growth rate of about 25%, while overall energy investment during the same period grew at about 19% per year. In Pakistan, the share of energy in national investment increased from 15% in 1975 to 21% in 1981. Examples from most other countries would show similar trends.

Confirmation of the growth of investment also is found in the volume of external lending for energy investment in developing countries which rose from $6.5 billion in 1975 to $16.5 billion in 1980. Commercial lending (commercial banks and export credit agencies) rose from US$4.2 billion to US$11.2 billion between 1975 and 1980, constituting about 68% of the total. Bilateral concessional lending for energy rose to about US$1.6 billion in 1980 or about 9% of the total. Multilateral institutions financed $4 billion in 1980, or 23%. In the World Bank, energy lending rose from about 15% in 1977 to 26% in FY1982, representing in that year about US$3.4 billion in loans and credits.

But the investments of the past few years are dwarfed by the requirements for the future. We estimate that annual energy production in the developing countries will have to increase from 1.7 billion toe in 1980 to about 3.1 billion toe in 1995 to support the rather modest rates of growth and industrialization projected. This will require an average annual investment of $124 billion (in 1982 dollars) during 1982-92 -- an investment level by the second half of the decade almost double the current level in real terms. Nearly half of this required investment is in power, which is becoming more capital-intensive because of an increasing reliance on hydro resources and coal-fired thermal generation. Both are relatively capital-intensive compared to oil-fired generating capacity. For instance, a large oil-fired plant requires an investment of about $800 per KW (in 1982 prices) whereas the investment cost of an installed KW of a large coal plant is $1100 per KW (or as high as $2000 for a small coal-fired plant) and $3000 per KW or more for hydro power generation. When hydro sites, coal mines and gas fields are a distance away from the centers of demand, significant investments are also needed in the transport of fuel or the transmission of electricity.

Investments in oil production are also likely to rise dramatically from historical levels. An increasing number of countries have expanded their exploration efforts and will develop their oil production potential. While investments in other fuels, refinery modification and expansion, energy efficiency programs, and the development of new primary energy sources may be relatively small in relation to total anticipated energy sector investment requirements in developing countries, their importance may be large in individual countries.

The mobilization of adequate finance -- domestic and external -- will be one of the critical issues in meeting the demand for commercial energy in the developing world.

Let me turn to the domestic financing issues first.

Domestic Resource Mobilization

The domestic financing needs of an expanded energy investment program reinforce the need for realistic pricing of all types of energy. As already noted, price is a major determinant of the growth of demand -- both for the aggregate and for individual products -- and of the investment response to energy demand. But price also plays a central role in the mobilization of domestic resources for future investments. Since virtually all of electric power and much of the production of other fuels are supplied by public corporations in most of the developing countries, the recovery of investment and operating costs is by no means automatic. Prices are governed more by political judgements than by financial consideration. And yet without adequate cost recovery the operating companies will not be able to generate the necessary funds to finance their

share of the expanded investments needed. The result would be excessive reliance on government budgets for loans or equity financing. This not only places the burden on revenue systems which are already strained but also reduces the resonsibility of the energy user. And experience suggests that government budgetary support is not always available on a timely basis, even when high priority is assigned to the energy sector.

Domestic resource mobilization also is critical in meeting energy requirements because the local currency component of many energy projects, particularly in the power sector, is high. To borrow externally to finance such local costs, instead of generating the financing through energy prices paid by users, is likely to involve an excessive reliance on the external sector to supply the savings while domestic consumption is inappropriately high. In the current international economic environment this is not a suitable policy.

But despite this, an appropriate tariff policy remains elusive in many countries. In the power sector, public utilities operate in a highly regulated environment with limited autonomy. During the early 1970s, most power utilities were fairly successful at generating a satisfactory portion of needed investment from internal resources. But inadequate tariff increases coupled with rising unit investment costs and fuel costs, have resulted in a deterioration in power sector finances. In the face of efforts to reduce domestic inflation, and with political presssure from consumers, many governments have been reluctant to approve regular power tariff increases.

These factors have made it difficult for national power companies to generate internal and external funds required to finance needed investment programs. In the Bank's experience, the consistent meeting of self-financing ratios of 20-30% of investment over a period of time has proved to be difficult for a majority of the main national power companies in the developing countries.

In the case of national oil companies, the situation is more complex. Production costs are only a fraction of international prices so that the investment resources the producing company can generate depends on the domestic sales price agreed with the government. To the extent the price is set too low, some of the receipts of the government have to be rechanneled to the company as loans or equity to support its exploration or development program. Generally, there is ample scope since consumer prices for most petroleum products, with the exception of diesel and kerosene, are much less sensitive politically than electricity tariffs or bus and railway fares. The number of consumers involved tends to be much smaller and are either middle/upper income groups or industrial users. But in some cases prices have been set in such a way that national oil companies have actually lost money. For instance, in Turkey the national oil company had to import much of its crude, but the government set

ex-refinery and retail prices at a level which would have allowed a profit only if Turkey had been self-sufficient in crude. Where producing companies are joint ventures with the government, or privately owned, setting prices at unrealistically low levels has an immediate impact. Even if present investors stay -- there is no new investment. An excellent example is gas pricing in Pakistan. Failure to allow the gas price to increase (the well known "old gas" argument) has led existing investors to cut new investment -- in exploration, production and transport -- to the bone. While there has been some change in policy, Pakistan still insists on negotiating prices field by field.

But whether the product is oil, gas, coal or electricity, the pressures for keeping the price low are great. This is true even for prices designed to cover present costs -- it is even more true for prices based on long-run marginal costs. And these pressures find fertile ground in most governments where too many policy makers still believe that low energy prices help the poor, (they do not - the poor use little commercial energy and budget subsidies reduce resources available for education, rural health and agricultural extension which are of much greater importance to the poor) and are essential to their industrial and agricultural development (they are not - low fuel prices channel investments into industries which later cannot compete or even survive without permanent government support). Lower prices obviously are politically more attractive than higher prices -- but they are to be preferred only if they can be sustained. Many countries have discovered the budgetary costs of subsidies and the distorting effects of inappropriate prices. More will find they cannot escape these consequences.

External Financing

Of the estimated annual energy investment requirement in all developing countries of $124 billion over the next decade, the foreign exchange component will be of the order of $60 billion per year. About half of this is in the oil exporting countries. By way of comparison, we estimate that the annual level of external financing for energy is now of the order of $24 billion. Excluding the substantial self-financing of the international oil industry, we estimate that the average annual flow of external financing should almost double in real terms compared to the recent past.

The areas where external financing is likely to pose the biggest problems can be identified by examining the need for foreign exchange financing in the various sub-sectors. Because of the high local cost component in electric power development, the foreign exchange requirements of this sector are likely to be less than one-quarter of the total, even though investments in power are estimated to be almost half of total energy. External financing needs for coal projects are relatively small compared to their total cost but in some countries (i.e., China, India,

Yugoslavia, Colombia and Turkey), where large investments are planned, governments must ensure that adequate foreign exchange is made available to the coal sector.

The major problem in mobilizing external finance would appear to be in the oil and gas sector where the foreign exchange costs form a high proportion (65-75%) of project costs, and where a quantum increase over current flows is required. In general, direct foreign private investment is particularly important in the oil and gas sector because of the large number of foreign private companies operating in this energy sub-sector in the LDCs and because the international oil industry has traditionally been characterized by low long-term debt-equity ratios and a heavy reliance on internal cash flow to finance exploration and production expenditures. The key financing problem will be faced in oil-importing developing countries where the investments are designed to meet domestic demand, substituting for imported oil. Such financing will depend heavily on commercial bank lending. Our estimate of the foreign exchange costs of oil and gas investment is about $11 billion per year to the oil importing developing countries, which could be up to four times the current flow of external finance in the oil/gas sector. Not an easy prospect in today's markets.

The World Bank

Against this background let me turn briefly to the World Bank's role in the energy sector - as an institution which helps to shape investment and pricing strategies and as the single largest source of official financing for energy investments.

Through our lending for energy projects, the Bank encourages appropriate pricing based on economic efficiency criteria, adequate cost recovery to ensure the financing of the investment program, and satisfactory arrangements to guarantee the autonomy and financial health of public utilities and energy sector corporations.

In World Bank lending, these issues are addressed through covenants in loan agreements for individual projects. Of 43 oil and gas projects approved by the Bank during 1979-82, 18 contained covenants or side letters dealing with questions of pricing. Some of these contain specific targets for consumer prices of petroleum products, generally requiring the weighted average barrel to be priced at or above the equivalent import values of the products. In countries where prices are adequate, the Bank usually insists on an agreement which assures that international price changes, due to changes in product prices or exchange rates, are fully and promptly reflected in domestic product prices. Covenants in gas projects specify the appropriate rate of return for the borrower, specific price floors or increases, or the economic principles

to be applied in the setting of prices. With some exceptions, performance under these covenants has been good.

In the power sector, each project contains an agreement on a rate of return for the utility and on the schedule of tariff increases necessary to achieve that rate of return. In some cases a self-financing ratio is agreed on specifying the internal funds to be generated by the utility to finance its projected investment program. In recent years, governments faced with massive structural adjustment programs, consisting of unpopular measures, have found it difficult to take necessary tariff actions. The past delays in tariff adjustment now often require price increases of 60-80% to guarantee the necessary levels of internal cash generation.

What makes the World Bank effective in this area is not only the size of its lending program in energy - about $3.5 billion this year - but its continuous involvement with the country's policymakers and planners through its lending in many sectors and its role as policy advisor. When energy pricing policy becomes a significant problem it also becomes part of the general policy dialogue.

Because of its broad development perspective, continuing dialogue with member countries on macro-policy issues, and its close involvement in several sectors in each of its member countries, the World Bank is unique in its capacity to be of practical assistance to member countries in formulating an energy strategy. These issues are routinely covered in economic policy discussions, particularly in countries where the energy sector has an important impact on the balance of payments and macro-economic prospects. Because structural changes in the energy sector have raised new issues, it was necessary to embark on a special series of energy assessments in developing countries. Financed jointly with UNDP, the energy assessments are expected to cover 60 countries and are designed to provide a rapid diagnosis of the major energy problems and a preliminary analysis of the options available to address the most pressing investment, pricing and institutional issues. To date, 11 energy assessments have been completed, 13 are in various stages of preparation, and 13 are targeted to start in the next 12 months.

The Bank has responded to the developing countries' demands for additional energy finance not only by significantly increasing the share of energy in its total lending, but by progressively diversifying its lending activities. The bulk of the lending is still in the power sector, where capital needs are high and the Bank has had an important role since its first loan in this sector in 1950. In 1977 and again in 1979, the Bank approved changes in its lending policy to enable it to be more active in supporting petroleum exploration and development. In FY79, the Bank's petroleum lending consisted of 4 oil/gas development projects, with a total lending of $91 million. In FY82, the Bank supported 14 petroleum projects, including 9 at the pre-development phase, with total financing

of $540 million. Upwards of 40 oil and gas projects have been aproved to date, with total World Bank financing of $1.7 billion and total project cost of about $6 billion.

The basic objective of the Bank's petroleum operations is to help accelerate the pace of exploration and development in developing countries.

In order to make developing country acreage more attractive to the international oil industry, the Bank has launched a program of petroleum exploration promotion projects that have contained one or more of the following elements:

- Preparation of a promotional data package, relying heavily on the orderly compilation of existing data but also occasionally financing the limited acquisition of new data through aeromagnetic or gravity surveys, or seismic reconnaissance.

- Technical assistance and training for the national entity in petroleum geology/geophysics and engineering, economics, accounting, and petroleum law.

- Expert consultant advice on petroleum laws, contracts and taxes.

- Consultant assistance to the national entity during the promotion and subsequent negotiation of contracts with the international industry.

- Political risk reduction through a variety of arrangements ensuring Bank "presence" during the exploration and/or development phases of foreign contractor activity.

The strong appeal of an exploration promotion project lies in its potential for a large multiplier effect. In Madagascar, the first to go through the full cycle of project definition, promotion and negotiation of contracts, disbursement of $2 million in Bank credits resulted within 18 months in total contractual exploration work commitments with four international companies, in excess of $70 million. Other countries where promotion projects are well-advanced and seem likely to result in new commitments, the current unfavorable exploration climate notwithstanding, include Liberia, Guinea-Bissau, Equatorial-Guinea, Kenya and Somalia.

The Bank has directly supported exploratory drilling by national oil companies where it was clear to us that the international oil industry did not find these opportunities interesting. For instance, in Bolivia, some delineation drilling was necessary to demonstrate sufficient gas

reserves for an export pipeline to Brazil. In Tanzania, Bank credits financed the appraisal of a known offshore gas structure that had been abandoned by the international industry as being not commercially interesting, although it is of significant economic benefit to Tanzania. In the Philippines, the Bank has supported a limited exploration program by the national oil company in areas where the oil industry views the projects as being too small, although sufficient to be of benefit to the Philippines. Several such projects have already yielded results, such as discoveries or confirmations of earlier indications of deposits in Egypt, Morocco, Tanzania and Bangladesh.

In FY79-82, Bank supported 17 projects for development of oil/gas with financing of about $1.5 billion and 26 pre-development projects with financing of about $250 million. The major part of development projects consists of the provision of infrastructure (e.g., gas pipelines), which are critical not only for development but also in many cases for progress on the exploration phases as well. For instance, in Thailand, the further evaluation of a gas discovery by an international oil company was delayed by lack of an assurance that the necessary infrastructure would be available when the field was ready for production. World Bank loans helped put the necessary infrastructure in place resulting in oil company commitment to development and renewed interest in gas exploration in adjacent areas. Sometimes, a government in a joint venture with an oil company may have difficulty in raising its share of costs even when a discovery has been made because the full production potential has not yet been demonstrated. The Bank's loan to the Ivory Coast is an example of this. It also was an example of how the World Bank can strengthen contract security. The basic features of the Operator's contract are incorporated in the Bank loan and changes could not be made without involving us.

Bank loans have also supported secondary oil recovery (in Peru, Turkey, China and Romania) and the exploration and development activities of the national oil companies where there has been a well-focused program (as in Argentina and India) and parallel private sector activity.

In development projects, where large investments are needed, an important objective of the Bank is to help mobilize additional finance from export credit and commercial financial institutions. On average, the Bank has financed 26% of the total cost of such projects. Moreover, a project supported by the Bank often is actually a part of a much larger investment program which, in the case of Bombay High in India, or the recent petroleum project in China, are expected to cost a total of $4 billion.

Whatever the type of project it is the Bank's objective to serve as a catalyst. In the oil and gas sector, the technical expertise is in the private sector, as well as much of the capital needed. Better geological data, more attractive incentive frameworks, clearer contractual

provisions and supportive legal frameworks, all are necessary elements for an effective collaboration to find and develop hydrocarbon resources. The Bank can help in creating such environments and in promoting the necessary partnerships between foreign and domestic corporations. But finance is crucial as well. Without a substantial increase in lending for energy, energy will become a constraint to growth in the next decade. This requires both an increase in resource flows and a reallocation within the limited availabilities. Here, too, the Bank has played, and will continue to play, a basic role. The preparation of sound projects, part of a well integrated energy investment plan, provide investment opportunities which general sovereign risk lending does not offer.

The Bank also serves as a catalyst within developing countries, by assisting in the development of energy policies and programs, in formulating pricing strategies, in identifying and preparing projects, and in helping to organize the technological and financial packages for them.

Energy always has been a central component of growth and development. As an increasingly scarce resource, and a very much more expensive one, its role is even more important and failures of strategy and implementation more costly. The growth prospects of the developing countries depend on many factors - but one of the central ones is their energy investment programs. To formulate these properly, to arrange for their financing, and to assure their implementation using the most effective technology international corporations can provide, is one of the basic challenges of the decade.

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SecM83-244(Rev.)

FROM: The Deputy Secretary

March 18, 1983

BANK LENDING AND OTHER SOURCES OF
PROJECT FINANCING

Attached is a note entitled "Bank Lending and Other Sources of Project Financing". This note should replace the version circulated on March 16, 1983 (SecM83-244) which contained several typographical errors (paras. 1, 3 , 4[second indent], 7 and 17). The note was prepared in response to requests from Executive Directors for a discussion of how the Bank currently views the relationship between its financing and that of other sources of project financing, and will be the subject of a seminar for the Executive Directors on April 6, 1983, at 3:00 p.m. (This seminar is shown in the Long-term Schedule as "Lender of Last Resort".)

Questions on this paper should be addressed to Ms. Pratt (X76993).

Distribution:

Executive Directors and Alternates
President
Senior Vice Presidents
Senior Management Council
Vice Presidents, IFC
Directors and Department Heads, Bank and IFC

## Bank Lending and Other Sources of Project Financing

### Introduction

1. This note responds to requests from Executive Directors for a discussion of how the Bank currently views the relationship between its financing and that of other sources of project financing.

2. The Articles of Agreement of the Bank, prepared at Bretton Woods in 1944, define the Bank's objectives as both a financial and a development institution. The Articles, although written in an economic environment which was radically different from that of the last two decades, have provided the Board and the Management with flexible guidelines to govern the Bank's growth over the last 40 years and have enabled it to respond to the changing needs for assistance of its members.

3. Article III, Section 4(ii) deals with the relationship of Bank lending with other sources of finance.1/ This section provides that, as a condition of Bank lending, the Bank must be satisfied that in the prevailing market conditions the borrower would be unable to obtain funds "under conditions which in the opinion of the Bank are reasonable." In making this judgement the Bank also takes account of other provisions of the Articles. Among those are the provisions of Section 4(v), Article III which require the Bank to act prudently in the interest of both the borrower and the institution as a whole.

4. The key features of the current approach are as follows:

- At the country level: Given the multiplicity of sources and uses of foreign financing, decisions by the Bank on the financing of projects must be based upon an overall assessment of the country's external financing requirements and the terms and conditions of all sources of available finance.

- At the project level: Here the test is whether the Bank's involvement in a project (or a sector) is required to achieve priority development objectives through policy change, institution-building and technology transfer which could not be achieved if the financing were provided wholly from other sources.

- In the project financing plan: Even assuming that the Bank's involvement in a project can be justified, policy also requires that the Bank's share in the project's financing be kept to the minimum necessary to make the Bank a credible partner to both the borrower and to other lenders.

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1/ The Annex provides a brief drafting history of Section 4(ii) of Article and of its application, particularly in the early years of the Bank's operations.

The following sections describe these three tests.

At the Country Level

5. The immediate concern of the Bank's founders was the reconstruction of the war-destroyed economies of Europe and the resuscitation of private capital flows for the development of productive resources in member countries. The international capital market was virtually non-existent at the time and private loanable resources were concentrated in the United States. Given the nature of the economies being helped, the extremely limited market for private loans, and the Bank's close ties to the U.S. banking community,it was a fairly simple task to determine - often by a phone call to New York - whether private financing, on reasonable financial terms for the borrower, was available to finance a specific project proposal of interest to the IBRD.

6. The evolution of the Bank's membership, its shift from lending for reconstruction to development, the expansion of its financial and developmental role, the expansion of international trade, the growth of international financial markets and the extent of interdependence of economies at different stages of development, led to a steady broadening of Bank analysis and advice to countries on questions of policy, institutions and general economic management. The dialogue on such questions has become an integral part of the Bank's relationship with borrowers, and is the context within which operations are conducted. It looks beyond the financing plans of individual operations so as to take fully into account the prospects for mobilizing capital from all potential sources, including a maximum effort to raise domestic resources.

7. Already in the early 1950's it had become clear that the developmental effectiveness of the Bank, i.e. its basic purpose, required a country focus. The 1951 Annual Report noted that:

> "The Bank has always emphasized that economic development is a continuous process, and that its success depends to a large extent on the ability of the countries themselves to mobilize their total resources successfully and to use them to the best advantage. The Bank does not conceive of itself merely as a source of funds for a few isolated projects, but is prepared to take an active and continuing interest in the overall development problems of a member country. In its lending operations the Bank has always evaluated requests for loans by assessing the contribution of a proposed project to the total economy of a country. This evaluation involves an appraisal not only of the technical and financial aspects of the project but also of its relative urgency and comparative value in accelerating a country's economic development."

This country focus has steadily strengthened over time.

8. The scope of the Bank's concern for the impact of projects on the overall economy, and for the general policy framework of its borrowers, including their ability to mobilize resources, also includes a careful assessment of creditworthiness. Originally the concern was limited, because private international capital flows were small and the Bank's exposure in any one country was limited. But the rapid expansion of the international capital markets, particularly since 1973, has changed that: the problem of countries borrowing excessively or on inappropriate terms, to sustain consumption levels or to finance inadequately prepared projects has become increasingly serious. Capital at competitive market costs became readily available from a variety of sources but was sometimes used in excess of the long-term servicing capacity of the country. The Bank's concern about this was based both on its responsibility for providing sound advice to member countries on their financial operations, and its responsibility for protecting the soundness of its own portfolio.

9. In monitoring country creditworthiness it is clear that the mere availability of capital for a particular operation is an inadequate basis for concluding that such borrowing is consistent with an appropriate volume of external borrowing of a country, in aggregate and consequently at the project level. Clearly it would not always be prudent to borrow simply because private financing is available. In fact, some of the major debt crises of recent years have occurred because some borrowers and lenders have not fully weighed these considerations. As the availability and sources of private capital have multiplied so has the need for a coherent and integrated approach to the utilization of capital. This approach involves the Bank's assessment of the country's development strategy, investment program and financing plan. The Bank's economic reports comment on the realism of the magnitudes, the appropriateness of the sectoral priorities, and assess the ability of the country to borrow the intended amount in the light of its long-term capacity to service external debt. This provides a basis for judging whether, in the aggregate, additional borrowing is justified. The overall volume of Bank lending also is planned in this context. The Bank would never counsel a government to borrow less than it could obtain from other sources, and prudently service, for a sound development program. To do so would be tantamount to suggesting a lower than attainable level of investment and consequently a suboptimal level of growth.

10. The application of this approach in practice has resulted in Bank lending that is quite a small proportion of external finance in countries that can service a high volume of debt on commercial terms. When a country can finance the whole of its investment program (on a sustainable basis) without Bank financing, the lending is phased down and ultimately ceases through graduation. This approach also ensures that there is no

displacement of foreign lending from other sources. Sound investment opportunities in most developing countries are in excess of the capital available, although this varies by country and over time. There is little doubt - as demonstrated by the tremendous growth of private lending and equity investments - that there is no shortage of projects. On the contrary, there are numerous examples of countries -- even at high levels of per capita income -- that are having to trim investment programs because of lack of resources on suitable terms. Official financing in middle-income countries has shrunk as a percentage of total flows and the Bank itself, despite its growth, meets only a small proportion of its members' external borrowing requirements - on an average less than 5%.

At the Project Level

11. With the availability of many sources of finance, public and private, national, regional and international, the Bank obviously must be selective in deciding what activities to support. The basic objective has been to maximize the Bank's developmental effectiveness by ensuring that the Bank contributes things other lenders do not, and by focussing our lending on the sectors which have the highest development priority in the country.

12. As the Bank expanded its operations in developing countries and, gradually, as more was learned about the development process, it became clear that one of the Bank's major contributions was assistance in planning and analysis, the discipline of project selection, the building of institutions, the transfer of technology, the training of skilled staff and the transmission of experience of successful solutions to development problems. Consequently, in reviewing the Bank's role in the country, a sector, and a specific project, the Bank must take account of the extent to which the country's needs for such assistance could be satisfied by other financiers. This approach has been widely accepted over the years. These features have often been at the heart of decisions over Bank involvement: given the relative scarcity of Bank funds, their deployment cannot be based solely on financial criteria, even allowing for the longer maturities associated with Bank loans.

13. In the selection of sectors for Bank involvement, and subsequently in the identification of suitable projects, the vastly expanded investment programs of the developing countries, combined with the evolution of the Bank as a development institution, made it clear that the relevant reviews could not take place at the project level only, nor were such reviews useful at a late stage in the decision-making cycle. The effect of a single "sound" project could too easily be overwhelmed by other, uneconomic projects in the same sector or by the same agency, or by generally inappropriate policies including an excessive investment program. In fact, the "soundness" of a project is highly dependent on an

appropriate sector policy framework within which it is designed, implemented and operated.

14. The selection of the sectors is based on a number of factors, including the importance of the sector in the national economy, the strength of the country's institutions in the sector, the adequacy of the policy framework, the prospect for technology transfer, the strength of the Bank's experience in the sector and the catalytic role the Bank can play both in attracting additional resources - domestic and foreign - to the sector in the near term and in developing broader investment opportunities - for domestic and external capital - in the longer term.

15. After sector priorities are mutually agreed with the borrower the Bank is prepared to participate in the financing of projects in that sector. In selecting sectors, and projects, the Bank takes account of the fact that the different sources of capital available to the country may have their own preferences as to sectors or types of projects. However, projects are not, by and large, full-fledged ideas technically prepared, economically analyzed and managerially structured, delivered to the Bank ready for presentation to the Board. A great deal of work is done to assist members in project formulation and implementation because this is one of the basic channels through which the Bank can assist its members. It is in this way that technology transfers can be achieved, experience in other countries drawn upon, and changes in the policy framework or organizational structure explored to help assure the efficient use of capital and the strengthening of the human resource base. The extent of such assistance varies with the complexity of the project and the management and technical capacity of the country or the agency. A very considerable portion of the Bank's expenditure on appraisal and pre-appraisal work (350-400 staffyears in FY 1983 at an approximate cost of $70-80 million) is in fact technical assistance in the shaping of projects. Obviously, this must be done at the very early stages and it is at that time that a tentative decision must be made about Bank involvement. It would not be financially feasible for the Bank routinely to prepare projects and then not participate in their financing - after all, costs of our staff services are financed by loan charges. Nor would it be consistent with our development function since a large part of our technical support comes after Board approval and during project implementation. Moreover, such an approach would quickly undermine our partnership with official and private co-financiers.

16. The Bank's influence on project design and sector policies is critical to the development impact of its lending. Its credibility would not survive long if it insisted on changes in such matters as design, competitive bidding, consultant selection procedures, or on policy changes in such areas as prices, tariffs or organizational structure and, after all the battles were over, told the borrower it had a good project but the Bank no longer wished to be associated with its financing. All experience

suggests this would be self-defeating. Without the Bank's continued involvement during the implementation phase many changes would not be implemented or, if made, not sustained. Indeed, if Bank involvement during implementation is not essential, the project would not warrant Bank participation at the outset. This problem is compounded when co-financiers are involved. They appreciate the Bank's role in project formulation and often base their decisions, in part or in whole, on its analyses. Should the Bank decide at the end not to participate in the project financing it would quickly cease to be seen as a reliable partner. For any particular project, the Bank's refusal to finance would have unpredictable consequences - in some cases additional financing could possibly be obtained; in some not; and in still others, co-financiers would withdraw too. But overall, this approach would obliterate the Bank's capacity to mobilize additional capital flows for the developing countries.

## The Project Financing Plan

17. The policy of the Bank on the share of its participation in a project is clear. It is the objective to minimize its financial participation in projects consistent with its development functions and with its ability to assure co-financiers of the Bank's capacity to supervise the project and to assist in its successful completion. In practical terms this requires a financial participation in the project financing plan which is large enough and sustained over the full implementation period to ensure effective supervision. The expansion of the Bank's co-financing operations in recent years is ample evidence that the Bank not only welcomes financial participation in its projects but makes a major effort to attract such financing. Of course, what constitutes an appropriate participation requires judgement at every stage of the process. Even if the Bank can contribute to the sector dialogue, assist in shaping the project, transfer technology and experience, and provide training, a judgement still must be made on what the appropriate share of Bank financing should be, taking into account the need to stimulate the flow of external capital from all possible sources. This judgement cannot be quantified. It involves technical issues, such as procurement, the need to enhance the effectiveness of Bank advice on sensitive policy and institutional issues and the borrower's views on how to allocate the other external capital and preferences as to source and type. Ultimately, the appropriate judgement depends on a clear understanding by the staff involved of the Bank's objectives and role, and careful management guidance and control.

## Conclusions

18. The above describes the basic elements of how the Bank applies the guidance provided in the Articles to assure itself that the Bank lending is justified, that the Bank has paid due regard to the prospects

of the borrower and that it is acting prudently in the interests of both the borrower and the members as a whole.

19. Operationally these concerns are embodied in the Bank's long-term planning for assistance to countries and its policy dialogue. These ensure that there is agreement on a policy framework, or on adequate progress toward establishing a satisfactory policy framework. This includes mutual understanding on the size of the investment program and a realistic assessment of the availability of external capital from all possible sources in light of the country's needs and creditworthiness capacity. Flowing from this also is mutual agreement on sector priorities and the identification of those sectors in which the Bank can make its most effective contributions.

20. Within these priorities, which usually far exceed the Bank's capacity to respond, projects are identified which can incorporate all, or at least several, of these objectives. For the reasons discussed above, the Bank's policy and institutional role make it essential that its association with a project start with its formulation and be carried through to completion. This leaves the apparent paradox that if the Bank makes its contribution to the policy framework, technology and institution building during project preparation, the actual financing could be done by others. But this ignores two aspects. First, while this could be done for a single project it would undermine the Bank's credibility as a partner - with the government, the executing agency, and co-financiers - and thereby erode its future influence. Second, a substantial part of the Bank's contribution to technology transfer, institution building, and policy improvements comes _after_ Board approval, during implementation.

21. The magnitude of the development task requires that the various sources of finance complement each other and that the determination of support for particular projects and sectors by the Bank be made in view of countries' overall development priorities, their access to all potential sources of capital consistent with their long term debt servicing capacity, the scarcity of the Bank's resources and the Bank's potential contribution to institutions, management and policies. These judgements must be made, indeed can only be made, in the overall context of the country's situation and with a long term view of its prospects.

ANNEX

## A HISTORY OF SECTION 4 (ii) OF ARTICLE III OF THE BANK'S ARTICLES OF AGREEMENT

### A. Introduction

1. This Annex presents a brief history of the drafting of Section 4 (ii) of Article III of the Bank's Articles of Agreeement and of its application in the course of the Bank's operations. This Section reads as follows:

> The Bank may guarantee, participate in, or make loans to any member or any political sub-division thereof and any business, industrial, and agricultural enterprise in the territories of a member, subject to the following conditions:
>
> [. . . .]
>
> (ii) The Bank is satisfied that in the prevailing market conditions the borrower would be unable otherwise to obtain the loan under conditions which in the opinion of the Bank are reasonable for the borrower.

This Section reflects paragraph (ii) of Article I of the Bank's Articles of Agreement, which read as follows:

> The purposes of the Bank are:
>
> [. . . .]
>
> (ii) To promote private foreign investment by means of guarantees or participations in loans and other investments made by private investors; and when private capital is not available on reasonable terms, to supplement private investment by providing, on suitable conditions, finance for productive purposes out of its own capital, funds raised by it and its other resources.

The purpose of promoting private foreign investment is carried out by the Bank in many ways. A key element in the furtherance of this purpose has been the establishment of IFC. This Annex deals only with that part of Article I which is reflected in Section 4 (ii) of Article III.

2. The history of Section 4 (ii) of Article III is concerned with two closely related themes: one is whether the application of the provision should be determined by an objective procedure, and the other is whether the provision should be applied only with respect to individual projects or a borrowing country as a whole. The evolution of these two

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themes may be summarized as follows: the early drafts for the Bank's Articles of Agreement took a project-by-project approach and provided for an objective test by which the provision was to be applied. At the Bretton Woods Conference, this objective test was replaced by the more subjective test now found in the Bank's Articles. While the original objective test precluded consideration of any other factor, the present test gave the Bank the flexibility to determine how the test would be applied and how this requirement of the Articles would be related to other provisions of the Articles. Early in the Bank's history, country-wide economic considerations became the focal point around which these considerations were weighed.

B. Drafting History

3. The earliest published draft of the Bank's Articles, the "Preliminary Draft Outline," prepared by the U.S. Treasury and dated November 23, 1943, 1/ contained the following conditions for lending by the Bank:

> Article IV, 1. (b) The Borrower is otherwise unable to secure the funds from other sources, even with the national government's guarantee of repayment, under conditions which in the opinion of the Bank are reasonable. 2/

> Article IV, 6. The Bank shall make no loans or investments that can be placed through the usual investment channels on reasonable terms. The Bank shall by regulation prescribe procedure for its

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1/ "Preliminary Draft Outline of a Proposal for a Bank for Reconstruction and Development of the United and Associated Nations," in Proceedings and Documents of United Nations Monetary and Financial Conference, Bretton Woods, New Hampshire, July 1-22, 1944, Department of State, 1948, Vol. II, p. 1616 (hereinafter the Proceedings). The introduction to the draft stated that "This draft is in every sense still a preliminary document representing the views of the technical staffs of the Treasury and other Departments of this [US] Government. It has not received the official approval of either the Treasury and or of this Government."

2/ Ibid at p. 1623.

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operations that will assure the application of this principle. [3/]

4. The draft outline did not indicate what procedures were contemplated to assure the application of the principle. An earlier, unpublished draft by Harry D. White, Assistant to the Secretary of the U.S. Treasury, gives an indication of what the drafters had in mind:

> To make certain that the international Bank makes no loans that can be handled by private institutions at reasonable rates, the following conditions of making any loan should be established:
>
> (a) A vote of the Board approving the loan should be followed as soon as possible by the publication of the technical report on which the decision was based, and the publication of the proposed terms and conditions of granting the loan.
>
> (b) The decision to make a loan shall not become operative until 30 days after such publication, and only if before the end of that 30 days no reliable financial agency is prepared to make a similar loan to the prospective borrower at rates of interest which are not more than one-third higher than the Bank is prepared to charge, and for a period of years that is not more than 10 percent shorter than the period for which the Bank is willing to extend the loan, and the rate of redemption proportionally greater than the Bank is willing to establish.
>
> If a reliable private financial agency indicates its preparedness to provide a loan under the above conditions,

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3/ Ibid at p. 1624. The Preamble to the Preliminary Draft Outline contained the following paragraph:

> 3. The Bank is intended to cooperate with private financial agencies in making available long-term capital for reconstruction and development and to supplement such investment where private agencies are unable to meet fully the legitimate needs for capital for productive purposes. The Bank would make no loans or investments that could be secured from private investors on reasonable terms.

> it shall be given 60 days in which to implement the arrangement. An appropriate guarantee should be required by the Bank of the financial agency to assure the availability of the Funds. 4/

5. At a meeting among delegations coming from Europe held on board the _Queen Mary_, the U.S. proposal was discussed. A contemporary account indicates that Lord Keynes had difficulty with the U.S. drafts quoted above:

> Sir Wilfred Eady drew attention to IV(1)(b) and IV(6) of the November 1943 draft which attempted to ensure that recourse should not be had to the Bank in cases where loans could be secured on reasonable terms through private channels. Lord Keynes thought that it would be very difficult to establish satisfactory criteria on this point. Would it, for example, be permissible for the Bank to make or guarantee a loan to a member at 4 1/2 per cent if that member could obtain money outside the Bank at 5 per cent. It was generally agreed that this section needed redrafting, particularly in view of the impossibility of ever bringing satisfactory negative proof. Lord Keynes mentioned, however, that Dr. White attached considerable political importance to this point, and did not therefore put forward any concrete proposals at the moment. 5/

Although these unpublished drafts and discussions occurred before the Bretton Woods Conference and are not part of the formal drafting history of the Articles of Agreement, they are quoted here because they provide useful background information on the decisions taken at Bretton Woods.

6. The initial draft discussed at Bretton Woods, which combined elements of the Preliminary Draft Outline and of a draft outline prepared by the United Kingdom, contained the following language:

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4/ "Outline of Draft Proposal for a United Nations Bank for Reconstruction and Development," unpublished draft dated April, 1943, Point IV. A.9.

5/ Unpublished document IMC (44) "Note of Fifth Meeting Held on Board Ship," dated June 22, 1944.

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[illegible] in Implementation [illegible]
and any case, [illegible] procedures should be
[illegible] which appears to me the
[illegible] possibility [illegible].[8]

[illegible] meeting [illegible] were [illegible] coming from [illegible], the U.S. proposals [illegible]. [illegible] enough [illegible] that [illegible] had differ[illegible] with the U.S. on the subject [illegible].

[illegible] objected to [illegible] (1)(b) [illegible] 1943 draft [illegible] attempted to ensure [illegible] should not [illegible] in the Bank in cases [illegible] could be secured [illegible] between [illegible]. [illegible] said it would be very difficult to [illegible] rule [illegible] agreed that [illegible], particularly in view of the possibility of [illegible] factors [illegible] proper. [illegible] what [illegible] importance to this [illegible], and [illegible] at the moment.[9]

Although these suggestions and discussions [illegible] considered before the [illegible] conference and are not part of the formal drafting history of the Articles of Agreement, they are quoted here because they show [illegible] at the Bretton Woods.

4. The Joint Draft discussed at Bretton Woods, which combined [illegible] of the [illegible] outline and of a [illegible] outline proposed by the United Kingdom, contained the following language:

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8/ "Outline of Draft Proposal for a United Nations [illegible] for Reconstruction and Development," [illegible] 1943, Point IV. [illegible]

9/ [illegible] Document [illegible] (46) "Notes of Fifth Meeting Held on [illegible]," dated June [illegible], 1944.

> The borrower is unable to secure the funds under conditions which, in the opinion of the Bank, are reasonable. 6/

In the course of the Conference, delegations proposed two amendments to this draft. One would have restored language broadly similar to that of the Preliminary Draft Outline quoted in paragraph 3 above; 7/ the other, proposed by the U.K., is the language which was finally adopted. 8/ The subcommittee charged with Articles III and IV reported that "The Committee's opinion was that the adopted text better expressed the general intention. It was considered that the text covered the proposal made on page 16 [i.e., the language similar to the Preliminary Draft Outline]." 9/

C. Application of the Provision

7. Thus, by the time the Bank was ready to make its first loans, the test had become a more subjective one. In reaching a decision to lend, the Bank also took into consideration other provisions of the Articles of Agreement. The purposes of the Bank set forth in Article I require it "to assist in the reconstruction and development of territories of members . . . ." In addition, Section 4 (v) of Article III contains the following language:

> (v) In making or guaranteeing a loan, the Bank shall pay due regard to the prospects that the borrower, and if the borrower is not a member, that the guarantor, will be in a position to meet its obligations under the loan; and the Bank shall act prudently in the interests both of the particular member in whose territories the project is located and of the members as a whole.

This paragraph emphasizes the importance of the member country in two different ways: first, the Bank must take into account the prospects that it will be in a position to meet its obligations under the loan, either as a borrower or a guarantor; and second, the Bank must act prudently in the interest of the member country concerned and of the members as a whole.

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6/ Proceedings, Vol. I, p. 195.

7/ Ibid, p. 378.

8/ Ibid, P. 376.

9/ Ibid, p. 560.

8. Within this framework, the Bank encouraged its borrowers to obtain funding from the private capital market whenever this could be done on reasonable terms. At the time when the private capital market was concentrated in New York City, the Bank monitored the access of its borrowers to it. In the course of appraisal of a project or program, the Bank made inquiries to satisfy itself that the borrower would not be able to obtain all or part of the funds for a program or project from other sources on reasonable terms. In many cases the Bank assisted the borrower in gaining access to the market, often through various forms of co-financing with private banks or bond issues. In other cases arrangements were made to sell participations in all or part of the loan to private banks.

9. Although these specific arrangements were made in connection with individual projects, from the very beginning of Bank lending, the decision to lend was responsive to the government's economic priorities and the impact the project would have on the economy. Indeed, many of the early loans were requested by, and made to, the member country, even in cases where the beneficiary was a non-government entity. In some cases, this may have been due to the fact that the entity did not have access to foreign loans on its own. But in many cases it resulted from the fact that the impact of the project on the member country's foreign exchange reserves was of great importance to the government and the government undertook the search for the foreign exchange resources itself. More importantly, the Bank stressed the need to examine the projects it financed in the context of their impact on the economy of the member country and its priorities. The matter was discussed as follows in the Bank's Fifth Annual Report (1949-50):

> There has been considerable criticism of the specific project approach, but the criticism has almost always been based on the assumption that the Bank examines the merits of particular projects in isolation, without reference to their relation to the over-all development needs of the borrowing country. In fact the Bank does precisely the opposite. As is more fully explained below, the Bank seeks in the case of each borrowing country to determine what are the appropriate investment priorities and then to adapt its program of financial assistance to meet the priority needs. Consistently with this approach the Bank has encouraged its members to formulate long-term development programs and is providing several of them with substantial technical assistance for this purpose. The existence of such a program greatly facilitates the task of determining which projects are of the highest priority in the light of their prospective contribution to the program as a whole.

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The Sixth Annual Report (1950-51) came back to the issue:

> The Bank has always emphasized that economic development is a continuous process, and that its success depends to a large extent on the ability of the countries themselves to mobilize their total resources successfully and to use them to the best advantage. The Bank does not conceive of itself merely as a source of funds for a few isolated projects, but is prepared to take an active and continuing interest in the overall development problems of a member country. In its lending operations the Bank has always evaluated requests for loans by assessing the contribution of a proposed project to the total economy of a country. This evaluation involves an appraisal not only of the technical and financial aspects of the project but also of its relative urgency and comparative value in accelerating a country's economic development. 10/

10. In 1965, these country-wide considerations were prominent in the Bank's decision to lend to "market eligible countries." In a paper entitled "Market Eligible Loans," which referred specifically to Section 4 (ii) of Article III, the President of the Bank proposed that the Bank should make loans at a slightly higher interest rate than for other borrowers to economically stronger countries whose ability to borrow in the capital markets had improved but for which the amounts they could borrow still fell short of the requirements (see FPC64-17, dated October 28, 1964).

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10/ The Third Annual Report (1947-48) contains the following paragraph in a section entitled "Stimulation of Investment From Other Sources":

> There may well be cases, too, where development projects which come to the attention of the Bank appear suitable for private financing. In such cases, the Bank may be able to suggest possible sources of capital, or to bring the projects to the attention of investing groups, or otherwise to assist in arranging the necessary financing. The Bank may sometimes also be able to facilitate the raising of private capital for meritorious projects by making loans to cover part of the capital cost. Bank participation in such investments would reduce the amount of capital that would have to be raised privately and at the same time the Bank's tangible demonstration of confidence in the soundness of the investments should increase their attractiveness to private investors.

[illegible] Sixth Annual Report (1950-51) [illegible] the Bank:

> The Bank has always emphasized that economic development is a continuous process, and that its [illegible] depends to a large extent on the ability of the countries themselves to mobilize their total resources successfully and to use them to the best advantage. The Bank does not conceive of itself merely as a source of funds for a few isolated projects, but is prepared to take an active and continuing interest in the over-all development problems of a member country. In its lending operations the Bank has always evaluated requests for loans by analyzing the contribution of a proposed project to the total economy of a country. This evaluation involves an appraisal not only of the technical and financial aspects of the project but also of its relative urgency and its potential value in accelerating a country's economic development. 1/

14. [illegible], these economic considerations were evident in the Bank's decision to lend to "market eligible countries." In a memorandum entitled "[illegible] Eligible Loans," which refers specifically to Section 4 (b) of Article III, the President of the Bank proposed that the Bank should make loans at a slightly higher interest rate than for other borrowers to [illegible] stronger countries whose ability to borrow in the capital market had increased but for which the amounts they could borrow still fell short of the Bank's [illegible] (see [illegible]-117, [illegible], 1949).

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1/ The Third Annual Report (1947-48) contains the following paragraph in a section entitled "Stimulation of Investment from Other Sources":

> There may well be cases, too, where development projects which come to the attention of the Bank appear suitable for private financing. In such cases, the Bank may be able to suggest possible sources of capital, or to bring the projects to the attention of investing groups, or otherwise to assist in arranging the necessary financing. The Bank may sometimes also be able to facilitate the raising of private capital for meritorious projects by making loans to cover part of the capital cost. Bank participation in such investments would reduce the amount of capital that would have to be raised privately and at the same time the Bank's tangible demonstration of confidence in the soundness of the investments should increase their attractiveness to private investors.

11. Since then, the requirement in Section 4 (ii) of Article III has consistently been read to require predominantly country-wide considerations, although other aspects of the Bank's lending policies are also responsive to it, as for example, the level of the Bank's financial participation in a given project. Board discussions of graduation of high income countries in the 1970's contain many examples of this country focus. The Board paper on the "Future Role of the World Bank and its Associated Capital Requirements" (R77-18, dated February 1, 1977), a section on 'Graduation and the Distribution of IBRD Lending,' contained the following language (paragraph 60):

> In accordance with the provisions of the IBRD's Articles of Agreement (in particular Article III, Section 4(ii)), the IBRD keeps the evolving situation of its borrowing member countries under close review in order to take action to reduce and eventually terminate lending to countries that become able to satisfy their external capital requirements elsewhere on reasonable terms. Since there is a general correlation between rising levels of per capita income and the ability of developing countries to finance their development programs out of their own savings and through resort to normal commercial sources of external finance, particular attention has been given in this connection to the higher-income countries among the IBRD's borrowers.

12. Similarly, the recent memorandum on "Graduation from the Bank" (R82-1, dated January 6, 1982) discusses graduation of borrowers in terms of overall economic considerations and contains the following reference to the Articles of Agreement (Footnote 1, page 2):

> See IBRD Article III, Section 4, Subsections (ii) and (v). In making a loan, the Bank must satisfy itself that the prospective borrower cannot obtain the loan on reasonable terms in the market, and that it is likely to be repaid. In judging the eligibility of a member country to borrow or guarantee loans, the Bank has interpreted these provisions of the Articles to refer to the country's ability to service loans in the amount contemplated (its creditworthiness) and its relative lack of access to the private market.

Legal Department
March 15, 1983

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We are here to honor and to remember Alex Lachman -- a dear friend and a colleague.

Alex was a man of many talents and many aspects. All of you - his friends and his family - knew him in different ways; we have shared some common experiences but also many which were unique. I could not hope to express what Alex meant to each one of us here, or how each of us mourns his passing. But I hope that you will find something of your own feelings in my thoughts about him.

Zina and I knew Alex for over 20 years. We first met in Turkey - my first overseas assignment for AID. Alex was one of my first supervisors and quickly became a role model for me. And he remained that for life. But that did not prevent us from becoming friends with the Lachmans and remaining in close touch as they, and we, moved to other cities and to other countries, and from time to time being in Washington together.

There was much to admire in Alex and for a junior foreign service officer, new to development, to emulate. He was an accomplished professional, well read and broadly cultured, always intellectually curious; a good talker as well as a good listener; a man of compassion as well as one of principle. Development to him was not an intellectual abstraction, a case for the specialist -- it was part of eternal human endeavor, of growth and of evolution. It was part of human history and mankind's future. It meant understanding people - their needs, desires and aspirations - and cultures as much, if not more than, balance of payments and economic models.

While Alex was dedicated to his work his professional life was clearly demarcated. It had to stay within bounds; it was not allowed to spill over and obliterate his other interests. He wanted to be, and remain, a whole man. And he succeeded admirably.

These were important lessons to learn but there was another thing that impressed me. Alex was the first person I had met who had been able to combine serious and effective concern about development with assignments which were almost entirely, though not exclusively, in Paris and Rome. I tried hard to follow in his footsteps in this, too, but I was never successful.

And Alex was ever intellectually curious. It made talking and travelling with him a special pleasure. I remember his visit to India in 1967, when he was working on his OECD study of counterpart funds. He was fascinated by this, to him, new culture and setting. He and Zina spent hours in the bazaars and one day came home, a bit sheepishly, with a 2 foot sandstone head weighing, I suppose, 100 lbs. We had never seen anything like it in India. It seemed the universal human face. It became a very special piece for Alex - when we finally managed to get it to Washington.

Despite his full life Alex also made time, in mid-career, to complete the dissertation for his doctorate. The degree was neither needed to establish his credentials nor to further his career. He did it because he wanted to continue to learn, to explore, to share that knowledge and to give that process concrete expression.

Professionally, Alex contributed much. He worked on the recovery of Europe but he contributed not only to the physical achievements of the Marshall Plan but to the concepts of the trade and payments systems which later were to evolve into the EEC. He was a senior officer in AID and served with distinction in the field and in Washington. His contributions were many and varied - and later in life the source of many of his stories. He remembered with enjoyment the burning of the money supply of one of the contending Laotian Governments as well as his management of the PL 480 program in Italy, his work in Turkey and his contributions to the shaping of the DAC.

And when, upon his retirement from AID he joined the Bank, his creativity, skills, judgement and experience helped to develop the strategic planning process which underlies relations with our members. Then, later, in the European and Middle East Region, he helped to introduce broader strategic and policy thinking to our project work - the early beginnings of what is today a much more policy oriented Bank lending strategy.

When Alex retired the second time, he remained professionally active. Despite what often seemed a relaxed approach to work and his appreciation of the other aspects of life, Alex was not a man to retire. There were too many things still to be learned - and too many things still to be accomplished. He became a consultant to the Economic Development Institute and travelled to countries he had not seen before or had not spent much time in to assess the utility of the training EDI offered. He met a wide range of people - not just senior officials - and he was fascinated. His reports were infused with a real understanding of what training meant to people who had little opportunity for career development, what training could contribute to the

the growth of a country - and what was wrong with the system and how it should be improved.

Throughout his career Alex was seen as a teacher - in the truest sense of the word. He was willing to share his knowledge and to provide the context of his judgements; he was a man of integrity neither given to intellectual fashions nor to bureaucratic wheeling and dealing. He always wanted to know the causes; the reasons, and once those were understood he believed sensible answers would follow.

The personal side of Alex had many facets. His roots went deep into Europe. They not only gave him his multilingual capacity - they also shaped his outlook and his values, his cultural life and his appreciation of good food and a fine bottle; the role of the intellect in the decision making process and the worth of one's word.

Alex had a life of happiness - not without viccisitudes but one of great happiness, nonetheless. He helped to shape and create that by his personality, his mind, his family and circle of friends and acquaintances, and his outlook on life.

Even after the signs of his illness appeared, Alex remained forward looking, optimistic, active, full of cheer and busy living. He wanted to continue to learn and to experience; to contribute and to benefit. And, when later his illness became worse, neither his courage nor his optimism diminished. He did not focus on his problems but on what was going on in the world; what was new in literature and the theatre; what was going on with his friends.

I remember well a visit with him early in 1982 when he was confined to bed. He was having a bad period then and I was distressed by his condition. But two weeks later I received a letter from Alex admonishing me to work less, to relax, to take care of myself - and not a word about his problems.

I had another letter from Alex after Zina and I visited him last August. He was better then and we were able to go out. First to dinner across the street and, the next day, to lunch at Angelina's on the Rue de Rivoli. His taxi ride back was his first solo in more than 10 months. He wrote to us afterwards, "During the past year I had other reasons and opportunity to ponder life and death, to think of my errors of commission and omission, and to wonder about the valuables in life. One of my few firm conclusions is - not surprisingly - that the love and care of my friends and relatives are among my most cherished experiences." How good it is for all of us here today to know this.

Alex led a full life. Like all of us he experienced unfulfilled hopes; frustrations with aspects of life; wished that he could have done more and that some things could have been done better. But the vision I shall always have of Alex is a man of contentment; pleased with having dealt well with the world and having the world deal well with him; a man rich in family and friends; a man whose mind never stopped growing, who refused to be limited; a man who enriched the lives of those who knew him.

May 2, 1983

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# The Financial Implications of Adjustment

Address delivered by
Ernest Stern
Senior Vice President, Operations
The World Bank
Bonn, May 4, 1983

I am grateful for this opportunity to discuss a problem which affects all of us deeply and directly, namely the current world financial situation and the prospects for growth in the developing countries in the next years. I do not want to dwell on the short-term problems which are featured daily in the newspapers and discussed in many fora. These problems are crucial. Growth must be restored; international trade must not be encumbered by further restrictions; the debt problems must be managed in a way which will both preserve the strength of the international financial system and enable the developing countries to strengthen their creditworthiness. But there is another set of problems that also must be addressed. These are structural problems, longer term in nature, and involve changes necessary to function effectively in a changing world economic environment and a period of more constrained resources. How this adjustment process is handled will be the principal determinant of the future prospects of the developing countries.

The need for structural changes is driven by two principal forces -- the growing interdependence of the world economy and higher energy prices.

## Growing Interdependence and the Need for Adjustment

The importance of the developing countries to the OECD economies does not need restating, but let me mention just a few examples:

- 18% of Germany's exports are to the developing countries (1979-81). In the United States, 41% of all exports go to developing countries (1981);
- the growth of manufacturing exports from developing countries grew by over 12% throughout the 1970's during which time the developing countries became a significant competitor in domestic and foreign markets;
- the share of developing countries in the growth of bank lending and of profits since the 1970's has been remarkable. Total borrowing rose by 24% per year through the mid-1970's, and total debt outstanding increased almost six-fold between 1972 ($90 billion) and 1982 ($529 billion). The health of the international banking system is now closely dependent on the capacity of the developing countries to service this debt;

- in energy consumption, developing countries already constitute 20% of oil consumption and they are expected to account for virtually all of the projected increase in oil consumption between 1980 and 1995.

These examples merely highlight what has by now become almost a cliche - the world is today profoundly interdependent. The growth of OECD exports, and the consequent creation of jobs, depends to a considerable extent on the resumption of growth in developing countries and on their ability to expand imports.

This growing interdependence is one of the principal elements that drives structural changes in developing and industrial countries alike. Interdependence is a fact of life and the pace of change is likely to accelerate. A more interdependent world offers efficiencies in production, better allocation of resources,increased trade, and stimulation of inventiveness. But it also has other effects. A more interdependent world also means more competition; the need for a constant reassessment of comparative advantage and a realignment of industrial structure; and a more volatile world economy since the policies in one group of countries are quickly transmitted to other economies.

The past decade has seen a painful adjustment process in many industries - textiles, clothing, shoes, automobiles, consumer electronics, steel and others where the comparative advantage has shifted -- both among the OECD countries and between them and the developing countries. While many countries have been tempted to erect barriers to protect their domestic industries, it is clear that such a course of action only produces slower growth and more inefficient industrial structures in the long run. The costs of such inefficiencies are borne by the consumer and the taxpayer. Despite the difficulties involved, facilitating these structural changes is essential to the continued evolution of the world economic system.

Second, the element which forces structural changes is the increased cost of energy. Since 1973, prices of oil have increased fivefold and, despite the current weakness in the market, there is every expectation that the prices of energy in real terms will be higher by the end of the decade than they are today. As a consequence all countries have had to make adjustments to expand exploration, to stress energy conservation and to invest in a variety of energy production which, though often very capital intensive, will substitute for imported oil. The problem of higher energy prices has been particularly difficult for the developing countries, since oil constituted a large proportion of their imports. But most of the developing countries have begun to reorient their energy policies and a significant shift in investment is taking place, with the share of energy investment almost doubling.

The reason I stress the adjustment process is because it lies at the heart of the current economic difficulties. The problems of debt and slow growth with which the developing countries are struggling are not only short-term in nature. There is no doubt that resumption of growth in the OECD countries will reduce the intensity of the current economic difficulties. Conversely, a resumption of growth in the developing countries would be an important stimulant to OECD growth. But the immediate problems of short-term demand management should not obscure the need for more basic structural changes. In the absence of such changes the recovery in the developing countries is likely to be short- lived.

The Scale of Adjustment

Let me now turn to the scope of the adjustment process and then look at how different developing countries have managed theirs. As businessmen, you know that to focus on the developing countries as a unit is to ignore investment opportunities. The necessary ingredients of investment decisions are judgements about individual countries, their policy behavior, economic management capacity and growth prospects.

During 1974-77 the developing countries, and the world, adjusted much more easily than had been anticipated. A worldwide boom in primary commodity prices in 1974, increased the export earnings of many developing countries. This, combined with increased lending by commercial banks and increased aid flows, cushioned the impact of the energy price increases and provided time to begin to make internal adustments. The fact that developing countries largely maintained their growth helped the recovery of the industrialized countries. Another important factor was the growth in import demand of the OPEC countries. Between 1973 and 1975, the oil exporting countries doubled their share of world imports. They managed to launch new investment projects much more rapidly than had been anticipated and increased consumption expenditures, providing important new markets for both developed and developing countries. As a result, the current account deficits of the oil importing developing countries which had reached about 5% of their collective GNP during 1974-75 -- a level which could not be sustained -- declined to about 2% by 1978, or about the level of the pre-1973 era.

The sudden further increase in the price of oil in 1979 generated new concerns, but not nearly the same degree of anxiety as the price increase of 1973-1974. The fact that the first price increase had been absorbed with relatively little problem led to the sanguine assumption that the second increase also would be easy to absorb. While we overestimated the difficulties caused by the first increase, we have underestimated the difficulties caused by the second.

The length and severity of the present recession is the result of several factors. First, the increase in oil price in 1979 added to inflationary pressures which had already been accelerating during the later 1970s. Governments in the major industrial countries saw inflation as their principal problem, and took steps after 1980 to deflate their economies in an attempt to control it. The result was a paradoxical period of very high nominal interest rates, declining inflation and rising real interest rates. In the earlier period, much of the borrowing had been on fixed interest rates and the repayment burden was eroded by inflation. In response, lending shifted to a floating rate basis and the developing countries, which had contracted by now almost half of their debt on variable interest rate terms were particularly squeezed by the high real interest rates. The decline in demand in the industrial countries resulted in a slowdown of growth of world trade, a decline in prices of commodities and a steady deterioration in the terms of trade.

At the same time, growth in the OECD countries slowed. The task of restoring growth in the OECD countries after the inflation objectives were in sight has proved more difficult than initially anticipated and the forecast now is for only a mild recovery in 1983 (1.5% now forecast compared to 3.0% a year ago). While there are signs of recovery in the United States, with some experts predicting growth as high as 5% in the last quarter, it is, of course, important that the accelerating growth not rekindle price inflation. Should that happen, monetary authorities might have to tighten monetary policy and raise interest rates, which would choke off or at least moderate the pace of recovery.

The slow growth in the OECD countries led to a stagnation of international trade and a severe decline in commodity prices. Not only was the growth of exports from the oil importing developing countries reduced, but also their terms of trade worsened. While these countries have benefitted recently from lower oil prices, reduced inflation in manufactured imports, and lower interest rates, the beneficial effects have been more than offset by steep declines in primary commodity prices. The Bank's overall index of 33 commodity prices, for instance, shows a 25% drop in nominal terms between 1980 and 1982, with the most dramatic changes occurring in prices received for sugar (-69%), cocoa (-32%), and copper (-32%). The overall terms of trade for the non-oil developing countries declined over 6% in 1980, and about 4% each in the years 1981 and 1982. The low-income countries have been particularly hard hit. The cumulative change in their terms of trade between 1979 and 1982 amounts to an adverse shift of close to 25%. Thus, unlike the earlier period, the import capacity of the developing countries - i.e., their demand for OECD exports - declined.

Growth of GDP, by region, 1960-95

| Country group | GDP (1980 billions of dollars) | Average annual percentage growth a/ 1960-73 | 1973-80 | 1981 | 1982 |
|---|---|---|---|---|---|
| Low-income oil importers | 544.2 | 4.5 | 5.3 | 3.7 | 3.7 |
| Asia | 492.4 | 4.6 | 5.6 | 4.1 | 3.9 |
| China | 283.0 | 5.5 | 6.6 | 3.0 | 4.0 |
| India | 159.2 | 3.6 | 4.1 | 5.6 | 3.6 |
| Africa | 51.8 | 3.5 | 1.5 | 0.1 | 0.8 |
| Middle-income oil importers | 999.9 | 6.3 | 5.2 | 1.4 | 1.1 |
| East Asia and Pacific | 204.5 | 8.2 | 8.1 | 6.9 | 4.2 |
| Middle East and North Africa | 28.0 | 5.2 | 3.3 | 0.1 | 2.7 |
| Sub-Saharan Africa b/ | 42.8 | 5.5 | 3.7 | 4.4 | 4.0 |
| Southern Europe | 200.7 | 6.7 | 4.6 | 2.4 | 2.2 |
| South America & Caribbean | 444.0 | 5.5 | 4.7 | -2.4 | -1.2 |
| Oil importers | 1,544.1 | 5.6 | 5.2 | 2.2 | 2.1 |
| Oil exporters | 686.8 | 7.0 | 4.0 | 1.5 | 1.9 |
| All low and middle-income developing countries | 2,230.9 | 6.0 | 4.8 | 2.0 | 1.9 |
| High-income oil exporters | 207.2 | 10.7 | 7.5 | -1.8 | -11.7 |
| Industrial countries | 7,395.3 | 5.1 | 2.5 | 1.1 | -0.5 |

a/ Estimated
b/ Does not include South Africa

The result of the high real interest rates and stagnant world trade has been a period of extremely slow growth for the developing countries. The growth of the oil-importing developing countries, which was close to 6% per year during 1960-73 and about 5% per year between 1973-1980 declined to slightly over 2% in 1981 and 1982. But the picture is even worse than these aggregate figures suggest. Latin America experienced a drop in GNP of about 2% in each of the last two years -- an unprecedented phenomenon. The low-income countries of Sub-Saharan Africa stagnated. The Sub-Saharan countries are highly dependent on trade in primary products, lacking access to private capital and dependent on stagnant or declining amounts of official assistance, and lacking in trained manpower. Their GNP grew, on average, by about one percent during the past decade. With population growth of about 2.8%, these countries have experienced a steady decline in living standards since 1973. Only the two large low-income countries - India and China - and the countries of East Asia managed to maintain reasonable levels of growth.

The middle-income countries were able to borrow in the rapidly expanding capital markets. Total debt outstanding to developing countries rose from about $90 billion in 1972 to $530 billion in 1981, and this does not include at least $100 billion of short term debt (World Debt Tables, 1982 and IMF estimates). Between 1980 and 1982, debt service payments of oil importing developing countries rose by 47%, while export earnings declined by 7%. It is not surprising, that these economic forces created debt servicing problems for major countries.

The magnitude of the adjustment problems faced by individual countries in light of these developments was, and is, formidable. For instance:

- In the Ivory Coast, investment expenditures have been reduced by 40% in real terms, over the last three years, and the bulk of the present investment program is limited to the completion of on-going projects. Lower prices for coffee and cocoa have not only lowered export earnings, but also reduced the Ivory Coast's creditworthiness and its access to private capital. Borrowings from the IMF already total 380% of quota.

- In the Philippines, the current account deficit nearly tripled between 1978 and 1982 ($1.2 billion to about $3.2 billion) or to about 8% of GNP. This sudden increase can be traced to the combination of a 28% decline in the terms of trade; the increase in oil prices which added $1.2 billion to the import bill, despite the fact that oil imports have declined in volume terms; and a four-fold increase in interest payments on external debt. As a result, the growth of GNP has fallen from 7% in 1977-78 to 2% in 1982. Despite new government revenue measures, public investment is expected to decline 23% in 1983.

- In Togo, high phosphate prices in the mid-70s led it to launch a large and poorly designed investment program which produced few benefits and an enormous debt burden. While debt reschedulings have helped reduce this burden, a 22% drop in phosphate earnings, combined with lower prices for coffee and cocoa exports, have worsened the situation. Debt service now constitutes 40% of export earnings and 50% of government revenues. Public investment has been cut 65% below its 1978 level, and current expenditures in 1983 will have to be reduced by an additional 15% in real terms as part of a further adjustment program.

- In Malaysia, reductions in imports led to customs revenues 24% below expectation. As a result there was a 12% reduction in development expenditures, despite cuts in defense and internal security allocations.

<u>Managing the Adjustment Process</u>

The developing countries have been grappling with these massive changes in their economic prospects and, despite some failures, have been successful on the whole in their adjustment programs. The "structural adjustment" which they are undertaking essentially means finding ways to reduce import demands and/or increasing export earnings to reduce their balance of payments gap. Their focus is on increasing output from efficient import substituting industries, strengthening the incentives for export, making more efficient use of existing capital and reducing government deficits by lowering the unit cost of services, and by redefining the respective roles of the public and private sector.

But, carrying out a major structural adjustment program is likely to require additional imports in the early years as investment in new lines of production takes place. Since very few developing countries are major producers of capital goods, their investment tends to be import-intensive. In order to finance this investment there must either be an increase in domestic savings or in capital inflows from abroad during the adjustment period until these investments result in additional output and exports. While some increase in domestic savings is an indispensable part of the adjustment, there are limits to the cuts in consumption which any responsive government can carry out in the short term. For this reason, structural adjustment almost invariably requires a temporary increase in foreign borrowing. It was fortunate that these increased borrowing needs in the 1970's came at a time of substantial international liquidity due to surpluses of the high-income oil exporters. Inevitably, there have been questions as to whether countries like Brazil and Korea have been wise to push up their borrowing to such high levels and whether commercial banks have been well-advised in enabling them to do so. That judgement must rest <u>on the uses to which those resources have been put</u>.

Those economies which have not sought to shelter their producers and consumers from international price changes, and which have emphasized exports, have maintained their growth rates better than others. Of course, developing exports is difficult at a time when industrialized countries are experiencing a recession and erecting new barriers to imports. But success is possible, as demonstrated by Korea, Singapore, and Brazil. Between 1979 and 1981, for instance, Korea and Brazil expanded the volume of their exports by 30% annually.

But not all of the external borrowing was incurred to finance structural change. Turkey, for instance, borrowed to maintain consumption levels while propping up an inappropriate industrial structure rather than reorienting production. Turkey postponed structural adjustment until it could no longer afford the level of imports needed to sustain normal economic activity. The subsequent adjustment has been more painful, both

politically and economically, than if the initial policy responses had been more appropriate. Countries such as the Philippines, Brazil and Korea maintained the outward orientation of their economies; production, whether for the domestic market or exports was subjected to the tests of international competition. Turkey, by contrast, maintained high levels of protection, insulating its productive structure and particularly its highly inefficient state enterprises from competition by foreign producers. Nor were domestic expenditures kept under control during the period since Turkey was forced into ever larger deficits to maintain consumer subsidies and to cover the operating losses of public enterprises. The consequence was the virtual breakdown of the Turkish economy in the late seventies requiring a massive debt rescheduling and a severe austerity program.

But the Turkish recovery in the last two years is also instructive and it has been impressive. It was based on coming to grips with some of the basic issues other countries had dealt with earlier. The lira was devalued and floated to maintain the new competitiveness of exports. This was supplemented by priority exchange allocations for exporters and a major drive to increase exports. Exports responded well, rising 29 percent in 1980 and 63 percent in 1981. The ability to increase exports substantially during a period of virtually flat levels of world trade, belied the earlier export pessimism and lack of confidence in the capacities of Turkish exporters. Subsidies were cut, interest rates were raised, the access of state enterprises to the Treasury and Central Bank to cover operating losses was curtailed. Budget deficits began to come down. The import regime was liberalized and streamlined, within the limited foreign exchange available, to introduce greater competition. The investment program was overhauled - reducing its size, eliminating uneconomic and premature projects, and emphasizing the completion of investments and quick yielding activities. And the longer term balance between private and public investment was altered both to make more investable resources available to the former and to remove the protective price umbrella of inefficient public enterprises. But having delayed the process for so long the extent of the adjustment was far greater and it is not yet complete.

In Latin America, a number of countries facing serious debt problems have adopted IMF stabilization programs and secured IMF assistance. While these programs vary somewhat among countries, those for Mexico, Brazil, Argentina and Chile have broad similarities; limitations on the size of government deficits, controls on foreign borrowings and domestic credit creation, the establishment of realistic exchange rates and the reduction in exchange controls. But the result of these austerity measures is likely to mean slower growth, or even no growth at all, in these countries in 1983.

The severity of the current world recession carries with it the danger that countries will be unable to carry out previously initiated programs of economic reform and structural adjustment. In Pakistan, for instance, a number of steps have been taken since 1977 to restructure the economy along more viable lines and lay the groundwork for long term growth. Higher agricultural prices have stimulated food output, and some agricultural subsidies have been eliminated. Higher water charges have increased the funds available for the operations and maintenance of the irrigation system, while the investment program in irrigation has been reoriented toward projects having short gestation periods and higher yields. The biases of the trade regime have been reduced through better incentives for exports and a phased program of import liberalization. Greater private sector investment has been introduced into the manufacturing and energy sectors, and energy prices made more realistic.

While these reforms have been supported by structural adustment lending from the Bank and by the Fund (EEF), much more needs to be done. Despite these measures, Pakistan's current account deficit increased 54% in the past year, principally due to a 17% decline in exports and slower growth in migrant remittances, and official assistance has continued to decline over the level received in the mid-70s. Without further support, it will be difficult for the government to carry out its structural adjustment program.

There is, of course, no universal prescription. Each country must select the combination of policies which it sees as being appropriate, effective and politically acceptable. But what one sees in the successful cases is a substantial capacity to manage the economy and a sufficiently diversified economic structure to produce the necessary responses when the right signals are given. But in the real world the right signals are not always given at the right time. Effective management means not only the analytical capacity to define the need for change, but also the capacity to formulate an appropriate action program and the political ability to have the changes agreed on and implemented with reasonable speed. Since structural adjustment involves changes in real income of politically vocal and organized groups - urban consumers, industrial workers and the bureaucracy - effective management is much more than a technical concept.

Adjustment for many governments has meant difficult choices between reducing investment and growth or raising taxes and prices and lowering subsidies. In reducing investment, countries are often tempted to cut the social sectors most severely; education, health, nutrition, water supply and related areas. While these sectors have little direct influence on short-term growth, reductions here can decisively influence long-term growth, particularly in low-income countries where skills are in very short supply. Furthermore, since these sectors often directly help the

poor by providing basic goods and services, the poor may bear a disproportionately high share of the burden of adjustment. In the long-run, furthermore, policies which deny the benefits of development to the majority of the poor population are likely to result in disruptions to the pace of development because of increased social and political instability.

In the low-income countries of Sub-Saharan Africa the problem of change is perhaps most severe. Too many governments have pursued approaches which are not in the best interest of rapid development for too long. For instance, African leaders during the 60s and 70s saw agriculture as consisting of two entirely separate components: one, the export-oriented, highly commercialized estate-type sector; the other, subsistence-oriented and family-based. The latter was identified with backward peasants, low levels of technology; the former with subservience to distant and anonymous world market forces. By contrast, industrialization was the symbol of modernity, technological advance and self-reliance. The result has been a tilting of incentives in favor of industry, the neglect of infrastructure and services in rural areas, the lack of emphasis on agricultural research, particularly on food crops. Africa's poor economic performance throughout the 1970s is largely the result of low growth in agriculture -- even though development assistance directed at agriculture and rural development increased. Not only was this neglect of agriculture inconsistent with its comparative advantage, leading to an increased dependence on food imports, it also meant the neglect of the vast majority of the population who live in rural areas and whose prospects for a better life depend on increasing agricultural productivity.

Agricultural policy is not the only source of major distortions. Subsidies, particularly for urban inhabitants -- the relatively well-off minority -- are as prevalent as unprofitable public enterprises; wage rates in the modern sector have been allowed to rise to unrealistic levels; and exchange rate adjustments have too often been unreasonably delayed. As a result, many countries were not well placed to adjust to a changed external environment in the 1970s and 1980s. While some countries, such as the Ivory Coast, Kenya and Malawi, have done quite well under the circumstances, most have not been able to adopt the kinds of policies that make for a successful adjustment.

Although there is an increasing willingness among African countries to undertake policy changes, the scope of the necessary changes is far-reaching because the need for structural change is piled on top of the need for a basic revision of development strategy. At the same time the prospects are poor for obtaining the needed flow of assistance necessary to support such changes. The impact of the energy price increases, the slowdown in economic growth worldwide and the consequent weakening of the prices of primary commodities has created a very difficult situation even

for the well-managed economies -- it has created an almost impossible situation for the others.

Financing Structural Change

Two important conclusions can be drawn from the foregoing:

- First, the requirements for external capital of the developing countries will continue to be large and increasing. External capital is an essential component of development financing and the normal requirements have been augmented by the financial requirements of adjustment and the higher costs of energy production.

- Second, it is not the volume of external borrowing of the last decade which is at issue but the purpose for which the borrowed capital was used. Borrowing to support a poor policy framework cannot be a viable approach. And although the depth of the recession has forced some countries with reasonable policies, such as Brazil, into debt rescheduling, these are temporary liquidity problems. In other countries more basic policy changes are necessary to restore creditworthiness.

But where are these funds to come from? First, from improved domestic resource mobilization; second, from the private capital markets; third, from aid agencies, and from the international financial institutions.

Domestic resource mobilization must be improved in developing countries in several ways. In too many countries scarce resources are still wasted on subsidies which generally do not achieve their stated objectives. Yet they are a major drain on the economy. It is wrong to think that fertilizer subsidies are necessary for farmers who, by using it, can double their yields. The cost to growth can be very large. For instance, in Nigeria, all of the World Bank's agricultural projects are stagnant for lack of budgetary allocations because the States cannot afford the fertilizer subsidy which is mandated. But the problem is not, of course, limited to fertilizer. It is also perverse to keep foodgrain prices low for urban consumers. The results are both predictable and common. Foodgrain production stagnates and imports rise, while budgetary resources are inadequate to support development activities. Africa is well on its way to becoming a major foodgrain importer because of such policies. For now the costs are hidden by concessional supplies from the US and the EEC. But for how long? Pesticides are subsidized, if not free, and water - which can make a major difference in output in most of these countries - is charged for at a rate barely enough to cover operating expenses. Little wonder that maintenance is inadequate and new investments in irrigated acreage depends heavily on external finance.

Countries have similar difficulties in charging real rates of interest - with the result that the farmer cannot borrow money from the banks but must borrow from the moneylenders at usurious rates. They also lag in setting electricity tariffs, rail and bus fares at levels which would assure a reasonable contribution to future investments. The beneficiaries generally are not the poor for which these subsidies were intended. More selective tools must be developed to assist specific target groups. It is clear that in the current economic situation it is highly inappropriate for governments to borrow abroad while not making every effort to increase domestic resources for investment.

A second area for urgent attention is the parastatal institutions. They make profits only rarely and yet consume large portions of domestic investable resources. Governments increasingly recognize that inefficiently run state economic enterprises have an adverse impact on many sectors of the economy. They often serve as a disincentive to efficient operations in the private sector, lead to more capital intensive investments and to high levels of protection. In this area, too, government action is an essential element of structural change and a necessary component of resource mobilization.

But even with the major improvements in domestic resource mobilization the external financing needs of the developing countries continue to be large and ways and means must be found to provide such capital if development progress and growth is to be resumed. Of primary importance in this is the role of the commercial banks.

Many banks now believe that they were overly optimistic of the abilities of countries like Mexico, Argentina, and others to manage their economies, particularly in a period of stress. Thus, even when the world economy revives, commercial banks are likely to be much more cautious about extending new credits to these countries. This is particularly true of the smaller banks. The middle-income developing countries, including the oil exporters, which rely most heavily on private capital are naturally apt to be most affected by restricted access to the international capital markets. Only 10 years ago, private creditors constituted 34% of the public or publicly guaranteed debt outstanding and disbursed to the developing countries, the remainder being debt owed to official creditors. In 1982 over 65% of medium and long term finance going to middle-income countries came from the private sector, in the form of either loans or direct investments. This is a truly major development and the question of whether it can be sustained is basic to the long-term prospects of the developing countries. It is important to note in this connection that the share of commercial banks in net flows rose much more slowly - from 52% to 59% - reflecting rising and variable interest rates and shorter maturities. And since 1979 net flows have declined steadily in nominal terms.

Despite the present payment difficulties the issue is how the private sector capital flows to developing countries can be maintained and expanded in support of sound policy reforms and reoriented development strategies. If net flows continue to decline recovery in the developing countries will not be possible, debt servicing problems will multiply, and new investment opportunities will be drastically limited.

By contrast to the middle income countries, the low income countries depend primarily (over 80%) on Official Development Assistance for their external capital. Within the low-income group, aid is particularly important for the Sub-Saharan African countries where Official Development Assistance finances about 55% of total investment (1980 data). The low-income Asian countries have been able to finance a larger part of their investment needs through domestic savings and (1980) Official Development Assistance financed only about 5% of investment. Nonetheless, their capacity to borrow on commercial terms is limited and Official Development Assistance is essential if they are to raise their growth rates and avoid debt servicing difficulties. A doubling of aid flows to Africa could mean an increase of investment of about 50%. Such an increase would be sufficient to raise growth rates substantially, probably to the level of 3-4%. Since Africa receives only about 15% of total Official Development Assistance a doubling of Official Development Assistance for Africa would entail a total increase of only 15%, or about $3.8 billion annually (over current 1981 level of $25.6 billion).

ODA Flows, 1980-82
($ Billion, Disbursements)

| | 1980 | 1981 | 1982 |
|---|---|---|---|
| Low Income Countries: | | | |
| Africa | 3.4 | 3.5 | 3.8 |
| Asia | 7.2 | 4.7 | 5.2 |
| Total, low income | 10.6 | 8.2 | 9.0 |
| Other LDCs | 13.8 | 15.0 | 14.9 |
| Total | 24.4 | 23.2 | 23.9 |

Source: Short-term Prospects paper, Supplementary Tables.

The prospects for a large increase in ODA are, regrettably, not very good. DAC aid performance has remained stagnant during the past several years at about .35% of GNP, and there is little prospect for an

increase. In the past decade, large increases in Official Development Assistance have come from the OPEC countries. In 1980, they contributed about $7 billion in Official Development Assistance or about 1% of their combined GNP, compared to $25.6 billion for the DAC countries. With the current weaknesses in the oil market, however, further large increases from this source are unlikely.

Despite the clear need for assistance in the poorest countries, they receive only about 35% of total Official Development Assistance (1981) while having over 60% of the population of the developing world. The reasons for the skewed distribution of ODA can be traced to the political role foreign assistance plays in foreign relations. Almost one-half of United States' bilateral aid goes to just two countries: Israel and Egypt. Syria, Jordan and Lebanon receive the bulk of OPEC aid. French aid tends to favor former French colonies in Africa. Given political realities, one cannot expect to have a perfectly even distribution of bilateral official aid. Nevertheless, there is tremendous potential for meeting the needs of some of the poorest countries through a somewhat more even allocation of bilateral assistance.

Another major source of external capital is the international financial institutions, including the World Bank. Given the uncertainties in the private capital markets and the budgetary pressures which restrain bilateral development assistance it is essential that the lending capacity of these institutions be expanded. Growth in the volume of lending from these institutions is vital to the recovery of the developing countries and the expansion of their investments. Of equal importance is the contribution of these institutions to policy formulation, their insistence on careful project selection and the discipline in the investment process which they help develop. These are necessary elements if the external borrowing from all sources is to be in support of a sound policy framework and appropriate structural changes, and consistent with the capacity of developing countries to service the debt. Yet, there is a reluctance to expand the lending capacity of these institutions so that they can respond more effectively to the problems facing their borrowers, even though such expansion can be achieved at little cost to the budget of their members.

## Conclusion

Let me conclude by summarizing some of the principal lessons we have learned from the recent past and what these indicate for our future actions.

First, the adjustment process which started in 1973 is far from complete. Internally, changes are still necessary in many countries to enhance efficiency, to give greater weight to market prices, to make better use of existing capital and human skills, and to have a more realistic definition of the role of the government in the productive

sectors. Levels of protection must be reduced so that markets can expand and the efficiency of production can be tested against international competition.

Second, the current financial crisis has created many immediate problems but its roots go deeper. The liquidity problems of the borrowers can be overcome by a resurgence of growth and careful debt management. But unless the longer term structural issues are dealt with also, these economies will remain very vulnerable to future downturns.

Third, the adjustment process takes time. Changes involved in structural adjustment affect many interest groups directly - prices of their consumption goods tend to rise, the growth in wages in the formal sector slows down or real wages decline, external competition is increased and real interest rates tend to rise. The ability to have the need for such changes understood and to forge a concensus on the need for action determines the feasibility of not implementating change and the speed with which the country can act varies widely among counries.

Fourth, it is important to be able to distinguish between good performers and others. An important aspect of the current debt problem is that too many institutions take an undifferentiated view of the developing countries, and developing country debt. Good performers find their access to financial markets almost as restricted as poor performers. And without access to new capital, even good performers can quickly develop debt-servicing problems. At the same time, little distinction is made between the causes of debt problems in different countries - the extent to which they are caused principally by the harsh international economic environment and the extent to which they are due to longer term structural issues.

Judgements about the management capacity of individual countries should underlie decisions of public and private investors alike.

Fifth, the business community has a vital interest in helping to assure that external capital flows to the developing countries are maintained at appropriate levels. Growth in the OECD countries will be retarded if the import capacity of developing countries cannot expand.

Sixth, a prudent increase in external borrowing requires an expansion of commercial bank lending, increased capacity for export credit agencies, and expanded capacity for the international financial institutions.

Seventh, while commercial type lending is vital to the long-term growth prospects of the middle income countries, concessional flows - bilateral and through IDA - are the underpinning of progress in the low

income countries. The world neither wishes, nor can afford, continued regression in Sub-Saharan Africa and other least developed countries.

Despite the variability of the past, development is one of the success stories of the twentieth century. It has benefitted not only the developing countries but has provided export opportunities, employment and growth in the industrial countries. And we can be confident that the developing countries will also accommodate to the massive changes of the 70s. The important issue is whether the developing countries will be given the time to take the measures needed for adjustment. And time in this case is defined by the willingness of lenders - private and official - to provide the necessary external capital. For the lower-income countries, this is a matter of aid, since they cannot service commercial debt. No matter how well managed their economies, without significant increases in concessional flows over projected levels from bilateral programs and through IDA -- their adjustment will be slow and they cannot lay the basis for accelerated growth in future years. For the higher income developing countries this is not a matter of aid -- they do not require resource transfers on concessional terms -- nor are they now significant recipients of such aid. Rather, for the middle- and higher-income countries what is important is continued growth of net lending by commercial banks, the World Bank and the regional development banks, to allow these countries to make the transition at a pace which does not strain their political and social fabric to the breaking point.

It is the responsibility of we who work in, and with, the developing countries, whether as businessmen or as officials, to make sure that this is understood well by the public and political leaders because the cost of failure is high.

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Address by Ernest Stern

Senior Vice President, Operations of The World Bank

to the International Conference on Oral Rehydration Therapy

Washington, D. C. - June 10, 1983

# HEALTH AND DEVELOPMENT

Mr. Chairman, distinguished guests, ladies and gentlemen:

I appreciate the opportunity to address this international conference on oral rehydration therapy--a subject so vital to health in developing countries. Diarrheal diseases continue to be a major public health problem and a leading cause of illness and death in children under five throughout the developing world. This conference has highlighted the potential that oral rehydration offers for controlling these diseases. It is essential that this technology now be incorporated as rapidly as possible into effective, broad based health delivery systems.

The last two decades have witnessed significant improvements in infant health in the low income countries.[1/]

- An average of 91% of infants survived the first year of life in 1981 as compared to only 84% in 1960.
- Reductions in infant mortality have been the major contributing factor to the increased life expectancy in these countries over the same period and the willingness of an increasing proportion of families to reduce overall family size.

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1/ The World Bank defines low income countries as those with a 1980 per capita gross national product (GNP) of $410 or less.

Nevertheless, for the low income countries[2], excluding China and India, infant mortality rates remain more than 10 to 15 times higher than in the industrial market economies. The death rate in children one to four years of age in these same countries is more than 20 to 30 times that in industrial market economies. And the average life expectancy at birth is 26 years less. These disparities are profoundly unacceptable, all the more so since the majority of the direct causes of these infant and child deaths--neonatal tetanus, diarrhea and dehydration, childhood infectious diseases, malaria and respiratory infections, can be effectively and relatively inexpensively controlled by existing measures.

Oral rehydration therapy is a prime example. It adds a major weapon to the low cost health system's armory to combat ill health, particularly for the large portion of the world's children under five years of age who may have three or more potentially life threatening diarrheal episodes each year.

Oral rehyration therapy represents the essence of appropriate technology:

- it promotes increased self-reliance by providing families with a sense of control over their environment, and strengthening their ability to protect their childrens' health.
- it is adaptable, since it can be used in the formal health sector as well as at home, and it can be produced in a variety of settings as dictated by local circumstances, ranging from pharmaceutical industries to villagers.
- it can substantially reduce overall health care costs, most profoundly when used as part of an early diagnosis and treatment regime which can be expected to significantly reduce the proportion of severe cases. Even in that small proportion of severe cases where intravenous fluids are initially indicated, ORT can quickly replace this much more costly and complex therapy.
- it is widely applicable to countries at all levels of development.

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2/ Note: For all low income economies, the average infant mortality rate in 1980 was 94/1000 live births; the child death rate was 12/1000 children aged 1-4 years; and the average life expectancy at birth was 57 years. If China and India are excluded, the low income countries' key health status indicators change significantly, with an average 1980 infant mortality rate of 130/1000, child death rate of 22/1000 and life expectancy at birth of 48 years. In contrast, by 1980 the industrial market economies had reduced infant mortality rates to an average of 11/1000; child death rates to 1/1000 and achieved an average life expectancy at birth of 74 years.

## The Need for an Integrated Approach

The development of an appropriate technology is the first vital step in improving the quality and scope of health care. The development and refinement of this technology stands as testimony to the commitment, creativity, and perseverance of a large international body of scientists and health professionals, many of whom are assembled here today. We must now focus on how this technology can be disseminated effectively and adopted within national health care delivery systems.

The complex interrelationships between diseases, and the multiple causes underlying excessive infant and child mortality in the developing world demand an integrated response. Redressing just one direct, albeit key, cause of death is insufficient to achieve desired reductions in mortality if the contributory causes remain. The child saved from death by dehydration remains at high risk of illness and death from numerous other causes, among the most important of which is malnutrition.[3/] We need, therefore, to establish health delivery systems which can deal with an array of interrelated problems, and can accommodate change over time as the dominant pattern of illness in the population shifts and new technologies emerge. And, of course, they must be cost-effective and affordable.

## Appropriate Delivery Systems

The accumulating evidence that relatively simple existing technologies can significantly improve infant and child health status challenges us all to get on with the perhaps even greater task ahead--that of designing, implementing and managing appropriate systems which ensure that these technologies are delivered when and where needed. The existence of a technological advance does not necessarily imply its availability. In fact, the vast majority of the population of the low income countries remains relatively untouched by these promising technologies. Among the poorest population groups, key modern health services too often remain inaccessible geographically, economically and socioculturally.

The need to develop appropriate delivery systems has been widely recognized within the international health community. Systems development constitutes the core of many of the diverse disease control programs which

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3/ Malnutrition is a pervasive and insidious problem; a Pan American Health Organization supported study of childhood mortality in Latin America implicated malnutrition as the most important contributor to excessive mortality in under fives. While fecally related and airborne diseases exceeded malnutrition as the primary cause of death, immaturity (whether prematurity or low birth weight) and nutritional deficiency were the underlying or associated causes of death in 57 percent of the children studied. See R. Puffer and C. Serrano, Patterns of Mortality in Childhood. Washington D.C.: Pan American Health Organization, 1973.

have been launched throughout the developing world with impetus from and under the leadership of the World Health Organization. The program for control of diarrheal diseases, as has been noted at this conference, has devoted substantial human and financial resources to both operations research in pursuit of cost-effective interventions as well as strengthening program planning, manpower training, and ORT production and logistic capability.

But the still largely underdeveloped state of national health systems in the poorer countries continues to be a major obstacle to the efficient operation of existing programs and the effective use of new technologies. And this is exacerbated by the tendency in developing countries to imitate the high cost, curative care bias of the Western industrial nations. This diverts resources from more urgent and appropriate health care needs. The lion's share of health sector expenditures in the Third World still is targeted on the service needs of the few to the relative neglect of the many. For example,

- in Malawi the two largest urban areas, with 20% of the total population, in 1981 received over 60% of the recurrent government budget for health services.
- in Senegal the hospital budget represented 51% of total recurrent public health expenditures in 1981/82 as contrasted to 29% of outlays on all regionalized services.
- in the Philippines the 53% of the Ministry of Health's current budget spent on hospitals in 1982 contrasts sharply with the 29% expended on field health services.
- Botswana's hospitals accounted for 42% of recurrent health outlays by central and local government in 1978, or nearly double that allocated to lower levels of care.

These examples can easily be multiplied.

Substantial capital investments--usually supported, if not initiated by, well meaning donors--in equipment and facilities, particularly hospitals, have in many cases locked countries into unsustainable recurrent cost requirements. Capital replacement can be a very costly substitute for adequate maintenance and repair of such investments. Given the general lack of resources for health, increasingly rigorous efforts to obtain cost-effective solutions, which reflect the tradeoffs between capital and recurrent costs and which address the needs of the mass of the population, are required if a major impact on the world's health problems is to be effected.

The initiation and viability of primary care oriented systems will, therefore, be dependent to a large extent on the redirection of existing sectoral policies and programs. This redirection must be not only by the concerned governments but also by the multitude of bilateral, multilateral and domestic and external non-governmental organizations whose activities influence the long-term pattern of health development. This is a

responsibility which all of us concerned with the improved quality and scope of health care in the developing countries share, and it is an objective toward which we must work.

The World Bank's Strategy

Although the World Bank has long supported activities which contribute to improved health, mainly but not entirely through population projects, it was not until 1979 that it was decided to lend explicitly for health. We did this because the exclusive focus on family planning limited our ability to function effectively in family planning, particularly in those countries where the subject remains politically and culturally sensitive; but also because we felt that the Bank could make a contribution to health--in planning for it; in improving its efficiency; in integrating it in the planning of development, and in financing high priority needs. Starting in 1979 we have emphasized health sector work to improve our understanding of health needs in a number of developing countries. This has laid the foundation for a lending program of which we now estimate at about $250 million annually over the next few years. I would like to emphasize that while we of course strive to bring about improvements in health for their own sake, an equally important reason for the Bank's increasing involvement in the health sector is that, through common delivery systems as well as the physical and behavioral interrelationships involved, investments in health yield huge developmental benefits through their impact on fertility reduction. This alone would justify our concern with health and, therefore, with ORT.

The projects we are supporting form part of a general Bank strategy which is characterized by a three pronged approach:

(1) The first prong is institution-building. In developing our lending program, the main focus of our efforts has been on building and strengthening country capabilities at all levels of the health system in five areas fundamental to the successful application of any technology: organizational and financial management and planning; analysis of perceived needs and consumer education; mobilization of resources; manpower development; and monitoring and evaluation--key elements of all first generation Bank-supported health projects.

(2) The second prong is packaging of interventions. Bank projections are that the low income countries will have available little more than $4-$5 per capita to spend annually in the public sector on health through the balance of this century. The scarcity of resources makes explicit choice among competing health care needs all the more imperative, though difficult. Within the Bank's health sector work and lending activities, we have emphasized a quantitative, epidemiologic approach to health decisionmaking. This requires, for a particular country, an assessment of the prevailing health status (the incidence or prevalence, as well as the severity of various diseases), the underlying causes of those diseases, and identification of specific targets for reduction of morbidity and mortality. The least cost package

of interventions necessary to achieve the desired improvement in health status should then be selected. In this process, family planning interventions tend to play a dominant role.

Building health programs on a solid quantitative and analytical base is both information- and time-intensive. Our firm belief, however, is that such analysis is the basis of sound health programming, and essential to strengthening the ability of Health Ministries to participate in the formulation of development strategies, to improve their own planning capacity and to make effective use of scarce resources. It is within this general framework that Bank economic and technical support has been provided to 33 governments in the conduct of population, health and/or nutrition sector analyses since our health program commenced in late 1979.

While we must tailor our lending for health to each country's specific needs, nevertheless, a common set of requirements consistently emerges for low income countries--control of diarrheal, respiratory and other childhood infections; stimulation of appropriate infant and child feeding practices; growth and development monitoring; and control of factors adversely affecting the health of women, particularly during their reproductive years. Behavioral changes in relation to health, nutrition and family planning will be the key to achieving desired improvements in health status.

Within this framework, given the strong linkages between high fertility and high maternal and infant mortality, family planning, including child spacing continues to command very high priority. Frequent, successive pregnancies exact a high maternal health toll. Maternal mortality rates are estimated to be up to 100 to 200 times higher in the low income countries than in the industrialized world,[4/] and total fertility rates are commonly three times greater than in industrial countries. The mother is central to implementation of all key interventions within primary care programs--both as provider, as in the case of ORT, and as key decisionmaker in most countries as to when and where to seek child health care. Protection of her health is essential, therefore, not only to her own welfare but to that of the entire family.

While birth spacing is important--since the risk of children dying is very much greater for infants of short birth intervals as compared to those widely spaced--it is only one aspect of family planning. The continued high levels of fertility in many countries continue to be a major threat to their long-term viability, to the success of economic

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4/ World Health Organization. Sixth Report on the World Health Situation: Part One Global Analysis. Geneva, 1980, p. 129.

development and to the prospects of improving the well-being of their population. None of us working to help reduce disease and mortality, can ignore the demographic impact of these changes. We fail in our responsibilities as advisors and supporters, if we do not continue to stress the importance of this issue and if we do not include as a priority objective in the expansion of health care delivery systems provision for rapidly expanding family planning services. Reduction of mortality and of fertility cannot be seen as separate objectives of we have the long-term welfare of the developing countries at heart.

(3) This brings me to the third prong of the strategy--accelerating socioeconomic development. The successful delivery of key technologies such as ORT is not the end of the road. ORT is still curative care. Thus, while it can be a cost-effective short term response, over the longer term disease prevention, focusing on the key underlying causes of illness and deaths, should command higher priority.

Unravelling the seamless web of poverty and associated ill health will require a long term commitment by governments as well as by the diverse public and private organizations involved in development, many of which are represented here. Health development demands more than the application of technology. Its direction and pace will be integrally linked to the national planning process and the political, social and economic policy choices each country makes. Population is the denominator in the most widely used indicators of economic development. The prospect of diminishing returns to labor and continued high unemployment rates suggests that lowering population growth rates is an essential prerequisite to progress.

Health development will necessitate significant policy and institutional reforms, and substantial investments in key sectors widely recognized as important to achieving desired health status improvements and fertility decline, notably agriculture and food; water supply and environmental sanitation; education, particularly female education; and housing. Such investments may be included as components of rural and urban development programs. To maximize the potential benefits of investments in these areas, the Bank has frequently included components which specifically address health objectives, such as population, health and nutrition education. More generally, assistance in projects and policies designed to stimulate economic growth and employment generation will continue to be an essential element of the World Bank's contribution to the alleviation of population and health problems.

The general Bank strategy, described above in terms of the three-pronged approach, is illustrated in virtually all Bank-supported

health projects. Following extensive sector work, they all aim at facilitating institutional changes which emphasize the orientation of health care delivery systems to meet the needs of the most disadvantaged groups, whose health problems are typically most acute.

The packaging of interventions, based upon a system-wide review of demographic and epidemiologic priorities and identification of cost-effective solutions, is illustrated in a project in Mali, where a large-scale population-based epidemiologic survey, combined with evidence about household expenditures on health, helped to identify priorities and assess the financial feasibility of the selected interventions. Similarly, in Peru considerable care has been taken to identify those communities where the epidemiological needs are greatest, and to give them priority in the project design. This choice parallels decisions made in other sectors to emphasize these same population groups in the provision, for example, of water supplies, education, and income-generating activities. The search for the least cost means of providing health care and the choice of appropriate financing mechanisms are major features of this project. Indeed, cost-effective approaches are sought in all projects: for example, in Malawi, the project should result in considerable savings in the cost of pharmaceuticals; and in Brazil, savings in delivering urban health services will be achieved. More generally, in all projects, institutional reform, training and education programs, as well as investment in actual health facilities, are designed to build institutional capacity to identify and respond to the most urgent health needs, and to facilitate the introduction of family planning services.

Overall, in Bank-supported projects we aim to create an environment in which appropriate choices and appropriate technologies will emerge from the institutions we have helped to build. The increasing use of oral rehydration therapy in project areas will help to accelerate this progress. It will serve not only to address the vital and immediate problem, but it will also help in freeing up resources either to expand and strengthen the general capacity of health care systems, or to address the more fundamental causes of poverty and ill health in the developing world.

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LUNCHEON WITH THE LATIN AMERICAN GOVERNORS - September 24, 1983

The past three years have been the most difficult since the Great Depression of the 1930s. Income per capita of the region will have fallen about 10% by the end of this year. Most of the countries in the region are suffering from record unemployment.

The major cause of this grave recession is the combination of weak demand for exports and of high interest payments due to high levels of external debt. Both have sharply reduced the region's capacity to import.

The present crisis underlines increasing interdependence in the world economy. Latin America and the Caribbean had to cut its imports from industrialized countries from $65 billion in 1982 to $50 billion in 1982. There has been a further sharp decline during the first half of 1983. This cut in imports has caused over 300,000 jobs lost in the industrialized countries. Therefore, it is clearly in the interests of the world economy as a whole to see a recovery in Latin America and the Caribbean.

But the recession has also highlighted the need for structural change and reorientation of development strategies. Most of the countries in the region have confronted this adverse situation with courageous domestic economic measures. Exchange rates have become much more realistic. So have domestic interest rates. Fiscal deficits have been cut. Subsidies have been reduced or eliminated on such basic commodities as gasoline, bread, milk, as well as goods and services produced by public firms. But more needs to be done. Savings rate must be increased so that a larger portion of investments can be financed from domestic resources and export earnings. This will

require further review of the need for and social utility of the remaining subsidies. It will also require firmer control of public enterprises to make and generate a reasonable proportion of their investments.

Short-term measures are being accompanied in many countries by structural adjustment measures. For example, the present cuts in public investment have provided an opportunity to rationalize future investments, incentives for exports have been improved, and biases in resource allocations are being reduced.

These efforts have received the support of the international financial community. In spite of the debt crisis of 1982, the commercial banks have continued to increase their exposure in the region. The World Bank and the IMF have both accelerated their disbursements.

As the dust settles after last year's crisis, the prospects for the region are becoming somewhat clearer. And these prospects offer reasons for hope. That hope is based on three major premises:

- continued domestic adjustment efforts on the part of the governments of the region;
- continued recovery in the industrialized countries;
- continued support on the part of the international financial community.

Commodity prices have already responded to somewhat faster OECD growth. In particular, prices for grains and oilseeds have increased substantially during the last few months. This will have beneficial effects

for Brazil, Argentina and other food and feed exporters. Metal prices have also recovered somewhat.

Exports of manufactured goods are also improving. Overall, Mexican and Brazilian exports are now running 10 to 15% ahead of last year. If the recovery in the industrialized countries gathers momentum, so will the region's export recovery.

This also requires that protectionism not increase, and where possible be reduced. But until now, as noted, the region has been able to export more.

There will be a continued need for support by the international financial community and continuation of domestic adjustment efforts. We can expect improvement in the attitudes of commercial lenders as the fruits of the initial adjustment efforts become apparent in a gradual improvement in creditworthiness ratios and as further programs of adjustment are firmly pursued. For example, the ratio of debt exports has already begun to decline and we expect it will continue to decline during the next few years as export-oriented programs are pursued and external borrowing is kept within reasonable limits.

The World Bank for its part has committed and disbursed unprecedented amounts to the region during the last fiscal year. This shows the trust we are placing in the policy-makers of the region and in the future of their economies. As a result of the Special Action Program, we have been able to accelerate disbursements considerably in recent months. Commitments during the last fiscal year reached an all time high of $3.5 billion, including Special Action lending amounting to some $700 million. An increasing share of our

lending is directed to quickly-disbursing export-oriented activities and to efforts to make the most effective use of existing productive capacity.

In conclusion, two things are clearer than ever. One is interdependence for better, for worse. Two is that cooperation is absolutely essential. Cooperation between governments which are continuing to make politically difficult adjustments; commercial banks which look toward improvements in economic indicators; international institutions which are increasing their support; and the industrialized countries whose growth, trade and financial policies are of such crucial importance.

The World Bank will continue its support of well-conceived programs in Latin America with financial and technical cooperation. But our ability to support your efforts depends on the support we receive from our members in mobilizing the necessary resources. Your help during this week to move forward in our discussions on the VII-IDA replenishment and the Selective Capital Increase in all your conversations with your colleagues from industrialzied countries, is essential if the institution is to continue and expand its role in the difficult years which still lie ahead.

7

Working Paper

# MEETING OF CONSULTATION OF THE HEADS OF MULTILATERAL FINANCIAL INSTITUTIONS

## The Role of Multilateral Institutions in the Present Economic Environment

Washington, D.C.

September 24, 1983

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## The Role of (the) Multilateral Institutions in the Present Economic Environment

### A. The Global Outlook

1. For the developing countries as a group to return to the growth rates of the 1960s and the 1970s, three central ingredients are required: concerted international efforts to sustain the present economic recovery; increased capital inflows; and significant domestic efforts to improve resource use. The multilateral institutions have an important contribution to make, particularly in increasing their capital transfers during the present difficult period and in assisting in developing countries' programs of domestic restructuring; but much depends on the extent of recovery in the industrialized countries.

2. A strong recovery would greatly increase the potential for developing-country exports. If GDP in the industrial countries were to rise by 5 percent a year in 1983 and 1984, the oil-importing developing countries could increase the value of their exports by a total of 20 to 30 percent. Large though this improvement would be, it would still not match the experience of the recovery of the mid-1970s, when the oil-importing developing countries raised the value of their exports by 42 percent in two years. On the other hand, if recovery in the industrial world were to falter, the adverse consequences for world trade would probably be intensified by increased protectionism. Restrictions are likely to be directed particularly at developing countries whose relatively labor-intensive exports compete with the most vulnerable manufacturers in the industrialized countries.

3. Even if there is a rapid recovery, the base from which any upturn in the developing world would start is generally extremely shaky. Export earnings fell by 7 percent in the 1980-82 period and, by 1982, the developing world had a combined current account deficit of $118 billion, more than twice the level in 1980. This total was equivalent to 25 percent of its exports, significantly higher than the 17.5 percent level reached at the peak of the previous recession. Furthermore, the proportion of export earnings used in servicing external debt rose from 14 to 21 percent over the same two years, and future growth in a large number of developing countries is severely constrained by such high debt burdens.

4. A second ingredient for recovery of the developing countries is thus substantial net inflows of external capital, especially in the immediate future. However, the prospects for adequate external financing for either the middle-income or the low-income countries, are not good. The middle-income countries, which had been able to buffer the previous recessions by the rapid growth in commercial capital flows face a much more cautious lending

environment. The creditworthiness of some of these borrowers has been substantially eroded. The commercial banks reduced their lending in 1982, and the most recent signs are not encouraging: although medium-term credit commitments to developing countries amounted to $13.9 billion in the first quarter of 1983 -- as against $10.3 billion in the first quarter the year before -- all but $4.5 billion of these commitments were taken up by debt reschedulings for Brazil and Mexico. In the medium-term, and assuming growth in the industrialized countries of about 3-4 percent a year in 1985-95, the World Bank estimates that commercial lending to developing countries would expand by no more than 9 percent a year in nominal terms, compared with over 22 percent a year in the 1970s. For many of the middle-income developing countries, this more modest growth of commercial lending will put a greater premium on increasing domestic savings and more efficient use of capital to sustain the largest possible investment program and to obtain the most effective yields from the more limited investments.

5. For the low-income countries the major problem is the poor prospects for concessional assistance. Their growth depends crucially on concessional loans, which constituted over 80 percent of their capital flows in 1982. Concessional aid is particularly important for low-income Africa, where it was equivalent to at least 40 percent of gross domestic investment, as against only 5 percent in the populous countries of South Asia.

6. If growth is to take place in the low-income countries and if world poverty is to be reduced, the industrialized countries will have to raise the proportion of their national income which they commit to ODA significantly above its present level of about 0.35 percent of GDP and/or reallocate concessional funds from middle to low-income countries. Prospects for either development are not good. Most bilateral aid programs are stagnant or shrinking in real terms. Total bilateral aid programs are in nominal dollar terms than in 1980; 1982 seems to have shown an increase although details are not yet available. At the same time, tying is increasing, making available resources less valuable. And while the redistribution of aid has been discussed many times in many fora, still less than half of bilateral ODA goes to the low-income countries. The difficulties in increasing ODA are, of course, reflected in the replenishment discussions of the various international and regional lending institutions. IDA, the single largest source of lending for low-income countries, has had virtually no increase in commitment authority in FY82-84, and, of course, IDA VI contributions were not completed in the agreed time. Had it not been for the generosity of donors other than the U.S., who made special contributions of over $2 billion for FY 1984, there would have been virtually no IDA lending this year. And the discussions for IDA VII, which should be replenished at a level of SDR 15 billion, are proceeding very slowly.

## B. The Adjustment Process

7. The developing countries face the challenge of achieving a resumption of growth despite a markedly less favorable international context. The most crucial requirement for meeting this challenge is broad restructuring of domestic economies to emphasize exports and efficient import substitution, to increase the efficiency of capital use, to further improve energy efficiency and to increase domestic savings. These measures will be essential to sustain and accelerate growth in a period of slower growth in external capital flows and international trade and maintain or restore creditworthiness. In many countries, economy-wide reforms are required to provide more appropriate incentives to producers, and investments need to be restructured and better managed so as to make better use of the limited resources available. Such programs will need the support of the international agencies and the commercial banks if they are to succeed.

8. More efficient use of investment resources is of high priority within the restructuring process. GDP growth per unit of investment - a rough index of the trend in overall productivity in an economy - has fallen in the developing world by nearly a quarter between the 1960s and the 1970s. Moreover, investment itself has been sharply cut back in many countries, with worrying implications for future growth. Evidence from a variety of countries points to the seriousness of this latter problem. In the Ivory Coast, for example, lower earnings from coffee and cocoa have meant that investment expenditure has had to be reduced by 40 percent in real terms over the last three years. In the Philippines, adverse terms of trade and higher interest rates have reduced GDP growth to 2 percent in 1982 and, despite new government revenue measures, public investment is expected to decline by 23 percent in 1983. In Malaysia, customs revenues in 1982 were 24 percent less than expected, while debt service was 23 percent higher than budgeted; as a result, there was a 12 percent reduction in development expenditures despite cuts in the defense and internal security allocations. Togo, a low-income country, heavily dependent on phosphate and on coffee and cocoa, has had to cut public investment to 65 percent below its 1978 level.

### The Restructuring of Investment Priorities

9. With less resources available for investment than had in many cases been planned, there is an obvious danger that high priority projects will suffer. Rather than spreading a reduced budget more thinly, first priority should be given to completing those projects which fit within the revised production structure, yield results quickly and are export-oriented. Work on less urgent projects should be suspended wherever feasible. It is also important to recognize that existing capital stock must be maintained if excessive future replacement or rehabilitation costs are to be avoided

and high priority should therefore be accorded to maintenance and rehabilitation activities - in preference to new starts. It is also essential to maintain an appropriate level of investment in human capital - education, health, and other services - if future development prospects are not to be impaired. Savings in these areas sometimes seem deceptively easy because the long-term costs are not readily quantified.

## The Efficiency of Investments

10. A prerequisite for efficient investment is careful analysis of costs and benefits. In private sector investment this is best assured by maintaining an appropriate pricing framework. But where the government is involved there is a need for explicit project evaluation methods, clear rate of return objectives and careful monitoring that these objectives are met. Where inadequate analysis has occured, the cost has often been very large, both directly and through the effects on the country's creditworthiness. Better planning would also be helpful in avoiding the expensive tendency to stretch projects over longer periods than intended because of financial or managerial shortages. For a sample of countries, the World Bank has estimated that the incremental cost of a two-year delay in the implementation of a project - a common occurrence - amounts to about 20 percent of the investment cost.

## Pricing Policies

11. While the public sector can act directly to ensure that its investment program is in line with national adjustment priorities, the influence on private sector investment choices is only indirect. If the productivity of private sector investments is to be raised and resources channeled to the most important activities, prices and incentives, broadly defined, must give the right signals. Price distortions, particularly artificially low agricultural prices, have resulted in unnecessarily slow growth in many developing countries. Using an index of price distortions, the World Bank has estimated that the average growth in the 1970s of developing countries with high distortions was 3 percent a year, as against 7 percent a year for those with low distortions. About one third of the variation in growth rates can be explained by differing pricing policies. Excessive protection and overvalued exchange rates, for example, have been a major problem in a number of countries, particularly in Sub-Saharan Africa where the average real effective exchange rate appreciated by 44 percent between 1973 and 1981. Even in such countries as Argentina, Chile, Sri Lanka and Uruguay, which introduced major economic reform programs in the 1970s, the real exchange rate was subsequently allowed to appreciate, thereby dampening the impact of the reforms.

## Energy

12. A major element in the search for better use of domestic resources must be measures to increase domestic energy production and improve energy efficiency. The recent drop in oil prices is expected to be a temporary

phenomenon. If GDP in the developing countries rises at 5.5 percent a year, commercial energy consumption will increase at an annual rate of 4.5 percent or more; much depends on the extent to which progress is made in conservation and the production of new energy supplies. The recent World Bank energy paper* suggests that the investment needed to exploit the developing countries' potential energy resources is $130 billion a year (in 1982 dollars) for the next ten years, $64 billion of it in foreign exchange.

13. No one set of adjustment policies can be prescribed for all developing countries. The ways in which their economies need to adjust clearly differ, as do their experiences with policy reform programs. Thus, many Sub-Saharan African countries could greatly improve their economic performance by eliminating biases against agriculture, while some middle-income countries with well-developed industrial sectors can best exploit their comparative advantage of reorienting manufacturing output towards export markets. In supporting the adjustment efforts of the developing countries, it is important that international agencies are aware of the special needs of various groups of countries.

## Low-Income Countries

14. Structural adjustment is most difficult in the low-income countries. They rely heavily on exports of primary commodities, do not have the flexibility to switch the composition of their exports and lack access to external finance, both official and private. Sub-Saharan Africa faces the greatest challenge. Many African countries suffer from a legacy of chronic fiscal deficits, inadequate producer prices and overvalued exchange rates. These problems have been greatly magnified by the falling value of commodity exports. At their worst, commodity prices had fallen in real terms to the lowest level for forty years. Many African countries have recognized the importance of structural adjustment, particularly in agriculture, and some impressive results have been achieved, for example in Sudan. The low-income countries of South and East Asia are generally in a stronger position than those in Sub-Saharan Africa. China and India in particular have benefitted from the introduction of liberalization programs in the second half of the 1970s, while there has been general restraint in monetary and fiscal policy and strong process has been made towards eliminating price distortions and improving producer incentives.

## Middle-Income Oil Importers

15. Of middle-income oil importers, the Asian countries have fared the best during the recent recession. Although their general reliance on manufactured exports makes them vulnerable to downturns in the terms of trade and to protectionism, their exports and GNP have continued to grow. This was due in part to an emphasis on efficiency and competitiveness in,

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* "The Energy Transition in Developing Countries", The World Bank, August, 1983.

for example, encouraging better resource use through appropriate price policies. On the other hand, the middle-income importers of Latin America fared badly. Their GDP fell by almost 2 percent a year, while their debt-servicing problems deepened. By 1982, the debt service burden of the Latin American oil importers had reached 53 percent of exports, compared with 9 percent for East Asian oil importers. This clearly had a major impact on imports and thus also on growth. Domestic policies have contributed to the problems of many oil-importing countries, both in Latin America and elsewhere. Negative real interest rates have hurt savings and encouraged the flight of capital. Protectionism has led to inefficiency, and expansionary fiscal and monetary policies to inflation. Where these problems have been corrected, some remarkable progress has been made, most notably in Turkey.

Middle-Income Oil Exporters

16. Although enjoying an obvious advantage, the middle-income oil exporters include some of the countries currently facing the worst immediate difficulties. In a number of cases, the recent fall in the oil price, combined with their strongly expansionary domestic policies, has caused severe balance of payments problems. Over-ambitious investment programs have been a common problem. Latin American oil exporters in particular borrowed heavily to support capital-intensive industries on the assumption that oil revenues would continue to hold up. Their debt increased by 23 percent a year between 1972 and 1981, with the proportion held at variable interest rates reaching 70 percent in 1981, well above the already high figure of 56 percent for the rest of Latin America. Restructuring of investment programs is obviously of particular importance for these countries if they are to adjust successfully to their changed circumstances. Mexico, for example, is already making considerable progress in this area as part of its Fund and Bank-supported adjustment process.

C. Actions by Multilateral Institutions

17. A sustained world recovery will eventually do much to ease the developing countries' problems but many developing countries will continue to face major problems in the next few years. There is an urgent need for the multilateral development institutions to help their members by accelerating resource flows of of existing commitments; by increasing their emphasis on quick yielding projects, projects in the export sector and the financing of maintenance and rehabilitation; by assisting in the formulation of programs of domestic structural adjustment, including the review of investment programs and the identification of projects which, because of changed circumstances, have lower priority; and by strengthening country level coordination to assure optimal utilization of available external resources.

18. In order to begin to reorient its lending program in these directions, the World Bank introduced earlier this year a Special Assistance Program to run, initially, for two years. Some of its principal elements may be of interest. The Special Assistance Program seeks to assist countries that are making significant efforts to implement appropriate adjustment policies. Explicit judgments on eligibility are made. The Program involves increased policy advice, measures to accelerate disbursements on existing loans, increased cost sharing, including a degree of retroactivity, lending for exports and working capital and assistance in the restructuring of investment programs, including existing Bank projects.

19. The objective of the Special Assistance Program is to increase Bank/IDA disbursements in the next 18-24 months by restructuring existing loans and by increasing the share of lending for quick disbursing activities. IBRD disbursements in fiscal years 1983-85 are expected to increase by $2 billion, or 8 percent, as a result of the Program; net transfers, however, are projected to rise by almost 25 percent. The effect of the Program on IDA countries will be more limited because the Bank already finances a very high proportion of project costs in those countries. The most that can be done is to restructure lending programs so as to move towards more quick-disbursing activities.

Structural Adjustment Lending

20. A major element of the Special Action Program is expanded structural adjustment lending. Such lending has proven to be an excellent medium for promoting broad policy reforms and for providing substantial amounts of quick disbursing assistance. Until now, structural adjustment loans (SALs) have been restricted to about 30 percent of a country's lending program, in conformity with our primary emphasis on project lending. But many developing countries' economic difficulties are such that they need to give priority to support of existing rather than new investment, as well as to policy changes to render that investment more productive. Both priorities frequently can best be supported under a SAL and the Bank has thus temporarily waived its 30 percent limit on the SAL component of individual country lending.

21. The SAL program has contributed to major economic restructuring in a number of countries, notably Turkey, the Philippines, Thailand, Korea, and Jamaica. It has done so by reducing levels of protection, by reducing price distortions and improving the incentive framework for investments and by reducing obstacles to sound investment decisions; in agriculture, improved incentives have encouraged farmers to increase their output and to operate more efficiently and more in line with prevailing comparative advantage. The current SAL to Yugoslavia, for example, supports the Government's comprehensive adjustment program through financial and policy

assistance. Like many other middle-income countries, Yugoslavia has been badly affected by the difficult world economic situations; but it has also suffered from a failure to exploit fully its comparative advantage and from serious price and investment distortions. The SAL program consequently includes policies aimed at expansion of exports to the convertible currency areas, increased factor productivity and less distorted prices. The $250 million available under the loan will support the export drive by helping to finance imports needed by enterprises selling to the convertible currency area.

22. It should be noted, however, that there have been problems in some of the lower-income countries, for example in Africa. Expectations of reform may have been pitched too high in countries where governments' capacity to introduce structural changes is more limited, both because of lower analytic capacity and because of more difficult political circumstances. Whatever the results may have been for low-income countries, poverty remains a strong focus for structural adjustment lending. The Bank has stressed efficient investment in social sectors so that the poor are not ignored and so that longer-term investments in education and human resources are maintained. Housing programs, for example, have been amended to reduce subsidies to higher-income groups and to make units available to low-income groups. Land tenure programs have been strengthened, education programs have been revised to reduce unit costs while expanding coverage, and strong support has been given to family planning programs.

Sector Adjustment Support

23. Where the Bank does not have a program of structural adjustment lending, as in Brazil and Mexico, we are increasing lending for working capital and to finance essential imports for exporters. These sector report operations are designed to result in rapid disbursements. For instance, in Mexico the World Bank has restructured one loan to provide $100 million of working capital on a temporary basis. Funds will subsequently revert to investment purposes. In addition, a loan of $175 million was made for small and medium scale industry with a large working capital component and a loan of $350 million was made to establish an Export Development Fund to finance import requirements for exporters. The export loan supports measures to reduce the anti-export bias of the trade regime and to streamline the licensing system. Support for this kind of reform in incentive structures will be a major element of sector lending under the Special Assistance Program. In the Sudan, an Agricultural rehabilitation Credit helped to restore the production of cotton, the country's principal export. The Credit provided key inputs for production and stressed physical rehabilitation, improvements in the incentive structure, in marketing and in the distribution systems. In this case, as in others, the loan supports policy reforms, including the elimination of subsidies. In agriculture, in particular, subsidies for inputs have often been a major drain on government

budgets, displacing productive investments. Phased elimination of such subsidies will generally be made easier, both economically and politically, if finance is made available for increased imports or production of relevant inputs.

24. Export Development Fund loans will play an important role in sector support. Such loans generally finance a revolving fund which enables exporters to obtain raw materials, spare parts and minor equipment necessary for current production. The foreign exchange is repaid by the exporters in 6-12 months out of their export earnings. The objective is to prevent the vicious circle in which foreign exchange shortages lead to under-utilization of export capacity, thereby reducing further the availability of foreign exchange. This kind of finance will only be effective, of course, if appropriate incentives and exchange rates are adopted, and policy dialogues will be an essential element of our loans.

Project Financing

25. As already mentioned, the problems being encountered by increasing numbers of developing countries in finding the funds to finance even existing projects means that lending should be more concentrated and new investment starts minimized. To help deal with the constraint on local resources, the World Bank has raised the share of projects it is prepared to finance. In the case of existing projects, the main instruments for raising the proportion of costs covered are:

- a reduction in the scope of some projects, but with the World Bank finance kept constant, thus effectively covering a higher percentage of costs;

- the provision of supplementary loans so as to increase the share of project financing, including interest during construction where appropriate. Such loans include an agreed plan to accelerate project completion;

- composite supplementary loans in exceptional cases where a set of similar World Bank-financed projects is affected by budgetary constraints; and

- the restructuring of loans which finance broad programs in such areas as irrigation, water supply and feeder roads. By reducing the time period covered by the project, the share of costs financed by the Bank is increased.

26. For new commitments in FY83 and FY84, the main instruments are:

- financing of a larger share of recurrent costs for the next two or three years, offset by a sharper reduction in later years;
- emphasis on maintenance and rehabilitation projects in view of their importance in increasing the productivity of existing capacity; and
- financing of working capital requirements in loans to DFCs, or to other financial intermediaries.

New Cofinancing Instruments

27. In order to help maintain the flow of commercial bank lending to creditworthy countries, the World Bank introduced in January 1983 a series of additional cofinancing instruments. Like the Special Assistance Program, they are aimed to raise the net flow of funds to development projects. With commercial banks becoming more wary of sovereign lending, direct project finance is growing in importance and it is hoped that the new instruments will make cofinancing arrangements more attractive to both lenders and borrowers. Traditional cofinancing arrangements consisted of separate World Bank and commercial bank negotiations with a borrowing country, which were then linked by an optional cross-default clause. The new instruments, however, allow a direct World Bank role in commercial loans. Three options are available, each intended to provide longer maturities than are possible with ordinary market operations.

28. Direct Financial Participation. In addition to providing a direct loan, this option allows the World Bank to hold an initial share - ranging from 10 to 25 percent - in a parallel syndicated loan from commercial banks. Annual repayments of principal by the borrower are made first to the commercial lenders; only when they have been fully repaid will repayments of principal be made to the World Bank, thereby allowing maturities to be extended beyond the normal eight years.

29. Loan Guarantees. Instead of direct participation, the Bank guarantees repayment of the later part of an extended syndicated commercial bank loan. When the guaranteed portion starts to come within the normal range of market maturies, its size can be reduced.

30. Contingent Participation. Here the borrower's annual debt service on a commercial loan is fixed even though the interest on the loan is variable. If interest rates rise, amortization is delayed and

the Bank finances any balance on the principal remaining at the end of the initial term; the commercial lenders have the option of purchasing this balance for their own account.

31. The first two such operations have been completed, both involving direct participation. The first, a Yen 8 billion loan to Thailand, helped to improve both the spreads and the maturity. It supplements a World Bank loan for telecommunications. The second, a $250 million loan, with both a yen and Eurodollar component, to Hungary, supplements two World Bank loans. This syndication sharply improved the terms Hungary was able to obtain -- nine-year maturity with commercial bank participation of seven years, compared to $200 million club deal several months earlier which was repayable in full in three years.

32. By providing increased resource transfers in the next few years and more effective policy advice, the World Bank and the other multilateral agencies can make an important contribution to sustaining growth in developing countries. But these efforts can only be successful as part of an overall effort to improve the world economy and to adjust to the changing economic realities. A concerted effort is needed by the industrial countries to encourage further recovery in the world economy; new protectionist measures must be resisted, and steps need to be taken to reduce the scope of existing restrictions. The industrialized countries' banks must not allow the level of their new lending to drop further, and should respond positively to genuine programs of structural adjustment. In the developing countries, structural reform is essential if growth is to become more self-sustaining. Effective use of domestic resources is the only secure route to long-term growth; much has already been achieved, but much also needs to be done, most especially in the low-income countries of Sub-Saharan Africa.

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CHAPTER 5

# World Bank Financing Of Structural Adjustment

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Since the early 1970s the developing countries have faced a difficult and volatile international economic environment in which major developments seem to be neither transitory nor cyclical. Countries have adjusted to the resulting marked deterioration in their balance of payments through increased borrowing, expansion of exports, increased import substitution, and lower growth rates. As the 1981 *World Development Report*[1] points out, oil-importing countries were quite successful in adjusting without reducing their rates of growth, with the exception of low-income countries in sub-Saharan Africa. But the process of adjustment is becoming increasingly difficult. The previous rapid expansion of debt has limited the net incremental borrowing capacity of a number of countries. Trade growth has slowed while, simultaneously, more countries emphasize export development. The opportunities for easy import substitution have been increasingly exploited, and further progress may involve relatively heavy investment. Having exhausted these externally oriented adjustment factors, a great many more developing countries will likely be forced to accept lower growth, or no growth, in the next several years as the primary means of adjusting to the international economic environment.

Slow growth and high interest rates have created a much less favorable investment climate, making it more difficult for a country to achieve a rapid adjustment in its production structure. The adverse external trends have been compounded in many instances by inap-

[1] World Bank, *World Development Report, 1981* (New York: Oxford University Press, August 1981), ch. 6.

propriate domestic policies and weak institutions that are incapable of adapting promptly to changing circumstances. For example, external inflationary pressures from the rapid increase in the cost of imported manufactures have often been intensified by an expansionary domestic monetary policy. Export growth has been handicapped by overvalued exchange rates, inadequate price incentives for producers, and the mismanagement of agencies handling credit, marketing, and export promotion. Mobilization of domestic resources has been undermined by negative real interest rates.

Some developing countries postponed domestic policy reforms, or introduced them only slowly, and relied instead on increased external borrowing. In others, government sought to offset constraints imposed by external factors or uncertainty on the part of private investors through increased deficit financing to expand public sector investment programs. But as economic activity slowed down and external capital flows, both commercial and concessional, became less buoyant, the costs of such partial adjustments became increasingly severe. This was reflected in growing expenditures on subsidies and in unsustainable budget deficits. To limit inflation and control the balance of payments deficit, some of the countries then resorted to price controls and import restrictions, which led to a misallocation of resources and to an incentive system biased against exporters.

Remedial actions at this stage are often politically difficult because the degree of change needed is large. Moreover, the economic effects can be seriously perverse. Efforts to reduce credit expansion can, unless accompanied by other policies, squeeze out the private sector at the expense of the public. Reductions in overall investment may leave a disproportionate share of large, public sector projects of long gestation while reducing investments in quick-yielding activities. Reductions in public expenditures may easily result in cutting back on such essential investments as education and health while safeguarding steel mills, or in reducing expenditures on maintenance of plant and infrastructure rather than reducing subsidies. Even where reductions in public investment are undertaken, both scarcity of relevant data and political commitments make it extraordinarily difficult to prune selectively, rather than to cut across the board, thereby delaying the productive benefits from a wide range of investments.

The objective for the developing countries must be to introduce policy changes to permit a reduction in the current account deficit over the next several years while minimizing the penalties to growth in the long run, hence allowing continued progress toward the achievement of their development objectives. Because some of the mitigating mechanisms, such as external borrowing, have been used



extensively, and because delays in action have exacerbated problems of pricing and subsidies, a complex set of changes in policies and incentives are now required. It is to support such changes that the World Bank developed its program of structural adjustment lending.

There is, without doubt, considerable scope for strengthening economic management. Structural adjustment lending is intended to assist governments to adopt necessary, though often politically difficult, policy and institutional reforms designed to improve the efficiency of resource use. By focusing on the policy and institutional reforms required to correct distortions in the pattern of incentives and to adapt each economy to the changed international price structure and trading opportunities, structural adjustment lending also helps create a more appropriate environment for the Bank's project lending. In this way, the two forms of assistance are complementary, not alternatives.

## Rationale for Structural Adjustment Lending

In response to the increasing severity of the balance of payments problems faced by its members and the related need for assistance—both in financing and in policy analysis and formulation—the Bank proposed to initiate a program of structural adjustment loans (SAL) at its Annual Meeting in September 1979. This new form of lending would:

- support a program of specific policy changes and institutional reforms designed to reduce the current account deficit to sustainable levels
- assist a country in meeting the transitional costs of structural changes in industry and agriculture by augmenting the supply of freely usable foreign exchange
- act as a catalyst for the inflow of other external capital to help ease the balance of payments situation.

It was clear from the outset that the issues faced by individual countries would vary greatly, as would the institutional and management capacity to deal with them. Consequently, the specifics of the structural adjustment programs would vary among countries. Many countries would have to undertake programs of financial discipline to moderate or reduce the level of aggregate demand for goods and services in order to bring their current account deficit to levels that could be supported more realistically by external capital flows. Such programs could be supported by the International Monetary Fund

(IMF), particularly through the use of its extended Fund facility (EFF). But merely reducing aggregate demand was not enough. Unless stabilization measures were accompanied by specific actions, at both the operating and policy levels, that were designed to make more effective use of productive capacity and to reduce aggregate demand in ways consistent with development objectives, the cost in growth forgone was likely to be excessive, and the imbalances were likely to recur when growth resumed. Thus, from the outset Bank lending for structural adjustment assumed the existence of a stabilization program, normally supported by a Fund stand-by or EFF arrangement, which would provide the foundation for more detailed measures to improve incentives, eliminate distortions, promote production, and increase the efficiency of resource use.

The structural adjustment programs might involve a variety of sectors and policy issues. Although in many developing countries it is possible to work out limits for budgetary expenditures and credit controls, there are few countries that have the data and the analytic capacity to trace the specific impact of such changes on the economy. Countries as advanced as Turkey and Brazil lack consolidated accounts of public investment programs; others may even lack financial statements accurately reflecting performance in the most recent years. Financial requirements for public investment projects may only be known in the most general terms for a budget year. Yet, if the external payments problem is not merely temporary, limiting public investment without understanding the longer term impact on production and incentives may lower demand, but it will result in limited structural change.

Similarly, in limiting noninvestment expenditures, it is important to follow a set of priorities that reflect explicit development objectives rather than to reduce expenditures across the board. For instance, despite overall stringency it may well be that expenditures for agricultural extension and research should be expanded, rather than curtailed, if there are prospects for a rapid increase in production. And often there is scope for providing services such as education and health at lower unit cost, thereby avoiding a reduction in service levels despite reduced funding.

The same requirement for detailed analysis, leading to the design of soundly based action programs, exists in the areas of exports. It is, of course, essential that the exchange rate be realistic and that interest rates reflect the scarcity of capital, matters that are typically a central concern of the Fund. But beyond these issues lies a range of concerns: the relative roles of the public and private sector; the responsibility and capacity of governments to organize and control



markets; the process and criteria by which the structure and level of agricultural prices are set; the tariff, licensing, and incentive schemes that determine the composition and location of industrial investment; the appropriate structure of energy prices to bring about desired levels of conservation; and the infrastructure—both physical and institutional—that is required, in addition to incentives, to expand exports and support investors in new, less capital-intensive areas.

Distortions in the policy and allocation framework that were undesirable in the 1960s have become unsustainable in the much more difficult international economic environment of the 1980s. The flexibility to cushion the impact of change, to move gradually on politically contested reforms in the context of fragile political structures, and at the same time to avoid further reducing the incomes of already very poor people was gradually exhausted. Today policymakers have little room for maneuver. It can be argued that governments should have acted sooner; indeed, some countries have exhibited a remarkable unwillingness to come to grips with these issues, an unwillingness often combined with an inadequate understanding of the scope of the problem. But the risk of political failure in implementing the more urgently required actions is now much greater. It is the acceptance of the more urgent requirement for change—not the need for changes nor, often, the specifics of change—that is the new element. That present policies are proving unsustainable has given rise in some countries to a willingness to reexamine basic premises and development strategies that was absent before and makes feasible a public call for increased sacrifices in the face of political opposition.

Structural adjustment lending enables the Bank to address basic issues of economic management and development strategy more directly and more urgently than before. The advantage of SALs over alternative lending instruments derives from three features of SAL operations: the comprehensiveness of their coverage in terms of both macro and sector issues of policy reform; the exclusive focus on policy and institutional reform; and the detailed articulation of the precise modifications in policy necessary to adjust the economy to a changed economic environment.

## Design of Structural Adjustment Lending Operations

In brief, the objective is to support—by means of a series of (possibly three or four) discrete lending operations over a period of approximately five years—measures specifically designed to strengthen

countries' balances of payments over the medium term (i.e., within a five-year to seven-year time frame).

SALs normally address both macro and sector issues of policy and institutional reform. For macro policy, SAL operations typically cover agreement on the size and composition of the public investment program and often specify important components of recurrent expenditure. Precise changes in the institutional arrangements, procedures, and criteria by which public development expenditure programs are determined and implemented are also typically part of the agreement. In addition, SAL agreements would also cover policies required to mobilize resources for development purposes. As regards sector coverage, SALs cover the directly productive sectors of agriculture and industry as well as the energy sector. Within each of these sectors the approach is generally sector-wide, although the SAL agreement might include understandings on subsectoral policies as part of the sector-wide approach.

Because the level of development, current situation, prospects, and policital framework vary from country to country, the Bank has stressed that there can be no single model to guide adjustment. Although the objective is the same in all countries in which structural adjustment lending is considered, the content of programs would vary. The main features of structural adjustment programs have evolved on a case-by-case basis. To date, 12 countries have received such assistance. Although the Bank's experience with the implementation of the structural adjustment programs is as yet limited, it is already possible to discern some of the strengths and weaknesses of this form of assistance. The scope and variety of the structural adjustment programs so far supported by the Bank is summarized in Table 5.1.

The structural adjustment programs comprise three distinct elements. First, the SAL programs set out a statement of specific structural objectives to be achieved over an approximate period of five-to-seven years; for example, increasing nontraditional exports, reducing levels of protection, removing export bias in incentive systems, expanding incentives for private investment, reducing the rate of growth of total energy use and of imported energy by given amounts, and increasing agricultural output.

Second, the SAL programs present a statement of the measures that will be taken over an approximate five-year period to achieve the adjustment objectives. These might include reforming the pattern and level of industrial protection to erase its anti-export bias and to make industry more efficient by stimulating those subsectors in which the country has a comparative advantage and by subjecting manufacturers to greater external competition; increasing the real price of



energy and also the pattern of energy pricing to conserve energy and to increase domestic supplies in an efficient manner; modifying the internal terms of trade of the agricultural sector of the economy; undertaking major changes in the organization of agricultural marketing, including the respective roles of the public and private sectors, and so on.

The third component of a SAL program is a set of specific actions, to be taken by a government and monitored by the Bank, either before approval of the SAL operation by the Bank's Board or during the following 12 to 18 months. Each loan typically is provided in two tranches in order to establish a formal opportunity for reviewing implementation of the adjustment program in general and to consider progress in carrying out specific key measures identified in advance. The monitorable program of actions might include the first (or subsequent) actions to modify tariffs, to strengthen export incentive schemes, to remove quantitative restrictions on imports and exports, and to introduce industrial investment incentive schemes. Similarly, in energy and agriculture there may be agreement on a precise set of monitorable actions relating to prices and institutional agreements. These monitorable programs embody detailed actions for both policy changes and institutional reforms that a government obligates itself to implement according to an agreed timetable. To the extent that some of the precise actions can only be defined after further study, the terms of reference and timetable for such studies are incorporated in the monitorable program. Actions based on the findings of these studies would form part of subsequent SALs.

Because the strengthening of the balance of payments over the medium- to long-term is the fundamental aim of structural adjustment lending, programs to date have covered a broad range of policies related to the more efficient use of resources in the key sectors (see Table 5.1). The measures mainly fall within four areas: (1) *the restructuring of incentives,* which covers pricing policies, tariff reforms, taxation, budget subsidies, and interest rate policy; (2) the revision of *public investment* priorities in light of the changed international price structure and resource availabilities; (3) improvement in *budget and debt management;* and (4) the *strengthening of institutions,* particularly public enterprises. Each program is a combination of complementary and mutually reinforcing measures.

### *Structure of Incentives*

A frequent concern—especially for middle-income countries—has been to reduce the bias that has crept into the industrial incentive

TABLE 5.1 SCOPE AND VARIETY OF STRUCTURAL ADJUSTMENT PROGRAMS SUPPORTED BY THE WORLD BANK

| *Item* | *Senegal* | *Turkey*[a] | *Guyana* | *Kenya* | *Bolivia* | *Philippines* | *Mauritius* | *Malawi* | *Ivory Coast* | *Korea* | *Thailand* |
|---|---|---|---|---|---|---|---|---|---|---|---|
| *Trade policy* | | | | | | | | | | | |
| Exchange rate policy | | X | | | X | | | | | | |
| Tariff reform and import liberalization | X | X | | X | | X | | | | | |
| Export incentives and improved institutional support | X | X | X | X | | X | X | X | X | X | X |
| *Sector policies* | | | | | | | | | | | |
| Energy | | | | | | | | | | | |
| Pricing policy | | X | X | | X | | X | X | | X | X |
| Conservation measures | | X | X | | | | | | | X | X |
| Development of indigenous sources | | X | X | | | | X | | | X | |
| Agriculture | | | | | | | | | | | |
| Pricing policy | X | X | X | | X | | X | X | X | X | X |
| Improved institutional support (marketing, etc.) | X | X | | | | | X | X | X | | X |
| Industry | | | | | | | | | | | |
| Incentive system | X | X | | X | | X | X | | | X | X |
| Institutional improvements and subsector programs | | X | X | | | X | X | X | | X | |
| *Public investment program* | | | | | | | | | | | |
| Revision and review of structural priorities | X | X | X | X | X | | X | X | X | X | |
| Strengthening of institutional capacity to formulate and implement public investment program | X | | X | | | | | X | X | | X |
| *Public sector enterprises* | | | | | | | | | | | |
| Financial performance | X | X | X | | X | | | X | | X | X |
| Institutional efficiency | X | X | | | X | | | X | | X | |
| *Resource mobilization* | | | | | | | | | | | |
| Budget policy | X | X | X | X | | | | X | | X | X |
| Interest rate policy | | X | X | X | | | | X | | X | |
| *Debt management* | | | | | | | | | | | |
| Strengthening of institutional capacity to manage external borrowing | X | X | X | X | X | | X | X | X | | |

*Source:* World Bank.

a. Includes two structural adjustment loans to Turkey.

systems. High tariffs and import controls have often encouraged high-cost production for import substitution and have, therefore, been biased against exporting. SALs have incorporated agreement to phase out quantitative import restrictions and to modify the level and structure of tariffs, export subsidies, and excise and sales taxes in order to equalize the incentives for production for both the export and domestic markets. For example, the Philippine structural adjustment program aims to even out the effective rates of protection and to liberalize trade with the objective of stimulating a radical improvement in industrial efficiency. Reforms are also being introduced to reduce or to simplify administrative procedures that have obstructed exports. These measures will encourage Philippine industry to become increasingly competitive in both domestic and foreign markets; they not only will benefit local consumers but also will serve as a precondition for achieving sustained growth of output and employment in this sector. However, given the existence of an industrial structure built up behind protectionist barriers, transitional measures are also required to assist in the rehabilitation or phasing out of uncompetitive plants.

For most structural adjustment programs, revised prices are crucial to foster production in the agricultural sector. Substantial empirical evidence exists that farmers respond well to price incentives, yet in many countries producer prices have been allowed to fall well below export or import parity prices. Under SAL operations, the Bank has frequently sought agreement on price changes in both output and input prices and the related tax and subsidy arrangements. In addition, criteria have been established for determining the level and structure of agricultural prices. For example, improved price incentives to stimulate food production, both for the domestic market and for export, were a key feature of the SAL programs in Bolivia, Guyana, and Senegal.

Although most structural adjustment programs give priority to reforms relating to agriculture and industry, problems in other productive sectors have been addressed. In Bolivia, for example, mining taxation was modified to provide greater incentives for investment in new mines and to encourage existing mines to exploit marginal ore bodies. Incentives to stimulate both energy conservation and import substitution are also, at least in part, a pricing issue—to ensure that domestic fuel prices adequately reflect international prices. In Bolivia, the price of oil produced locally was raised to encourage fuel conservation and, hence, to raise export earnings. Higher fuel prices also provide an added incentive for oil and coal exploration.



*Public Investment*

A critical review of public investment programs is an integral part of most structural adjustment programs, with priority being given to projects that will ease the foreign exchange constraint. The most obvious examples are investments in hydroelectric power, oil exploration, and the expansion of export crops. Often, too, the level of public investment has to be cut back to match reduced resource availabilities. Considerable attention was given to the structure and size of public investment, for example, in the Turkey SAL. In this case the shortage of investment funds had led to cuts across the board in many of the ongoing projects, whereas what was needed was selectivity and careful attention to priorities determined in the context of the objectives of the structural adjustment program.

The public sector too often makes investment decisions without adequate attention to the likely economic rate of return. Moreover, with a binding constraint on the balance of payments, project analysis needs to assume a realistic shadow price for foreign exchange that is determined within a long-term planning frame. This consideration will normally lead to preference being given to the more quickly gestating projects, which are more capital saving and more employment creating. Unfortunately, many countries lack well-staffed and authoritative units within their government to undertake the required rigorous project evaluation. Thus, strengthening the planning capacity has also been a feature of several programs.

*Budget and Debt Management*

Although it has been important to reduce budget deficits to achieve greater financial stability, the expenditure items to be reduced must be carefully chosen to ensure that the cuts have the minimum adverse effect on productive activities. It must be remembered that inadequate maintenance of infrastructure has often created production bottlenecks, and reducing operating expenses may be more expensive in the short term than reducing capital outlays. Moreover, it may be found that expanded agricultural production will depend on improved agricultural services, as was the case in the Kenya SAL. Achieving the objective of expanded production to save or earn foreign exchange while containing or reducing the budget deficit requires selective cutbacks to shift expenditure away from nondevelopmental activities. One approach is to target welfare programs and consumer subsidies more sharply on the needy, as well as to seek ways of reducing unit costs of social programs; another is to take a hard look at nondevelopmental expenditure (e.g., military and administrative services).

With the high levels of debt prevalent in so many countries, careful attention must be paid to the character of the foreign debt. Debt restructuring has been a precondition for several SALs, and in one case (Mauritius) a clear understanding on debt policy was incorporated in the SAL program. In these matters the Bank has worked particularly closely with the Fund; the Bank, through its debt-recording system and related technical assistance, has played an important institution-building role.

*Institutional Reform*

Recognizing that many of the management problems in developing countries stem from weak institutions, structural adjustment lending has given special emphasis to institutional reform. For example, agricultural pricing incentives are not likely to be effective unless measures have also been introduced to improve marketing, access to credit, and the supply of tools, seed, fertilizer, and pesticides. In Senegal the SAL program provided for major reform of the agricultural parastatal enterprises, including exposing state marketing organizations to competition from the private sector to encourage efficiency.

Since parastatal organizations often enjoy a monopoly, their mismanagement can constitute a major bottleneck to production. An important component of Turkey's program involves the progressive reform of state economic enterprises by introducing tighter financial discipline, more economic staffing, and greater managerial autonomy. Other examples of institutional reforms include measures to improve agricultural extension services in Turkey and to provide better credit and insurance facilities for exporters in Kenya and the Philippines. In the case of the Ivory Coast SAL, agreement was reached on a whole series of measures to improve public investment planning. Finally, establishing better systems for maintaining external debt records—for example, in Kenya and Turkey—was also seen to be essential for sound financial management.

*The Phasing of Structural Adjustment*

It is recognized that structural change can only take place over a period of several years. Modifications to the productive structure depend to a large extent on new investment. This process is inevitably slowed down when the rate of investment is reduced as a consequence of short-term balance of payments constraints. Furthermore, in periods of economic difficulty there is likely to be political resistance to reforms that entail short-term costs, as may be the case with reforms of the system of industrial protection. In this context, structural adjustment lending serves both to initiate reforms and to maintain their momentum—hence the need for a series of SAL operations spaced over several years.



The precise scheduling of reforms is clearly a matter of judgment for each country, with the political preference normally being to postpone painful decisions. While this is understandable, the Bank, as an international financial institution, has a responsibility to assess whether the scope and timing of the program of reform that it is asked to support will be adequate to achieve the government's goals of adjustment.

*Nature of SAL Conditionality*

It follows from the earlier discussion that the Bank must reach a firm understanding with each government on the monitorable action programs, specifying both the steps to be taken and the studies required as a basis for further progress. The practice is for this understanding to be spelled out in detail in a Letter of Development Policies that is explicitly referred to in the loan agreement. The tranching of disbursement involves the identification of a few key actions that are specified as preconditions for the release of the second tranche. However, satisfactory progress on the implementation of the overall program is also a requirement.

While this procedure may be called "conditionality," it is in principle no different from the relationship involved in Bank sector or project lending. The action programs for structural adjustment are of course different in scope from the issues dealt with in most projects, and they often involve policy matters in sectors in which there is no project lending. There will be many countries for which structural change is necessary, but for which there will be no basis for structural adjustment lending because of political constraints faced by the government or because of institutional weaknesses that would make the implementation of broad policy changes unduly uncertain. In many of these cases, there nonetheless would remain a sound and valid basis for project financing.

## Key Issues

The introduction of structural adjustment lending has led to protracted discussions among member countries. Three key issues frequently raised are: (1) the roles of the Bank and Fund, (2) project versus nonproject lending, and (3) additionality in the flow of external capital assistance. These are briefly addressed below.

*Roles of the Bank and Fund*

The Bank's structural adjustment lending clearly interfaces with the Fund's stabilization programs and extended facility arrangements. Both institutions now provide funds that are available to finance a broad range of imports, and both impose conditionality that requires the development of action programs focused on policy and management issues. The Fund is increasingly taking into account considerations of supply as well as demand management, and its programs now have a medium-term perspective. The Bank, for its part, is acutely aware that effective long-term development programs cannot be undertaken by a country that is disrupted by an immediate financial crisis. In such cases priority must be given to stabilization measures. Experience over the past two years has shown that the Bank's SALs and the IMF programs are in practice both complementary and mutually reinforcing.

Though both institutions share the same ultimate aim—to foster broadly based growth in incomes and employment in their member countries—they nonetheless have distinct roles and pursue distinct operational objectives. The immediate focus of the Fund's attention is primarily the country's overall financial situation, while the Bank's central preoccupation is primarily the efficiency of resource use in the productive sectors. In practice both institutions, each from its respective vantage point, will have views about the appropriateness of the key elements of a country's economic policy. For example, both will be concerned that the exchange rate should not become overvalued, since this will have an impact not only immediately on the balance of payments, but also in the medium term on the structure of production that will be determined by the price structure, which in turn reflects the exchange rate. Another example is subsidies. The Fund often advocates reducing subsidies to state enterprises to limit the budget deficit. The Bank's complementary objective is to encourage the enterprise to operate more efficiently.

The nature of the structural changes required provides in large measure the answer to the question of the respective roles of the Bank and the Fund and of the connection between Fund conditionality and the policy actions agreed to by the Bank. It is not, as is sometimes simplistically suggested, that one institution is concerned with macroeconomic issues while the other is concerned with microeconomic issues. The case of Ghana demonstrates, if any demonstration of the obvious is needed, that development cannot proceed when exchange rates are seriously out of line for prolonged periods. Equally, a stabilization program is not likely to succeed if domestic



energy prices differ markedly from border prices or if agricultural prices result in insufficient incentive to produce. It is similarly obvious that many policy measures will have an impact on both demand and the volume and pattern of supply. Changes in interest rates affect aggregate demand and individual investment decisions; increasing prices of food may reduce subsidies and increase incentives to producers. There are a multitude of similar examples.

There has been, and to some extent still is, a difference in the time horizons of the Bank and the Fund. However, this difference is becoming less as account is taken of the medium-term nature of the balance of payments problem of the developing countries. Providing EFF resources with eight- to ten-year maturities focuses the Fund's attention not only on the actions agreed for the first three years, but also on the repayment capacity of the country for the next five.

The complementarity between Fund arrangements and action programs supported by the Bank's structural adjustment lending derives from two factors. The first has already been alluded to—structural adjustment can only take place effectively in the context of actions to limit aggregate demand and, where necessary, external borrowing. Thus, conditions adequate to permit access to Fund resources are usually a prerequisite to a detailed program of structural change. Second, as a consequence of the distinct mandates of the institutions, their respective staffs have different specializations.

The Fund, when it deals with prices—for example, of oil, foodgrains, or parastatal products—is concerned with the effect on aggregate public expenditure and on the distributional aspects of such expenditures. But such changes are not only often highly controversial politically, they also require specialized technical and economic knowledge to be implemented effectively. Changing the price of a principal crop when it is markedly out of line is relatively easy in the direction and initial order of magnitude required, but account must also be taken of the impact on the overall cropping pattern, on the balance of land use between domestic and export crops, on the capacity of the market system to assure the producer the price agreed on, and on the supporting services and supplies that will help to translate better incentives into higher production. It is in these areas, including the associated institutional issues, that the Bank can help to define programs that will not only support the stabilization objective, but that will also enable the country to expand output.

Similar considerations apply to such goals as eliminating parastatal deficits and further improving their performance to the point where the parastatal enterprises contribute to national savings by generating financial surpluses. Obviously, one important aspect of such a reform

is its impact on the budget and government savings. But agreement on the objective, even when accompanied by agreement on greater price freedom and a more commercially oriented operation, will not ensure long-term institutional change. Managers who have grown up in a framework of controlled prices and access to budget funds or deficit financing are likely to have neither the capacity nor the tools nor the data to align prices with marginal costs, to reduce unit costs in a sensible manner, or to define their investment priorities in terms of market demand and competition. In the absence of programs to deal with these deficiencies, they will reduce investments, and possibly operating deficits, but these will recur as soon as conditions improve sufficiently to permit relaxation of the financial restraints. To translate the general objectives into permanent changes requires programs at the plant level to assist managers in developing analytical and monitoring systems, administrative and managerial policies, financial and accounting systems, and appraisal and marketing capacity quite different from the present ones. At times it may also require different managers. The Bank's staff is equipped to assist countries in these areas precisely because they involve the same expertise that the Bank has furnished and continues to furnish in its project operations.

In summary, the fundamental distinction to be made between the roles of the Bank and the Fund is not that of objectives, nor that one institution is concerned with the short term and the other with the long term, one with macroeconomic issues and the other with microeconomic issues, or one with monetary and financial aspects and the other with real resources. On the contrary, the difference lies primarily in the orientation of each institution's staff and the experience and expertise it is capable of mustering.

An important difference also arises in the procedures of the Bank and Fund. These reflect the difference in the nature and scope of each institution's operations. The Fund's involvement is restricted to a single type of operation—balance of payments support—with relatively infrequent and limited staff visits to a country, whereas the Bank has many missions relating to a wide range of operations. Fund support is generally, though not always, seen as a rescue operation in response to a crisis. In these circumstances, failure of a Fund arrangement is likely to have grave consequences for a country's international creditworthiness. The Bank's individual SAL operations have a much lower profile and are negotiated at a less intense pace. The consequences of failure to reach agreement are therefore much less serious. In these circumstances, negotiations tend to be less confrontational, and it may be possible for the Bank to achieve a more fundamental government commitment to reform.



Given the commonality of their interest but their different mandates, it is vitally important for the Bank and Fund to work together to harmonize policy advice. For this reason increased efforts have been made to ensure that Bank and Fund staff collaborate closely in the analysis of policy issues. In the process, a clear division of labor has arisen whereby each institution contributes in the areas where it has special expertise and is recognized as having the lead role. Over the past three years, the number of missions with staff participation from both institutions has more than doubled. In documents submitted to the Bank's Board, the position of the Fund is always clearly set out, and the Fund has adopted a similar practice.

Another issue often raised in defining the Bank's and Fund's distinct roles is whether balance of payments support should not be left to the Fund, implying that Bank financial assistance should exclusively take the form of project and sector lending. The argument against this has been set out above in the discussion on the rationale for structural adjustment lending. Nonetheless, it must be reemphasized that the primary purpose of a SAL is not to fill a current account deficit but to support a medium-term program of changes necessary to reorient the economy and to bring its current account deficit to a more sustainable level over a number of years. Of course, as do the disbursements under project loans, the disbursements under structural adjustment loans add to the country's external capital flows.

### *Project vs Nonproject Lending*

Related to the concern about the respective roles of the Fund and the Bank is the proposition that the Bank should rely exclusively on project lending. The question is often asked why it has not been possible for the Bank to address key policy issues in the project context—or why it could not do so in the future. Of course, the issues that require attention today are not new, nor have they remained unidentified in most countries. Bank reports are replete with problems of subsidies, distorted incentives, unrealistic interest rates, excessive public deficits, and inefficient parastatal operations. Nor was the Bank merely crying in the wilderness, as some would suggest who view the depth of change required today. Producer prices were raised in many countries, agricultural services strengthened, operating subsidies reduced or abolished, tariffs raised to make public utilities viable—and there is a long list of countries where, at Bank insistence, interest rates have been raised repeatedly to ensure that they are at

positive levels. But all such changes involved difficult political decisions, and the pace of change was modest.

Yet it has not been possible to achieve the same degree of comprehensive coverage of structural adjustment policies through project lending. A project operation is typically related to one subsector (e.g., a power project in the energy sector or a palm oil project in the agricultural sector), which inevitably limits the scope for taking a broad sectoral view. For understandable reasons, the less directly the policy issues are related to the project being financed and to the subsector of which it is a part, the greater the difficulty in both reaching agreement initially on these policy issues and subsequently ensuring that they are implemented. Sector lending—defined as an operation in which the Bank finances a slice of the sector investment program—provides greater opportunity to address broad sectoral policy issues. But in many countries the Bank is involved in only a limited number of sectors. Even in those countries where this is not the case, loans in each sector are typically spaced over three or more years. Given the low probability that the Bank would have a concurrent series of project or sector operations in all sectors in which the policy issues are important for structural adjustment, structural adjustment lending provides a unique opportunity to achieve a comprehensive and timely approach to policy reform.

Although Bank project operations have contained important covenants spanning the whole spectrum (from detailed technical, administrative, and financial issues relating to the project, through subsectoral policy and institutional issues, and on occasion sectoral policy), for obvious operational reasons priority is given to the immediate project objectives. In contrast, SAL conditionality is related entirely to issues of macroeconomic and sectoral policies. It raises the level of dialogue to the highest ranks of government and provides a single focus that helps ensure that adequate attention is given to the program's prompt implementation. Whereas in project lending, the Bank will typically be dealing with agencies or sectoral ministries, SALs are always the concern of the key government decisionmakers. The commitment to a series of operations spaced at 12–18 month intervals, and with tranching of each loan or credit, makes the monitoring of policy implementation a continuous process. The availability of SAL funds is made entirely dependent on progress in implementing policy reform.

### *Additionality for Structural Adjustment Lending*

Although the SALs are intended to support much needed programs of structural change, it is sometimes suggested that such lending must



be additional to the Bank's regular lending. It is argued that, if structural adjustment lending were to result in a noticeable reduction in project lending (i.e., if it is not additive), governments would be discouraged from negotiating SALs. There is no doubt that, despite the need to restrict investment levels in many countries, the investment requirements for increased energy self-sufficiency, for reorienting the industrial structure, and for making more effective use of existing capacity are considerable. There is justification, therefore, for increased Bank lending to countries prepared to undertake major structural change. However, in determining the global planning figure for Bank Group lending, current constraints have made it difficult to add a specific allowance for structural adjustment lending. Thus, although for Bank borrowers as a whole there is no explicit additionality because weight is given to country performance in allocating Bank resources, it is possible to increase lending to a country undertaking structural change for a few years. But even when the additionality is modest, countries recognize the importance of involving the Bank in the design and support of their programs of structural change.

The size of individual SALs is determined in relation to the size of the country's borrowing program, and a judgment is made on the optimum balance between project and nonproject lending in that country (Table 5.2). Although individual SALs usually are small com-

TABLE 5.2 WORLD BANK STRUCTURAL ADJUSTMENT LENDING OPERATIONS
(million dollars)

| *Country* | *Amount* |
|---|---|
| Kenya | 55 |
| Turkey[a] | 575 |
| Bolivia | 50 |
| Philippines | 200 |
| Senegal | 60 |
| Guyana | 22 |
| Mauritius | 15 |
| Malawi | 45 |
| Ivory Coast | 150 |
| Korea | 250 |
| Thailand | 150 |
| Jamaica | 75 |

*Source:* World Bank.
a. Includes two lending operations.

pared with a country's foreign exchange gap, the total program implicit in the intent to provide a series of such loans over a five-year period usually is of the same order of magnitude as resources available under an extended Fund loan over a three-year period.

## Conclusion

The Bank's project lending provides many opportunities to address specific sectoral issues. These opportunities are increasingly being exploited to assist countries to improve the policy framework for development, but there are broad policy issues that cannot be appropriately addressed in a project context. Yet, although the Fund is effectively overseeing the management of the principal macroeconomic aggregates, it lacks the functional and sectoral specialists able to analyze in depth the long-term development implications of alternative macroeconomic strategies. Nor does the Fund have the frequent staff-government contacts afforded the Bank through its economic and sector missions and its extensive project work. Structural adjustment lending provides a framework for the Bank's intensive economic dialogue. It enables the Bank to provide support for an agreed program of action to change both policies and institutions to make more effective use of resources and to increase foreign exchange availability. Through SALs and associated project lending, the Bank helps to institutionalize changes at the operating level—in both plants and agencies. Without change at that level, countries are unlikely to establish a permanent basis for accelerated growth. Thus, the Bank's structural adjustment lending complements both Fund operations and the more traditional forms of its own lending.

Structural adjustment lending is one in a whole spectrum of lending instruments. Only a minority of countries are expected to be prepared to commit themselves to the explicit set of reforms required. Many countries lack the political and technical capacity to formulate credible programs. In these cases, existing forms of project and sector lending are available to support more limited, but more manageable, progress.

The Bank's structural adjustment lending is still in a pilot stage and has given rise to some misunderstandings. There is no intention to displace project or sector lending by structural adjustment lending. But the developing countries are facing difficult problems of adjustment in the face of a drastically changed, and considerably more hostile, economic environment. The Bank, as the largest development finance institution, cannot stand aside and fail to support these ad-



justment efforts. Structural adjustment is the central problem of development at present, and experience has shown that SALs are an important means of assisting a country—intellectually and financially—in reorienting its development strategies.

1984

# LIST OF SPEECHES
## Ernest Stern

1984

(1) The Evolving Role of the Bank in the 1980s, Closing Remarks at the Agriculture Symposium, January 13, 1984

(2) EDI High Level Seminar, Washington, D.C. March 18, 1984

(3) LDC Financing, International Conference Sponsored by the Federal Reserve of New York, May 7, 1984

(4) 1984 Senior Operational Managers' Retreat, Closing Remarks, Bedford Springs, May 1984

(5) IPA Press Seminar, Airlie House, June 22, 1984

(6) The Role of the World Bank, Address at the 40th Anniversary of the United Nations Monetary and Financial Conference, Bretton Woods, July 13, 1984

(7) DAC Presentation, Paris, December 3-4, 1984

(8) After Adjustment: Restructuring Productive Capacity in Developing Countries, Address at the Annual Meeting of the U.S.-Yugoslav Economic Council, New York, December 12, 1984

(9) The Africa Crisis, United Nations, New York, December 17, 1984

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Agriculture Symposium
January 13, 1989

Closing Address

by

Ernest Stern*

Monty, this is the last year that you plan to chair this meeting -- I say "plan" because all kinds of things can happen to plans and you're not going to disappear from the Bank, but it is still an appropriate opportunity to point out that the well-deserved congratulations you have given to the agricultural staff are also very much due to you and the leadership you have exercised and the contributions you have made both in implementing the department's many accomplishments, and in the intellectual thinking-through of where agriculture ought to go in the Bank and how we ought to treat it. So, -- not to say goodbye, but to express on behalf of all of us our thanks to you for what you have done.

I hope the symposium this week has been more fruitful than the meeting which has been going on next door, on IDA. We face a very constrained resource situation, - not just the World Bank but the developing countries and the world in general. There is no doubt that the last five years, indeed longer than that perhaps for some countries, have been years of increasing difficulties, and many countries are having to undertake fundamental structural adjustment of their economies. Now structural adjustment is a term we have grown familiar with, since we have developed structural adjustment lending as a tool to help deal with these problems, and sometimes this familiarity disguises the profundity of the problems. But in the real world, structural adjustment means very many painful and difficult things. In many places, it means reductions in income levels, in expectations about future growth, and in real wages. It means shifts in industry as comparative advantage shifts. It means a period of relatively slow growth since the world has been used to a period of very rapid growth ever since the second world war. It means major pressure on budgets. And it means cuts -- which are always very difficult -- in social expenditures and in investments in human resource development.

And this list is not unique to the developing countries. Unfortunately, it is a world wide phenomenon. It's an adjustment process which is by no means complete, and one which I think no one can see through very clearly. It's a very dynamic process which affects political decision making everywhere. It makes nations and people turn inwards, makes them less confident of the future, and makes them less willing to be part of an international framework, in which every country ought to be doing its share without an excessively narrow or short-term view of direct and quantifiable benefits. I may sound gloomy, but I think it is true that this adjustment process in many places has been misunderstood, has been downplayed, has been seen as a short-term phenomenon. I don't think it is a short-term problem. It is going to be with us for many years to come. And of course the Bank lives in a world environment deeply affected by this, which in turn affects the resources we will have available.

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*Senior Vice President, Operations
World Bank

The IDA negotiations have not gone well -- we will settle tomorrow morning on a 9 billion IDA with some hope that there will be voluntary supplementary contributions thereafter, but it is only a hope -- no committments and no certainty. This will mean very difficult choices in our lending program, that will affect the low income countries -- not only directly, in terms of what we can contribute to them, but also, I am sure, their willingness to continue to make hard policy choices in areas that require effective support, including external financial support. For the Bank as a whole, on the other hand, we expect in the years to come to have an increase in the overall supply of loanable resources. The basic problem we're going to face is how to find new ways and means of channelling increasing resources to low income countries.

On the budget side, we also face a very constrained environment. Everybody says that every year at this time, so I don't want to break tradition -- but it too is getting worse. We now have developed a longer term budget policy framework. We are doing for the first time a five-year planning exercise on administrative expenses, and that shows a very healthy demand far in excess of what our shareholders are prepared to see us commit. We have proposed a budget frame where at the end of the five-year period our administrative expenses will grow on the order of 2% per year. As we look at the near term, however, FY85 and FY86, it is very clear that the intitiatives we have in place, the modest expansion of the lending program that we hope for, the increased efforts at aid coordination, and just generally trying to deal with the increasing complexity of project design, and modern economies in an increasingly complex world, that the demand for additional resources eats up more than what our Board is prepared to see by way of growth in administrative expenses.

We have in the past several years grown more rapidly in real terms than our lending program, and I very much agree that ought not to be the case. It seems to me when administrative expenditures consistently rise faster than product - product not defined just as new loans but as the total services rendered to our members - it is a sign of institutional senility. We've got to be very careful that we don't allow that to happen. This, in turn, puts great emphasis internally on flexible organization, on flexible administration, on innovation, and doing things in a less cumbersome way. I'm sure everyone of us here can enumerate at least ten examples right off the top of his or her head as to what those ten ways would be, and I don't think they're all the same. So there's lots of scope. We have done a lot, but there still are possibilities for productivity improvement. We want to be sure that in a constrained situation, however, we don't let resource constraints cut into the quality and imagination of our work, the incentives for attracting and retaining high quality staff, or the services we render to our member countries.

Because the world is so different and because the Bank continues to change in response to the needs of its borrowers, we have undertaken a study of the role of the Bank over the next decade or so. I don't expect any revolutionary conclusions, not only both because institutions are very hard-put to be revolutionary about themselves, but also because we have done a lot of things in the past few years which move in the direction in which I think we need to continue to move, perhaps more vigorously and rapidly than we have.

It is clear, that there are increasing differences between our member countries. The problems of Africa are severe and Africa really presents a very separate set of issues, combining very low levels of income with immense shortages of skilled manpower and management capacity which, while obviously not in each and every country, make it unique as a Region. At the other end of the spectrum in Latin America, the Middle East and East Asia, are countries which have grown in management capacity and the availability of skills, which can and do use the most modern management techniques and have investments at the outer edges of technology, and their requirements for assistance are very different.

So one basic fact is that we need to organize ourselves better intellectually, and perhaps structurally, to recognize those differences and to provide different kinds of services. Secondly, we have in the last several years moved into policy areas much more vigorously than in the past. And I think that's going to stay with us.

Now sometimes people are a bit concerned -- technical staff in particular -- that if you do too many structural adjustment loans or too many sector loans -- what am I going to do for a living? But the concern is unfounded. The structural adjustment loans and the policy dialogue and the sector lending and other tools that we have developed, all have their foundation in a concern about projects, about implementation of sensible investment decisions and about how you make the most effective use of existing assets. That is what we are all about. What label we stick on it at the end and just who signs the cover memo to the Loan Committee or who presents it at the Board table is not what's important. That we need to continue to deal more intensively with policy issues is clear; because as the adjustment process continues, with resource constraints as severe as we all know they are, the emphasis in every developing country is going to be on more efficient use of existing and future resources. And that requires appropriate policy frameworks and incentives.

And that means we've got to be flexible. We have to have a range of tools. We have to find the kind of lending format which can most effectively help a member country to overcome current difficulties and make most efficient use of existing resources, and use our influence to make sure that the investable resources go to the highest priority areas. This is going to mean a more permeable set of walls around the little empires we all run and all live in -- it means more effective collaboration, it means more imagination, and as I said, less turf protection. We need to get rid of the little boxes we have in our heads, the terminology we've lived with so long, "project" and "non-project". These simple definitions have many variants -- as we know from our daily work. The semantics are not important -- what is important is what is helpful and relevant to borrowers. What the Bank is engaged in is operations, and each operation has as its primary concern the efficient use of resources, the development of skills and the strengthening of institutions.

When we lend for agricultural credit so a farmer can go out and buy fertilizer, everybody knows that's a "project" and therefore a good thing. And when we lend for an export development fund so that some private industrial entrepreneur can go out and buy his raw material, some people think that's "non-project" lending and therefore a bad thing. We have outgrown these kinds of semantic differences and we need to be sure that we don't carry them in our minds because people oughtn't to live too long with a growing gap between their official rhetoric and their actual practice.

Many of the things we need to struggle with in the years ahead also need to be of concern to you, in agriculture. Monty has talked about our achievements, and indeed they are many and we can and should be proud of them. But it is also true that the problems which still lie ahead are tremendous, not only in the narrow sense of how many tons of grain we are going to produce or the world is going to produce and how that's going to be shipped. Rather, we need to recognize that agriculture everywhere is changing and that the lessons of the past are not going to be a very good guide for the future, except in a very general sense.

We also need to recognize that whenever we overdesign projects, they fail; whenever we are rigid about the design we end up with a not very good project; whenever we don't try to keep costs down to the maximum extent feasible we live to regret it, or at least the country lives to regret it; when we ignore the market and try to implement our programs through essentially public sector and governmental approaches, and when those institutions so often lack the managerial capacity and the financial discipline, they and we turn out to be sorry.

Agriculture in many countries is in the process of modernization -- we need to be more concerned than ever before about its contribution to exports which are crucial to all developing countries. We need to be much more concerned with the link of our agricultural production activities to agro-industries and their development. We need most especially to give adequate attention to marketing, which remains a serious problem.

And we need to recognize that in many of the middle income countries -- in countries like India, China -- our interest in agriculture is going to become more diverse, and move away from the relatively standard patterns of the past. We need to equip ourselves to do that intellectually, analytically and in terms of staffing. And then we need to begin to deal more effectively with the problems of agriculture in Africa.

It may be true that Africa has limited absorptive capacity and that the preconditions for a rapid growth in agriculture are not there. But then that is our challenge, that's not an excuse. We, along with other donors, I think it is fair to say, among all of our achievements have failed in Africa. We have not fully understood the problems, we have not identified the priorities, we have not always designed our projects to fit both the agro-climatic conditions of Africa and the social and cultural and political frameworks of Africa. This

is evidenced by the percentage of poorly performing projects in the agricultural portfolio, and by the fact that we, and everybody else, are still unclear about what can be done in agriculture in Africa. And certainly I don't have the solutions, but some of the elements of it are clear. We need to do very much more about research -- it has taken us a long time to recognize that research in Africa is important. We need to build up more institutions in the agriculture sector. We need to work very much more at the simple approaches to extension. Some may think that T&V is too simple-minded, but I would like to see something better before we snikker a lot about the present.

The designs of agricultural projects in Africa have been excessive, they're over-intellecutalized and are not suitable to the implementation capacity of many of those countries -- and that's got to change. And we must be prepared for frustrations because sometimes the availability of solutions is going to outrun the ability of the institutions to implement them.

Time and time again we're drawn into dependence on institutions that are weak. We've got to be very conscious of this weakness, and minimize our reliance on institutions which cannot perform. There's very little of a private sector in many African countries, and that's got to be nurtured to provide alternative investment and implementation channels. In most places the private sector doesn't exist, or is very limited, so that takes nurturing and how we do that is a question we have not very often addressed and we may not be very good at. I hope that's wrong.

These are, I think, the important intellenctual challenges ahead of us. In terms of human misery, alleviation of proverty and equity considerations, the African challenge is the most difficult. It's the one in which we have a special responsibility for making a special contribution and a special effort. The requirements for our support in the middle income countries, of course, is also very great and the challenge there is a very different one -- it's going to require us to look at different aspects of agriculture. In that area we're not the only ones, but nonetheless our role can be very important. And the two together -- those two sets of challenges -- I think are going to keep us very busy.

Money is very important, but money isn't everything, and in some cases money is the least important of the contributions we can make. That we haven't got a large IDA is deplorable; that more concessionary money is essential is indisputable. But we should not let financial constraints stand in the way of doing our utmost to help our members deal with the tremendous challenges they face. We have a lot to be proud of, but if we are going to continue to be proud of ourselves in the future, we've got to be sure that we stay on top of the issues, and that those issues are the ones that are most important to our member countries so that we can serve them as effectively in the future as we have in the past.

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EDI High Level Seminar
March 18, 1984
Washington, D.C.

On behalf of my colleagues in the World Bank, it is a pleasure to welcome you to this seminar arranged by our Economic Development Institute.

The topic you will be discussing during the coming week---Management in Development---is vital for the future prospects of your countries, and indeed for all developing countries.

Effective management means efficiency in the use of scarce resources and that has always been important. But today, when so many countries face an extraordinarily acute shortage of resources to devote to investment and other basic development objectives, such as health and education, improving the efficiency of resource use has become paramount. Obviously, this is not to say that you, and we, should not do our utmost to increase the mobilization of domestic resources or to expand the inadequate flow of external capital to developing countries. That is one of our primary responsibilities. But, regrettably, we live at a time when official aid flows are stagnant and commercial flows have declined sharply due to uncertainties about creditworthiness. While we must continue our efforts to improve the external environment, and especially for the low-income countries, we cannot afford to wait for the results of these efforts. In the meantime, you, and we, must focus on ways to increase the output from available resources---human, financial, and physical. We cannot allow the deterioration in per capita income to continue; it is economically unsound and politically and socially disastrous.

Improving the effectiveness of resource use---through better policies and better management---is a long term effort. But we must start now since, to be frank, the difficult situation facing developing countries, particularly the countries in Africa, is likely to continue for some time. It is not, I believe, a cyclical phenomenon.

Let me indicate briefly some of the reasons why we see this as essentially a long term problem. The decades following the Second World War were a period of unprecedented economic expansion in the history of the world. Almost everywhere, people's living standard improved, and even the very poor countries of Africa and South Asia achieved widespread progress in health, education and technology.

But this era of global growth has been interrupted by over a decade of economic turbulence---volatile exchange rates, rapid oil price increases and finally, the worst recession in over 40 years. The world economy is just beginning to recover from these disturbances. But that recovery is uneven, and still fragile.

Continued progress in world recovery, and accelerated growth in developing countries requires fundamental changes in the structure of economies and

the development strategies, in industrial and developing countries alike. This process, "structural adjustment", requires different measures in different countries. But they all have a common theme---measures to increase the competitiveness of exports and of domestic production to reduce import requirements; incentives to increase productivity; price policies which eliminate differences between sectors; the elimination or reduction of subsidies; charging appropriate prices for public services both to reduce burdens on the budget and assure replicability and reduced unit costs in such cases as education and health to provide service to the largest number of people. But these are not simple things, though the words are easy. It involves sunch painful things as reductions in real wages or at least a slow down in their growth; it involves restructuring industries; it involves reduced protection to existing investments and hence lower profit margins. It affects almost every vested interest group and thus is politically difficult. The natural response is to go slow---to make the transition as gradual as possible. And that is an understandable desire---though not a realistic objective. Time is not on our side. Comparative advantage is shifting constantly; technology changes as rapidly. The resources to buffer any economy against external movement are not at hand. The longer the delay, the greater the pain and the political cost. Adjustment cannot, today, be seen as a temporary phenomenon. It is likely to be at the center of our attention for many years.

But structural adjustment is not limited to re-orienting production processess, to moving in to new industries and to phase-out industries where others have developed a comparative advantage. Structural adjustment also involves changing attitudes and practices. It requires training and relocation of people; it may mean shifts in the output of the educational system, and it means creating more and new types of jobs. It also means more emphasis on efficiency---on the careful management of limited resources. This is an even longer-term task.

The changing world environment, and the changes individuals see impinging on them, affect the political decision-making process everywhere. People are less confident of the future; hence, they are more protective of the present. They see their future incomes stagnant or only growing slowly so the will to support those less well off diminishes. In a slow growth environment, change becomes particularly difficult.

These circumstances and attitudes affect the resources that are available for many competing domestic social requirements, and, of course, also affect resources available to support development.

We in the Bank are, of course, painfully aware of these attitudes and pressures, having just been forced to conclude an IDA-7 replenishment of only $9 billion. This is grossly inadequate to the needs of our IDA borrowers. In addition, the total flow of development assistance has been

stagnant and this problem of resource constraint affects Bank borrowers as well, as commercial bank lending to developing countries has declined dramatically.

And this decline in resource flows has eliminated the buffer developing countries have had for most of the past decade where foreign savings could be used to reduce the impact of external events and stretch out the period for adjustment. But with reserves depleted, debt burdens large, capital market access reduced and aid flows stagnant, delay is no longer affordable. There are few alternatives to structural change and the postponement of action has a much higher cost, for more people, economically and socially than action now.

Now all of this may sound gloomy, and so in fact it is, but it also presents a unique set of opportunities and challenges. The world has now almost 40 years of experience with management of development problems. All developing countries during this period have amassed enormous experience, both successful and unsuccessful, in handling their economic problems. Some have done very well in developing their industrial sectors, in building up efficient small farmer production and marketing organizations, and in handling problems of rural and urban development. Other countries have not been so successful in modifying their policies and structuring their economies to meet the rapidly changing circumstances. But all of these experiences need to be examined honestly and with all the analytical rigor which can be mustered to see what lessons can be drawn for governments, and for international institutions, such as the World Bank.

We will need to learn from our common experience the lessons of efficiency and effectiveness, if we are to deal together successfully with the problems now facing the global economy and, most acutely, the economies of developing countries. The future rate of economic growth and success in poverty-alleviation are both dependent upon greater managerial efficiency and effectiveness.

Two points are important to keep in mind here. First, the need for efficiency is relevant in any political system and consistent with a broad range of social objectives. Efficiency considerations do not dictate strategy---they are an element of strategy. Second, efficiency considerations do not run counter to the achievement of social objectives; on the contrary, they are conditions for the achievement of these objectives.

No sustained generation of employment opportunities in industry can be brought about if industry is unable to compete internationally. Attempts to improve the incomes of small farmers will fail unless they can be taught to use their limited resources efficiently; efforts to expand urban housing or irrigation; to increase education or to bring clean water to the villages will not succeed unless the cost per unit are brought down to

affordable levels and unless those whose income benefits from those services, in turn, help to provide the resources to assist others. Economic growth is a pre-condition for the alleviation of poverty and in the decade ahead economic growth will depend on the increasingly efficient utilization of resources. The success of poverty-alleviation efforts also will depend on increasingly effective management and increasingly effective institutions.

That is why we need to be sure we profit and learn from our experience to date. We need to know, for example, what is the most effective role of national economic planning. What are the appropriate responsiblities for government and the public sector more generally---particularly where budgetary resources and experienced administrators are scarce. What can be done to ensure that what the private sector does for profit is also consistent with, and furthers, national development objectives. What can be done to improve the efficiency with which resources are managed in the public sector. These and similar questions require answers not of theory or answers based on eternal truths---but answers based on what is practical in the circumstances of a specific country today.

The 1983 World Development Report, which forms the basis of your discussion during this seminar, has attempted to take such a retrospective look at these and similar issues. We believe the 1983 WDR has been a very useful and constructive document in helping raise some of the important issues of managing development and in turn of efficiency and effectiveness in use of resources. But the WDR is no cookbook. It has no recipes. It tries to draw together experiences from around the globe but these need to be understood so they can be adapted to the future and to the specific circumstances of a particular country.

The challenge for you this week and for our staff who will be particpating with you, will be the same challenge facing your governments in the decade ahead: namely, what sound policy conclusions can be derived from our store of knowledge and how can appropriate policy lessons be implemented most effectively. But while I hope that by the end of the week each one of you will have extracted his own cnclusions from the discussion about the specific issues on the agenda, there is one lesson which, despite what I said earlier, is the single most important: the need for flexiblity and adaptablity. Those countries whose policy-makers and institutions are able and willing to accommodate changes---external and internal---which impinge on their plans, their resource availabilities and their objectives, and act to adjust accordingly will do well; those who seek to resist change will not.

March 18, 1984

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International Conference on LDC Financing
Sponsored by the Federal Reserve Bank of New York
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Speech delivered by
Ernest Stern, Senior Vice President, Operations, The World Bank
May 7, 1984

The magnitude of the problem many of the creditworthy developing countries face is well-known. External debt grew more rapidly than debt servicing capacity for a number of reasons—a general euphoria about the ability to service debt matched by a disbelief in the power of compound interest rates; external shocks, the permanence of which was not fully accepted so that the adjustment to them was too slow and economies were excessively cushioned; failure to realize the essential unsustainability of certain domestic policies; an over-optmistic assessment of investment capacity and a failure to foresee the depth and severity of the international recession. These factors had different relevance in various countries; some represent failures of judgment known, or at last knowable, at the time; others represent truly unforseeable events. But in many countries the difficulties resulted from an inability to be flexible in the management of the economy; an inability to react effectively and expeditiously to changes in the external environment and trying instead to shelter the country from such changes.

I do not want to dwell on the analysis of the past problems in the limited time available. There are many excellent studies available (including the Enders/Mattione paper from Brookings and Cline's paper from the Institute of International Economics), including the background paper prepared for this meeting. All agree that the problem is a long-term one, that growth in the major debtor countries will, at best, be modest for much of the 1980s, and that the process of adjustment is far from complete.

Continued stagnation or decline in per capita income is not consistent with the social and political stability necessary to the medium-term health of the economies of the middle-income countries or to the strengthening of their creditworthiness which is essential if they are to attract the domestic and external investment capital necessary for their development.

The basic problem for the creditworthy developing countries is how to manage their way back to a growth-oriented development strategy; for the providers of external capital—how they can support this process and on what criteria while protecting their investments and restoring the liquidity of their assets; and for the international community, including the international financial organizations, how it can best assist in these efforts.

Before turning to some approaches to help ensure the availability of the necessary external capital and how we, in the World Bank, in association with the IMF, can assist, let me comment briefly on the adjustment process itself.

Adjustment has a nice antiseptic ring to it, but it is a politically difficult and socially painful process. It involves reductions in real wages or at least a slowdown in their growth; restructuring of industries; reduced profits from sheltered investments; elimination of many subsidies; and reconsideration of public service levels. The objective of these measures is to improve the efficiency of resource use; to increase the competitiveness of exports and of domestic production to reduce imports; and to strengthen the incentives for increased productivity. Most important probably are those measures—economic and institutional—designed to reduce rigidities so the economy can respond more flexibly to the changing external environment. The changes required by structural adjustment involve almost every vested interest group and many national objectives.

The adjustment process in recent years often has started with a stabilization program, supported by the IMF. And this has been both correct and inevitable. It is essential to reduce budget deficits and current account imbalances to manageable levels, to reduce inflation and the underlying excesses in public and private spending. Without a sustainable macro-economic framework, the longer-term task of restructuring cannot even begin. But adjustment of such broad macro-economic parameters is, by itself, not enough. And this is, so far, for two reasons: First, stability without the prospects of growth is neither feasible nor sustainable. For some countries in Latin America, even under optimistic assumptions, it will take to the latter part of the decade to restore per capita GNP to the 1981 levels, in real terms. The social and political strains in these circumstances will continue to be severe; a delay in the resumption of per capita income growth can only exacerbate these tensions. Second, market institutions, the political framework and the development strategies in developing countries are not such that improved price signals and incentives necessarily lead to changes which will expand output efficiently. It is important to understand that unless changes in allocation criteria, investment decisions and management structures are institutionalized, there is a high probability—and in some countries a certainty—that the underlying inflationary pressures due to excessive public expenditure and inefficient resource use will recur as soon as the resource constraints ease.

I would draw three major lessons from the adjustment process thus far. One important element of success is the ability to manage the economy, in the broadest sense. This, of course, involves many things. Economic institutions need to have developed to a point where they are likely to respond to an appropriate set of policy signals. Generalized prescriptions are easy to come by, but they are often not seen as relevant or ready for implementation until they have been assessed, analyzed, and internalized in the countries' decision-making process. Getting the prices right is sound advice, but what the definition of a right price is in a developing country setting is not simple since it involves economic,

social, and political objectives. Moreover, it is a continuing process—not a once-and-for-all change. The intellectual infrastructure is important, as is the connection to the decision-makers. Broad participation in the analysis of alternatives helps to assure that solutions will be supported. The absence of such participation makes decision-makers more hesitant about changing course and economic management less flexible. The intentions of a government are important, but so is its capacity to implement these intentions.

Second, appropriate policies are vital. This has two components, the first relating to the link between the economy and the rest of the world, and the second to the level and composition of domestic expenditure. Successful adjustment involves a recognition of the interdependence of the world economy. In order to take advantage of the opportunities world trade offers, it is necessary for countries to transmit, within a reasonable timeframe, to both their producers and consumers, the signals the world economy is giving about energy, agricultural commodities, industrial goods and services. Delay in conveying changes in relative prices to domestic producers and consumers places unsustainable strains on the economy.

But simply maintaining an open economy is not enough. A relatively open economy requires an even more careful management of domestic demand than a closed. A major element is a realistic public investment program—realistic as to size, but also appropriate in composition and requiring public enterprises to generate a reasonable share of their investment programs. More generally, the margin for error in economic management is drastically reduced in today's volatile economic environment. Policies which may have been affordable in the 1970s are not sustainable today. These range from subsidies on foodstuffs and energy to benefit urban consumers, to protection of industries which are not viable in the long-term, to wage policies which serve to price nascent industries out of increasingly competitive markets.

Third, adjustment requires investment and an adequate flow of external capital. The transition must be financed. To some extent, it is possible to draw on the more efficient use of the existing productive base—and the immediate impact can be great. But even during the crisis phase, it is vital to maintain the flow of imported inputs to the productive sectors, particularly to the exporters, and to maintain the supply of working capital. Moreover, the longer-term, sustainable response requires new investments and these will take time to yield returns. Similarly, re-orientaton of markets and of production lines, restructuring of corporate finances, shifts from public to private investors cannot happen instantaneously. And they happen more easily in a growing than in a stagnant economy. There is no doubt that continued availability of net external capital is a vital ingredient in a successful adjustment

process---to cushion the transition, to support new investments and to help restart growth.

I recognize, of course, that the situation in the major debtor countries varies widely. There is a similarly broad range of interests among the banks. There are no universal solutions. But there are many common themes. Let me briefly outline what I think is feasible and necessary, and how the World Bank can help the developing countries to manage their way back towards a growth-oriented strategy while helping to provide the commercial banks a better basis for their decisions and a greater sense of security in the necessary and inevitable transition back to voluntary lending.

Before turning to the specific problems of capital flows and debt rescheduling, I want to simply note the importance of the resumption of sustained growth in the OECD countries and the maintenance of an open international trading system. The point is obvious and I need to elaborate on it for this group---but neither should it be forgotten as we look at the medium-term framework. To grow, and to service their debt, the developing countries must have access to export markets and these markets must be growing. Capital flows cannot offset the effects of stagnant export markets---whether stagnant because of slow growth in the OECD economies or because of trade restrictions---and no likely changes in interest rates will have as powerful an influence on the recovery of the developing countries as variations in export prospects. But adjustments in the developing countries to more open, competitive economies requires a matching willingness to adjust to a more interdependent world economy by the OECD countries.

Let me now turn to the major elements of a system which can help facilitate the necessary flow of external capital:

- First, a medium-term plan for major debtor countries, and others facing major structural changes, which is consistent with continued economic stabilization while providing for a resumption of growth;

- Second, an effective system to monitor progress towards agreed goals;

- Third, a more coordinated approach between lenders and borrowers;

- Fourth, a restoration of project-based lending to keep those banks which have, for institutional reasons, a strong preference for this in the system;

Fifth, a reduction in the uncertainty about annual debt service requirements, despite floating interest rates, to permit a better planning of external capital requirements during the period of adjustment.

Let me comment briefly on these points.

A medium-term framework.

The adjustments which have taken place in the last several years have been essentially to deal with the short-term aspects of major disequilibria in the economies of the principal debtor countries. The steps which have been taking place, such as the establishment of more appropriate exchange rates, reductions of budget deficits, and the beginning of a more realistic relative price systems must be continued. But short-term adjustment programs can be no more than the basis for a longer-term program which seeks to restore growth as rapidly as possible within a continued stable framework. In order to achieve that requires going well beyond those essential elements which make up stabilization programs. Adjustment policies cannot produce lasting results unless they are placed in a longer-term structural perspective and firmly rooted in institutional changes. And this will require even closer collaboration between the Bank and the Fund in the years ahead than has been the case in the past three years.

In the past three years, generally in support of stabilization programs, the World Bank has substantially increased its policy-based lending. It now accounts for about 25% of our annual lending of $15 billion. Our experience in this clearly shows that much needs to be done beyond getting the major economic aggregates right. Our policy-based lending has involved structural adjustment loans to such countries as Turkey, Thailand, Korea, and the Philippines, Export Development Funds loans to Jamaica, Mexico and Brazil, loans to help restructure agricultural policies in Brazil, the Philippines and Yugoslavia, and loans to restructure industrial and trade policies. In our policy-based lending, particularly in our structural adjustment loans, we have focussed on three main areas:

— the improvement of trade regimes to increase the competitiveness and profitability of exports reducing tariffs on imports, reducing levels of effective protection, and providing financing for exporters;

— increased mobilization of domestic resources by emphasizing more efficient operations of public enterprises, reduction in a wide-range of subsidies,

raising of tariffs for public services, and the establishment of real interest rates;

— improvement in the efficiency of domestic resource use, by obtaining agreement on the size and composition of the public sector investment program; agreement on the application of profitability criteria in the review of public investments; improvements in the management of large-scale public sector; elimination of biases against the private sector and the export sector; and agreement on the devolution of investments from the private sector.

Such lending has been an important complement to the Fund's stabilization program and has pushed reforms beyond those covered in the Fund's standby agreements.

We need to continue the development of this type of lending if long-term development is to be restarted.

Let me give you some specific examples of why such actions are central to the medium-term viability of the borrowers. In many countries, a major drain on the budget has been the mismanagement of public enterprises. Together with the Fund, we have succeeded in reducing the access of these enterprises to the budget or to special borrowing facilities in the Central Bank. But this, by itself, is not enough. Equally important, the levels of protection for their products must be reduced to provide realistic yardsticks of efficiency, and to avoid having profits generated by passing the costs of inefficiency on to the consumer through monopolies. For the the longer term, it is also important to recognize that these enterprises often do not have either the managerial or the technical capacity to quickly become self-sustaining profit-making enterprises. Important first steps clearly are to give them price autonomy and to insist that managers are held responsible for making profits. But these first steps must be supplemented by managerial assistance to turn these enterprises into profit-oriented entities, to give them the capacity to resist the inevitable resurgence of political involvement, to have them restructure their production lines—in short to equip them to compete effectively in a market environment. Unless this is done, the adjustments which have been made, including the reduction in their investment programs, are likely to be short-lived because few governments will (can afford to) allow many of these enterprises to go bankrupt.

Another example is in the agricultural sector. Agreement is reached relatively easily on the principle that producers should be given adequate incentives. But the setting of agricultural prices is a difficult task. It involves minimum support prices and the operation of bufferstocks, interest rates on agricultural credit, the price of fertilizer and other

inputs. The restructuring of the research and extension services to assure that farmers, who now face a very different price framework, have the technical knowledge and the capacity to respond productively to these changed signals; the improvement and extension of infrastructure to allow increased production to be marketed, and the modernization of marketing systems to allow the products to be brought to the markets efficiently. In countries such as Jamaica, this has involved the dismantling of a number of public sector enterprises devoted to marketing of agricultural products, in Brazil and Mexico agreements on positive real lending rates. And, perhaps most important, it means the establishment of a system which enables the country to review regularly the appropriateness of its agricultural prices. In the absence of this, inflation and changes in exchange rates and other relative prices very quickly undermine the objective of maintaining competitive border prices.

Similar institutionalization of change needs to take place in public expenditures. Limiting public investment is one thing, reducing the demand for investment capital and for budget support of operational deficits, another. But it is this aspect which is vital to maintaining, in the longer term, a reasonable public expenditure program. Operational deficits will not disappear permanently, and the self-generated portion of investments of public enterprises will remain inadequate unless processes are changed. The establishment of appropriate tariff schedules, whether for transport or electric power, is a difficult technical job and a continuing one. Our experience is that even when changes are made in response to immediate requirements to raise resources, governments have a tendency to believe that these are once-for-all changes. The establishment of systems which permit electricity tariffs to be increased regularly in response to changing long-run marginal cost of power supply or to reflect changes in comparative fuel prices, is essential. Governments or power authorities are often not equipped to undertake the analysis, or if undertaken, to get the increases approved. In our programs, we have insisted on the restructuring of such tariffs and have provided assistance to develop systems which will provide regular reviews as a basis for more automatic adjustments.

The same is true of the public investment program. Reducing its size often is an important component of the stabilization program. But the problem is not only one of volume; even more important for the longer term is the composition and the process by which new public investments are decided on. The establishment of review systems which evaluate public sector investment proposals on sound economic and commercial criteria is essential if control is to be maintained. Our experience has been that from 25-35% of public investment projects are no longer consistent with current resources availabilities, priorities or comparative advantage. Yet, there is the danger that such projects will be merely postponed or their completion suspended—pending increased financial resources, unless the criteria and decision-making processes are changed.

The central point is that to move beyond stabilization, and to facilitate the resumption of growth, requires a carefully worked-out medium-term program which is realistic in terms of available resources and appropriate in its priorities; includes continues progress in the implementation of appropriate macro-economic, sector and sub-sector policies and the strengthening of institutions to implement these objectives. And such a program can provide a framework for assessing performance and creditworthiness in the medium term---provided it can be monitored.

Monitoring

There is always the fear, and the risk, that intentions will not be implemented. The further one moves into detail, the more difficult monitoring becomes. Credit ceilings, and total public expenditures, are relatively easily monitored. But agricultural prices, the multitude of public tariffs, and the extent of effective protection are more difficult to track. Even more elusive are such things as the effectiveness of debt management, the application of sound investment criteria and the capacity for medium-term budget planning. Yet our experience with our structural adjustment lending shows it can be done. Agreement on objectives, supplemented by a schedule of specific steps to be taken, has provided an adequate basis for assessing progress in these areas and for reaching decisions on the release of the tranches. Of course, the less quantified the objective, the greater the degree of judgment as to what constitutes satisfactory progress; and the broader the scope of actions, the greater the need for flexibility in judging which are truly basic measures and which measures, through important, can be delayed slightly without undermining the objectives of the program. And, of course, expectations must be realistic. The anticipated results of any program can be overwhelmed by unforseen circumstances. Sometimes, this will require further adjustments in total demand and changes in policy; sometimes the judgment will be that the program is sound, the changes can be weathered and the time frame needs to be adjusted.

The relevance of the monitoring, and its utility, will also depend on what is at stake. If the focus is on short-term factors that is what decision-makers in the country and in the markets will concentrate on. But if it is correct that the interest of the lenders is in security for the medium-term ---matching their exposure---, then it is essential that they be concerned with all aspects of the medium-term program and that their lending decisions will recognize good performance beyond short-term demand management. The Bank, together with the Fund, is in a good position to help countries develop such programs and to monitor them effectively.

More Coordinated Approach

Medium-term programs and better monitoring can provide a basis for more effective collaboration between borrowers and lenders in this period of uncertainty. It is anomalous that thousands of hours are spent on the formulation and negotiations of debt reschedulings while very little time is spent on developing a mutual understanding of the basic issues of the country's long-term objectives, its policies, the realism of its plans and the efficacy of its economic management. For a few countries (e.g. Colombia and Korea), the Bank has helped to arrange meetings between the country's economic management team and senior officers of its principal lending institutions, in which the IMF participates. But much more of this is necessary. Such fora should become regular features for all major borrowers. If the problems are long-term, as we all recognize they are, if the concerns about creditworthiness and the increase in exposure will remain central to most banks, as they are likely to, and if the world economy continues to be volatile, as is probable, then a more regular, systematic exchange of views between borrowers and lenders surely serves the interests of both. It is, in fact, a necessary ingredient of a medium-term program, in which lenders can have confidence that it is reasonable and practical and it provides both borrower and lender with assurance that the program can be financed by rescheduling of debt and new lending.

Increased Certainty about Debt Service

Several of the adjustment programs of major borrowers are exceedingly sensitive to changes in the interest rate. Relatively, minor variations (2-3 points) can make the carefully designed programs and associated financing packages unrealistic. At the same time, there is growing concern about the suitability of the maturities of rescheduled debt and new lending. In the Bank's new cofinancing instruments, we are experimenting with an approach which I believe may be more generally applicable. Simply put, it involves agreeing on a fixed semi-annual payment schedule for the life of the loan, based on a reference interest rate which can be set at current market rates or below. To the extent actual interest rates exceed the reference interest rate, the semi-annual payments will consist of a higher-than-planned portion of interest and less principal will be amortized. The World Bank accepts the contingent liability thus created and finances it. We incorporate a take-out option so that the commercial lender can retain the asset in light of conditions at the end of the original amortization period. If the reference interest rate is higher than the actual over the life of the loan, the loan simply is amortized sooner. It is feasible, and indeed desirable, to cap the variability in both directions. On the downside, to avoid excessively short maturities; on the upside, in order not to have an excessive amount of principal unamortized at the end.

While this approach may not be suitable in all countries, or for all lending, I believe it can make an important contribution to increasing the certainty in planning annual programs and thus facilitate the regular payment of interest by borrowers. It may be of particular interest to regional banks. The World Bank is prepared to join in the expansion of such arrangements, either by agreeing to finance the potential contingent liability or to guarantee it. Even for larger scale borrowers, the contingent liability would be well within the range of our annual lending programs to these countries. Moreover, we would expect that by the end of the established maturities, many lenders would feel comfortable to retain these assets.

But, in addition to dealing with the variability of interest rates, it is also necessary to deal more realistically with the restructurng of the existing debt. It is unlikely that the major borrowers can digest the bulge in maturities which lies 2-3 years ahead. It is clear that, if they make good progress, they should not be asked to do so. Multi-year restructuring of those maturities can make an important contribution to a smoother growth path. Here, I believe the Bank's guarantee authority can assist to increase the security of outer year's maturities. It should be feasible to structure such multi-year rescheduling contingent on continued satisfactory performance on the medium-term adjustment and stabilization program.

Restoration of Project-based Lending

Finally, a word about project-based lending. I believe there is general agreement that involuntary lending, in the context of adjustment programs, is not a satisfactory long-term arrangement. This is particularly true of the regional and secondary banks. The necessary continued expansion of net lending to the developing countries requires a more direct relationship between lenders and borrowers, and between the loans and actual investments, to help restore confidence. In countries making good progress in their adjustment programs, this transition can be relatively rapid. But it is also necessary to start this process in the more difficult cases—where recovery may be slower.

What it needs to involve is a set of measures which will help to protect both borrowers and lenders against downside risks. The ones I have sketched out, and permutations of them, can help. But these measures also need to include realistic debt restructuring, including some "headroom" subject to effective performance, more realistic maturities, and a diversification of financial instruments so that lenders, with different interests and objectives, will willingly hold them. For some, this may involve project-based lending, for some, a more general link to the approved investment program of a particular sector, and for others, securities which can be marketed.

The World Bank can assist in this transition by using its existing project portfolio, its knowledge of the investment program of the principal infrastructure agencies, and its project expertise to develop project or sector-based loans. For instance, it is feasible to review the investment program for an electric power sector in a country, agree on its scope, composition, and priorities, for the next several years, and identify the cash requirements of projects under implementation for, say 1985 and 1986. Such a package of projects might be an attractive basis for lending to some banks, who would find a more specific project identification of interest. This could be done in association with a World Bank loan—through our joining in the syndication—or without but still based on our analysis and, possibly, our supervision. Similar arrangements are feasible in other sectors, or for specific projects and need not be limited to public agencies. And such an approach is practicable both as a component of a restructuring arrangement with new organized lending or as a component of financing a medium-term program.

Let me summarize briefly. The problems of the debt overhang and the adjustment to changed external circumstances is a long-term problem. Much progress has been made in the restoration of economic stability. But that is not enough. We must find a way to resume growth in these developing countries because without it neither political nor economic stability is possible nor will the satisfactory management of their debt be possible. Our expertise is precisely in the areas which now require attention—complementing improved short-term management with the development of a medium-term framework, the monitoring of its implementation, providing expanded opportunities for project-based lending and increasing confidence in, and marketability of, financial assets. The broader use of our guarantee authority, together with some creative financial engineering, can assist to make financial instruments more attractive to lenders—by reducing the risks, particularly for the later years—and increase their marketablity. But our effectiveness will depend not only on the interest of our shareholders in the World Bank playing this role, but also on the recognition by the commercial lenders that good performance in implementing a medium-term program is a basis for expanded lending.

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

# OFFICE MEMORANDUM

OPS/MC84-22

TO: Members of the Managing Committee

DATE: May 11, 1984

FROM: Ernest Stern, SVP, Operations ES.

SUBJECT: Conference at the Federal Reserve Bank of New York

I attended a meeting at the Federal Reserve Bank of New York last Monday and Tuesday, on the subject of LDC Debt and Growth and its implications for commercial banks and bank regulators. I participated in the opening panel with Mr. de Larosiere and the Governor of the Central Bank of Turkey. In the afternoon Lou Preston of Morgan Guaranty and Fred Bergsten spoke.

I bring this to your attention because several points of interest emerged:

a) We are clearly the most pessimistic about the adjustment process and the resumption of growth. The IMF scenario and the views of the commercial bankers are much more upbeat.

b) Most of the concern about the debt problem and the resumption of growth, at least in the minds of the participants (copy of the participants' list attached), is sharply focussed on Brazil, Mexico and Argentina. Their implicit view is that the problems of any lesser debtor countries are not likely to have a significant adverse impact on the system. While there was some discussion about the political and social consequences of excessively sharp adjustments, the common view seemed to be that to be successful, economically and politically, adjustments had to be done quickly. The example of Mexico, and the prospects of Brazil, were cited frequently as evidence of the fact that resumption of growth was not far away if adequate adjustment measures were taken.

c) Adjustment continues to be thought of pretty exclusively in terms of current account balances and budget deficits.

d) Only Bergsten argued strongly that the crisis might not be over because the projections used were only mid-points of ranges and the variations could be quite large. He pressed repeatedly on what contingency plans might be in case interest rates rose or another recession occurred. His line of argument got no response.

e) The issue of net transfers was raised and was greeted by a veritable fire storm of negative comments, from several Governors and other participants. The World Bank was also attacked by several speakers for having endorsed this concept. Since I am

not aware that our official view is other than that interest payments are part of current charges, and since my own opinion that the net transfer concept is intellectually inappropriate has been discussed in the Managing Committee, I sought to defuse the criticism by noting that the net transfer concept was not central to our analyses nor did we use it to design our country lending programs.

f) There was very broad recognition that multi-year debt rescheduling was desirable and feasible in countries where there was good performance in the adjustment process.

g) There was also broad agreement with de Larosiere's proposals that the Fund stay in the system for monitoring purposes, even if no new Fund resources were required in a year.

h) Our proposal for a contingent liability approach, with fixed semi-annual payments, received a great deal of interest, as did the possibility of use of our guarantee authority.

i) A number of other approaches were discussed, such as ways to allow the smaller banks to exit gracefully from involuntary lending arrangements, use of floating rate notes (not favored) to increase marketability of LDC assets, to net capitalization of interest, which was strongly opposed by the US bankers persent.

Attachment

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LDC FINANCE -- MANAGING THE WAY BACK

May 6 - 9, 1984

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CENTRAL BANKS AND INTERNATIONAL INSTITUTIONS

AUSTRALIA

Reserve Bank of Australia — R. A. Johnston, Governor

BANK FOR INTERNATIONAL SETTLEMENTS — Alexandre Lamfalussy, Assistant General Manager and Economic Adviser

BRAZIL

Banco Central do Brasil — Affonso Celso Pastore, President

CANADA

Bank of Canada — G. K. Bouey, Governor

FRANCE

Banque de France — Jacques Waitzenegger, Director General, Foreign Department

GERMANY

Deutsche Bundesbank — Wolfgang Rieke, Director, International Department

HUNGARY

| | |
|---|---|
| National Bank of Hungary | Janos Fekete<br>First Deputy President |

ITALY

| | |
|---|---|
| Banca d'Italia | Lamberto Dini<br>Director General |

JAPAN

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|---|---|
| Bank of Japan | Takeshi Ohta<br>Director<br>Foreign Department |

MALAYSIA

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| Bank Negara Malaysia | Abdul Aziz bin Haji Taha<br>Governor and Chairman of the Board of Directors |
| | Andrew Sheng Len Tao<br>Manager<br>Economics Department |

MEXICO

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| Banco de Mexico, S. A. | Miguel Mancera Aguayo<br>Director General |

NETHERLANDS

| | |
|---|---|
| De Nederlandsche Bank N. V. | Willem F. Duisenberg<br>President |

SAUDI ARABIA

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|---|---|
| Saudi Arabian Monetary Agency | Hamad Saud Al-Sayari<br>Acting Governor |

SINGAPORE

| | |
|---|---|
| Monetary Authority of Singapore | Richard T. T. Hu<br>Managing Director |
| | Koh Beng Seng<br>Manager<br>Banking and Financial Institutions Department |

SWITZERLAND

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|---|---|
| Banque Nationale Suisse | Pierre Languetin<br>Vice President of the Directorate |

TURKEY

| | |
|---|---|
| Turkiye Cumhuriyet Merkez Bankasi | Yavuz Canevi<br>Governor |

UNITED KINGDOM

| | |
|---|---|
| Bank of England | C. W. McMahon<br>Deputy Governor |
| | Anthony David Loehnis<br>Executive Director |
| | W. Peter Cooke<br>Associate Director and Head of Banking Supervision Division |

UNITED STATES

| | |
|---|---|
| Board of Governors of the Federal Reserve System | Paul A. Volcker<br>Chairman |
| | J. Charles Partee<br>Member |

UNITED STATES (cont.)

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|---|---|
| Board of Governors of the Federal Reserve System | Henry C. Wallich<br>Member |
| | Michael Bradfield<br>General Counsel |
| | John E. Ryan<br>Director<br>Division of Banking Supervision and Regulation |
| | Edwin M. Truman<br>Director<br>Division of International Finance |
| Federal Reserve Bank of Minneapolis | E. Gerald Corrigan<br>President |
| Federal Reserve Bank of New York | Anthony M. Solomon<br>President |
| | Thomas M. Timlen<br>First Vice President |
| | Sam Y. Cross<br>Executive Vice President<br>Foreign Group |
| | Ronald B. Gray<br>Executive Vice President<br>Bank Supervision Function |
| Federal Reserve Bank of San Francisco | John J. Balles<br>President |
| International Bank for Reconstruction and Development | Ernest Stern<br>Senior Vice President<br>Operations |

| | |
|---|---|
| International Monetary Fund | Jacques de Larosiere<br>Managing Director and<br>Chairman of the Executive Board |

## OTHER PARTICIPANTS IN SELECTED SESSIONS

| | |
|---|---|
| Citibank, N.A. | William R. Rhodes<br>Senior Vice President |
| Davis Polk and Wardwell | Bruce W. Nichols |
| Institute for International Economics | C. Fred Bergsten<br>Director |
| International Bank for Reconstruction and Development | J. William Stanton<br>Senior Adviser<br>External Relations Department |
| International Monetary Fund | Richard D. Erb<br>U. S. Executive Director |
| Morgan Guaranty Trust Company | Lewis T. Preston<br>Chairman of the Board |
| Price Waterhouse | J. Thomas Macy<br>Partner |
| Securities and Exchange Commission | John S. R. Shad<br>Chairman |

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(4)

1984 Senior Operational Managers Retreat

Closing Remarks by E. Stern

We live today in a new and substantially different economic environment compared to the relative stability of the post-war economy we had grown familiar with, and in which we formulated our thinking about development--both as individuals and as an institution. The increasing diversity, complexity and volatility of the global economy now seems to be not a temporary but a permanent feature of our lives. And this changed and changing economic environment requires massive structural adjustments on the part of our borrowers. Now change is not new to us--it is, in fact, the essence of development--but the pace and rapidity of the adjustment which must be undertaken is qualitatively different from what we have known before. It is in the context of this environment that we must decide on how to shape the future of the World Bank.

A volatile environment and an increased number of participants in development finance requires that we be precise about what we, as an institution, can contribute. Let me suggest three principal areas. First, we can provide global perspective, since we are unique in having a global range of experience with all types of development problems and issues. Second, our close relationship with borrowers through our extensive project work in many sectors, equips us particularly well to assist with problems of policy implementation, institutionalizing the changes required by structural adjustments, and helping to develop the flexibility of management increasingly vital to sustained growth in developing countries. Third, our development experience enables us to place current problems in a longer term perspective, balancing concerns about current crises with the need for continued attention to such long-term issues as population, human resources and balanced growth.

As we think about the future and the future role of the Bank, we must bear in mind that not all countries have an equal capacity to react--and even less so the capacity to react quickly--to changes in the global environment. We need to be sure, therefore, that we remain flexible, and we need to be prepared to exercise a high degree of differentiation in our approach to different borrowers to ensure that our actions are realistic and sustainable in the longer term.

While we must be aware of, and responsive to, the current conditions, we must not let ourselves become overwhelmed by the current crises nor mesmerized by current fashions in responding to those crises. While it is fair to say that all of our borrowers have problems, not all countries are in crisis. What is more, all countries in crisis will not stay in crisis; so despite the preoccupation of our borrowers and ourselves with the problems of the moment, we need to remind ourselves on a regular basis that development is, and remains, a long-term business. We need to remind ourselves that our job is not just crisis-management, although that is sometimes necessary. We must not lose sight of our fundamental objective, which is to maximize the impact of the Bank in assisting our borrowers to promote balanced economic development.

Now, in doing this we will need to broaden the tools we have to assist our borrowers. Improved aid coordination, cofinancing, closer coordination with our sister institution, the IMF, a more flexible range of lending tools, including increased policy-based lending, further movement towards country focus, and assistance that is appropriately linked to country responsiveness.

Effective functioning in this new environment will require changes in our attitudes—extending even to semantics. We must stop talking about our output as "projects". First of all, our output is not "projects", it is much broader than that. It includes an unmatched array of services and technical assistance which culminates in specific lending operations. We do ourselves a disservice by describing our contribution too narrowly. To call ourselves a "project institution" is to misstate our function. Second, describing our output as "projects" continues the sterile distinction between projects and non-projects. We finance operations — operations which run the gamut in their policy aspects from the macro-economic to the appointment of technical staff, in their disbursement profiles from one to eight years and in the specificity of pre-identified investments from power plants and roads to lines of credit for small investors and imports for agriculture and industry. We need to recognize better the essence of our comparative advantage. The strength of our operations rests in the grounding of change in reality through investments, and in helping countries to institutionalize their policy intentions through improvements in processes and organization. The fundamental objective is to put in place a set of operations that are properly done and that reflect the maximum feasible improvement, given the particular environment. In this respect our policy advice is a key ingredient. In this expanding area of activity we need to remind ourselves, however, that our policy advisory role is not yet fully tested, particularly at the sectoral and macro-economic level and we still have much to do in staff development to enhance our capacity. Moreover, we are advisory officials without final responsibilty for the policy actions we recommend. We are bureaucrats, although also, I hope, good analysts and sensible people. Nevertheless, our policy advice has its limits and our experience is not with the specific situations faced by decision-makers in borrowing countries. So we need to be aware that our advice is just that: suggestions, not directives.

As we increase the amount of policy-based lending, we need to look carefully at the extent of conditionality in these loans. The key issue is not <u>how</u> agreement on policy change is recorded but whether policy change is undertaken and at a reasonable pace. To do this, we will need to undertake extensive preparation with more emphasis on economic and sector work, and on policy dialogue with our borrowers. We will need to adapt our policy packages flexibly and specifically to the conditions in each country. Moreover, the policy content of our assistance needs to be spelled out and mutually understood, to avoid uncertainty on our part, or

on the borrowers', as to what the necessary changes at the macro or sectoral level are. The conditionality also must be monitorable, and we must be careful to design conditionality in such a way that we can be firm in enforcing it. This is at the heart of our credibility if we are to develop such a thing as a "World Bank approved medium-term program" in a country, as a basis for lending by others.

As we continue to focus and redefine our role in this changing environment, we need to remind ourselves too that we are not, and cannot try to be a full service bank in the sense of providing all services to all borrowers. We need to understand better and be more responsive to the needs of our borrowers, but in a much more explicit framework of priorities and objectives. And we need to understand the competition better. We are not the king of the roost. We have encouraged and we welcome the expanded role of regional banks, commercial banks, and the more active role of other development agencies. But welcoming an expanded role for them also means that we need to take greater cognizance of their ideas about reform and their proposals for adjustment. An expanded role for others is welcome, not only for its own sake, but precisely because we cannot do everything ourselves. Our resources are limited and this means that we must become more selective. We have not been terribly good at being selective in the past, largely because the needs we see are so immense, and because the reasons that all of us are in the Bank and in the development business in the first place are the very reasons we feel compelled to do something about those needs. But we need to learn, and learn quickly, how to make choices that are often difficult, and to set priorities, and to make the criteria and priorities clear both to our borrowers and to our own staff. To make maximum impact with limited resources requires that we become more cost-conscious than ever before, to ensure that these limited resources are used effectively. Then, too, we are coming under closer scrutiny as an institution and we will need to demonstrate the utility and efficiency of our work if there is to be any future growth.

All of this means that we will need to effect substantial changes in our own attitudes and in our behaviour. We tend to manage bureaucratically and not entrepreneurially. This central feature has many facets. It means that we tend to avoid decisions. For instance, if one of those "windows of opportunity" opens, that has been mentioned frequently in our discussions, and we want to and should respond quickly, most managers tend to respond by saying, "I need more resources urgently!" We do this even though we know that not every task in our current work program is of equal priority. If we want to respond quickly, in most cases it must come at the expense of other activities within our planned work programs. We need to judge: is it worthwhile? are the changes sustainable? is what we want to pursue consistent with experience? is it consistent with long-term development objectives? are we breeding more dependency by rushing into the breach? And then, if we are persuaded that a quick

response is of high priority, we must ask how do we do this within the existing resources at our disposal. To assume that every new activity will elicit incremental resources avoids the need for choice; it makes decisions easy by not requiring any. There is evidence of bureaucracy versus entrepreneurship also, in our frequent failure to recognize that indecisiveness is expensive. On the lending side, for example, we often stay with projects too long. The reasons for this are always sound, in a way, but the result is rising costs and diminished credibility. We are bureaucrats and not entrepreneurs to the extent that we avoid honesty with our staff — and not only with respect to the AER process. We tend to avoid offending an economist, for example, by not telling him that his two-year effort is too long, too diffuse and beside the point. Instead, we go off and supplement what he has done with policy briefs and aides memoire and more missions. This not only escalate costs. It does not help the economist to be more satisfied professionally. On the contrary. And the bureaucratic approach means we still too often pass the buck. I never cease to be amazed at my luncheons with Division Chiefs, at how strong their impression is of the impotence of their managers. Too many of them are unaware that <u>their</u> Vice President determines their budget (centrally, we focus largely on the marginal increments, which amount to 2-3% of the total budget); that numbers of projects remain important only because their Vice President or Department Director has a country lending program he wants to maintain, <u>not</u> because the numbers are arbitrarily imposed from above; that personnel actions and practices reflect the decisions of <u>their</u> managers and not the mysterious machinations of a central staff. They seem unaware that it is their managers who have the responsibility, and who determine, their suitability for promotion or non-promotion and that it is their managers who participate in, and indeed approve, every change in policy.

And there is still too large a gap between what we say and what we do. This is not the result of an unusual degree of hypocrisy on our part, but because we rebel against the many dilemmas inherent in our job. We want to promote the growth of individuals through exposing them to different experiences, but not at the expense of unit stability. We want to have clear objectives, but we deplore the time required to frame them and integrate them with the objectives of other units; we want to have a better functioning system, but we hate the details we must deal with to establish it. We want to have a well-managed unit in a decentralized system, but we, in turn, hate to delegate and want to deal with the most interesting substantive issues ourselves. We love to talk about more streamlined processes, but do not take the time to teach our staff how to do it. We continue to believe that everything depends on the "system" instead of on us. We love to talk about being unappreciated, but we hate to make the time available to explain ourselves. We hate the griping and complaining that goes on and its impact on morale, but are slow to accept, and even slower to publicize, responsibility for the joint decisions we

take. And we often fail to accept that the institutional objectives are the framework for our managerial independence.

All of this does not mean that we need to do more in the administrative area. What we need is to do things differently. It does not mean that we cannot innovate. We need to innovate, but in consultation with others so that our innovations will be replicable by others. We need, in short, to accept responsibility for institutional decisions and to accept the consequences of our actions.

Now let me say just a word about our image, which has been referred to a couple of times in the discussion. Changes in our image have resulted partly from changes on the outside and partly on the inside. Externally, others have become increasingly competent and we can no longer dictate with all-knowing, superior wisdom. These are good developments. We certainly have not become worse. Quite the contrary, I think. But others have become better, so that we no longer are preeminent. Our image depends primarily on the quality of our work and on its perceived relevance in the long term, and on our utility to our borrowers. It requires intellectual leadership and managerial competence. This is a joint responsibility of all of us. This does not mean designing short-term, popular responses to current crises — that is not the way to maintain our reputation as a preeminent development institution.

I do not know whether our present environment is more or less complex, or more or less fragmented in a historical sense. A good case has been made on both sides of that argument. I do know the present environment is tough, it is competitive, it is very complex, and the psychic appreciation of a job well-done by the outside is modest.

But let us not let these problems become excuses. Let us not be overwhelmed by the uncertainty and settle for inaction. Let us not conclude that change is hard to bring about and therefore we should not try, and let us not content ourselves with settling for less than the very best. These are challenges, professional and managerial, and it demands the best of us and that we get the best from the very talented people we manage.

The essence of adjustment is flexibility. This is as true for us as it is for developing countries. The answer to the dilemma of "thinking the unthinkable" is to have a system which can detect turning points early so we can react quickly; be willing to consider any approach; and keep an open mind on both what is needed and what is feasible. The future is not predetermined — how we respond to the problems of today and tomorrow is what will determine our future.

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THE WORLD BANK

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Presentation of Ernest Stern

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Friday, June 22, 1984

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P R O C E E D I N G S

MR. STERN: Thank you, Frank, and ladies and gentlemen. What Frank just said is just a cover story, as I'm sure you'll recognize, for the fact that I hadn't intended to be and wasn't scheduled to be the dinner speaker. But unexpected circumstances at the Bank kept me there this afternoon and Mr. Benjenk was kind enough to turn his text for the after-dinner speech into a session this afternoon.

So here I am without a prepared text, and therefore, as Frank put it so nicely, I will be very brief and we'll have a free-for-all instead. Also, it's the end of a day-and-a-half and the weather outside is beautiful. The lake looks tempting. The swimming pool, I haven't seen yet, but I'm sure it's equally tempting; it's another inducement to be brief.

In the last day-and-a-half, as I understand it from looking at your schedule, you've heard about Africa; you've heard about the world economic environment. You've heard about capital flows; you've heard about factors affecting the growth of the developing countries.

And I must confess, looking at that imposing list of titles, I couldn't figure out anything whatsoever that you haven't heard about yet, and therefore I feel terribly hesitant to even try to add to your store of knowledge.

I would simply like to introduce whatever questions you may have by some brief comments on what I think is the central problem in the developing world, although it has many manifestations, which is the adjustment process, and that I think also underlies very much what the World Bank is doing today and what we necessarily must be doing in the years ahead.

First of all, the adjustment process or adjustment means many things to many people. I think it is important as we look at the developing world and as we look at the future and look at today's problems to understand that adjustment is a continuing process; it is a continuing process at all times.

And what is different today is that the speed of that adjustment has accelerated a great deal. It is not a problem that is unique to the developing countries. OECD countries, industrialized countries -- Europe, the United States, Japan -- face adjustment difficulties which are also complex, which also affect many people, which also are politically difficult.

Obviously, their adjustment processes are taking place in an environment of much more resources, therefore much more flexibility, many more options. But there is no doubt that as the world becomes more interdependent -- something that we've all recognized some time ago and I think we all

consider to be a relatively good thing -- the other side of interdependence is adjustment.

Industries which have a comparative advantage in one country today may not have that comparative advantage in that country five or ten years from now. There are many shifts which all of you are familiar with which have already taken place where particular products, such as textiles, ships, steel, are produced most efficiently, and this process will continue.

It means, or course, adjustment in the industrialized countries in terms of retraining people, moving to higher value-added commodities, more technologically advanced commodities. And this is precisely the process which the developing countries are also facing.

Now, their problem has been compounded, of course, in the last several years, as you know, by a recession in -- well, starting much earlier, of course, by major changes in the price of energy, followed by a very rapid and extraordinary level of rate of increase in inflation, which then was followed by a worldwide recession as the industrialized countries tried to fight inflation and reduce its level, which in turn led to a very adverse shift in terms of trade, lower commodity prices, and much to everyone's surprise, continued high levels

of interest rates.

And the adjustment process which the developing countries have faced, like that in the industrialized countries, is a long-term process. We're looking today in the early '80s, and I think for a couple of years ahead, at a very acute phase of that adjustment process because it means adjustment not only in the normal sense of evolution of economic growth and increasing comparative advantage for developing new skills.

It also means dealing with the overhang of the 1970s -- an overhang which was generated by the shift in energy prices, and then that was followed by a growth in debt, which is the immediate problem which faces many countries, not only the middle-income countries, which is what everybody writes about all the time because their debt is very large in dollar terms and whether or not they pay on time -- pay on June 30th or July 1st -- affects the income accounts of major banks, money center banks, and affects the workings of the international monetary system.

But the debt problem is equally as difficult in Africa, and there it gets very little attention because the amounts are very small; they don't worry any big banks. But for the countries concerned, the debt servicing requirements in

Africa are every bit as high as they are in Latin America, and every bit as much a problem of adjustment as faced in the middle-income countries.

Now, the adjustment process -- as I've said, it's a global one. It's a long-term one because these changes do not come easily, and it is essentially a problem of institutional changes which are politically sensitive, which affect different income groups differently, and which are therefore very often hotly contested.

And what it really boils down to is one looks at which countries are likely to be successful and which ones are not. It boils down to the question of how they manage their development processes, and in this what I think stands out as the paramount feature to look at is just how flexible is the decisionmaking process in individual countries.

The world today is a very volatile one. Many of the problems which the developing countries face today, whether they're middle-income countries or countries in Sub-Saharan Africa, have arisen because countries have not been flexible in the way they've managed their economies.

They have believed that changes are cyclical; that if they maintain their prices, maintain their exchange rates, maintain the composition of their investment programs, this

year or next year or the year thereafter the world will return to normalcy and what was started in a different period would again be justified.

And the problem they have run into is that the world refuses to come back to whatever one defined as normalcy or the good old days, and they get caught out; they get caught out spending a lot of resources, protecting exchange rates which are no longer viable, investing in projects which no longer yield an effective rate of return, subsidizing prices at levels which become a really incredible drain on the budgets, and in many other ways trying to make the world stand still within their own borders, which is simply not economically feasible.

So flexibility is, I think, the important criteria which has been lacking and which is essential if countries are going to succeed in the adjustment process in the future. Now, that's, of course, a nice term; it sounds good, but it involves many, many difficult components.

In order to have a flexible management of the economy, it is first of all, of course, important to have the political will and the political capacity to be flexible. It requires analytical institutions which throw out choices which tell decisionmakers what their options are.

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It requires a pretty broad-based decisionmaking process in which political decisionmakers test and indeed co-opt, if you will, or engage many, many of the different segments in the political and social systems.

And I think it requires growth to make changes. It's very difficult to change things when you're in a stagnant economy.

Now, this set of components of flexibility, of course, exists in very different degrees in diffferent countries. For instance, in Africa flexibility is very hard to come by. With a low level of institutional capacity, analytical institutions are rare. Governments are seen in very much of a monolithic role rather than a participatory role.

Africa has not been growing in terms of per capita income for a decade. The decisionmaking process is very narrow, very limited. Political structures are very fragile, so the decisionmakers do not feel much of a sense of security in taking unpopular decisions.

And these countries are subjected to a great deal of volatility since they do not control the capacity to manage their own exports. They're highly dependent on what happens in the world economy which is beyond their control.

In the middle-income countries, you have a very different set of factors at work. Generally, these countries have grown in the '70s and in the early '80s. They do have analytical institutions which can throw up alternatives. The decisionmaking process often is much broader.

But even there the question of political will and the willingness to look at alternatives has not always been present, and they have not always been able to bring it to bear effectively and on a timely basis.

And the basic lesson, I think, of this period of difficulty starting in the early 1980s is precisely that those countries who have been able to face reality, who have been able to muster the political will to undertake changes quickly, who have been able to translate that political will into a broad set of agreements involving most, if not all, of the population -- those countries have succeeded very well.

And those who have managed more flexibly have, in fact, continued to grow, despite the period of recession and despite the uncertainty in the world economy.

Now, if you look back at this series of adjustments, I think we draw or we focus on three basic elements. One that I have already mentioned in the institutional capacity of governments; secondly, money; and thirdly, policies.

It is very clear that without good institutions and without a willingness to adopt policies, countries cannot survive effectively in what is, and I'm sure will remain, a very volatile world economy.

And it's these latter two areas, the institutional side and the policy side, where the World Bank places a great deal of emphasis in its lending operations and in its relationship with its member countries. And it's these areas in which we have focused particularly strongly in recent years to help strengthen institutions, to help governments understand their options, and to help them initiate the policy changes which are essential if they are to realign their development strategies to be relevant in a period of change.

Now, the third element is also crucial. Advice is one thing; free advice, as you know, it is often said, is worth exactly what it costs. And adjustment by itself is not a free good. Efficiency, better management of institutions -- all of these are not a substitute for new investment; they are not costless.

You cannot change an investment pattern in a country, you cannot change an industrial structure, you cannot change an agricultural development strategy, without money. It requires an adequate flow of capital. Part of that obviously

has to come from internal savings; part of it has to come from external capital flows.

New investment to reorient industrial strategies, industrial outputs, take time before they yield their products. And in the interim these investments must be financed and, more importantly, in the interim raw materials are required, imports of all kinds are required to maintain the output of existing plants.

Most importantly, it is not easy, and in some places it is impossible to undertake policy changes if there is stagnation, if the economy is not growing. It is difficult to make the changes in consumption patterns which are necessary if there is the prospect of no growth for years to come.

And growth requires the inflow of external capital. There is hardly a country in the world which has ever developed without net external capital flows. It would be a mistake for the world as a whole, for commercial banks as financial institutions, for the international donor community on the official aid side to believe that adjustment and improved efficiency of capital use, improved efficiency in the management of existing enterprises, is a free ticket; that any of this can take place without significant and continued inflows of external capital.

Now, as you know, the World Bank is a major supplier of capital, not the largest, although we are in some countries, but a very important one. And what we do, I think, can have an important catalytic effect both in those countries which are dependent on concessional assistance, which is the low-income countries in Africa and Asia primarily, and we can have, I believe, a catalytic effect in terms of what the commercial banks will do in the years ahead.

Now, the World Bank today provides about -- well, this fiscal year, which is about to end in a few days, we have lent almost $16 billion of capital; approximately $12 billion to middle-income countries who are creditworthy, about $3.5 billion, a little more than that, to low-income countries which depend on highly concessional assistance.

Most of our lending, as you may know, goes for agriculture and energy; these are our two largest sectors, agriculture representing about 27 percent of the total of our lending, energy about 23.

And both of these sectors reflect what we think is the essential priority in development strategies. It remains essential even today, almost ten years after the first oil price increase took place, for developing countries to reduce their dependence on imported oil.

E~ually, it is essential, p ticularly in Africa, but indeed in many countries, to modernize agriculture, which still tends to be in most countries the single largest source of employment; to modernize agriculture, to increase its productivity, and to have agriculture serve as an engine of growth.

But this lending volume, of course, is only a small percentage of the capital that is required, and in these times where many countries have difficulty of accessing the capital markets, we have developed a lot of new tools which I think some of you are familiar with or perhaps you have heard about in the course of the last day-and-a-half -- new tools of cofinancing where we associate ourselves with commercial banks in an effort to catalyze increasing capital flows to developing countries.

There are many countries today who have managed their economies well, who ought to be essentially seen as creditworthy, who have, however, great difficulty in entering the capital markets because there is today a great reluctance by banks to lend to developing countries in general, and they make very few distinctions.

We think that our lending both strengthens the economy of the developing country so that they remain

creditworthy, but also it is important as a vehicle to attract the commercial banks to maintain their net lending to developing countries, because without that flow of capital, clearly the readjustment which is necessary and the resumption of growth which is essential will not be possible.

And on the official aid side, for those countries which require concessional lending, here too we play a role well beyond a financial one. Approximately half of all of our IDA projects are cofinanced with other development institutions.

And this is important because not all of these institutions have the capacity to develop projects themselves, and it is more important, I think, because in the low-income countries there is, if you will, an excess of sound advice. Unfortunately, the advice is not always the same.

Donors have different views, obviously, both professionally and sometimes commercially motivated. And to the extent we can get countries to join in with us in financing particular projects, to that extent we can help the countries get a considered view of what is an appropriate strategy.

We can attract more money to high-priority projects, and we can be effective in getting bilateral donors to increase

their lending low-income countries where the resources at the moment are scarce.

Well, with that very brief and very summary overview of the adjustment process, I haven't said anything about what lies ahead, but I'm sure -- at least I hope some of you will ask questions about that.

I'd be glad to address anything about what I've said, and equally to try and deal anyway with any questions that may have occurred to you in the course of the last day-and-a-half and you hadn't had time or hadn't thought about them -- hadn't time to ask them or hadn't thought about them at the time the presentation was made.

(The presentation was concluded.)

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# THE ROLE OF THE WORLD BANK

Address

by

Ernest Stern
Senior Vice President, Operations
The World Bank

at the

Meeting to Celebrate the 40th Anniversary
of the United Nations Monetary and
Financial Conference

Bretton Woods, July 13, 1984

It is a pleasure to join in the celebration of the 40th anniversary of the Bretton Woods institutions. Our founding fathers were a gifted and foresighted group of public servants and the concepts they laid down have guided the World Bank well in the past and remain relevant for the future. Like all good constitutional creators, they provided a framework within which the members and the management could work to adapt specific policies and practices to the unforseen and unforseeable changes in the world economy.

Although this is an anniversary, I would like to discuss the future. But before doing that, let me briefly look back over our evolution from July 1944 to the present.

Thirty-seven years ago almost to the day---July 15, 1947---the World Bank successfully completed its first public offering of $ 100 million 10-year bonds and $150 million 20-year bonds, with a coupon of 2-1/4 and 3 percent respectively! We had precisely one loan on our books---a $ 250 million reconstruction loan to France. Our total capital was $ 10 billion. Today, our authorized capital is $ 74 billion; we have $ 105 billion Bank loans and IDA credits on our books. In the fiscal year just completed on June 30, the Bank committed almost $12 billion in new loans, IDA committed $3.5 billion and the IFC $ 650 million---alltogether, almost 300 individual operations in our member countries. Our annual borrowings in various markets was over $ 11 billion.

The massive growth in the financial numbers (even allowing for what has happened to the 1944 dollar), of course, describe only one aspect of the growth and of the changes we have experienced. An equally dramatic and even more important change has been the growth of the Bank's membership. Forty-four countries were represented at the 1944 Bretton Woods Conference. A few did not remain members of the Bretton Woods institutions, but today, 146 countries are members of the Bank. About 3.3 billion people live in our borrowing member-countries. About 50% of our members became independent states only after 1960. And, our membership today includes the world's largest nation, the People's Republic of China, and some of the smallest, such as St. Kitts and the Seychelles, with population under 100,000; some of the richest countries such as Saudi Arabia, Kuwait, and Sweden, and some of the poorest such as Chad and Ethiopia; some of the industrially most advanced such as the U.S. and Japan and those where significant industrialization still has to begin. The Bank's members today represent the globe's full array of political and economic systems and its rich diversity of cultures.

How wise our founders were to require that decisions by the Bank should be based on "considerations of economy and efficiency and without regard to political or other non-economic influences or considerations." Without such a mandate, it would be difficult to operate in so diverse a context.

It is also interesting to look back at the composition of the Bank's staff because decisions are not made in the abstract, and even "considerations

of economy and efficiency" can mean different things in different cultures, settings and circumstances. In 1950, the professional staff of the Bank was small, only 180 people, with only 7% from developing countries. U.S. and U.K. nationals represented 77% of the total. Today, our total staff is just over 6,000 people; our professional staff numbers 3,100. Thirty-five per cent of our professional staff now comes from the developing countries; half of our Managing Committee is from our Part II members. The U.S/U.K share of the professional staff has shrunk to 36%.

How wise our founders were to insist on the "paramount importance of securing the highest standards of efficiency and technical competence" in our recruitment while paying "due regard to the importance of recruiting personnel on as wide a geographical basis as possible." These twin objectives are the foundation of our excellent staff, and enable us to serve the varied needs of our member countries effectively.

Another major change has been the evolution of the international economy and the growth of international economic institutions---public and private. This does not need much elucidation for this audience. When the World Bank was established, bilateral assistance programs were few and small; and there were no other international financial institutions providing capital for investment in developing countries. But in the 1950s and 1960s, bilateral aid programs evolved and a network of regional institutions developed to assist in the financing of development. Today, despite the rapid growth of the World Bank, its relative importance is less. In Latin America, for instance, the IDB committed $ 3,045 million in 1983, compared to World Bank lending in the region of $ 3,746 million; the Asian Development Bank lent $ 1,893 million in 1983, compared to $ 5,723 lent by the World Bank in Asia; the African Development Bank is growing and the EEC is a major provider of capital. Virtually every industrialized country, and the countries in the Middle East, today have an aid program, and U.N. agencies have substantially expanded their assistance to the developing world. Most important, many middle-income countries obtained access to world capital markets and, from the mid-1970s onward, the commercial banks became the principal source of external finance for the developing countries.

This evolution is a highly desirable one---even though it has reduced the Bank's relative importance as a source of capital and of analysis of development problems. Not only are the needs of the developing countries well beyond the capacity of any single institution, but different institutions can, and do, draw on different perspectives. In the heterogeneity of development issues, there are no universal prescriptions and the diversity of views is an important feature for the borrowing countries. And, although the rapid growth of external debt in the 1970s and early 1980s has created problems, the fact that the commercial markets are open to developing countries, and that they are an important and integral part of

the international financial system is highly desirable. Free access to these markets is precisely what our founders had in mind.

I need not dwell, of course, on the major changes in the global economic landscape since 1944, or how this affects the Bank. The economic world today is inter-connected by trade, technology, labor markets, and the financial system. Trade has grown in volume, but even more in composition and direction. Interest rate changes in the U.S. affect the adjustment program in Brazil; trade policies in the EEC determine the industrial structure of Korea, and the exports of Korea shape the adjustment process in the OECD countries; the debt problems of many countries affect the profitability of major money center banks, and the profitability of these banks, in turn, affects the amount of financing available and, hence, the investment capacity and creditworthiness prospects of the developing countries.

The list of these connections can be extended almost endlessly. And these relations make every investment decision more complex, the formulation of any development strategy more uncertain. But, there is an important similarity between today and 1944. Then, as now, our member countries face massive problems of economic and social adjustment. And how the World Bank can help in this process describes, I believe, its role in the decade ahead.

It became clear early on that our mandate to facilitate "the investment of capital for productive purposes"---while a statement of elegant simplicity---did not constitute clear and simple guidance. While the initial focus was on the financing of sound infrastructure projects, it soon became evident that building of institutions, the development of human resources and skills, and the policies which determine the profitability and viability of enterprises were as important in determining the soundness of an investment as the design and financial structure. Finance is important but, as the Bank learned, in developing countries it can be the least of problems. And so, the Bank began to finance not only the building of power stations, but also the strengthening of public utilities; not only the construction of highways, but the building of highway departments; and not only new construction but also maintenance capacity and training facilities. Today, we are as proud of the planning capacity of Electrobas in Brazil, or the work of the extension service in India as of the physical investments we have financed. And this was true in the OECD countries, as well as the developing countries. Our initial portfolio,like our portfolio today, was a mix of different types of operations---specific physical investments, lines of credit to financial intermediaries, and loans for specific categories of imports to enable the full use of existing capacity of industrial plants.

But, sound institutions require trained people. This was, of course, not a major concern when lending to the OECD countries, but skilled manpower

was soon seen as a basic constraint in the developing countries. And so, the concept of financing productive investments was broadened to include lending for education and training. Today, about 4.5% of our annual lending is for education and, in addition, we lend about $ 200 million per year for technical assistance.

As knowledge of the development process deepened, other areas emerged as serious constraints to growth. The massive shift to urban centers, which all developing countries have experienced, found their urban management and planning totally unequipped to deal with the influx. Massive public works were involved---for water supply and sewerage, for power distribution, for urban transport and housing---but equally important was the need for better urban planning and management, for reducing unit costs to affordable levels, and to adapt technologies and management systems to the capacities and resource availabilities of the country.

And, as global health conditions improved, birth and population growth rates soared beyond levels ever experienced in the OECD countries. The rapidly growing population made the achievement of many social and economic objectives more difficult. Much of the investment was absorbed merely to keep capital per worker constant, instead of increasing the capital per worker on which growth of productivity depends; much of the expansion in education was required to accommodate the growth of new entrants, instead of reducing illiteracy, improving quality, and deepening the range of educational services. And, of course, the growth of population puts tremendous strain on public services and on the need for employment creation. To help its members deal with these problems, the Bank initiated not only lending for health and population programs, but also its support for smallholder agriculture and small-scale, labor-intensive industries to help provide employment for the growing numbers.

Two other aspects of development have affected the meaning of the "investment of capital for productive purposes" and influenced the Bank profoundly. The first, obvious today but not at the outset, is that capital--- even capital supported by technical assistance and institution building--- is too narrow a view of development. Social patterns, habits and structures profoundly influence what is feasible in terms of rate and scope of change, and the original conditions determine who will benefit from this growth.

The second is that how the benefits of growth are distributed is, in fact, a central issue in development. Central not only because it affects the long-term prospects for political stability and national cohesion, but also central because it is a major reason why the world community is concerned about development. In the early 1970s, the Bank began to focus increasingly on the question of equity, how development strategies and investment programs could be designed to more rapidly improve the lives of the millions of desperately poor in our member countries by increasing

their ability to produce more. It involved a major shift in our lending in agriculture to emphasize smallholder farmers, an expansion of our lending to small and medium-scale industrial enterprises and a major effort to redirect public services---ranging from extension services to potable water supplies---from the relatively rich to the neglected. Ten years later, we can say with confidence that this increased concern for equity, for the growth of income of the lower-income groups, has not come at the expense of growth. On the contrary, dramatic increases in agricultural production in many countries derive from the provision of inputs and technical know-how to small farmers, stimulated by adequate prices to produce more. And in country after country, the adoption of more appropriate standards for low-income housing, for health service delivery, for water supply, have dramatically increased the share of the population serviced at no, or modest, increase in expenditure.

The evolution of the Bank has yielded an institution which today has competence in the productive, social and infrastructure sectors of the economy; which can draw on over thirty years of experience with development issues, ranging from export competitiveness to income distribution and from aggregate investment policies to project analysis. It is an institution which continually invests in its analytical capacity (about 1/3 of its staff time) so that it can bring the best of worldwide experience to bear on the development issues facing its members.

This expertise is the foundation of our role in the years ahead. One of the principal lessons of the last decade is that the productive use of capital is crucially dependent on the appropriate policy framework, at the macro-economic and sectoral level. In a world where capital comes from many sources---domestic and foreign---the productivity of any specific investment can only be assured if the policies governing total resource use support efficiency and productivity. We cannot be relevant to our members if we are concerned only that the Bank's resources are used efficiently---even if we could insulate them---we must help our members to ensure that their total investments are so utilized.

The adjustment to the rapid changes in the world economic environment is a problem which faces all countries---developed and developing alike. And of course, adjustment is an ongoing and eternal process. But the changes in the last decade have been massive which makes the problems of adjustment acute. And, the developing countries have fewer resources to draw on, less flexibility and weaker institutions, and more fragile economies. The depth and rate of adjustment for them is today tearing at the fabric of their political systems and social cohesion. It may not compare with the depth of the Depression, but Latin America has had declines in per capita consumption of over 8% for two years; in Africa, consumption declined for a decade. Unemployment is at unprecedented levels. Asian countries, India and China have been exempt. And, prospects are that income levels will not be restored until the end of the decade.

Operating in a resource constrained environment, with prospects for low growth, puts a great premium on the efficiency of resource use. Efficiency of resource use has been a central concern of the Bank's operations, and it enables us today to help our members restructure their investment programs, their policy framework and their development strategies.

The process of structural change requires different measures in different countries. But they all have a common theme---measures to increase the competitiveness of exports and of domestic production to reduce import requirements; incentives to increase productivity; price policies which do not discriminate between sectors; the elimination or reduction of subsidies; charging appropriate prices for public services both to reduce burdens on the budget and to ensure replicability and reduced unit costs in education and health. But these are not simple things---though the words are easy. It involves reductions in real wages or at least a slow down in their growth; it involves restructuring industries; it involves reduced profits from sheltered investments. It affects almost every vested interest group and, thus, structural change is politically difficult. The natural response is to go slow---to make the transition as gradual as possible. But time is not on the side of the developing countries. Comparative advantage is shifting constantly; technology changes as rapidly; the bulk of the problems they face are not cyclical. The resources to buffer any economy against external changes are not at hand. The longer the delay, the greater the pain and the political cost.

But, structural adjustment is not limited to re-orienting production processes, to moving in to new industries and to phase-out industries where others have developed a comparative advantage. Structural adjustment also involves changing attitudes and practices. It requires training and relocation of people; it may mean shifts in the output of educational system; and it means creating more and new types of jobs. It also means more emphasis on efficiency---on the careful management of limited resources.

The changing world environment, and the changes individuals see impinging on them, affect the political decision-making process everywhere. People are less confident of the future; hence, they are more protective of the present. In a slow growth environment, change becomes particularly difficult.

It is to facilitate this change that the Bank has redirected its lending to support policy reform at the macro-economic level in collaboration with the IMF and at the sector level. The focus of our attention today is on the policies within which investments take place. The form of our lending has proliferated---loans for structural adjustment, sector loans, loans for industrial restructuring and working capital, loans for rehabilitation

and maintenance loans-to promote exports---but the objective is a common one: to help the borrower reduce subsidies to consumption and capital, to re-establish a consistent pattern of market- related relative prices; to enhance the incentives for efficiency and investment; to limit the growth of budgetary expenditures and to assure the most efficient use of those resources; to ensure that the size of public investment programs are consistent with resource availability and that public investment programs are composed of projects which meet sound economic criteria; to reduce the drain on public resources from inefficient state enterprise and to strengthen the country's ability to export so that it can attract the investment and capital necessary for continued growth. These actions are not only aimed at redressing the immediate problems of balance of payments and budget deficits, though they will help with those. These measures, and others, are essential if the developing countries are to resume growth and progress toward their development objectives. And these programs of stabilization and structural changes must be designed to minimize the impact on the poorest segments of society and to safeguard, to the extent possible, the necessary expansion in such public services as education and health.

These programs of structural change also are essential if developing countries are to restore their creditworthiness and access to capital markets. Without an adequate flow of private capital, resumption of growth is not feasible. In the early days of the Bank, it was believed that, if the Bank were to finance infrastructure and, if it could help governments provide a secure environment for private investment---domestic and foreign---development would take place. The process turned out to be more complex, but it was right to focus on the catalytic role of the Bank. And that is true today. Our support for policy change---in terms of policy advise and lending---is central to the ability of countries to formulate and implement appropriate medium-term programs, which will combine stability and a resumption of growth, which will attract external capital in prudent amounts and for productive purposes.

But, these comments apply primarily to the middle-income countries. Low-income countries face a different set of problems, particularly those in Sub-Sahara Africa, where no growth in per capita income has occurred in the past decade. These countries, too, face major problems of adjustment---but in quite different environment. For the countries of Sub-Sahara Africa, the problems are particularly acute---but so is the need for policy reform. The world economic environment has been particularly harsh on exports of primary commodities and aid. But, it has not always been so. Many of the problems are the results of misguided policies. Policies which denied farmers a reasonable price for their product; which subsidized capital at the expense of labor; which promoted and protected inefficient industries while neglecting agriculture. The potential for Africa is considerable---even with present technology and the measures needed are not in dispute. But, policy change and economic

adjustment comes slowly in societies where the political structure is still very fragile and regionally fragmented; where analytic institutions are weak; where govermental authority is highly personal and poverty pervasive. To enable these countries to resume progress will require that they see the need for change and be willing to take the necessary steps. In that respect, major progress has been made in the last few years. But, their willingness to adjust must be supported by the international community. And, in this the Bank has a special role. As a respected and neutral analyst, the Bank can help countries re-orient their development strategies and programs. Second, the Bank can take the lead in coordinating assistance from the many donors, large and small, active in Africa. But, programs of adjustment and growth require capital and for the low-income countries, concessional capital is a very scarce resource. And for the Bank, the inadequate availability of concessional capital inevitably affects our ability to lead.

As many of you know, one of the problems our founders did not foresee was the need for concessional finance for the poorest countries. Like most people in 1944, they had little knowledge of development problems. Their model was the industrialized countries and, to the extent that lending to the developing countries was envisaged, they assumed that it posed no special problems. It became soon clear, however, that lending on the Bank's commercial terms was not appropriate for the low-income countries. Their poverty limited savings and, hence, their rate of growth; and the likely growth in domestic output and exports would not be enough to service the debt on commercial terms. In response to that problem, the Bank's first affiliate, the International Development Association, was established in 1961, to provide "finance...on the terms which are more flexible and bear less heavily on the balance of payments than those of conventional loans." The terms of IDA lending were set at 50 years, with 10 years grace and a nominal service charge which is now 1%. Funds for such lending cannot, of course, come from financial markets. They are contributed by govenments. Since its inception, IDA has committed $ 33.7 billion to the poorest developing countries—90% of IDA's its lending last year was to countries with a per capita income of less than $ 400. The founders of IDA matched the foresight and wisdom of the founders of the Bank, for without such resources, the Bank could not have functioned in the poorest countries. It is regrettable that this wisdom no longer governs policies—as the needs of the least developed countries in Sub-Sahara Africa and elsewhere has grown, the replenishment of IDA just concluded provides 25% less resources, in nominal terms, than in the previous replenishment. Throughout Africa today, we see governments instituting basic reforms—major devaluations, restructuring of price systems, abolition of subsidies) which cannot be supported at a level we know is essential, if they are to be successful.

But, looking today at the need for structural change to restore growth and creditworthiness should not lead us to conclude that we have come full

circle. We have not. The developing countries today face many problems, but there is no doubt about the progress. By every conceivable indicator. The developing countries today are major markets for the OECD countries, as well as major suppliers. Their people live longer, are better fed, clothed, educated, and housed despite the massive increase in population. Life expectancy in the low-income countries was 45 years in 1960—it was 60 in 1982. Infant mortality was 150 per thousand—it has dropped by half. In 1960, 34% of females were enrolled in primary school in the low-income countries. It was over 80% by 1981. Male enrollment averages 100%. Enrollment in secondary schools has doubled. The fear of population outrunning food supplies has been put to rest by the dramatic expansion of production in countries such as India, Bangladesh, and Indonesia. Korea, which in 1960 was considered a insoluble development problem, is a major exporter of manufactured goods to the industrialized countries; multi-national companies are no longer the preserve of the OECD countries. Management capacity—in the public and private sector—is immeasurably more sophisticated. There is no doubt that the current problems, though severe, are a temporary setback to a process of effective development, the speed of which is unprecedented in mankind's history.

I believe that those who were here in 1944 would take great satisfaction in the progress which has occurred in the world economy, in the way the economic system has evolved; in the progress of the developing countries and the alleviation of poverty and the improvements in living standards which has been achieved. And, I do not doubt that they would take great pride in the contribution the World Bank has made to this. But, it is also true that the vitality of institutions is a fragile thing—particularly the vitality of international institutions. They require the support of their members, if they are to function effectively. The Bank's strength lies in the vision of its members—and this seems an appropriate time and place to hope that today's vision will be as dedicated to a world which is free of poverty and in which each individual can realize his full potential as was that of those who met here 40 years ago.

July 13, 1984

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## A. Themes for DAC Presentation

December 3-4, 1984
Paris

### AFRICA AS A SPECIAL CASE

- Appreciate the opportunity to participate in the discussion on Africa today. The discussion is timely since the drought has raised awareness of the problems of Africa but also because Africa is at a turning point and the development challenge of Africa will engage the primary attention of all development agencies for years to come.

- The DAC Chairman has captured the African crisis very well in his 1984 report I need add little.

- Only in Africa has there been
  - A generation of declining per capita incomes. This is the result of the combination of:

    (i) highest and accelerating population growth; and

    (ii) lowest and declining efficiency of investment.

    The average African is poorer today than in 1970. By 1995 he will be poorer than at the independence.

- The drought which is ravaging many parts of Africa is an issue which requires an immediate response, but the drought also reflects the inadequacy of the long-term development effort. The reorientation of development policies which is essential also will help avoid the drastic consequences of Africa's uncertain rainfall.

- The weather also symbolizes an external environment which has been exceptionally hostile. Whether it is the deteroration of the terms of trade, or the trend in the availability of capital, Africa has been hardest hit.

- Net capital flows averaged $12 billion in 1980-82; they declined slightly, to $11 billion in 1983, if early estimates are correct. But a more important set of figures is the official capital flows to the low-income countries of Africa. From an average 1980-82 level of $7.3 billion, flows seem to have been only $6.3 billion in 1983. Disbursements in 1984 and beyond, from known commitments, do not suggest a turnaround -- excepting food aid in response to the drought.

<u>Second theme:</u> MESSAGE OF HOPE -- NOT DESPAIR.

- But while Africa has experienced a decade of declining per capita income and has been beset by a variety of adverse external circumstances it would be wrong to conclude that today's problems also are tomorrow's prospects. We must not forget how recent the development process is in Africa, how young the states, how fragile the institutional structure and how limited the human resources.

- The Asian drama, as seen by Myrdal during the '60s, was not worse than the African tragedy today. A combination of strong policy reform programs and appropriate external support turned the situation around there. It can also do so in Africa although the differences between the two situations is large and our expectations as to time required must be more modest.

- The economic performance in Africa has been poor -- but not uniformly so. Many countries -- both middle-income (e.g. Ivory Coast, Cameroon, Botswana), as well as some of the poorest countries (e.g., Rwanda and Malawi), have performed well for some time, achieving real average annual GNP growth rates, ranging from about 5% to over 12%, between 1970-82.

- This success has been achieved by a combination of a number of factors, including the implementation of sound investment programs, maintaining appropriate economic incentives for producers and consumers and timely corrective action, when their economies have been subjected to external or internal shocks.

- The promising performance of countries such as these serves to illustrate that in spite of daunting external and domestic constraints marked progress can be achieved when sound domestic policies are supported by a timely supply of coordinated external support.

- The question in Africa is how this pragmatic approach to development, this flexible management of the economy, the realistic alignment of objectives with resources available can become the hallmark of more governments. And on this, there is considerable progress.

- There is now an incipient intellectual revolution in Africa. The Chairman's report cites examples and there are many others. The change has been quick and dramatic. Three years ago, when we issued our first report on SSA, it was roundly attacked by many governments and

institutions. The Action program issued this year, uses the same analytical framework but finds itself in the mainstream of African thinking. Governments and agencies acknowledge the need to change policies. This is true not only in countries such as Ghana, Guinea, Malawi, and Uganda, which are implementing ambitious adjustment programs, but of others, such as Burundi, Mauritania, Senegal, and Tanzania, which are in the process of formulating such programs. In a recent conference on the Lagos Plan of Action a senior minister from Tanzania submitted a paper on planning in which he said "a theoretical exercise can be most harmful because it almost always leads to much greater distortion in the use of resources than would be the case under the operations of the market, within certain broadly planned parameters". They realize the inadequacy of past policies, the limits of existing public institutions and the failure to develop a base for growth. Gradually they are finding political will to undertake necessary reforms.

- To change the current dim prospects for Africa is a long-term task. It requires a better policy framework, a heavy investment in human resources, and much greater emphasis on technology development and its application. There are no magic solutions nor will there be instant results. It will have to be a pragmatic, step-by-step approach to build on existing strengths and to eliminate the distortions of the past. The first such step is to assist those countries which are ready to implement realistic and efficient programs of reforms.

- Within donor community too there also is need and hope for change -- for a more supportive, disciplined approach. We have also recognized our failures and deficiencies. These have not been minor and they have contributed to Africa's problems.

  Too often projects have been financed without adequate regard to long-term priorities or the ability to operate them efficiently. And it is no satisfaction that some of these activities were financed by exports credits rather than aid funds. We have continued to prefer new investments long after it became clear that budget revenues would be inadequate even to maintain past investments.

  We have, in pursuance of the preferences of aid agencies or the commercial interests of export credit agencies, undermined the authority of core ministries, rather than strengthen their discipline.

  Africa has received many advisors and consultants but who can claim that these have been the best and the brightest. Too many have technical knowledge which is outdated and their contribution is minimal. African Governments and agencies were not in a position to demand quality and too often donors permitted their second and third best to make their careers in Africa.

  The design of our projects too often has ignored the fragility of African institutions and the scarcity of skilled manpower.

  And too often, projects have reflected the perceived priorities of many donors rather than being formulated within a coherent national strategy. And, perhaps most important of all, we have not held African countries to the standards of performance common elsewhere in the world, including other low-income countries.

So it is time for us -- as well as for African Governments to undertake necessary reforms.

- The prospects for growth in Africa are considerable. The opportunities of present technologies are far from exhausted and much can be done to expand the knowledge base.
  - -- For both partners the time is now for action. No need to wait. The full length of the road is not yet known and it will be full of unforeseen difficulties. But we surely know enough to start.
  - -- The issues paper poses "the fundamental question" for the community of development assistance institutions whether to accept the African challenge as a collective task which calls for the closest international cooperation. There can be but one answer.

Third Theme: A PROGRAM OF ACTION

- The Bank has outlined a program of action, with which you are all familiar. The substantive essence of it is, by now, widely shared.

- It involves a focus on agriculture because of the scope for increased yields with present technologies and because it is by increasing productivity in this sector that the lives of most people can be affected most directly.

- It suggests a policy framework which stresses efficiency of investment and private innovation through prices which reflect production costs, innovation and risk taking rather than political objectives bureaucratically applied.

- It emphasizes the practical limitations on the management capacity of governmental institutions and the need to tap and foster the ingenuity and drive of the private individual, be he farmer, in services or in industry.

- But above all, the Bank's program is an <u>approach</u> to be applied at the country level. It involves the careful definition of a realistic set of country investment and expenditure priorities and a reorientation of the incentive framework. If this process is started it can yield substantial change -- and a resumption of growth. To be successful it will require the collaboration of all participants.

- The Bank's program requires action by both the African Governments and by donors.

- African Governments must elaborate national programmes of rehabilitation and development, which specify priorities and corresponding policy reform. This is no easy task and not all governments have the capacity to do this independently. Nor should the exercise degenerate into endless studies and long-term preparatory work. In most countries the more obvious distortions are well documented; the direction of change is clear. Fine tuning can come later. And in countries where capacity is limited, one can start with

a single important sector, such as agriculture. The objective is not comprehensiveness, or intellectually polished five-year plans, but to begin to infuse a new approach into the political and administrative decision making process, to begin to change the incentive structure, to begin to make more effective use of existing resources.

- An essential element of such programmes of rehabilitation and development is the review of the public investment and expenditure programmes. They must be realigned with a realistic assessment of resource availabilities and with revised development priorities.

- Donors, to support this restructuring in Africa will need to take several important steps. They should have the resources and flexibility to support Governments undertaking painful policy reforms, by providing timely assistance -- including assistance which is not linked to specific identifiable projects.

- Donor programmes must recognize the need to emphasize maintenance and rehabilitation of existing investments for several years. New investment opportunities will be limited.

- Donors should support, on a long-term basis expanding programmes in health, family planning, education and agricultural research and help formulate efficient, low-cost programmes in these areas.

- And donors must help to cordinate aid activities better to ensure that scarce external capital supports national priorities and policy change.

- We believe (perhaps inevitably) that this is essentially a realistic programme. Based on improved performance of countries and improvement in quality of aid rather than massive expansion of capital flows. But expanding aid programmes are necessary simply to maintain the 1980-82 level of net capital flows in real terms. Structural change and policy reform holds out the prospects for increased production and reduced dependence on aid. But it would be dishonest to believe that such changes can be accomplished with declining capital inflows now.

Fourth theme: WHAT THEN ARE THE NEXT STEPS TO BE TAKEN, WITHIN THE NEXT 12 MONTHS

- Within countries themselves: Many countries are working to elaborate a well-defined development strategy, including adopting policies for profound structural adjustment. We expect many others to follow this route.

- In the Table which I have circulated 12 countries have been identified which have adjustment programmes in sight and we expect a further 9 countries to work towards this over the next 18 months or so.

- The efforts undertaken by the borrowers will need to be broadened and sustained if they are to lead to sustainable growth levels. Nonetheless, they are important initiatives, which must be supported by the donors financially and technically. They are the building blocks of the future.

- For Donors: Given urgent need for action and resource scarcity, concentrated efforts should necessarily focus on countries, sectors and individual lending operations which promise the greatest returns. This implies three things --- one a reorientation of routine aid programming, a programming which fails to take account of performance. It requires both a willingness to reconsider a reallocation of resources between countries, to increase the support for those undertaking reform, and a greater flexibility in tools to reflect the priorities between new investment and maintenance and changes in priorities which makes the completion of some investments inappropriate --- second, it requires meaningful coordination; ---

third, it requires an internationally administered fund, as we have suggested, to provide a quick response capacity based on a professional assessment of structural adjustment efforts. And this fund should supplement, not substitute for, increased bilateral assistance for Africa, in support of policy reform.

- Meaningful coordination must include:
  - a mechanism to systematically evaluate the priority development needs identified by the borrower;
  - a mechanism where donors make monitorable commitments in support of specified priority development needs over a 'reasonable planning horizon' (say three years); I should note here that what we mean by 'monitorable commitments' is that the borrower has a right and need to know resource availability. If we insist that borrowers plan realistically, then they must know resource availability.
  - willingness to adjust policies and procedures to enable donors (a) to reallocate resources in support of redefined priorities when necessary, (b) to provide financial support for rehabilitation of existing facilities, operation and maintenance, and (c) to provide increased program assistance in support of agreed economic reform programs;
  - participation in local groups which can focus on sectoral investment and policy issues, linking assistance to the country in the formulation of its sectoral programmes to decisions by donors at Round Tables or Consultative Groups for support of the overall country programme.

- Officially supported technical assistance and export credit programmes must increasingly be placed in the context of a coordinated priority oriented development plan.

But it also requires increased funding.

The table we circulated shows that for 21 sub-Saharan African countries, which have either on-going programs for policy reform or can be expected to have such programs in place within a year or two, net official capital inflows during 1985-87 will be less in real terms than these countries received in 1980-82.

The table indicates the additional assistance requirements in 1985-87 to meet the simple objective of maintaining net official capital inflows at the 1980-82 level in real terms for these countries. The indicated amounts show a short-fall from this objective of $1 billion per year for countries with programmes already in place or expected within one year and a short-fall of $1.6 billion per year for countries for which programmes are expected to be initiated in the next two years. This does not take account of the payments due to the International Monetary Fund which equal about $700 million per year in the 1985-87 period.

These figures are orders of magnitude relevant for framing decisions on the additional support to be provided to Africa. The numbers are not based on a detailed assessment of country requirements nor are they the aggregate of balance of payments gaps. But looking at African development in the last two years it is a reasonable proposition that the level of external capital of 1980-82, is the minimum necessary to support structural change. Factors which drive up external capital requirements, particularly in countries with structural adjustment programmes in place, out-weigh the

factors which will reduce these requirements. Obviously, specific aid programmes need to be developed for each country and this cannot be done in plenary meetings such as this. It requires careful consultation with the country concerned and can best be done in the framework of Consultative Groups or Round Tables. But these orders of magnitude are a reasonable indication of the objectives which we need to keep in mind if sustained growth is to be resumed on a sound basis, in these countries.

The financing required can be met in several ways. Although much has been done in the way of debt rescheduling, there is room for some additional measures as the numbers indicate. However, a substantial portion of the amortization payments are due to OPEC countries and other non-DAC members and it is important that this matter be taken up with those countries because they are an important element of financing availability in the years ahead. Second, it is a matter of urgency that bilateral assistance programmes increase resources to the low-income countries of Africa as rapidly as possible and particularly to those which have agreed to, and are now undertaking, effective policy reform measures. Third, additional resources can be provided both efficiently and quickly through use of existing multilateral channels. These have the capacity to provide financing in support of monitorable medium-term adjustment programmes.

- Maintaining net aid flows in real terms, for countries with an effective structural adjustment programme is not an ambitious objective. For the donors or for the recipients. It would be easy to argue the case for more. But let's be realistic and take these first steps.

Let me mention briefly what the Bank is doing to put in place the framework to support African countries to continue the movement for policy change and to help organize a coordinated response. We have submitted to our Board a budget supplement, to start to implement the action plan we outlined at the Annual Meetings. It will be discussed by our Board and I hope approved, one week from today. We will

- increase our missions in Africa, from the present 19, to better assist countries in national economic management and the reformulation of policies and investment programmes;
- increase the size of field offices, to better support local coordination efforts;
- increase our funded technical assistance;
- together with the UNDP increase the efficiency of Consultative Groups and Round Tables.

  These fora have the same objective and we are working to ensure that they are equally efficient and policy oriented;
- expand our analytical support for Africa, including addressing the long term issues of desertification, population growth and institutional development;
- expand agricultural research (ICIPE) at regional and subregional level;
- Special Project Facility. Providing funding on a grant basis to supply preparatory work for projects to be financed by the Bank or other donors. This facility is also open to other donor contributions.

Let me conclude:

- Within Africa, serious efforts at structural change must be continued. They must be supported and rewarded. To treat good and poor performers alike does not recognize the scarcity of resources and devalues the process.

- Bilateral aid programmes for low-income Africa must be increased beyond what is now envisaged.

- Aid programmes must recognize that for the next several years new investment projects will be few. The emphasis must be on maintaining present infrastructure, developing human resources and improving the efficiency of the existing investments.

- To assure the effectiveness of aid we must make aid coordination a practical reality.

- And: finally, to supplement bilateral efforts, a multilateral fund is necessary to underpin a disciplined approach to policy change, and to provide the necessary flexible capacity to respond. I hope there is enough of a concensus among DAC members to warrant the convening of a meeting, in January, to consider the creation of such a fund. We recognize that concessional resources are scarce; we recognize that many countries face serious budgetary problems, and we recognize that there are many competing priorities. But I am also convinced that policy reform in Africa is vital to its future and that without a clear symbol of international support, such as the Special Fund, it will not be sustained.

December 4, 1984

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(8)

"AFTER ADJUSTMENT: RESTRUCTURING PRODUCTIVE CAPACITY IN DEVELOPING COUNTRIES"

Address by

Ernest Stern
Senior Vice President, Operations
The World Bank

at the Annual Meeting of the

U.S.-Yugoslav Economic Council
Hotel Roosevelt, New York
December 12, 1984

Two years ago when I spoke to you, the world economy was in the midst of a deep crisis. The industrial countries were enduring the longest recession experienced in 50 years. World trade was stagnant and many developing countries had experienced a sharp deterioration in their current account deficits. In the period after the second oil price increase, these countries had borrowed heavily to maintain their levels of consumption and investment. When first Mexico in mid-1982, and then a large number of other countries were unable to meet their debt obligations as they fell due, the magnitude of the prospective defaults endangered some of the world's largest commercial financial institutions and jeopardized confidence in international capital markets. Many developing countries were confronted with the prospect of having to reduce aggregate demand sharply since external capital was financing an unsustainable share of total consumption and investments. Debt service could no longer be financed by new borrowing while at the same time the efficiency of investments, on which repayment capacity depends, was declining. Maintaining service on debt obligations meant consumption cuts which were widely perceived to be politically untenable, making adjustment difficult, if not impossible to sustain.

As we near the end of 1984, the worst fears about what might have happened have not materialized. You are all familiar with the rescheduling packages put together under the leadership of the IMF for countries such as Mexico and Brazil. All told, some thirty countries, ranging from some of the richest in the developing world to some of the poorest, restructured about $100 billion of debt in the two years 1982-83. As a result all the major debtor countries have continued to service their debt. Growth in the OECD economies has been faster than foreseen a year ago, and with it, world trade has begun to recover. Due largely to compression of imports, there has been a striking reduction in the external current account deficits of developing countries from a peak of $109 billion in 1981 to a projected $45 billion for this year. There has been no breakdown of the financial systems of the industrialized world. Nor has there been major political instability in the borrowing countries.

However, we should not underestimate the costs of the adjustment in the developing countries in the past few years, the long-term effect of these disruptions or the adjustment which still lies ahead. I want to talk about those effects today and about what needs to be done to restore reasonable rates of growth in the developing world.

The Adjustment So Far

For almost all of the developing countries, the adjustment task was to generate a sufficient surplus from trade in goods and services so that they could service the interest payments on their debt, i.e. put the current account into balance and halt the rapid growth of debt. The expansion in long-term debt between 1977 and 1982 was explosive, rising from $270 billion, or about 18% of GNP, to $590 billion or about 25% of GNP in 1982. Debt rose faster than total output and exports, on which future debt service capacity depended. For instance, total debt outstanding as a share of exports rose from 123% to 279% in Argentina; from 75% to 204% in Ivory Coast; and from 260% to 310% in Brazil. The ratio of debt service payments to export earnings rose commensurately from 12% to 20% in this same period. The debt service ratios for Chile, Mexico and Brazil exceeded 40% last year. Even low debt or debt service ratios can cause problems for low-income countries which have little capacity to expand their exports or reduce imports in the short run. Nearly half of all reschedulings between 1975 and 1983 were by African countries.

The debt crisis forced almost all countries to increase exports, to reduce imports, or to do a combination of both. For most middle-income countries, particularly those in Latin America, the expansion of exports has proven difficult as a means of solving the crisis. Many of these countries developed their industrial structures behind high protective barriers which meant their manufactured goods were expensive and could not compete with imports either in design, technological standards or other aspects of quality. Items produced for the home market could not be shifted easily into the external market without substantial redesign of products or improvements in their quality. As a result, these countries adjusted primarily through compressing imports. For example, the volume of imports in Argentina between 1980 and 1983 dropped from $10 to $5 billion; in Mexico imports in 1983 were 40% of the 1980 level. In Yugoslavia, imports dropped by 25% between 1981 and 1983. These declines in imports generally were achieved by the imposition or tightening of import and exchange controls and by sharp devaluations which raised the cost of imports. In addition, public sector deficits were reduced through sharp cuts in public expenditures and increases in taxes and increases in prices of publicly produced goods and services. Private investment dropped as consumer demand declined and many businesses faced severe cash flow

problems as their foreign debt increased due to devaluation and to sharply higher interest rates.

Because of these dramatic changes in investment and real income, many of the developing countries have grown little since 1980, some not at all. This stagnation or decline in output, combined with continued population growth, has resulted in substantial declines in per capita income. Between 1980 and 1983 per capita consumption fell by an estimated 6% in Brazil, 16% in Argentina and 4% in Chile. The decline in Yugoslavia is estimated at about 6%.

Let me illustrate the problems with some specific cases. For instance, in Brazil the government has undertaken very large cuts in public spending, and a major devaluation during the past three years. The magnitude of Brazil's achievement can be measured by the turnaround in its trade balance from a deficit of $5 billion in 1980 to a projected surplus of $10-12 billion this year. However, this adjustment has come about for the most part through constraining import levels. Export receipts declined by 10% from 1981-83; only in 1984 did exports begin to rise, running at a rate 21% higher than in 1983. Whether this growth will be sustained remains to be seen since Brazil's industrial capacity is still largely geared towards serving the domestic market, and some of its major export earners, such as steel, are highly vulnerable to protective barriers in the OECD countries. However, one major element of the adjustment has been the expansion of production to substitute for imports. Thus it is unlikely that imports need to be restored to previous levels as a prerequisite for a resumption of growth.

In Mexico, a trade deficit of $1.7 billion in 1980 was turned into a surplus of $14.5 billion by 1983. Imports declined from $19 billion to $8 billion, but non-oil exports remained stagnant. Exports are showing growth only in 1984 with an increase of about 7.5% over the 1983 level. More realistic prices for a range of agriculture products are increasing output of import competing items and generally the changes in relative prices have made domestic producers of a wide range of manufactured products more competitive.

Most of the developing countries of Southern and Eastern Europe have also been experiencing stagnant or slow growth. The recession in Northern Europe affected countries like Portugal and Yugoslavia from almost every direction---lower demand for their exports, less remittances from workers abroad and slower growth of tourism earnings. The resort to borrowing at the high interest rates in the early eighties to maintain aggregate demand only made things worse. Adjustments in these countries also took the form of sharp cuts in domestic demand and import levels.

Among middle-income countries, the severe difficulties that even oil exporting countries have had in adjusting to the world recession is

particularly worth noting. Nigeria's predicament, in the face of the recent oil price declines, has brought into focus structural problems which had developed during earlier years. Windfall profits from oil led to an appreciation of the exchange rate which reduced incentives for non-oil exports and for import competing products. Food imports rose from $460 million in 1975 to $2.8 billion in 1982. Domestic agriculture was emasculated. Total imports almost tripled in the same period to $17 billion. But non-oil exports declined from $570 million to $200 million. The failure of the government to move to realign the exchange rate is compounding the problem.

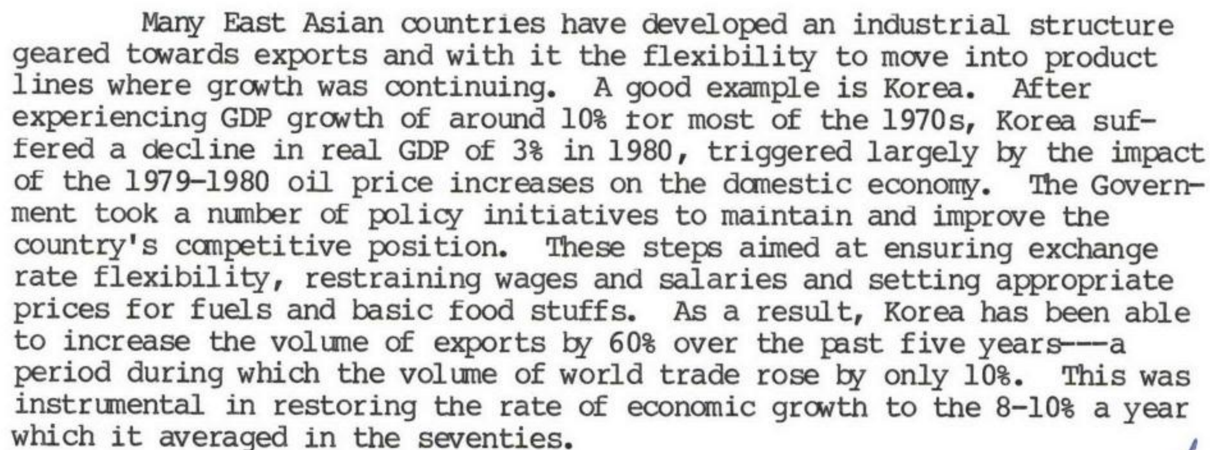
Turning to the low income countries of Sub-Saharan Africa, they face perhaps the most difficult adjustment problems, because of their very limited economic base and management capacity, and their failure to recognize the need for change until much later than other countries. They not only face the need to adjust to the changing external environment but also they need to reverse a decade of decline and deterioration. During the 1970s per capita GDP grew by only 0.7% annually. Per capita GDP has fallen by 3-4% each year since 1980. Among developing countries, only in Africa has the long-term trend in per capita grain production been negative even before the recent period of drought which is the worst in this century. Production has been held back by poor incentives to farmers, inefficient agricultural marketing systems for both inputs and outputs and overvalued exchange rates. Much industrial capacity now stands idle, the victim of inadequate domestic demand, poor investment choices, a failure to develop export opportunities and inadequate foreign exchange for raw materials and spare parts.

Many African economies developed through the sixties and early seventies on the basis of primary exports and large and growing aid flows which financed a rapid growth of public services and investments in some extremely inefficient public sector enterprises producing for the domestic market. When primary commodity prices fell and import prices rose, policy-makers, often operating in politically fragile environments were unable or unwilling to make the needed cuts in public expenditures. But more basically, African development was based on a role of the state which was unrealistic in terms of management capacity and skilled manpower availability, on a concept of modernization which thought of industry as the primary force and neglected agriculture, and on the concept that because of the poverty of the people, prices of food, shelter and services had to be kept low. In this inappropriate strategy they were supported by the international community. The impact of a sharp deterioration in the terms of trade, the stagnation of aid flows and of the recession in the OECD countries hit Sub-Sahara African countries particularly hard. The result has been a virtual collapse in domestic savings; deteriorating institutions both in physical capacity and in their technical and financial ability to perform efficiently; decline in investments and a deterioration of their capital stock. Roads are not being maintained and

machines are being cannibalized for spares. Although the picture varies from country to country, even those African nations which were good performers in the past now face serious difficulties. In the Ivory Coast, for example, GDP fell by 4% last year as a result of the combined effect of the drought and a decline in public investment. For many other African countries whose productive base in not as well developed as in the Ivory Coast, the situation has reached crisis proportions.

The principal feature of the adjustment process in Africa is the intellectual revolution which is taking place. The need for change is now accepted and domestic policies are recognized as the cause of many of the structural impediments. Some 12 countries have begun adjustment programs. In all cases, these programs involve a sharp reduction in the role of the state, both through reduction of subsidies and the elimination of state enterprises by closure or sale, improved incentives for producers and much greater priority to agriculture. But the turn-around will be slow and many more countries must start on the process if the prospects for Sub-Saharan Africa are to improve.

A few countries have fared reasonably well in this difficult environment. These include several East Asian countries and the two largest developing countries, China and India. China and India have recorded high growth rates through the last three years. They have achieved this through exceptional performance in their agricultural sectors. In both countries industrial growth has been achieved mainly through supplying the large and growing domestic market fueled by the agricultural surplus. Both economies are largely insulated from the world economy and have been little affected by the various external shocks of the recent past.



Many East Asian countries have developed an industrial structure geared towards exports and with it the flexibility to move into product lines where growth was continuing. A good example is Korea. After experiencing GDP growth of around 10% for most of the 1970s, Korea suffered a decline in real GDP of 3% in 1980, triggered largely by the impact of the 1979-1980 oil price increases on the domestic economy. The Government took a number of policy initiatives to maintain and improve the country's competitive position. These steps aimed at ensuring exchange rate flexibility, restraining wages and salaries and setting appropriate prices for fuels and basic food stuffs. As a result, Korea has been able to increase the volume of exports by 60% over the past five years---a period during which the volume of world trade rose by only 10%. This was instrumental in restoring the rate of economic growth to the 8-10% a year which it averaged in the seventies.

The Task Ahead

Overall, the picture at end-1984 is encouraging when compared to the dangers that loomed in 1982. Yet, there is not much cause for complacency. Assuming continued growth of 2-3% in the industrial economies and a reasonable policy response on the part of the developing countries, the debtor countries of Latin American will be doing well if they are able to restore per capita consumption levels to what they were in 1980 by 1990 ---- i.e., a decade of zero per capita consumption growth. For much of Sub-Saharan Africa even this modest target seems unattainable. The middle and upper-income developing countries of the Middle East, North Africa and Southern and Eastern Europe should fare better, with at least some growth in per capita incomes.

But this scenario is still far from certain. Much depends on the sustainability of growth in the U.S. economy. Interest rates, despite recent declines, are still high and it takes a brave person to exclude the possibility of a renewed rise. The oil market remains uncertain; protectionist pressures have not abated and Europe remains very slow in addressing its structural imbalances. And, most important of all, most of the adjustment process still lies ahead. The success to date has been largely in stabilization programs---although even here few countries have succeeded in restoring reasonable price stability. The changes in development strategy---more market-oriented prices, incentives for production and rewards for efficiency, realistic exchange rates, reduced levels of protection and greater reliance on the skills and entrepreneural ability of private individuals, a reduction in budget deficits, and a commercial basis for operating state enterprises---remain to be institutionalized. Their implications need to be worked out within the framework of each country's social and political objectives, and their implementation needs to be accelerated. To date, the developing countries have found the resources to service their debt during a period of recession in the OECD countries, low primary product prices and high real interest rates, primarily through such "expenditure reduction" as increased prices, import restrictions, and tax increases. But while these actions were necessary conditions for adjustment and for creating the basis to resume sustainable growth, they are not sufficient. Reactivating growth in face of a changed external environment involves a continuation of the adjustment process. It means that the new set of pricing signals to producers must be continued through realistic exchange rates, that prices for agricultural products must reflect their true production costs and that removal of price controls, the elimination of barriers to exports and increased domestic competition must be accelerated. The latter involves reduction in protection---against imports and protection afforded by the high prices of inefficient public enterprises. Such policies will stimulate new

investments, an expanding supply of exports and efficient import substitution which are necessary for higher levels of growth with a reduced dependence on external capital.

What needs to be done? When I spoke to you two years ago, I stressed the importance of improving the management of the development process in the broadest sense. This involves strengthening of economic institutions in the public and private sector, enhancing their capacity to analyze problems and to formulate efficient responses to changing circumstances. That remains the central objective everywhere and the crux of the adjustment process. Countries cannot again allow their strategies and policies to become so rigid that external change cannot be reflected in internal adjustments. The cost of delay, as we have seen, is very great---greater by far than the cost of gradual adjustment.

I would now like to turn briefly to the central role of trade in this process both because of the critical need to expand exports in the medium term and because of the discipline for domestic development strategies that a more externally-oriented policy implies.

For most middle-income developing countries, their longer-term growth prospects are likely to depend on their success in capturing a larger share of export markets for manufactured goods, especially if expansion in world trade is not vigorous. The fact that relatively few countries have been able to tap the market for industrial exports does not reflect a lack of progress in industrialization among middle-income countries. Their share of GDP originating from industry has risen from around 30% in 1960 to nearly 40% in 1982. Instead, the problem lies more in the nature of the industrial base which has developed.

Experience suggests that only a limited phase of protection is required in the early stages of industrialization. All of the newly industrializing countries, with the unique exception of Hong Kong, have protected domestic production. In the early stages of industrialization, the encouragement of import-substituting industries has generally led to a rapid expansion in manufacturing output and helped to create and spread industrial and entrepreneurial skills. Once early import substitution opportunities have been fully exploited, countries have tended to pursue divergent policies. Most have continued with inward looking strategies. They have relied on continuing protection to produce more sophisticated goods at increasingly higher costs to their economy. Because of limited domestic markets and a structure of incentives that discouraged exports, capital intensive industries in countries such as Colombia and Pakistan were condemned to inefficient levels of production. Even in larger economies such as Brazil, India, Mexico and Turkey, the prolonged use of protective measures has contributed to the development of high-cost domestic industries. Many of these countries were also slow in transmitting

higher energy prices through to their producers, so that some of the industrial capacity in these countries is overly energy-intensive.

The alternative is reflected in the experience of Korea and Taiwan. These countries have shown that very high levels of initial protection need not prevent an industry from becoming internationally competitive within a reasonable time frame, provided that all concerned are given clearly to understand that protection is to be temporary. Development of a more efficient industrial base tends to follow naturally from re-orienting production for export. A major prerequisite is an appropriate exchange rate. It is worth noting that those countries with large manufactured exports generally have allowed their effective exchange rate to depreciate more rapidly than other developing countries over the past decade. Given the low starting point of many countries, the potential for increasing manufactured exports is phenomenal. During the peak years between 1961 and 1976, for example, manufactured exports of Taiwan and Korea grew at annual rates of about 25-50% respectively.

This is, of course, much easier said than done. The longer import-substitution policies are maintained, the more powerful the vested interests which seek to maintain them become, and the more difficult it is to change them. But, at the same time, recent experience of nations such as Brazil and Colombia, which are well along in the process of making the transition, despite a prior history of almost exclusive reliance on import substitution, demonstrate that the task is feasible.

However, a number of uncertainties cloud the prospects for adjustment through the trade side, including strong protectonist sentiment in the OECD countries. For countries such as Brazil, Korea, and Yugoslavia, the international environment argues in favor of a trading and industrial strategy supporting a more balanced and gradual expansion of exports from a broad array of manufacturing subsectors. Protectionist tendencies are more likely to evolve from major spurts in overseas sales involving the deep penetration of a few products into slowly growing OECD markets. In this respect, ongoing efforts to diversify exports to new markets, including those in the Middle East and other developing countries need to be sustained. Each country will need to examine the potential for further diversification, particularly into product lines reflecting shifts in comparative advantage between the advanced countries and the developing world. This is likely to be in areas requiring more skills and capital, making room in the process for other developing countries in more basic and labor-intensive areas.

The process of restructuring the economy that I have just sketched will require programs and investments whose costs are likely to be substantial. For countries in the earlier phases of industrialization, the adequacy of their infrastructure is likely to be a critical constraint. This will typically require substantial investments in transport services,

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power stations, sewage plants and telecommunications facilities. Countries which are at the stage of reorienting industrial production in favor of exports will often need to retool existing factories as well as push for fresh investments. Diversification into new product lines will necessitate major investments. In addition, their continuing success will require timely acquisition of new technology. Much of the technology transfer can be achieved through capital imports and a more positive approach to direct investment but also much more attention will need to be paid to establishing national research and development programs.

Most of the resources needed to continue the restructuring process will have to come from the middle-income countries themselves. Despite recent widespread improvement in the fiscal situation of developing countries, central government deficits now average about 6% of GDP compared with about 4% in the late 1970s. Government deficits will need to be reduced further by insisting that public enterprises operate on a commercial basis and generate a reasonable share of any new investments out of earnings and by eliminating subsidies which distort investment decisions. All of this means that consumption will remain constrained throughout the 1980s and, to minimize this period of austerity, efficiency of investments must remain a primary concern. The yardstick of efficiency and the discipline of competitiveness---domestic and external---lie in a relatively open economy, as do the pressures for flexibility and continuous and, therefore, gradual adjustment.

For the low-income countries in Sub-Saharan Africa, the policy priorities are not very different, though their programs of action will be. Of all the major regions of the developing world, Sub-Saharan Africa has had the slowest growth in food production and the fastest growth in population during the past 20 years. The poor performance in agriculture reflects mistakes across a wide range of policy fronts, including an unwarranted bias in favor of industry at the expense of agriculture. Increasing agricultural production is possible, despite poor soils and a variable climate. Yields today are only a fraction of what is possible even with present technology. And increasing agricultural output is essential for improving the living standards of the bulk of the population and for generating an increasing volume of investable resources. Revitalizing agriculture will require more effective programs in agricultural research, strengthening marketing and extension services and, above all, incentive prices for producers. It will also mean more developed rural infrastructure, including access roads and expanded education and health services. But while in Africa, the focus must be on revitalizing agriculture and on investments in human resource development and in infrastructure, the disciplines must be the same---more efficient use of scarce resources and a greater ability to modify policies as circumstances change. While exchange rates have to be managed differently and import regimes structured taking different factors into account than in the middle-income countries, in Sub-Saharan Africa also movement toward

greater cognizance of import prices as yardsticks for efficiency will help create the necessary discipline in economic management. The extent to which the international community will provide financial and technical resources to facilitate this transition will be a critical factor for reestablishing the basis for sustained development.

But actions by the developing countries will only be successful if there are comparable policies in the industrialized countries. For the developing countries to adjust effectively rather than to resist change, with its associated costs of lower growth, declining consumption and increased unemployment, three things are especialy important. First, there must be greater stability in the world economic environment. Industrial countries can do much to ensure this by continuing policies which will sustain the hard-won price stability and by efficiency enhancing policies which must underlie stable, long-term growth. This requires policy-makers in the industrial countries to undertake adjustment programs to address the underlying structural weaknesses in their own economies. These structural problems show up in the marked cycles in GDP growth, unemployment and inflation since the mid-1960s. The severity of the anti-inflationary policies of the early 1980s in many OECD countries can be interpreted as a determined effort to break out of this cycle. While inflation seems to be under control, the associated productivity increases and shifts in the composition of output have been slow in coming in most countries. The U.S. has been unique in its ability to create new jobs and new growth industries. Europe lags badly on both counts. Steady, non-inflationary growth and continuous adaptation to new technology are essential.

Second, it is essential to halt the movement towards protectionism, and to reverse it. An open trading system is necessary if the middle-income countries are to find markets for their expanding manufactured exports. Developing countries account for less than 15% of the total imports of manufactured goods by industrialized countries, and for about 3% of their total consumption of these goods. In an expanding market, rapid growth in imports of manufactures from developing countries into the OECD economies should not be a major problem in terms of its impact on incomes and employment. In the short run, however, as long as unemployment in industrial economies remains high, political pressures in favor of protectionism are likely to remain strong. These pressures reflect the highly visible adjustment costs which often fall on certain groups in industrialized countries. Such groups tend to be workers in labor-intensive industries, often located in relatively depressed regions. Studies have shown that there are very high costs involved in protecting these jobs. Nevertheless, producers often see no choice but to seek protection: governments grant it because it imposes no immediate fiscal burden. Those who lose from protection, such as consumers and export industries, are dispersed and, therefore, usually weakly organized in comparison.

<u>Third, it is vital that middle-income countries continue to have access to commercial lending</u>. The stages of adjustment which lie ahead require substantial investments in infrastructure, in the restructuring of industries and new investments to augment the capital base. Adjustment and the resumption of growth requires capital, including external capital. The commercial banks have functioned responsibly in working out reschedulings which alleviated the immediate crisis, and they have provided net additional capital. But much of this lending has been of an involuntary nature and that is not sustainable. The objective clearly must be to restore creditworthiness so that market access is restored. The lesson of the debt crisis is <u>not</u> that borrowing is bad; it is that excessive borrowing is bad. With the resumption of growth and a clearer export orientation, more lending will become justified though the growth of debt must be kept well below the growth of export earnings. But clearly, it is unrealistic to expect the developing countries to be net exporters of capital. Without external capital, growth in the developing countries will remain low, their creditworthiness will not improve and, thus, the risk to capital now outstanding will be enhanced, not reduced. No doubt, the resumption of net new lending will take place in a more structured framework, with more concern for the efficiency of the projects financed, more awareness of the medium-term policy framework, and more attention to the productivity and size of public investment programs.

Let me now turn to Yugoslavia and briefly comment on its economic situation in the context of the adjustment process we have been discussing.

While Yugoslavia's economy grew rapidly in the 1970s, it suffered from many of the same problems as other middle- income countries. Rigidities in the decision-making process intensified, price distortions increased, and increased losses incurred by inefficient enterprises were tolerated. The policy framework promoted the development of production for domestic markets through increasing protection, ignored the cost of capital in investment decisions and failed to allow domestic prices to reflect international changes, including in energy. After the first oil price increase the unsustainability of this set of policies was disguised by Yugoslavia's access to capital markets, the associated bouyancy of exports and the continued flow of workers' remittances. The second oil price increase was dealt with similarly. Debt grew rapidly and substantially faster than exports. With the rise of interest rates debt service payments reached 30% of exports of goods and services. The efficiency of investments continued to decline. By 1982 the misallocations caused by an inapropriate policy framework, exacerbated by events in Poland and Latin America, led to an unsustainable balance of payments situation.

The objectives of the adjustment program in Yugoslavia, supported by both the IMF and the World Bank, were essentially the same as in the

other middle-income countries---reduce total outlays, increase domestic resource mobilization, and make the resource allocation process more efficient.

A number of measures have been taken by the Government to limit the growth in aggregate demand and to put in place criteria which would ensure a more careful screening of investments. The exchange rate was devalued to encourage exports and curb imports. These policies were successful in converting a current account deficit of $3.7 billion in 1979 to a small surplus of about $300 million in 1983, a current account surplus of $600 million is expected in 1984.

Along with these demand management policies first steps towards longer term reform were taken. A program of price liberalization, to reduce the degree of government intervention, is underway. A partial reform of the foreign exchange allocation system has been initiated, interest rates on deposits have been progressively adjusted with a view to the attainment of positive real interest rates by the first half of 1985, while lending rates are scheduled to become positive in real terms in the next two to four years. A number of laws have been passed that penalize loss making and illiquid enterprises and existing laws on bankruptcy are increasingly being enforced. Steps have been taken to develop least cost development programs for power and coal. In the field of investment, efforts are underway to develop and adopt a nationwide social compact which specifies a set of uniform investment criteria to be used in project selection.

While the steps taken have been important, the question is whether they are adequate judged against the policy framework sketched out earlier and the flexibility of economic management necessary in a volatile world economic environment. Judged against these requirements, it is clear that the process which has been started must be broadened and expanded considerably in Yugoslavia, as in other developing countries, if Yugoslavia is to return to a sustainable rapid growth path.

An important element in this respect is the introduction of more efficient coordination of the regional decisions and increased flexibility in the pricing of resources. The present procedures for coordination, although reflecting the multinational character of Yugoslavia, are extremely cumbersome and time-consuming. They make it difficult to reach comprehensive and harmonized decisions which are efficient from the national point of view. By lengthening the time between the occurence of external developments and policy responses, they increase the risk of the misallocation of resources.

Fiscal policies and credit allocation at the regional levels reflect essentially regional priorities. These will only accidentally correspond to the most appropriate priorities from a national point of

view. Coordination of investment decisions on energy resources is a good example. The coordination of the use of hydro, thermal, and nuclear energy sources between the Republics and Autonomous Provinces would allow Yugoslavia to improve its supplies of energy, properly allocate credit facilities and reduce oil imports. Yet, such coordination is not yet practiced.

The policy instruments in the hands of the Federal authorities are still too limited in number and too narrow in scope. They are insufficient to sustain a more efficiency-oriented development strategy. Demand management tends to rely more heavily on the instruments available at the Federal level, namely, monetary expansion and the exchange rate, and this has enabled Yugoslavia to successfully implement a stabilization program. However, the tools for improving investment allocation, ensuring incentives for efficiency, correcting trade incentives, enhancing energy conservation, and ensuring the efficient use of scarce domestic and external resources are not yet in place.

Yugoslavia is now in the process of preparation of the next Five Year Plan (1986-90). Reforms are envisaged in a wide range of areas, including prices, foreign exchange allocation, and credit allocation and measures to implement these reforms are being formulated. The macro-economic framework assumes growth of output of 4% annually The growth would be led by an average annual increase in exports of 6% while imports would grow at 5%. This scenario is expected to allow a reduction in the foreign debt by $3 billion (to $17 billion) by 1990, and to bring the debt service ratio to 25% by 1990. But these rates of growth require rapid progress in adjusting the policy framework. As in other middle-income countries---such as Mexico, Korea, Brazil, and Hungary---further changes are necessary to set yardsticks of efficiency for managers, to provide incentives for modernization and to establish a system which can respond quickly to changing external circumstances. The courageous way in which the Government has handled the problems of the last few years, including its stabilization program, gives reason to expect that they will deal effectively with the further stages in the adjustment process.

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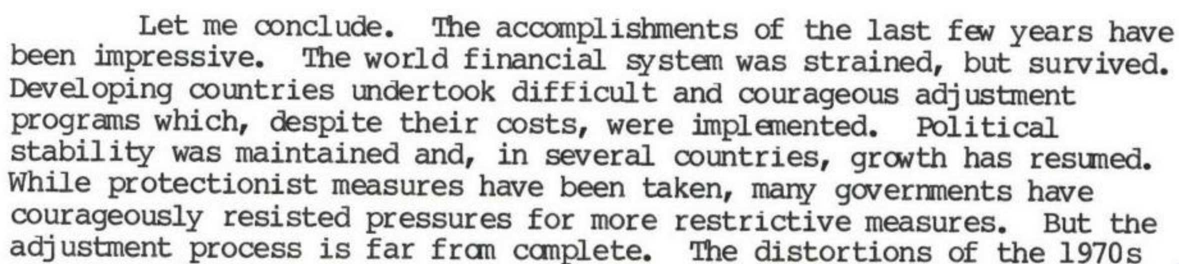

Let me conclude. The accomplishments of the last few years have been impressive. The world financial system was strained, but survived. Developing countries undertook difficult and courageous adjustment programs which, despite their costs, were implemented. Political stability was maintained and, in several countries, growth has resumed. While protectionist measures have been taken, many governments have courageously resisted pressures for more restrictive measures. But the adjustment process is far from complete. The distortions of the 1970s

were deep-rooted and it will take time to realign economies and time to reduce the burden of debt to more manageable proportions. In industrialized and developing countries alike policy-makers will have to continue to grapple with difficult political choices, reducing the comfort of established interest groups by insisting on efficiency in the use of resources and on change to benefit from new technologies. But none of these actions are beyond reach; none chart untested waters. With joint efforts of the developed countries, the developing countries and the official and commercial lenders, it will be possible to resume and accelerate growth in the world economy in a stable environment. It is a task we all can, and must, participate in. Thank you.

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Address by Ernest Stern

Senior Vice President, Operations of the World Bank

to the United Nations

New York - December 17, 1984

# THE AFRICA CRISIS

Mr. Secretary-General, Excellencies, ladies and gentlemen:

I appreciate the opportunity to participate in today's discussion on Africa. You have already heard from the Secretary-General and from the Director General of FAO about the extent of the current drought, its devastating impact on millions of people and the international response to the crisis. I can add nothing to this picture except to underline the need for prompt additional measures, both nationally in Africa and by external donors, to minimize the starvation and suffering.

Although Africa faces one of its worst crisis in modern history the famine is not only the result of inadequate rainfall. The effects of the drought, in terms of its impact on agricultural production, on the conditions of national economies and on people, is the result of long-term trends. And it is these I would like to talk about to complete the presentation of the Africa Crisis. Because, unless different development strategies are adopted, and a different approach taken to domestic policies, the famine of 1984 will become recurrent on ever increasingly massive scales, and the poverty of the people will deepen.

Of course, we in the Bank are, like everyone else, trying to do what we can to help alleviate the emergency. We hope to have a quick disbursing Drought Emergency Project ready shortly for Ethiopia to provide agricultural inputs, improve transport and rehabilitate and expand potable water supply for people and livestock. Existing projects in drought-affected countries are being restructured to replenish the supply of seeds for the next harvest, to provide fertilizer and transport, and to provide spare parts and fuel to fully utilize existing facilities. We contributed $2 million earlier this year as a grant from our administrative budget to the WFP to resolve logistic problems in emergency food distribution. It was the first such grant in the Bank's history. Since the funds have been utilized - in about 10 countries - we are planning to recommend to our Board that we replenish this amount. And we will continue these efforts to assist in the emergency. But let me turn to the underlying issues.

Today, the average African is poorer than in 1970. By 1995 he is likely to be poorer than at independence. The neglect of agriculture is the primary cause of this trend.

Only in Africa has there been a generation of declining per capita income. This has been the result of a combination of:

° the highest and accelerating population growth,

and ° the lowest and declining efficiency of investment.

Although you have recently discussed the African situation in the General Assembly, let me briefly comment on these two elements.

First, Population is a major aspect of the long-term crisis in Africa. The population of Sub Saharan Africa is growing faster than that of any other continent. Population growth accelerated from 2.3% per year in 1960 to over 3.1% today. And still health facilities are poor and mortality rates high. As the former improves the latter will decline and population will grow still more rapidly. Children under 15 already

constitute almost 50% of the total population - placing tremendous pressures on education facilities and future employment creation. And even if the number of children desired per family will drop slowly, this young age structure has built in a population dynamic which will mean rapid population growth for years to come even if the problem is more explicitly recognized and more African Governments commit themselves to reducing population growth.

Today the continent faces a population of 1.2 billion just 35 years from now (2020). Population today is about 400 million. By 2020 Nigeria's population will approach 200 million, Ethiopia's 80 million, Kenya's 60 million. Mali's population will be larger than Ghana's today. The impact of such population sizes on forests, on desertification, on water supply, on urban growth and growth of agriculture merely to feed people is staggering. And so is the impact on poverty. Under all projections, the number of poor is expected to rise above current levels - but this rise would be less than 20% if there were a rapid fall in fertility as compared with a 70% increase if fertility were to decline at the rate in the standard UN projections. And even such a decline is far from certain.

Second, the efficiency of investment must be improved. Average returns have declined since the 1960's. And this requires action in several areas. One cause of the declining efficiency of investments - less than satisfactory production per dollar invested - has been deteriorating economic management. This has been evidenced in policies which do not provide producers incentives for efficiency; which have eroded incentives in agriculture; which have allowed public enterprises to grow irrespective of their ability to manage effectively or to make a profit on the scarce resources the nation has entrusted to them. It is reflected in unrealistically large public investment programs, in the neglect of maintenance, and in the reluctance to stimulate traditional community activities and the private sector. Poor economic management also has been caused by the downgrading of central ministries - Finance Ministry losing control of budgets and Planning of new investment approvals. The weak human resource base has, of course, compounded these problems.

And, the selection of poor projects has cost Africa dearly. Both in terms of declining efficiency of investment and in the need to service debt arising out of these projects while they have not yielded the expected output. And here, the donors must share the responsibility. The pressures they have put on governments to accept projects, the inappropriate design, the lack of coordination among them and the disregard for national priorities and comparative advantage have contributed massively to the low rates of return on investment.

Third, within the area of investment, agriculture deserves special mention. Agriculture requires a much higher priority - of funds and management skills. It is sometimes assumed that poor natural resources are at the root of Africa's slow growth in food production. While this is certainly a factor, particularly in the Sahel, it is not, we believe, the basic cause. The Sahel represents only 20% of Africa's land area and less than 8% of its people. There are many areas of high potential. The FAO has estimated potential rainfed cropland in Africa at about 800 million

hectares, compared with 350 million in Asia.

More realistically the causes are an inattention to agriculture as a primary sector for growth. Research on new seed varieties as well as water conservation and afforestation has been inadequate. However, it is worth emphasizing that resources (in terms of both dollars and staff years) devoted to agricultural research in Africa have been relatively large in comparison with those in Asia and Latin America. It is the efficiency of research effort and the pace of dissemination of research findings (because of inefficient and underfunded extension services) that have been the main problems. And the policy framework has been particularly pernicious in agriculture,

(a) inadequate incentive prices for agricultural products;

(b) neglect of the rural sector in terms of allocation of public sector resources, particularly in the field of rural infrastructure, water supply, health and education;

(c) increasing intervention of the public sector in marketing of agricultural inputs and outputs, and exchange rates which boosted food imports greatly at the expense of domestic producers and sharply reduced the competitive edge in non-food exports.

The importance of the policy regimes and the potential for increasing food production is illustrated by the experience of several countries in Africa (e.g., Cameroon, Malawi, Rwanda, Ivory Coast and Mauritius), which have achieved high food production growth rates. While none of these countries are located in the very difficult Sahelian zone, neither Malawi nor Rwanda nor Mauritius can be considered to be well endowed with natural resources. What these countries do have in common as a group, is a history of avoiding major distortion in prices and sound policies with considerable reliance on incentives and markets to stimulate production.

While even with good policies it is unrealistic to expect annual increases in food production in excess of 3-4% over the long term, that would be a massive improvement over the stagnation experienced by many countries. Such an increase in production requires a commitment to a modernization of agriculture in all its aspects - marketing, production, research, extension - for foodgrain and for export crops; and a recognition that in the near term foodgrains present the most important import substitution opportunity for Africa. A more rapidly growing agriculture also will do more than any other measure to increase the income of the lowest income groups - the rural inhabitants.

While domestic policies have contributed to the long-term crisis, the external environment also has been exceptionally hostile. Whether it is the deterioration of the terms of trade, or the trend in the availability of capital, Africa has been hardest hit.

Net capital flows averaged $12 billion in 1980-82; they declined slightly, to $11 billion in 1983, if early estimates are correct. But a more important set of figures is the capital flows to the low-income

countries of Africa. From an average 1980-82 level of $7.3 billion, flows seem to have been only $6.3 billion in 1983. Disbursements in 1984 and beyond, from known commitments, do not suggest a turnaround — excepting food aid in response to the drought.

But while Africa has experienced a decade of declining per capita income, and has been beset by a variety of adverse external circumstances, it would be wrong to conclude that today's problems also are tomorrow's prospects. We must not forget how recent the development process is in Africa, how young the states, how fragile the institutional structure and how limited the human resources.

The Asian prospects in the '60s, were like the African situation today. A combination of strong policy reform programs and appropriate external support turned the situation around there. It can also do so in Africa although the differences between the two situations is large and our expectations as to time required must be more modest.

The economic performance in Africa has been poor - but not uniformly so. Many countries - both middle-income (e.g., Ivory Coast, Cameroon, Botswana), as well as some of the poorest countries (e.g., Rwanda and Malawi), have performed well for some time, achieving real average annual GNP growth rates, ranging from about 5% to over 12%, between 1970-82.

This success has been achieved by a combination of a number of factors, including the implementation of sound investment programs, maintaining appropriate economic incentives for producers and consumers and timely corrective action, when their economies have been subjected to external or internal shocks.

The promising performance of countries such as these serves to illustrate that in spite of daunting external and domestic constraints, marked progress can be achieved when sound domestic policies are supported by a timely supply of coordinated external support.

The question in Africa is how this pragmatic approach to development, this flexible management of the economy, the realistic alignment of objectives with available resources can become the hallmark of more governments. And on this, there is considerable progress.

There is now an incipient intellectual revolution in Africa. The change has been quick and dramatic. Three years ago, when we issued our first report on Sub Saharan Africa, it was roundly attacked by many governments and institutions. The Joint Action Program issued this year, with which you are all familar uses the same analytical framework but finds itself in the mainstream of African thinking. Governments and agencies acknowledge the need to change policies. It is reflected in analyses by the African Development Bank and the ECA, in the recent discussions of the OAU, in the Development Assistance Committee of the OECD, in the unanimous decision of the Development Committee to endorse the Bank's Joint Program of Action, and in the recent UN resolution on Africa.

But, to change the current dim prospects for Africa is a long-term task. It requires a better policy framework, a heavy investment

in human resources, and much greater emphasis on technology development and its application. There are no magic solutions nor will there be instant results. It will have to be a pragmatic, step-by-step approach to build on existing strengths and to eliminate the distortions of the past. The first such step is to assist those countries which are ready to implement realistic and efficient programs of reforms.

The prospects for growth in Africa are considerable. The opportunities of present technologies are far from exhausted and much can be done to expand the knowledge base. The time for action is now. The problems of the past are behind us and little purpose is served in assigning blame. The important thing is that the lessons have been learned. The length of the road is not yet known and, no doubt, it will be full of unforeseen difficulties. But we surely know enough to start.

## What then needs to be done: A Program of Action

The Bank has outlined a program of action, with which you are all familiar. The substantive essence of it is, by now, widely shared.

It involves a focus on agriculture because of the scope for increased yields with present technologies and because it is by increasing productivity in this sector that the lives of most people can be affected most directly.

It suggests a policy framework which stresses efficiency of investment and innovation, through prices which reflect production costs, and through the reduction of bureaucratic controls which benefit the rich rather than protect the poor, as intended.

It emphasizes the practical limitations on the management capacity of governmental institutions and the need to tap and foster the ingenuity and drive of the private individual, be the farmer, in services or in industry.

The Bank's program is an approach to be applied at the country level. It involves the careful definition of a realistic set of country investment and expenditure priorities and a reorientation of the incentive framework. If this process is started it can yield substantial change -- and a resumption of growth. To be successful it will require the collaboration of all participants.

The Bank's program requires action by both the African Governments and by donors.

African Governments must elaborate national programmes of rehabilitation and development, which specify priorities and corresponding policy reform. This is no easy task and not all governments have the capacity to do this independently. Nor should the exercise degenerate into endless studies and long-term preparatory work. In most countries the more obvious distortions are well documented; the direction of change is clear. Fine tuning can come later. And in countries where capacity is limited, one can start with a single important sector, such as agriculture. The objective is not comprehensiveness, or intellectually polished five-year plans, but to begin to infuse a new approach into the political and

administrative decision making process, to begin to change the incentive structure, to begin to make more effective use of existing resources.

An essential element of such programmes of rehabilitation and development is the review of the public investment and expenditure programmes. They must be realigned with a realistic assessment of resource availabilities and with revised development priorities.

Donors, to support this restructuring in Africa, will need to take several important steps. They should have the resources and flexibility to support Governments undertaking painful policy reforms, by providing timely assistance -- including assistance which is not linked to specific identifiable projects.

They must recognize the need to emphasize maintenance and rehabilitation of existing investments for several years. New investment opportunities will be limited.

Donors should provide support, on a long-term basis, for expanding programmes in health, family planning, education and agricultural research and help formulate efficient, low-cost programmes in these areas.

And donors must be willing to participate in more effective aid coordination to assume that scarce external capital supports national priorities and policy change.

We believe that this is a realistic program; one that can be implemented in an increasing number of countries. It is a program based on improved performance of national economies and a relative reduction in Africa's increasing dependence on aid. It also is a program which emphasizes improvements in the quality of aid.

But it is not a program which can be implemented with presently planned aid programs. Increases will be essential. Structural change and policy reform hold out the prospect for increased production and reduced dependence on aid-but it would be dishonest to believe that such changes can be accomplished with declining capital inflows.

And that is the current prospect. Therefore, let me now add a word about financing.

Net disbursements of ODA in 1985-87 are expected to be less in real terms than they were in 1980-82. Part of the problem is the growth in amortization payments. While OECD countries have gone far in converting loan obligations to grants, other donors have not done so. Almost $800 million per year are due to non-DAC bilateral lenders--a much higher percentage of gross flows than for DAC countries. A second aspect of the problem is that almost $700 million per year is due to the IMF, in payments due for earlier drawings. Urgent attention to these aspects of the debt problem is essential. A third component is that gross official flows are estimated to be stagnant in nominal terms. While we are familiar with the budgetary difficulties of many donor countries, this need not be reflected in the allocation of their resources for Africa. While it would be

desirable if aid programs could be increased in general -as Japan and Italy are doing- even where this is not the feasible, allocation to Africa can be increased reflecting the urgency of the problems there.

We recently estimated requirements for some 10 countries which have adjustment programs, supported by the IMF and the World Bank, in place. Merely to keep net aid flows to these countries in 1985-87 at the same level as they received in 1980-82, i.e., allowing for inflation and increases in amortization payments, would require $1 billion per year more than is now in sight based on current aid programs. For all of Africa, the amount is in excess of $2 billion per year.

Maintaining net aid flows in real terms, for countries with effective structural adjustment program is not an ambitious objective. It would be easy to argue the case for more. But we must be realistic; but we also must take the necessary steps to achieve that minimum objective.

As you know, the Bank has launched an effort to mobilize $1 billion in incremental resources for Africa for 1985-87. We are encouraged by the response so far and hope to convene a formal donors meeting shortly. But this is only a fraction of what is needed. Much needs to be done bilaterally as well.

The Bank itself lent $9.5 billion to Africa in 1979-83 and, despite the reduction in IDA availability, expects to lend $11 billion in 1984-88. Our Board last week also approved an expanded programm of technical support for Africa and a special grant-funded program to support agricultural research in regional and sub-regional centers.

The increased aid flows will require more effective aid coordination and all DAC members committed themselves to this at their recent Ministerial Meeting. To lay the basis for this we are collaborating closely with the UNDP first, to help individual countries define their investment program and articulate their sectoral priorities and second, to make sure that the UN Roundtables and the Bank's Consultative Groups have the same quality of preparatory work, the same concern with development strategies and lead to the same integrated approach among donors. We very much appreciate the intimacy and effectiveness of this collaboration with the UNDP. We are also prepared to collaborate in water resource surveys and water management programmes in African countries.

Let me conclude:

With Africa, serious efforts at structural change have started and must be continued. They must be supported and extended. Policy change, strengthening of institutions, increased efficiency of investment, and a more realistic realignment of the role of the state with the capability for effective management are essential if Africa's potential is to be realized.

Bilateral aid programmes for low-income Africa must be increased beyond what is now envisaged. This must be a priority objective of all donors.

Aid programmes must recognize that for the next several years new investment projects will be few. The emphasis must be on maintaining present infrastructure, developing human resources and improving the efficiency of the existing investments.

To assure the effectiveness of aid, we must make aid coordination, a practical reality.

To provide a central element of flexibility, the modest multilateral fund to augment available multilateral resources which we have suggested is vital.

The current crisis is urgent--but so is the longer term one. The prospects for Africa can be improved--considerably. But it will take the combined effort of African peoples and governments, bilateral donors and multilateral agencies. The problems must be seen in a realistic context --weak institutions and limited trained manpower will limit the rate of progress; but we must not permit patience to become an excuse for inaction or understanding of the difficulties faced by Africa a justification for inadequate performance. A great development challenge lies ahead; it must be dealt with --and it can be dealt with only together.

1985

# LIST OF SPEECHES
## Ernest Stern

1985

(1) Statement at a Special Meeting on SSAs, Paris, January 31 & February 1, 1985

(2) Statement at the Special Board Meeting on Sub-Saharan Africa on February 7, 1985

(3) Overseas Development Council (ODC), February 20, 1985

(4) Colombia: Bankers Meeting, April 16, 1985

(5) 1985 Senior Operations Managers' Retreat, Closing Remarks, April 20, 1985

(6) Interview, WRC-TV on "The Economic Summit" April 28, 1985

(7) South Asia Regional Retreat, (Talking Points), Wye, May 30, 1985

(8) Committee of the Whole Meeting, Remarks on Baker's Initiative November 12, 1985

(9) DAC High Level Meeting, Paris, December 2-3, 1985

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SPECIAL MEETING ON SUB-SAHARAN AFRICA

Paris, Thursday and Friday, January 31 and February 1, 1985

Statement by Mr. Ernest Stern,

Senior Vice President, Operations, World Bank

# AFRICA AS A SPECIAL CASE

Ladies and Gentlemen:

On behalf of the Bank I would like to welcome you and to thank you and your authorities for your interest in and support for the strategy that we have proposed in the Joint Program of Action for Sub-Saharan Africa. I would also like to thank Mr. Abdlatif Al Hamad for his personal support in promoting this meeting and agreeing to chair it.

Mr. Abdlatif Al Hamad has summarized the main elements which bring us together today. The problems in Africa are well known to everyone here. But let me comment briefly on the sources of these problems, some lessons from the past and how we see the way forward.

In recent months, the plight of millions of Africans has been brought starkly to our attention because of the severe drought. Peoples everywhere have responded munificently and through a wide range of mechanisms, your Governments, and many multilateral institutions, have mobilized public resources to respond to this crisis.

But the problems of Africa are not just problems of drought. While every effort must be made to avoid starvation and to alleviate the misery of those affected by the immediate tragedy, food aid and emergency assistance will not solve the problems of Africa. Our responsibility is to reach beyond this crisis and to address, together with the governments of Africa, the underlying factors which are responsible in no small part for these events. Together we have a choice of more Ethiopias with ever increasing frequency or the painful and slow process of putting in place policies, institutions and incentives which will make more efficient use of Africa's resources, expand its abilities and reduce its vulnerability to external factors, including drought.

The World Bank's Joint Program of Action lays out a feasible approach and the Facility we will discuss in the next two days, and the financing associated with it, can do much to make the objectives of that program a reality.

And we do not have much time. Today, the average African is poorer than he was in 1970. By 1995, on current trends, he is likely to be poorer than at independence. Only in Africa has there been a generation of declining per capita incomes reflecting the highest population growth in the world, which continues to accelerate, and the lowest efficiency of investment, which continues to decline.

I would like to focus on some of the key long-term trends which we feel must be addressed systematically and as a matter of urgency.

First, population. This is a major and too often neglected aspect of the long-term crisis in Africa. The population of Sub-Saharan Africa is growing faster than anywhere else in the world. Population growth accelerated from 2.3 per cent per year in 1960 to over 3.1 per cent today. Just 35 years from now, by the year 2020, the African continent will face a population of some 1.2 billion. Population today is about 400 million. As health facilities improve and mortality rates decline, population will grow still more rapidly. Children under 15 already constitute almost 50 per cent of the total population, placing tremendous pressures on education facilities and future employment creation. The pressure on land is leading to desertification and the pressure on forests to provide minimum fuelwood required is leading to massive deforestation. And even if the number of children desired per family drops slowly, the existing age structure has already built in a population dynamic which will mean rapid population growth for years to come, even if the problem is more explicitly recognized and more African Governments commit themselves to reducing population growth. But these numbers are not immutable. Action now can reduce the growth rate, and the eventual size, of national populations.

Second, the efficiency of investment must be improved, average returns have declined since the 1960s. Obviously any program of change must have as one of its basic objectives a reversal of this pattern. Better use must be made of existing assets and of new investments. This requires action in several areas. One cause of the declining efficiency of investments has been deteriorating economic management. This is reflected in policies which do not provide producers with incentives for efficiency; which have eroded incentives in agriculture; have allowed public enterprises to grow irrespective of their ability to manage effectively or to make a profit on the scarce resources the nation has entrusted to them.

It is also reflected in unrealistically large public investment programs, in the neglect of maintenance, and in the reluctance to stimulate traditional community activities and the private sector. Poor economic management also has been caused by the downgrading of central ministries - Finance Ministries losing control of budgets, and planning Ministries of new investment approvals. The weak human resource base has, of course, compounded these problems.

Third, agriculture has been neglected for too long. It requires a much higher priority - of funds and management skills. It is sometimes assumed that poor natural resources are at the root of Africa's slow growth in food production. While this is certainly a factor, particularly in the Sahel, it is not, we believe, the basic cause. The Sahel represents only 20 per cent of Africa's land area and less than 8 per cent of its people. There are many areas of high potential. The FAO has estimated potential rainfed cropland in Africa at about 800 million hectares, compared with 350 million in Asia.

The problem has been twofold - agriculture has not been viewed as a primary sector for growth and modernization, despite the fact that it involves the incomes of the bulk of the populations, offers relatively low cost opportunities for expansion and has been the cause of  Africa's increasing dependence on imports for more than a decade.

And Government interventions have been of the wrong kind. Instead of concentrating scarce resources on increasing the knowledge base through research and its dissemination through effective extension services, the access to and functioning of markets,on expanding output, and on reducing the susceptibility to drought, governments have restricted markets, depressed prices and extracted resources from agriculture for consumption and investment elsewhere.

Looking back over the past decade of African development it seems clear that African development has been greatly hindered by Governments' belief that the industrial sector could bring faster development than emphasizing its agricultural resources, that the administrative efforts of Government should be used to produce a wide range of commodities, rather than concentrate these scarce resources on the expansion of services only public agencies can provide, and that administered prices could protect consumers, without recognizing the effects of such prices on producers. Realism, efficiency and pragmatism have generally not been guiding principles.

But in drawing lessons from the past we must not take the domestic policy problems out of context. The ability to maintain growth has been greatly reduced by a hostile external environment. Africa has been affected adversely by the recession; it has benefited little from the recovery in trade. Commodity prices for most major African products have shown secular declines and, for minerals, competition from efficient producers elsewhere is increasing. Real interest rates have been at unprecendented levels, exchange rates are volatile, and net capital flows - on which growth in Africa depends - have been declining. Net capital flows which averaged $12 billion in 1980-82 declined to $11 billion in 1983, based on current estimates. And more importantly the capital flows to the lowest-income countries of Africa fell from an average 1980-82 level of $7.3 billion to some $6.3 billion in 1983. Disbursements in 1984 and beyond from known commitments, do not suggest a turnaround - excepting food aid in response to the drought.

And in many ways donors have contributed to the low efficiency of investments and supported policies which are inconsistent with sustained development in Africa. We have continued to prefer new investments well after it became clear that budget revenues would be inadequate even to maintain past investments. We have, in pursuance of the preferences of aid agencies or the commercial interests of export credit agencies, undermined the authority of core ministries, rather than strengthen their discipline. Africa has received many advisors and consultants but we cannot claim that these have been the best and the brightest. Too often conflicting advice has served to prevent action. The design of our projects too often has ignored the fragility of African institutions and the scarcity of skilled manpower to operate them. And, too often projects have reflected the perceived priorities of donors rather than being formulated within a coherent national strategy. And, perhaps most important of all, we have not held African countries to the standards of performance common elsewhere in the developing world, including other low-income countries.

Therefore, when we look at African performance in the last decade, we are not just examining the performance of African Governments, rather we must ask whether the policies of African Governments and the support of donor agencies combined have adequately served the needs of Africa. The answer to this question is much less clear than any of us would like. But what is important now is that we extract the lessons learned and apply them pragmatically to the future. In the Bank's Joint Action Program, by now widely endorsed by African and donor governments, we have tried to do this. And effective implementation of the Joint Program hinges on the collaborative interaction of African Governments and donors.

On the part of African Governments, national programs of rehabilitation and development must be elaborated which specify priorities and corresponding policy reform. This is no easy task and not all Governments have the capacity to do this independently. However, in most countries the more obvious distortions are well documented, the direction of change is clear and in countries where capacity is limited, one can start with a single important sector such as agriculture. Furthermore, existing development programs must be reviewed and revised within the framework of a realistic assessment of resource availability.

For their part donors must exhibit flexibility to support Governments which undertake painful policy reforms, by providing timely assistance - including assistance which is not linked to specific identifiable projects. Donor programs must recognize the need to emphasize maintenance and rehabilitation of existing investments for the next several years, joining with African Governments to make the most effective use of existing resources. New investment opportunities will be limited. Donors should also support expanding programs in health, family planning, and education to strengthen the human resource capacity on a long-term basis and, by designing efficient, low-cost programs in these areas, do so within existing resource availabilities. Finally, coordination of donor programs, in the context of the recipients' development priorities, is critical to the effectiveness of the Joint Program of Action.

An example of what needs to be done, and how it can be done, is in the case studies we have circulated, on Senegal, Ghana, Madagascar and Zambia.

However, as noted in the case studies, in their recent Consultative Group meetings none of the four countries discussed succeeded in obtaining sufficient fast disbursing funds for complementary imports, to enable them to derive the maximum possible benefits from their structural reform process. And the objective of obtaining monitorable commitments from donors,on which recipients could rely in formulating their future programs,has not yet been reached.

To help support change in development strategies and policies in Africa and to help make more effective use of external resources in a coordinated framework, we have proposed the establishment of a Special Facility for Africa. As you know, our objective is $1 billion, for the three years 1985-1987.

This amount does not represent the capital requirements of Sub-Saharan Africa, nor even of those countries which have already committed themselves to programs of stabilization and medium term adjustment. Much more needs to be done in the bilateral aid programs to expand the available resources for Africa. The Facility is not intended to be a substitute for these bilateral efforts. However, the facility will clearly signal to those governments in Africa that are prepared to take the political risks of implementing necessary structural change, that the donor community will make a special effort to support them. And the Facility will provide a mechanism through which we can respond quickly and effectively to support policy change, which then must be bolstered and deepened in the longer term through the regular operations of the bilateral assistance programs.

To support policy change requires incremental resources. The changes envisaged will not take place, and growth and development will not be resumed, in an environment of declining net capital inflows. Countries would inevitably adjust to such a situation but this type of adjustment is inconsistent with the objectives of every country and institution represented here.

Incremental resouces are especially necessary to support structural change. This involves expansion of availability of resources, reallocation of resources between countries, and reallocation between purposes.

The objective of the Facility is simple. To assist those countries which are putting into place programs of stabilization, with the assistance of the IMF, and of structural change at the macro-economic or sectoral level with support from the Bank, and to provide quick disbursing assistance in support of programs which have clearly monitorable objectives which require additional resources for effective implementation. This will provide policy makers with the flexibility to implement programs of adjustment leading to sustained growth.

These programs will also be the centerpiece for Bank Consultative Groups and UNDP Roundtable discussions, so that they can provide the framework for the allocation of bilateral assistance.

The facility and the financing associated with it is modest and we have proposed, in the papers circulated, a simple structure. We propose to use the IDA staff for the preparation of operations and their implementation. And the IDA Board of Directors, in which all members are represented, would review the proposals and approve the commitment of funds. It would be the intention to commit all funds available to the Facility, and any funds associated with its objectives, by the end of 1987 and we would expect disbursements to be completed within two years thereafter. Necessary arrangements would be agreed to inform the contributors regularly about the Facility resources and to consult with them about its planned operations.

Later on in this meeting I will be glad to expand on these and other aspects of the Facility.

Let me conclude Mr. Chairman with what I started with - our appreciation to those who have come to this meeting to provide incremental resources in support of the objectives of the Joint Program of Action. We recognize that these proposals come at a difficult time. Adjustments are not limited to Africa. Almost everywhere budgets are constrained and budgetary priorities are being reexamined. And these proposals come at a time when many governments are devoting substantial additional resources to help avoid disaster in Africa and to alleviate the massive human suffering there. I know that everyone here has gone through a protracted and difficult internal process to reach the conclusion to support this effort to the fullest extent possible within the constraints of their own situation. And this applies not only to the funds which can be made available. It applies equally to the willingness of everyone to be flexible on the modalities of the operation so that, by tomorrow afternoon, we can be agreed not only in principle but in practice. For this we are particularly grateful - not because it will launch another Bank effort or expand Bank resources - but because it is a necessary first step to support a resumption of growth in Africa - which is the world's greatest development challenge.

I also recognize that there remains uncertainty about the prospects for success in Africa, or even how success should reasonably be defined.

And we can provide no guarantees. Development is an uncertain process, particularly so in Africa. Our expectations must be realistic. These are countries, most only recently independent, all at the early stages of modernization. Their political structures are fragile, their capacity to manage economies weak, their human resource base inadequate, their private sectors small, their infrastructure and policy instruments still rudimentary. And they are very poor. Change will come slowly; progress haltingly.

But nonetheless, there are no alternatives. The Joint Program of Action has been widely endorsed not only because it is a pragmatic, country by country approach to the more effective use of available resources to achieve growth and better lives for the people, but also because it is seen, by African governments and donors alike, as being based on the lessons we have all learned from the past. The proposed Special Facility, and the financing associated with it, will be a timely and vital complement to the other elements of the Joint Program. By itself, it is not a solution; but it is the first step we must take in collaboration with the African governments to alter dramatically the prospects for that continent.

The task is immense and will be long, but together it can be done.

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FROM: Vice President and Secretary

February 21, 1985

EXECUTIVE DIRECTORS' MEETING - FEBRUARY 7, 1985

Special Meeting on Sub-Saharan Africa
- January 31 and February 1, 1985

Statement by Mr. Stern

As requested by Executive Directors, attached is a copy of the statement made by Mr. Stern on the above subject at the meeting of the Executive Directors held on February 7, 1985.

Distribution:

Executive Directors and Alternates
President
Senior Vice Presidents
Senior Management Council

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EXECUTIVE DIRECTORS' MEETING - FEBRUARY 7, 1985

Mr. Stern's Statement on the Special Meeting
on Sub-Saharan Africa - January 31 and February 1, 1985

I think since press communications travel faster than even the Concorde, everybody is, I think, familiar with the results of the meeting which we held last Thursday and Friday in Paris. It was, I think, indeed a very successful meeting, after weeks of prior discussions and preparatory work. It led to a substantial commitment by a wide number of countries for the Special Facility for Africa, and there are reasonable expectations that some additional resources beyond those already reported will become available in the next several weeks.

As you know, Mr. Abdlatif Al-Hamad chaired the meeting and I negotiated the agreement on behalf of the Bank. But, of course, many of the donor countries who participated played a very major role in its success, in particular, the Deputy Governor of the Bank of France, Mr. Lagayette. Of course, France is also the largest single contributor to the fund itelf.

Basically, I think the achievement is noteworthy because it is a substantial amount of resources which, despite the well-known aid weariness in the world, was collected on an entirely voluntary basis. We were able to persuade everybody that the needs of Africa are paramount and that we ought to avoid getting into the detailed issues of burden-sharing and, indeed, everybody did stick to a voluntary basis.

And I am very confident from our preparatory discussions and the meeting itself that every government which did contribute made a major effort to find all available supplementary resources which are possible within the budget cycle.

Secondly, in Europe in particular, but also in Canada and the United States, there is, of course, a very great awareness at the moment of the humanitarian crisis, the need for emergency food relief in Africa. And not only is that the focus of much debate, but it is also absorbing quite a lot of personal resources---the voluntary individual contributions are very large---and also very substantial draws on government budgets which are unanticipated.

And I think it is very relevant that, despite this, and in this framework, it was possible for governments to recognize that food aid by itself will not cure the difficulties of Africa, and that even now we must begin to look and deal with the longer-term issues and to be able to find these resources and make them available for developmental purposes.

And, thirdly, I think it is significant that this fund was created particularly to support structural change and policy reform in Africa, and it has received quite a lot of attention and discussion among the participants. There is strong support for what we are all familiar with here, but the joint program of action for the Bank is the basis for a more coordinated approach and a collaborative approach between donors and recipients in a more disciplined framework, to make sure that resources are efficiently utilized.

As you know, from the press notification, the direct contributions to the fund total a little less than $700 million. France and Italy gave aproximately $150 million at the exchange rate then prevailing---I think France came out a little bit ahead, $154 million and some change, and Italy had $153 million and some change. We will accord them pride of place together.

But everybody else who contributed---the Netherlands, the Scandinavian countries, Austria, Ireland, all, I think, made a major effort to contribute as much as was possible within budgetary constraints. This appeal came, as you know, in the middle of the budgetary cycle; there was no time to prepare in advance---and so it wasn't always easy.

Canada indicated its very strong support for the fund and its very clear intention to contribute directly to the fund, but was unable at the meeting to indicate the amount. And we were told that Canada hoped to be able to notify us of the amount within a very short period of time.

In addition to direct contributions to the fund are other contributors who are going to be associated with the fund through special joint cofinancing arrangements. Switzerland is one of these---and Switzerland indicated its contributions of $30 million over the three-year period.

For all of the special joint financiers, the agreement is that (a) their funds will be available for the same countries eligible for financing from the special facility, (b) that the monies will be available to cofinance operations which are eligible to be financed under the facility, and (c) that the financing made available will be reciprocally untied with the direct contributors to the facility.

On that basis, we received from Germany an indication of 100 million Deutsche Marks for 1985, with the expectation that similar amounts could be made available in each of the next two years.

We had an indication from Japan that Japan would try to make available $100 million in the first year, and make an effort to make similar amounts available in subsequent years.

But in the Japanese case, it was not possible at the meeting to get a precise indication of how much of this $100 million, possibly all, but it wasn't clear, would be available on an untied basis and on terms equivalent to the terms of the facility.

So that is an issue yet to be clarified.

In the case of UK, there was an indication of availability of 75 million pounds for commitment over a three-year period, but here, too, some obscurity crept in in the second half of the meeting and UK was unable to indicate that its funds would be untied, as it had hoped to be able to do. And we expect to hear from the UK within the week what its final decision on that matter is.

With the indicated contribution from Canada and possibly some other contributions from other countries who were notified of the meeting with inadequate lead time to consider the matter internally, I think, despite the remaining elements of uncertainty on the special joint cofinancing, that we will exceed the 1.1 billion figure which was indicated in the press release.

We will now prepare the resolution and circulate that to the contributors in the next week or so. It is a very simple resolution, it really deals only with the mechanics. And then, of course, submit it to the Board of IDA for approval, to authorize the Bank to become the administrator of the Special Facility.

The Bank also indicated its interest---or the management's intention---of recommending to the Board a contribution to the Special Facility over a three-year period amounting to $150 million to be taken out of net income after appropriate provisions for reserves. And, of course, we made it clear that this was only a statement of intention, that our ability to fulfill it would depend on adequate net earnings, and the decisions of the Board of Directors and the Board of Governors on the apropriateness of additions to reserves and what might be left over after that.

We would expect to have the resolution before the Board for approval by the end of March. The trigger point for effectiveness on the Special Facility is notification of $200 million in contributions from four countries, and, from what we were told at the meeting, we think we should be operational well before the expected date of July 1st, 1985.

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Ernest Stern's

Speech at the Overseas Development Council Dinner

February 20, 1985

Ladies and Gentlemen:

The severe impact of the drought in Africa and the consequent suffering of millions of Africans have been brought starkly to our attention in recent months. People everywhere have responded generously and through a wide range of mechanisms. And governments and many multilateral institutions have mobilized public resources to respond to this crisis.

But the problems of Africa are not just problems of drought; and the impact of a drought is not inevitable. Obviously, every effort must be made to avoid starvation and to alleviate the misery of those affected. But food aid and emergency assistance alone will not solve the problems of Africa. Our responsibility is to reach beyond this crisis and to address, together with the Governments of Africa, the underlying factors which are responsible in no small part for these events. Together, we have a choice of more Ethiopias, with ever increasing frequency, or the painful and slow process of putting in place policies, institutions and incentives which will make more efficient use of Africa's resources, expand production possibilities, and reduce the vulnerability to external factors, including drought. And it is this aspect of Africa that I wish to speak about this evening.

The development issues in Africa seem long-term compared to the drought---but, in fact, there is not much time. Today, the average African is poorer than he was in 1970. By 1995, on current trends, he is likely to be poorer than at independence. Only in Africa has there been a generation of declining per capita incomes, reflecting the highest population growth in the world, which continues to accelerate, and the lowest efficiency of investment.

When we look at the plight of millions of Africans today, and when we consider that many donors have provided substantial human and financial resources to Africa in the past several decades, it is inevitable that we ask what went wrong. Are the problems of development in Africa so different from those in the rest of the world that our combined knowledge and experience simply is irrelevant? Does the basic endowment of Africa require a unique development strategy? Is the decline in living standards inexorable?

I believe strongly that these propositions are false. Looking back at the development in Africa over the past decades, the weak performance of most African countries can be quite readily understood, and the factors leading to this situation are not immutable. While many African countries have experienced economic declines in the past ten years or more, there are also those African countries—low and middle-income—which

have achieved sustained economic growth, ranging from 5% to 12% per year between 1970 and 1982. Their development strategy and policy performance, not their natural endowments, were different from their neighbors.

Three basic and interconnected areas---domestic policies, the external environment, and donor performance---help to explain a great deal of the poor development performance in Sub-Saharan Africa. Let me turn to these now.

The domestic policies of African Governments have been adversely affected by the belief of governments, advisors, and academics that the industrial sector could bring faster development than emphasizing its agricultural resources, that the administrative efforts of Government should be used to produce a wide range of commodities, rather than concentrate its scarce administrative resources on the expansion of services only public agencies can provide, and that administered prices could protect consumers without recognizing the effects of such prices on producers. Undoubtedly, the room for maneuver of African policy-makers has been severely constrained by the extreme poverty of their citizens, the inadequacy of their infrastructure, weak institutions and fragile political systems. But the unwillingness to recognize agriculture as the foundation of growth has been costly. It has led to increased dependence on food imports, to declining exports of primary commodities, to urban drift and to political interests based on unsustainable incentive structure. There are many reasons for this strategy---the colonial aura of export crops, the limited experience of planners with small scale agriculture, the impatience to obtain quick results and the view, not unique to Africa in the 1960s and early 1970s, that agriculture could not be a growth sector. Although there has been much investment in both infrastructure and education in Africa, today there still are few countries with effective agricultural research organizations, or extension services, and minor irrigation has been hardly developed at all. A second aspect of domestic policy, reflecting some of the same drives, was the growth of government. Of course, in many countries the private sector was in trade only and government activity was seen as filling a vacuum. But too little thought was given to the skills necessary to run industrial or marketing operations efficiently---skills in very short supply---or to the difficulty of running public enterprises on a commercial basis in the political frameworks existing in many of the countries. And a third factor was that for much of the 1960s and 1970s, African governments did not lack resources. Aid flows were large, from a variety of sources, and budget deficits often were foreign-financed. Under these circumstances, no high value was attached to the efficient use of resources. Realism, efficiency and pragmatism generally were not the guiding principles.

Second, the external environment has been particularly harsh for Sub-Saharan Africa. Commodity prices of major African products have shown secular declines, many for more than a decade. Sugar, ground nuts, tea,

palm oil, and cotton, have shown annual average price declines of between 2% and 4% in each of the past 12 years. Real interest rates have hovered at unprecedented levels, while concessional aid flows have declined. The volatility of industrialized economies has resulted in rapidly changing exchange rates and trading patterns in international markets. Even the most developed of the industrialized countries were unable to muster the necessary institutional flexibility to adjust to this volatility. But their difficulties don't begin to compare with the demands which the uncertain external environment has placed on the novice policy-makers of many African countries.

Third, has been the support rendered by donors. And in many ways donors have compounded the problems of African policy-makers and supported policies which are inconsistent with sustained development. After all, in many African countries external financing accounted for the bulk of the investment program. Inefficient investments and declining yields reflect on the decision-making of both African governments and donors. Donors continued to prefer new investments well after it became clear that budget revenues would be inadequate even to maintain past investments. In pursuance of the preferences of aid agencies or the commercial interests of export credit agencies, the authority of core ministries has been undermined, their discipline weakened. Advisors and consultants often lacked the skill or the will to make a constructive contribution and too often their conflicting advice has served to prevent action. The design of projects too often ignored the fragility of African institutions and the scarcity of skilled manpower to operate them. And, too often projects reflected the perceived priorities of donors rather than being formulated within a coherent national strategy of the recipients. And, perhaps most important of all, African countries have not been held to the standards of performance common elsewhere in the developing world, including other low-income countries.

In short, while little inspiration can be drawn from this record, important lessons surely can.

These lessons are reinforced by those African countries which have succeeded in achieving economic growth in the past decade. As I mentioned earlier, several countries---both middle-income (e.g. Ivory Coast, Cameroon, Botswana), as well as some of the poorest countries (e.g. Rwanda and Malawi) have performed well for some time, achieving substantial real average annual GNP growth rates. This success has been achieved by a combination of factors, including the implementation of sound investment programs, with an appropriate balance between investment in new assets and the maintenance and rehabilitation of existing facilities. They have provided appropriate economic incentives for producers and consumers and have taken timely corrective action when their economies have been subjected to external or internal shocks. The evidence of their achievements clearly contradicts any suggestion of an immutable downward spiral.

But beyond the achievements of these countries, there is much cause for hope in Africa because the basic issues---of priorities in development strategies and the scope of government action---are being addressed, for the first time, on a broad scale. We are now seeing an incipient, intellectual revolution among policy-makers in many parts of Africa. The change has been quick and dramatic. Three years ago, when we issued out first report on Sub-Saharan Africa it was roundly attacked by many African Governments and institutions. But the Joint Program of Action, issued by the Bank last September, which uses the same analytical framework, finds itself in the mainstream of African thinking. Governments and agencies acknowledge the need to change policies. This is true not only in countries such as Ghana, Guinea, Malawi and Uganda, which are implementing ambitious adjustment programs, but of others such as Burundi, Mauritania, Senegal and Madagascar, which are in the process of formulating such programs. Decision-makers today realize the inadequacy of past policies, the limits of existing public institutions and the failure to develop a base for growth. Gradually, they are finding the political will to undertake necessary reforms.

Recent developments in Ghana provide some impression of the nature of the policy reform programs being undertaken by some of the poorest countries in the world, and the difficulties associated with these efforts. By 1983 Ghana found itself with an oversized and poorly managed public sector, rapidly declining agricultural production and an estimated annual inflation rate of some 140% and egregiously overvalued exchange rate. Incomes had declined steadly, Ghana had lost its preeminence in the cocoa market and its production had dropped by almost 60% in a decade. Infrastructure was decaying and plant was idle.

In April 1983, the Government launched a major reform program which systematically addressed the many constraints to Ghana's development and involved a wide range of policy initiatives, including movement towards a realistic exchange rate, the establishment of domestic prices consistent with the vastly depreciated new exchange rate, a gradual liberalization of price controls, the restoration of fiscal and monetary discipline, and the design of rehabilitation programs for key sectors of the economy.

Late in 1983, Ghana was affected by a severe drought which reduced agricultural production, including cocoa exports. This worsened an already acute foreign exchange problem and prevented the economy from responding in a major way to the significant policy changes, because the Government was unable to increase the level of vital imports. Urgently needed rehabilitation programs were slowed down, and the problems generated by major infrastruture constraints became even more pronounced. But despite these setbacks, the Ghanaians have persisted in implementing the reform program. Adjustments in the exchange rate and in prices of

socially sensitive commodities are continuing despite the fact that they are very unpopular, and the Government is taking equally tough decisions regarding necessary cutbacks in public expenditure. A supply response is beginning, but results have been slower than expected.

Despite these improvements, more than a decade of neglect cannot be repaired in a year. And, of course, the economy's overall response to the reform program is constrained by the long-term development factors, such as the weaknesses in the country's productive and social infrastructure. Nonetheless, there is no doubt that the new policy framework provides incentives for productivity improvement and growth. It was not nature, but policies which reduced Ghana's cocoa exports from 380,000 tons in 1973 to 160,000 tons ten years later. But until production increases, the ability of the government to maintain the program depends on its ability to provide basic consumer goods, raw materials and spare parts, which requires external support.

The challenge ahead, both for African policy-makers and for donors alike, is to maintain the political will to sustain these types of policy reforms through the long-term adjustment process which lies ahead. And this adjustment will be slow. While it is clear that some immediate benefit is derived from raising agricultural producer prices, liberalizing fertilizer distribution systems or rehabilitating rural road networks, the ancillary inputs are seldom readily available to benefit fully from these reforms. Access to seeds, fuel and spare parts, may be limited through severe balance of payments constraints, effectively minimizing the potential for immediate returns to painful reforms.

And there has been progress on the donor side as well. Donors are acknowledging that the interests of African countries can only be served if their resources are utilized within a coherent national planning strategy, which identifies priorities and recognizes domestic, financial, institutional and manpower resource constraints. And they recognize that the allocation of aid should take account of efforts at policy reform and structural change. There is increasing willingness to support Consultative Groups and Round Tables as a means for jointly discussing the investment priorities of the country and how individual donor programs can best fit within that framework. There is greater willingness to exchange information at the country level, to review projects financed by export credit agencies against economic efficiency criteria and to submerge individual preferences on methodology and style in a broader consensus. There also is much greater willingness to finance maintenance projects instead of new investments.

Against this background, what are the points of action?

First, <u>Population</u> is a major aspect of the long-term crisis in Africa. The population of Sub-Saharan Africa is growing faster than that

of any other continent. Population growth accelerated from 2.3% per year in 1960 to over 3.1% today. And still health facilities are poor and mortality rates high. As the former improves, the latter will decline and population will grow still more rapidly. Children under 15 already constitute almost 50% of the total population---placing tremendous pressures on education facilities and future employment creation. And even if the number of children desired per family will drop slowly, this young age structure has built in a population dynamic which will mean rapid population growth for years to come even if the problem is more explicitly recognized and more African Governments commit themselves to reducing population growth.

Today the continent has a population of about 400 million. Just a generation from now, it is likely to be 1.2 billion. By 2020 Nigeria's population will approach 200 million, Ethiopia's 80 million, Kenya's 60 million. Mali's population will be larger than Ghana's today. The impact of such population sizes on forests, on desertification, on water supply, on urban growth and growth of agriculture merely to feed people is staggering. And so is the impact on poverty. Under all projections, the number of poor is expected to rise above current levels---but this rise would be less than 20% if there were a rapid fall in fertility as compared with a 70% increase if fertility were to decline at the rate in the standard UN projections. And even such a decline is far from certain.

Second, the efficiency of investment must be improved. Average returns have declined since 1960s. And this requires action in several areas. One cause of the declining efficiency of investments---less than satisfactory production per dollar invested---has been deteriorating economic management. This has been evidenced in policies which do not provide producers incentives for efficiency; which have eroded incentives in agriculture; which have allowed public enterprises to grow irrespective of their ability to manage effectively or to make a profit on the scarce resources the nation has entrusted to them. It is reflected in unrealistically large public investment programs, in the neglect of maintenance, and in the reluctance to stimulate traditional community activities and the private sector.

Third, within the area of investment, agriculture requires higher priority---of funds and management skills. It is sometimes assumed that poor natural resources are at the root of Africa's slow growth in food production. While this is certainly a factor, particularly in the Sahel, it is not, we believe, the basic cause. The Sahel represents only 20% of Africa's land area and less than 8% of is people. There are many areas of hihg potential. The FAO has estimated potential rainfed cropland in Africa at about 800 million hectares, compared with 350 million in Asia.

More realistically, the causes are an inattention to agriculture as a primary sector for growth. Research on new seed varieties as well as

water conservation and afforestation has been inadequate. However, it is worst emphasizing that resources (in terms of both dollars and staff years) devoted to agricultural research in Africa have been relatively large in comparison with those in Asia and Latin America. It is the efficiency of research effort and the pace of dissemination of research findings (because of inefficient and underfunded extension services) that have been the main problems. And the policy framework has been particularly pernicious in agriculture:

(a) inadequate incentive prices for agricultural products;

(b) neglect of the rural sector in terms of allocation of public sector resources, particularly in the field of rural infrastructure, water supply, health and education;

(c) increasing intervention of the public sector in marketing of agricultural inputs and outputs, and exchange rates which boosted food imports greatly at the expense of domestic producers and sharply reduced the competitive edge in non-food exports.

Even with good policies, it is unrealistic to expect annual increases in food production in excess of 3-4% over the long-term, that would be a massive improvement over the stagnation experienced by many countries. Such an increase in production requires a commitment to a modernization of agriculture in all its aspects---marketing, production, research, extension---for foodgrain and for export crops; and a recognition that, in the near-term, foodgrains present the most important import substitution opportunity for Africa. A more rapidly growing agriculture sector also will do more than any other measure to increase the income of the lowest income groups---the rural inhabitants.

Fourth, African Governments must elaborate national programmes of rehabilitation and development, which specify priorities and corresponding policy reform. This is no easy task and not all governments have the capacity to do this independently. Nor should the exercise degenerate into endless studies and long-term preparatory work. In most countries the more obvious distortions are well documented; the direction of change is clear. Fine tuning can come later. And in countries where capacity is limited, one can start with a single important sector, such as agriculture. The objective is not comprehensive, or intellectually polished five-year plans, but to begin to infuse a new approach into the political and administrative decision-making process, to begin to change the incentive structure, to begin to make more effective use of existing resources.

An essential element of such programmes of rehabilitation and development is the review of the public investment and expenditure programmes. They must be realigned with a realistic assessment of resource availabilities and with revised development priorities.

Fifth, donors must be willing to reorient their programs. These must:

- support the programs of policy reform and structural change with timely fast disbursing funds;
- provide reasonable assurances of financial support over the medium-term to enable African governments to formulate realistic investment programs;
- accept as guidance to their priorities the national programs developed by the African governments;
- recognize the limitations of resources for new investments and support programs for maintenance and rehabilitation of existing assets;
- provide long-term support for such basic programs as education, health, family planning and agricultural research and assist in developing low-cost delivery systems.

We believe this is a difficult but realistic program; one that can be implemented in an increasing number of countries. It is a program based on improved performance of national economies and a relative reduction in Africa's increasing dependence on aid. It also is a program which emphasizes improvements in the quality of aid.

But it is not a program which can be implemented with presently planned aid programs. Increases will be essential. Structural change and policy reform hold out the prospect for increased production and reduced dependence on aid---but it would be dishonest to believe that such changes can be accomplished with declining capital inflows.

And that is the current prospect. Therefore, let me now add a word about financing.

Net disbursements of ODA in 1985-87 are expected to be less in real terms than they were in 1980-82. Part of the problem is the growth in amortization payments. While OECD countries have gone far in converting loan obligations to grants, other donors have not done so. Almost $800 million per year are due to non-DAC bilateral lenders---a much higher percentage of gross flows than for DAC countries. Urgent attention to this aspect of the debt problem is essential. A second component is that gross official flows are estimated to be stagnant in nominal terms. While we are familiar with the budgetary difficulties of many donor countries, this need not be reflected in the allocation of their resources for Africa. While it would be desirable if aid programs could be increased in

general---as Japan and Italy are doing---but even where this is not feasible, allocation to Africa can be increased, reflecting the urgency of the problems there.

We recently estimated requirements for some 10 countries which have adjustment programs, supported by the IMF and the World Bank, in place. Merely to keep net aid flows to these countries in 1985-87 at the same level as they received in 1980-82, i.e., allowing for inflation and increases in amortization payments, would require $1 billion per year more than is now in sight, based on current aid programs. For all of Africa, the amount is in excess of $2 billion per year just for those countries undertaking adjustment efforts.

Maintaining net aid flows in real terms for countries with effective structural adjustment program, is not an ambitious objective. It would be easy to argue the case for more. But we must be realistic; but we also must take the necessary steps to achieve that minimum objective.

We were very encouraged, therefore, by the strong and generous support of many donor governments for the Special Facility for Africa launched by the Bank. Participants at a recent meeting in Paris indicated they would contribute an additional $1.1 billion in fast-disbursing concessional funds, in support of major policy reforms undertaken by African governments to improve their prospects of achieving sustainable economic growth.

Already, the Bank has identified some 20 countries in Africa which are either implementing significant economic reform programs or are in the process of devising such programs. In most of these countries the reform programs involve major readjustments within the economy. Measures may include the elimination of distortions in agricultural and industrial prices or exchange rates, the liberalization of food marketing and input distribution systems, the redirection of investment expenditures to meet the needs for rehabilitation and maintenance, and the adoption of appropriate medium-term domestic price and trade liberalization policies. Each of these measures imposes considerable costs, political, social and economic. The Bank's own resources, now augmented by the Special Facility, and by better coordinated bilateral programs, can help assure that these programs can be sustained and lead to a resumption of growth.

Let me conclude:

In Africa, serious efforts at structural change have started and must be continued. They must be supported and extended. Policy change, strengthening of institutions, increased efficiency of investment, and a more realistic realignment of the role of the state with the capability for effective management are essential if Africa's potential is to be realized.

Bilateral aid programs for low-income Africa <u>must</u> be increased beyond what is now envisaged. This must be a priority objective of all donors. And aid programs must recognize that for the next seveal years new investment projects will be few. The emphasis must be on maintaining present infrastructure, developing human resources and improving the efficiency of the existing investments.

To assure the effectiveness of aid, we must make aid coordination a practical reality.

It takes time to generate the necessary technical skills to implement policy reforms, to strengthen institutions, to obtain the benefits of new incentives and knowledge. Even if African governments have started the painful and costly adjustments necessary to maximize the efficiency of the use of their own resources, results will not be instantaneous; progress will be halting. African governments, and all of us, have every reason to expect improved performance; a reversal of a decade-long decline. But we must be realistic in our expectations. Inadequate supplies of skilled manpower, poor infrastructure, weak institutions and unsystematic decision-making are not problems which will disappear overnight or in a year.

The current crisis is urgent---but so is the longer-term one. The prospects for Africa can be improved---considerably. But it will take the combined effort of African peoples and governments, bilateral donors and multilateral agencies. The problems must be seen in a realistic context--- weak institutions and limited trained manpower will limit the rate of progress; but we must not permit <u>patience</u> to become an excuse for inaction; or understanding of the difficulties faced by Africa, a justification for inadequate performance. A great development challenge lies ahead; it must be dealt with---and it can be dealt with---only together.

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(4)

Attachment 2

COLOMBIA: BANKERS MEETING
STATEMENT BY MR. ERNEST STERN
(Morning Session) 4/16/85 NY

I appreciate the opportunity of this meeting to share our views on four topics central to the decision on Colombia's request for additional borrowing from the commercial banks.

- our assessment of Colombia's creditworthiness;
- Colombia's program of stabilization and adjustment;
- the World Bank's lending program for Colombia; and
- the interrelation of the Fund, World Bank and commercial bank actions.

As you know, the World Bank has had a close relationship with Colombia for more than 35 years. During this period we have seen the country achieve remarkable economic progress, resulting in a substantial transformation from a predominantly rural and largely agricultural economy into one that is more diversified, urbanized, industrialized and linked to international markets. The Bank has operated in many sectors--from rural education to hydropower; from agriculture to industry--and that has contributed to an exceptionally close and fruitful association with Colombia's senior economic managers and political leaders.

Throughout our association we have kept Colombia's economic performance and creditworthiness under close review, as a basis for our own lending. Our commitments to Colombia total $4.7 billion, and our net exposure (actual outstanding as of now) is $1.8 billion. Our exposure now constitutes about 22.5% of total public medium- and long-term debt. Our concern for Colombia's creditworthiness is therefore at least as acute as any of yours. We believe that for more than two decades Colombia's economic management has been of high quality, with a pragmatic approach to dealing with its problems, in a stable political environment.

There have been situations in the past when Colombia has faced fiscal and balance of payments difficulties, which led to unacceptable declines in reserves--as happened in 1982-84. In those circumstances the Government adopted stabilization and adjustment programs which put the economy back on course. In this respect, current circumstances have their parallels in earlier situations. During the 1960s and 1970s, Colombia maintained an average annual rate of growth of about 6%; it managed its debt responsibly; and it paid its debt service on schedule. Colombia's economic history has had its ups and downs, policy mistakes have been made and sometimes--as in 1982-83--remedial action has been delayed longer than desirable. But the point is that Colombia has demonstrated repeatedly its capacity to analyze its problems, the political will to take the necessary tough decisions, and the professional capacity to implement programs of change pragmatically and effectively. And that, more than any specific set

of statistical indicators, is the foundation of our belief that Colombia has been, and is today, a creditworthy and responsible borrower. But there is no doubt that the maintenance of that creditworthiness requires an effective adjustment program.

Second, let me comment briefly on Colombia's stabilization and adjustment program--on which we have worked with the Government for the last nine months.

Colombia has responded to the adverse developments of 1981-83 by adopting major economic adjustments. Mr. Erb has already commented on the monetary, fiscal and exchange rate aspects. But the change in other areas is equally impressive--and was equally necessary. The purpose of these changes is to make Colombia a more open, competitive, efficient economy to assure its capacity to sustain growth, to strengthen its international competitiveness and to enhance its employment generation. To this end the Government has revised its public investment plans, reducing them in scope to match available resources and reorienting their composition. Emphasis is being put on the quicker yielding projects, on export and import substituting projects, and on the expeditious completion of projects, particularly in oil and coal, which will contribute significantly to the improvements in the balance of payments. More efficient use will be made of existing facilities and the public sector will substantially improve its saving performance. The adjustments to the exchange rate, the reduced demand for capital by the public sector, the program to hold down inflation and wage increases, all should serve to improve the investment climate for private investors in Colombia, increase the number of jobs created per peso invested and enhance the efficiency of the economy.

During the 1970s many distortions crept into the Colombian system, which contributed to the decline in its growth. We are satisfied that the medium-term adjustment measures are sound and will, if continued and deepened, restore Colombia's growth, its international competitiveness and further enhance its debt servicing capacity.

Let me now turn briefly to the World Bank program. The export boom of 1976-78 in fact led to a more inward-looking set of incentives, which were exacerbated by import surcharges and quantitative restrictions imposed to deal with foreign exchange shortages of 1981-83. The result was a drop in export volume by 7% per year, starting in 1981, and a consequent sharp increase in the debt service ratio as the growth of borrowing outstripped growth in export capacity.

To deal with the adjustments in trade policy, and to diversify exports, we have negotiated a Trade Policy Loan of $300 million, expected to disburse in the next 12 months. Mr. Schloss will be glad to go into the details of this program this afternoon. But this set of measures is central to the adjustment process. The essence is to support a basic change in outlook--from an inward-looking, protectionist approach to an outward-looking philosophy, relying increasingly on market discipline to assure competitiveness of exporters and of import-substituting industries. During the implementation of the loan, the Government plans to remove prohibitionson imports

(except those relating to health, arms and endangered species); to reduce import categories requiring prior licenses (free imports are expected to rise from less than 1% of the total tariff positions to about a quarter); to permit all imports required by exporters automatic entry; as well as those of spare parts and maintenance imports. To reduce the dispersion of tariff protection, which discriminates between industries, peak tariffs will be reduced from 200% to 80%. Further action will be undertaken to reduce the average tariff level to that prevailing in the mid-1970s. On the export side, the effective management of the exchange rate will be crucial. This will be supported by eliminating remaining biases against exports, to assure the exporter access to required inputs at internationally competitive prices. Export restrictions which now cover 725 tariff categories will be essentially eliminated, information and marketing support programs will be strengthened, and exporters' access to credit assured.

We believe these measures will lead to export growth of 10% per year and an increasingly diversified export basket. As a result, the deficit in the current account should continue to decline, and a positive trade balance--supported by exports of coal and oil--should emerge in 1986-87.

Beyond this loan, we have continued a substantial lending program in Colombia. In 1984, when Colombia's access to commercial bank lending was limited, we approved $730 million in new commitments and disbursements rose to $460 million--more than a 50% increase over 1983. In addition, the World Bank participated in two commercial bank syndications, through its B-loan program, which raised $170 million for the power sector.

In 1985 we expect to have a lending of about the same size, reflecting our judgement on Colombia's creditworthiness and economic management. We expect new commitments of about $650 million and disbursements of about $550 million--increasing our net exposure by over $400 million.

And this brings me to my last point--the interrelation of our program, commercial bank lending and the stabilization program discussed with the Fund. The maintenance of an effective stabilization program obviously is crucial. We are pleased that the program has been found satisfactory by the Fund and that agreement has been reached for a regular review of its implementation.

We plan to review the trade and associated economic policies on a regular basis, under the Trade Policy Loan. The first review will be held this Fall and satisfactory performance on the agreed trade issues will be a condition of the release of the second tranche. We will, of course, take account in our evaluation of the findings of the IMF on the stabilization program, which will conduct its review at the same time. In connection with the Trade Policy Loan, and subsequent sectoral adjustment loans, we will assess regularly the medium-term policy performance, particularly in the areas of trade, the investment and the borrowing programs. The conclusions of our reviews will be available to the Government and we would have no objection if it wished to share them with you. We will also prepare a Country Economic Report, in early 1986, which could serve as a basis for a

broader discussion with a Consultative Group of commercial banks and export credit agencies.

However, I want to emphasize that our program, and particularly the Trade Policy Loan, is seen by us as part of a total financial package necessary to support Colombia's program of stabilization and structural change. This program is not sustainable without the additional medium-term lending requested from the commercial banks by Colombia. We realize that increases in short-term credit lines may be expected as trade expands, but we also expect that there will be assurances that the credit lines in 1985 are maintained at the end-1984 levels to help sustain the export development program we will be supporting.

It is clear that the program on which Colombia has embarked will enhance the security of our outstanding loans and those of the commercial banks. Without the program the credit risk increases substantially. Yet the program requires additional external capital to be effective. Our substantially increased lending is justified <u>only</u> if the commercial banks also will provide the amounts required. Should that not happen, or should the decision be delayed unduly, the effectiveness of the Colombia program will be impaired--and indeed it may fail due to external and internal pressures. Consequently, my ability to present the Trade Policy Loan to our Board must take into account your decision on the funding request of the Government.

These linkages, let me add, are not only general and conceptual in nature. The bulk of the funding requested for 1985 relates to the financing of two projects--oil and coal exports--which are central to the improvement in the balance of payments in 1986 and beyond. Delay in their completion would have an immediate adverse impact on Colombia's debt service capacity and its ability to liberalize imports and diversify its exports.

Let me conclude by expressing our appreciation to the Colombian team for their collaborative approach in reviewing the problems and their efforts to formulate an effective program of adjustment, which our lending program will help to implement. We hope that the decisions on the availability of the complementary commercial bank funding will result from this meeting so that the highly promising medium-term prospects can be realized as quickly as possible.

## COLOMBIA: BANKERS MEETING

### STATEMENT BY MR. MIGUEL SCHLOSS ON ECONOMIC POLICIES AND TRADE POLICY LOAN
(Afternoon Session)

On January 18, 1985, the World Bank issued a statement on Colombia's recent economic problems, and the Government's policy response. This morning Mr. Stern, confirmed our willingness to continue to support Colombia based on a long and fruitful relationship, consistently good and pragmatic economic management, and promising prospects. In that previous statement we indicated that Colombia was carrying out an economic adjustment, which had begun to produce positive results. With a continuation of this process, stability with growth should be expected.

I would like to review with you four areas that have surfaced throughout our discussions: the country's actual economic performance, the prospective World Bank trade policy loan and some medium-term implications regarding the country's prospects; the underlying public investment program; and monitoring. As I go along these subjects, I will touch upon some of the questions that have been raised this afternoon.

A follow-up Bank mission visited Colombia subsequently overlapping with the Fund's Article IV consultative mission in the field. These missions confirmed the thrust of our previous statement. Actions taken to date by the Government constitute a significant and feasible adjustment program. A substantial fiscal reform is underway accompanied by a prudent monetary policy and more manageable public investment and external borrowing programs. A significant exchange rate adjustment is being pursued, supported by trade reforms to boost the performance of exports. As a whole, the policy package is designed to bring about adjustment with growth.

It is important, as recognized by the Government, that the execution of fiscal and monetary policies (such as revenue collection and expenditure control) does not suffer any setbacks. The envisaged program with respect to trade policy reform and export promotion, and the investment and borrowing programs should also stay in place as planned. The Government has been strengthening instruments to assist in the monitoring of developments in these areas over the short- and medium-term.

While 1984 continued to witness balance of payments difficulties, stabilizing trends particularly in the second half of the year are noteworthy. The real exchange rate measured against a trade-weighted basket of currencies in 1984 is estimated on a preliminary basis to have registered the largest depreciation since the crawling peg was established in 1967. The current account deficit of the balance of payments was cut by about a third from the previous year. The improvement in the trade balance was even more significant with a reduction in the deficit from US$2.1 billion

in 1982 and $1.3 billion in 1983 to only $300 million in 1984. Over the last quarter of the year, the reserves position stabilized.

Progress has continued in the first quarter of 1985. The exchange rate adjustment was accelerated and, despite a modest fall in reserves given the seasonality customary at this time, net reserves at the end of March were US$120 million above the level of half a year earlier and gross reserves were US$250 million higher. Fiscal restraint, which began to be evidenced in the second half of 1984, has deepened (with the Central Government overall deficit during the first quarter of the year reduced to less than one-third of the level of the corresponding period in 1984); and monetary emission remains under control now.

Thus, policy conclusions of the Fund and the Bank in key respects of macroeconomic management coincide with the Government's plans. The real exchange rate this year is targeted to reach the mid-1970s level which is the highest in 25 years, and is to be reviewed and improved thereafter if needed. Taking 1985 as the focus, the policy plans envisage a roughly 40% decline in the total public sector deficit as a percentage of GDP and a 70% decline in Central Bank financing of the public sector. The current account deficit in the balance of payments is targeted to decline further by roughly a quarter and the trade account to be in balance. For 1986, the total public sector deficit as a share of GDP would decline by a further 35%. A main goal of these policies would be to stabilize the reserves position during 1985-86, and improve it thereafter as oil and coal investments currently being undertaken in association with foreign partners come on stream and non-traditional exports respond to the exchange rate and other trade policy adjustments.

The outward-looking strategy that is being adopted provides the context for the proposed Trade Policy and Export Diversification Loan. In addition to the exchange rate policy, specific measures have already been taken to augment availability of imports to improve export performance. Other measures will be implemented over the coming months within a timetable by: (i) reorienting export policies so as to provide automaticity and uniformity of access to incentives and foreign exchange; (ii) adopting a program of phasing out of export restrictions; (iii) initiating a program of reducing import prohibitions and rationalizing quantitative restrictions and tariff dispersions and levels; and (iv) improving the administrative mechanisms of trade management. The Trade Policy Loan would be disbursed in two tranches. The first tranche of US$150 million would be available for disbursement at the same time of loan effectiveness; the second tranche of US$150 million is expected to be released six months later on the basis of a detailed assessment of the progress of the economic program, including the associated detailed policy actions on trade and the underlying investment program.

A steady growth in domestic oil production in recent years enabled Colombia to eliminate its oil trade deficit in 1984. Our medium-term projection based on investments currently underway, also with partial World Bank financing, foresees a net oil trade surplus of US$1,250 million by 1987 under relatively conservative assumptions of output from the

Occidental-Cano Limon field (100,000 barrels a day) and crude prices at about 10% below the 1984 level in real terms. A surplus of that magnitude would be maintained through 1990. Coal exports are projected to reach some US$500 million by 1987 and US$1 billion by 1990 with export volume levels of 10 and 16 million tons respectively, all but one million of which would come from the Northern Cerrejon field being developed with Exxon which begins limited production this year.

On this basis, the trade balance should be positive by about US$1.0 billion by the end of the 1980s and the current account deficit gradually reduced to just over 1% of GDP by 1990. With some build-up of reserves to maintain them at close to five months of imports of goods and non-factor services, and on the assumption of direct private investment levels of about US$350 million p.a. and very modest amounts of additional private sector debt, gross disbursements of public medium and long-term debt from all sources would need to amount to about US$2.0 billion p.a., during 1985-90 implying a net increase in outstanding public debt of about US$800 million p.a. on average. This would keep debt levels at manageable levels. The ratio of total outstanding public debt to exports of goods and non-factor services would decline from 1.8 in 1984 to less than 1.4 by 1990, and the public debt service ratio would remain at roughly 30% over this period.

In scaling down the public investment and borrowing targets in line with the requirements of the stabilization program, the Government has placed emphasis on investments geared towards productive sectors, export-oriented activities, and essential infrastructure development, thus postponing or redesigning large lower priority investments particularly in power and transportation. The resulting program is, on the whole, satisfactory and it places priority on investments that are geared to: (i) increase output rapidly; (ii) reorient production towards exports and efficient import-competing goods; (iii) support quick-yielding infrastructure investments, particularly those that enable the use of existing facilities more intensively; and (iv) increase resource mobilization. Continued action along these lines will provide the basis for further growth with sound balance of payments prospects.

This leads me to the final issue of concern to both the Government and the external financial community; the subject of monitoring. The World Bank's emphasis will be on the three critical areas relevant for the medium- and long-term growth. First; we would follow up on the trade reforms and performance in the context of the understandings under the Trade Policy Loan. Second; we will review with the Government the revised 1985-86 investment, borrowing and public sector financing program, which would be updated and extended towards the end of this year. Finally we will assess the overall progress being made on the execution of the Government's program, taking into account IMF's findings regarding stabilization. This three-fold review along with the Fund's assessment on stabilization will be carried out towards the end of the year, and will serve as basis for an evaluation of progress under the Trade Policy loan and for the release of the second tranche of that loan. This review could be shared with the banks if the Government so wishes.

The US$300 million Trade Policy Loan is now virtually ready to be presented to our Board of Directors for approval under the conditions mentioned by Mr. Stern this morning. The World Bank is also prepared to continue this type of association with Colombia in the future through a series of policy loans, which will be designed to support further this general policy direction. Our involvement of this nature envisages Colombia's ability to maintain normally adequate participation of the external financial community including commercial banks in its efforts.

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1985 SENIOR OPERATIONS MANAGERS' RETREAT

(5)

Closing Remarks by Ernest Stern
Hyatt Regency Hotel
Baltimore
April 18-20, 1985

At last year's retreat we discussed three key factors affecting our operations:

- Uncertainty - both in demand for our services and in determining appropriate responses;

- Flexibility - the need to respond on a differentiated basis to the needs of different borrowers; and

- Selectivity - Because we are not the only actors in the development business, our resources do not permit us to provide all services to meet all needs, we cannot afford to provide against all contingencies.

Let me reflect briefly on how these factors affected us in FY 1985.

Uncertainty

Uncertainty in the global environment has not diminished. It is likely to be with us for some time. Interest rates, exchange rates, and commodity prices remain both volatile and unpredictable. Three years of austerity programs have created social and political pressures, the results of which were unpredictable. And the movement to democratic regimes, particularly in Latin America, creates new uncertainties. Democracies, particularly recently resurrected ones, tend to be fragile. It takes time to build a consensus for adjustment and stabilization and for majorities to be decisive. And these uncertainties affected our lending program at great political cost to the institution. Nonetheless, we should take pride in how we handled the issue. We did not sacrifice our approach, which as we discussed yesterday, we believe is correct. We did not make the lending objectives supreme. We stayed the course and took the flack — demonstrating that while lending is a central part of our function, equally important is what we lend for. We still, to be sure, have much education to do of our members on this point and of our staff. It is an amazing failure of management communications to still hear that we are obsessed with lending targets, in a year when we are $ 2 billion below our objectives.

Flexibility

We have made a good deal of progress in the more flexible use of our staff, though much remains to be done to break down the walls of fiefdoms. Much experimentation has taken place in the strategy formulation process with good results. And we have further adjusted the composition of our lending and the tailoring of operations to individual country circumstances. This latter effort culminated in our paper to the Board on Lending Instruments which helped loosen the ties of anachronistic definitions and legitimized some of the hybrids we have developed. But flexibility has its costs too. There still is much unhappiness about the lack of a blueprint for adjustment operations. Managers and staff are uncomfortable

with the lack of guidelines, the absence of a mold. It puts a weight on judgment to which we are unaccustomed (for once we cannot cite the BOOK) and it requires collaboration in decision-making across functions.

Selectivity

The tighter budgets of 1985 and especially 1986 are forcing tougher decisions on priorities and resource allocations. New initiatives and programs no longer can be incremental automatically. Even if meritorious, they now must be judged in competition with ongoing activities. This, in many ways, is new to us and it is causing considerable pain. Yet, in our ESW programs and in the budget we have been more explicit about our choices, and have begun — but only begun — to move away from our habit of spreading resources over too many tasks.

Thus, despite a difficult environment, externally and internally, the past year has seen important achievements in these areas of adaptation on which our evolution and future growth depends. In operational aspects too we have much to be satisfied about. Let me just mention a few factors.

Africa

The Joint Program of Action had an exceptionally good reception and gave the Bank a broad vote of confidence. There is no doubt that we can take a good deal of credit for the changes in development strategies now taking place in Africa. The Bank's leadership there has received an overwhelming endorsement, reflected in the requests for leadership in aid coordination and in analytical support by the borrowers. No doubt we do not yet do Public Investment Program reviews as well as we should, and Consultative Groups and Round Tables can be improved, and our analytical work needs to be strengthened. But there is acceptance of the design we sketched out — donors are prepared to fit programs into borrower priorities; export credit agencies are similarly more responsive. Some of this acceptance is still at the level of principle, but a good deal has been translated into action. And, despite the aid weariness and trend away from multilateralism, we created the Sub-Saharan Africa Facility. It is a multilateral facility, in support of policy reform, and providing untied, quick disbursing assistance. Although $ 1.1 billion over three years is not a huge sum, it is a 30% increase over the existing IDA availability for Africa. We completed negotiations on the Resolution last Wednesday (April 17) and the special co-financing agreements with Germany and Switzerland are well advanced. Kim (Jaycox) said yesterday that our neck is out a mile in Africa. That's true. The task we are undertaking is immense. But our neck is not there by accident. We put it there consciously — because the problem needs to be dealt with and I have no doubt that — despite setbacks, frustrations and our inevitable grousing — we will succeed in making a difference.

In the middle income countries too there has been important progress. Commercial banks and export credit agencies increasingly, albeit slowly, are realizing the multiyear nature of the adjustment and restructuring process, and the need to look beyond stabilization. We can take a lot of satisfaction at the Colombia case which David (Knox) described yesterday. It may well prove unique in its specifics, but our participation in the Steering Committee deliberations and our role in formulating the adjustment program and shaping the joint monitoring arrangements are a significant step in getting our perceptions of the process integrated in the decision-making of the Fund and the commercial banks. Similar prospects exist in Costa Rica, Chile and the Ivory Coast.

And other building blocks are being put in place. For instance, an Energy Sector Loan in Pakistan has just been completed which contains the policy umbrella for projects in that sector for the next few years. It is a step (in two directions) towards managing conditionality, as Gautam (Kaji) called it yesterday, and towards giving a multiyear dimension to our policy agreements.

More broadly, we can take satisfaction in the improved quality and relevance of our analytical work and the experience we have gained in adjustment programs, which has enabled us to steadily improve the product, and in the growing awareness that the Bank's work on medium- and long-term issues is central to the resolution of the debt problem and the resumption of sustained growth.

And as to internal matters, I would highlight among the many things in progress, a change in the way we set our lending objectives. In the past, we agreed on aggregate growth objectives which then were translated into country-specific lending objectives. After completing the country by country analysis which we reviewed with the OVPs two months ago, we now have agreement to reverse this process. We will therefore establish realistic lending programs by country, and the aggregate of these will become our lending ranges.

Thus I would say that despite the turmoil, and contrary to popular opinion, a great deal has been accomplished this past year and much constructive change has taken place in our approach and assistance strategies. We are today a more effective, more relevant and more active institution than a year ago — a fact which we often do not appreciate fully as we look at what remains undone; and a fact which we certainly are not communicating to our staff. Of course, much remains to be done — our mandate with commercial banks is unclear, export credit agencies are dubious about getting too close, the Paris Club does not think that debt rescheduling has anything to do with development finance. As Vinod (Dubey) said — we need to continue to do our homework.

Now let me look ahead a bit. And let me deal with three areas:

- the composition of our work program;
- the management of our processes; and
- communications and accountability.

First, the work program.

There is, by now, broad agreement on the need and desirability of sharpening the country focus of our activities. Our objectives are to:

- provide appropriately focussed analytical work to our borrowers, including policy alternatives;
- have a lending program which clearly reflects the agreed policy objectives of the borrower, and the policy and institutional reforms necessary to achieve these objectives; and
- maximize capital flows to our borrowers in support of those plans, in an increasingly coordinated framework of agreed investment and sectoral priorities.

As I said we have made much progress in this, and the scaffolding is rising slowly to put in place the more clearly articulated, medium-term plans of borrowers on the one side, and the mechanisms by which other sources of capital will use those plans to make their own investment decisions on the other. We obviously need to continue our efforts in this direction since the scaffolding is only at about the second floor. But at the same time we need to bring another strand into the design, and that is Ravi's (Gulhati) point of yesterday — the implementation and sustainability of policy change. This problem may be most acute in Africa, but it is a general problem.

By this I mean three things:

- Policy dialogue without agreement on action is meaningless.
- Effective policy advice requires not only knowledge of macro-economic factors — the policy anomalies to be corrected — but also detailed knowledge of how the system (credit, imports, investment decisions, whatever) works under the present arrangements. Policies got the way they are for reasons. It is necessary to understand those reasons to know the nuts and bolts.

- Changes in policy rarely are enough by themselves to achieve desired supply responses; therefore, we must anchor the policy change in political reality.

And since we are an organization of fashion, there is considerable risk at the moment that the policy slogan has become too seductive and is losing its reality. Success in the policy area requires not only 1-2 (or even 5) policy-based loans; it requires a project lending program which helps to translate the new policy framework into different production processes, whether it is better extension services when producer prices are raised; investment assistance to industries when the trade regime is changed; infrastructure financing to support improved or redirected marketing channels, or management assistance to help restructure organizations to deal with a more competitive environment.

Efficiency of resource use in the developing countries is not _only_ a question of policy; the improved policy framework makes more efficient use of resources _possible_ — it does not make it happen. It is also a question of capacity — human and financial. And unless that is dealt with, the policy changes _will not_ survive. We do not say that the mainstay of our lending will remain in projects to pacify the Board or because we do not want to endanger the pillar on which our reputation rests — but because those operations wll enable producers to utilize the improved policy framework and to _benefit_ from it. Without such benefits there will be neither long-term support nor success.

And that is why I am concerned about how we are planning our lending programs and about the still frequent worries voiced by Projects Staff about their role in a Bank more expressly involved in policy change. These worries can only mean that the link between improving the policy framework and ensuring that benefits can in fact be derived from these improvements, is not well understood.

Let me turn to the management of our processes, about which we have heard much thoughtful comment this morning. These suggestions will take time to sort out and to consider. But let me throw a few more thoughts into the pot.

_First_, we have taken on many major new challenges. The additional work is costly, and we are, and will remain, in a constrained environment. That means we have to manage our resources better _and_ we have to be more selective.

_Second_, scarcity of resources should not only be seen as a constraint — it is also a management opportunity — and that is not just an idle phrase. We _all_ know of activities which are anachronistic, of activities which are not managed, of activities which could not stand competitive scrutiny.

Third, we all agree on the need for better management, for more cost consciousness, for streamlining of processes, for delegation of authority. But, as in the country policy dialogue I would ask whether we do enough, even whether we are interested enough, in the nuts and bolts of what would make these desirable policy objectives possible.

Let me list a few things we might think about. For instance, do we have an individual objective as to how our staff can be made to write shorter papers? We heard it mentioned this morning — and we have heard it mentioned for years. Are we going to say x pages and no more and stick to it? Are we going to give our staff the security they need to write shorter papers?

Are we defining our objectives at various levels, and for different activities, clearly enough, so we have clear purposes, minimum costs and maximum effectiveness? TORs are no doubt thought of as details — but without clear TORs we get the 12-man missions with the mission leader lacking purpose and authority and with sector specialists running around on their own and we get a long report full of data but short on information.

Can we say we do enough to avoid duplication in the many studies, costing millions, by making sure we focus on what we (not just in the Bank) do not know? We often speak of a supply driven lending program and, no doubt, that factor exists. But what are really supply driven are our studies. And they cost not only money — they cost staff time and management time; they impact on our public image, they clog the system and they offer the soft option for decisions. We know all that — there is little disagreement. But how many of us have objectives to have fewer studies and are staff aware of these objectives? Are they secure that they need not propose studies to deal with every possible aspect of a problem?

Can we say that we are conscious enough of the value of time? I am not referring to our personal time, the bunching problem or such like. But are we persuading our staff that action now, in the broadly right direction, even if based on imperfect knowledge, is better than action delayed — even if that is accompanied later by perfect knowledge?

Are we facilitating the learning process? The mission leader of a first SAL in a country, or the first Public Investment Review, is not now deriving maximum benefit from the work done elsewhere. Are we satisfied that we are teaching our staff to be open to this knowledge, to seek it elsewhere, to find those with more experience, or are we supporting the reinvention of the wheel every time because then it is our wheel, and our budget, and our credit — and because we can avoid all those advisors we have been speaking of.

Perhaps more to the point — Are we learning from our mistakes?

A key weakness in the Bank is our fear to make — or to be seen to make mistakes — or to be overruled. In a world of close judgment calls, we must prepare ourselves and our staff, psychologically and intellectually to encounter different viewpoints which, even if they prevail, are neither an intellectual insult nor impugn professional ability. When a proposal is overruled do we as managers articulate why, while if possible identifying variants on the theme which might make it fly. And when we turn something down, are we saying "I don't think this makes sense" or "This won't fly with my boss". If we say the latter are we sure that's what we mean, or are we afraid of the risk of being told no? Surely we promote innovation by letting good ideas go forward and letting the next level provide its own reading.

In short, unless we test the frontiers, we cannot collectively learn what might be useful. And when a trial balloon does not fly, are we disseminating appropriate information to explain the judgment to staff?

We cannot move forward in an uncertain world by trying to forge a consensus on each new idea, therefore, rebuttals (however politely they may be dressed), are an essential part of our work.

Are we consistent enough in our analysis of management problems and in our views on desirable changes? Do we take a systemic view or are we looking for something different — in the hope that it will be better? For instance, I was struck this year in the budget process, which was essentially a dollar based exercise and, I thought, smooth and streamlined, that the appeals were all based on coefficients — those same nasty bugs we have been told for years are pernicious, irrelevant and should be done away with.

And finally, let me ask whether we believe that all levels of our management have a clear understanding of their responsibility and their scope for action; whether we are encouraging ourselves and our subordinates to let the maximum number of decisions be made at the lowest possible level, not the minimum; whether successive reviews of decisions focus on dimensions the previous level is unlikely to be aware of or whether we try to make better decisions on the same data base?

And finally if our answer is 'yes' to all of these questions, do our staff know this? To this question I feel sure that the answer is 'no'.

Let me conclude by a brief word on communications and accountability. It never ceases to amaze me how large the difference is between staff information and reality. I know we love to talk and gossip, and grouch. We, like the media, like to talk about failures more than about success. We love to gloat about the immensity of our problems — in part because we

think everyone knows about our successes. Well, part of that is human nature but the extent is unreal. And there is no doubt that part of it is fueled by our own behavior — in three ways. First, we give too little weight in our public utterances to institutional objectives. Too much of the communication is about our unit — without giving expression to the institutional dimension, which is seen and conveyed as an exogenous burden — not an integral part of our own objectives. Second, our staffs are not yet aware of our individual roles in the decision-making process. They do not know that OVPs as a group make OMRG decisions, that all policy papers come to the OVPs, and are only adopted if there is agreement, and that we participate in the decisions of Finance, Personnel and Administration subcommittees, because, I can only conclude, this point is not stressed and we do not yet take public responsibility for joint decisions. Third, we ourselves are bad news addicts — if my perception of this past year, in specific accomplishments and in progress toward longer term goals, is even broadly correct, your view cannot be that different — but this surely is not what we are emphasizing to our staffs.

Well, let's go to lunch. But I hope we will leave here today more fruitfully confused than when we came — but also more sure that it is in the nature of being successful managers in a complex and unpredictable environment to have disagreements, to differ in judgments on solutions, and on timing and yet to recognize that decisions must be made in a timely fashion.

The key to a successful and innovative Bank is not to avoid these differences but to make them part of the learning process, for ourselves and all our staff. And I hope we can leave with the resolution to take time out in the course of the year — not too frequently of course — from our addiction to negativism and devote some time to expressing what, after all we must believe, that we are all doing a damned fine job.

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FOR WORLD BANK

PROGRAM Strictly Business STATION WRC-TV

DATE April 28, 1985 12:00 Midnight CITY Washington, D.C.

SUBJECT The Economic Summit

JOHN HAMBRICK: The Bonn Economic Summit comes at a critical time. The towering U.S. trade deficit only grows, European unemployment remains high, and a world trade war is now a genuine possibility. But the real victims may be the Third World Nations: Latin America, mired in $350 billion debt; Africa, with only $6 billionin debt, is suffering depression and famine.

To discuss just what issues the summit should stress, from Washington, Ernest Stern , a Senior Vice President of the World Bank; and here in New York, Richard Debs, President of Morgan Stanley International.

Gentlemen, we welcome you to Strictly Business.

Mr. Stern , what is the most critical international financial issue facing the West today, in your judgment?

ERNEST STERN : I think at the summit meeting we would certainly hope that they focus very much on the question of protectionism, the maintenance of a free trade system, as well as a more collaborative approach to the fiscal policies of the major industrialized countries, because both of these are crucial to the ability of the developing countries, the ones in Latin America and in Africa, in particular, to come out of the problems they're facing.

HAMBRICK: Mr. Debs, do you agree that any rise in protectionism could particularly hurt the developing Third World countries?

RICHARD DEBS: Absolutely. I would hope that we would,



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to any extent, be able to resist these protectionist pressures that are clearly mounting today. They're very tempting. They're a short-term solution. But long term, they're no solution at all. They simply just don't work. And their impact would be felt immediately on the Third World, immediately and directly. And the effects, I think, could be disastrous for them, in particular, but, more generally, would be disastrous for our system.

HAMBRICK: How practical is the coordinating of domestic policies in order to get cooperation in this area?

DEBS: Twenty years ago, thirty years ago, we didn't have to worry about that. We could have a domestic policy that had very little -- didn't have to worry about the international side. It's an attitude that we've got to change in our way of thinking. And when we get there, then you can talk about coordinating economic and financial policy worldwide. I mean that -- and to answer your question directly, there is certainly a need for that. We simply have to do it.

HAMBRICK: Do you believe that there's a real possibility for a trade war at this particular point?

DEBS: Yes. Unfortunately, I do. I think it would be the last thing we need in the present economic and political circumstances. But I don't think the probabilities are high at all. I think rational thinking will prevail, and with the realization that it's not going to achieve anything longlasting, any kind of solution to the problem.

A trade war would be suicidal, in my opinion.

HAMBRICK: Mr. Stern ?

STERN : Well, I agree a trade war would be suicidal. I think it has a low probability because everybody recognizes that.

It also requires not just bargaining on the trade side, it requires governments to understand, in the industrialized countries, that they too have an adjustment process to go through, that existing industries need to change, and that they need to keep their markets open, and that they have to move into new productive enterprises to make room and to accommodate new producers into those markets.

HAMBRICK: Thank you, gentlemen.

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TALKING POINTS FOR WYE SEMINAR
(SOUTH ASIA)
May 30, 1985

Retrospective Review (Bank-wide)

Difficult year with many challenging problems:

- Middle Income Countries. Debt burden, macro-economic reforms seem elusive; difficulty of mobilizing political will; difficulty in establishing a development focus in an atmosphere dogged with crisis and preoccupation with immediate demands of debt rescheduling negotiations, mobilizing additional resources from Commercial Banks, managing news media; political crises (e.g. Argentina, Brazil, and the Philippines).

- We are still very much in the learning phase in our work on structural reforms in middle-income countries---complex sequencing of policy reforms in the industrial, financial, trade, and public sectors. Work proceeds without a blueprint; we only know the right direction/judgments are difficult, but essential (Turkey, after 5 SALs, still needs major reforms in its financial sector; Agriculture sector policy is only beginning to be addressed). But we are learning---now we must recognize the importance of ensuring the effective transfer of accumulated knowledge;

- Last year, it was frequently asked where the Bank was. Well, we are not the fire company; today an enhanced role for the Bank is emerging for the middle-income countries---i.e., a role in providing the medium-and long-term perspectives for the Commercial Banks and ensuring that appropriate policies are undertaken to achieve sustainable medium and long-term growth, e.g. Chile........, Costa Rica.......

- Ultimately, the future of these highly indebted middle-income countries must be in maintaining a competitive export and import substitution sector which can generate the investible resources for future growth. It means a continuation of an adjustment process with increased emphasis on growth; it must mean increasing attention to issues of poverty---as the urgency of the crisis wanes.

Sub-Saharan Africa

From the beginning of the year, this area demanded hightened attention. Not just the Joint Program of Action, but more broadly, the

recognition that determined new efforts are essential if the downward spiral so starkly manifested by the famine in many parts of Africa, and seems almost predictable for the foreseeable future, is to be broken.

The Bank responded to the request by the International Community that we should take a leadership role in efforts to mobilize additional resources for Sub-Saharan Africa; to coordinate aid and implement and monitor the Joint Program for Action.

In retrospect, we must regard our achievements to date with some satisfaction. A total of over $1.2 billion has been raised in direct contributions and special joint cofinancing to be disbursed within 3-5 years, in support of policy reform efforts in selected African countries; disbursements will be on an untied basis. And in spite of the widespread attention focussed on the crisis of drought and famine, consciousness has increased that the nature of Africa's problems are primarily long-term and structural, some can only be addressed by consistently applied and adequately supported policy reforms. Others require a lot of imagination: (1) desertification, (2) deforestation, (3) agricultural research, (4) implementation capabilities, (5) human resource development. The task ahead in Africa is daunting and it will be several years before many countries will see per capita incomes increasing and even longer before per capita income levels can reach the levels achieved 15 years ago.

## Overall Performance of Operations

It is important when looking at FY85 that the lessons of the lending program be placed in context and internalized. We now expect FY85 lending to reach about US$11.3 billion; IDA credits will total a further $3 billion; these volumes are very substantial by any standards and it is difficult to understand the evident shock both among staff, the Board and the Press in response to the fact that our FY85 lending is some 4% below FY84 levels. Nevertheless, we all know that this fact did give rise to considerable negative publicity and much soul-searching which, in my view, was quite misplaced.

As has been discussed in many fora, but seems not to be widely understood, some 40% of FY85 lending is concentrated in four countries. Another 10 countries account for a further 40% of lending (each with annual lending of $300 million or more). Clearly, changes in our lending operations in any of these countries are of such magnitudes that they cannot be absorbed by our other clients. The lending program to individual countries can only be projected within a range---indeed in some cases, e.g., Argentina, Nigeria, and Romania, we are unable to project whether or not we will lend

next year at all, with any certianty. We are rightly preoccupied with what we lend for and not when, whether and how much we can lend. But this message does not simply apply to FY85. Rather, it has been a fundamental tenet of Bank operations and will continue to be so. While realistic programming of lending is essential, lending programs do not have a life of their own and appropriate responsiveness to changing circumstances---irrespective of the implications for lending levels---is an essential and inevitable implication of our mandate as a development institution. This does not mean that we see our involvement in countries as something passive---determined only by external forces. We can and do try to influence these forces, (and after we are successful). But when the circumstances do not permit effective lending for development, we also are obliged to recognize this limitation and respond accordingly.

For years, Bank staff have insisted on bemoaning management's preoccupation with lending targets. This year we fell some $1 billion short of our target---it did not rain fire and brimsone---most of us are still in one piece. It would be well worth the political flack, which we incurred, if we could use this experience to put the lending program and the meaning of targeting in perspective once and for all, at least within the Bank.

And since lending is far from being the only Bank product, it is important to add that I see marked improvements in the quality (i.e. policy and operational focus) of much of our CESW). We still have a long way to go but CESW is increasingly being used as it should be, namely to provide the analytical background for policy and lending decisions.

Aid Coordination

We are also learning that aid coordination is a time-intensive business, but it is an important role which we are being called on to play in many countries. The effectiveness of these efforts remain to be seen, but initial indications look promising in many African countries. (Must do more---investment programs, macro-economic management. Decide more clearly on decision points).

South Asia

May feel neglected since it "qualifies" for neither of the labels so prominently in the press in the last year. Cynics might be tempted to believe that a debt crisis, a war or a famine are needed to put the great needs of the Region on the map once again. On the one hand, South Asia provides a demonstration to much of the types of localized achievements which could be realized in Africa. On the other hand, India and

Pakistan, in particular, look cautiously at the ongoing difficulties of the heavily indebted middle-income countries, and rightly so. Defining the role of the Bank in South Asia is a challenge in itself. The Region is generally not moved by the crisis or necessity pushing many Latin American and African countries to become involved in meaningful policy dialogue. "Conditionality" is a concept which is simply unacceptable when applied explicitly. But still, the scope for making an active and very real contribution to the thought processes of decision-makers should not be under-estimated. For example, India's agriculture: T & V, after many years of widespread resistance, has been "institutionalized" by most States. Pakistan Energy Sector: A long-term seemingly endless "monologue" by the Bank seems now to be bearing fruit. On the other hand, at least for the time being, our policy dialogue in Bangladesh and Burma certainly leaves a great deal to be desired. Sri Lanka's difficulties in the immediate future are unlikely to be susceptible to significant Bank involvement.

The Bank could not offer substantially increased aid flow in South Asia---even if policy dialogue could be purchased---which it cannot.

The principal "asset" which we can offer in South Asia--as elsewhere--is an objective analysis of the prevailing situation and prospects for each country, as well as policy alternatives grounded in this analysis and supported by specific country knowledge and Bank-wide experience. Decisions necessarily rest with national governments.

Closely linked to our ability to provide objective analysis is the Bank's realization that the medium and long-term development potential must be kept in focus at all times. While decision-makers may be compelled by circumstances to address imminent policy or political concerns, our role must be to direct attention to those development areas where returns are not necessarily visible during an election term.

For South Asia, the development problems are different in many ways from other areas, but increased emphasis on (1) the establishment and maintenance of efficient competitive export and import substitution sectors, (2) improving the efficiency of public sector enterprises, and (3) improving productivity in the Agriculture sector, is certainly warranted in South Asia, as in other Regions.

Achieving progress in these areas is complex and requires difficult judgments anchored in the political and economic realities of the country. No blueprint can be prepard for this work, but lessons and

insights can undoubtedly be derived from experiences elsewhere, especially concerning the sequencing of reforms in the trade, industry, financial and para-public sectors.

While not directly comparable, experience in Korea, Turkey, Indonesia, and Colombia can provide useful lessons in the design and implementation of policy reforms in these areas---and even if the necessary measures are not imminent; the lessons from these experiences should be filtering through to our own staff and authorities in your countries.

Turning to some longer-term development concerns, I would like to focus on four main areas:

Human Resources. A key to development, whether or not we are lending in the sectors which have a direct impact on human resources, must remain an important focus of our work---serving to direct decision-makers' attention to the long-term benefits of increased efforts in these areas. Population and health projects have had some success in the Region (e.g., Tamil Nadu Nutrition) serving to provide guidance for similar operations in other countries. The point is not to have the Bank itself necessarily take the lead in work in these areas, but we should be alert to the adequacy of the efforts being made, in view of the long-term needs of the countries in the Region.

Poverty Alleviation. We are all aware of the difficulties associated with evaluating the poverty impact of our operations. But this work is essential and serves to focus our own---as well as the decision-makers'---attention on this important aspect of development. Our evaluation of poverty impact must not be seen solely in the context of individual lending operations, but must take into account the overall policy framework of countries---the biases in favor of, or against, the poor, focusing on the design of policy instruments with the objective of poverty alleviation in mind.

Environment. Deforestation, water use, chemical control---direct attention to long-term implications of actions affecting these areas---heighten awareness of our own sector specialists.

Science and Technology. Sectoral specialists must increase their awareness of the implications of these areas for their project and sector work (improve their own knowledge). Be alert to the need to broaden the scope for absorbing technological developments

(human capital development, appropriate research facilities) and effective transfer. [Inform staff that you see the strengthening of our efforts in these areas as an objective in coming years].

Role of Project and Sector Work. With the emphasis of recent years on increased policy dialogue (i.e. macro-economic dialogue) in many countries, a misunderstanding about the role of project/sector work has emerged in some quarters. Clearly, an objective is to establish a policy framework wherein all project and sector lending can be effective. Policy dialogue is not, and cannot be, an end to itself. The returns to a meaningful policy dialogue which results in policy reforms can only be realized in the context of the implementation of individual investment programs and the successful operation of these investments. Therefore, the key role of our project/sector activities in this process is clear.

These concerns are grouped under four myths which are prevalent in the Bank.

First, there is the myth that management is the art of defining the right organizational structure and of spelling out exactly how everything should be done. This, of course, is nonsense. Management is getting people to do things better, to match personal creativity with institutional objectives, to provide a vision of the overall purpose which makes the daily grind of detail bearable. A recent book, a sequel to the Search for Excellence, said it well:

> "The manager can't really do anything much of value. He can only suggest (symbolize) what's important by the way he behaves...So, you're in favor of quality...So what? The quality message will get across only if it ends up as marginal notes penned on memos day after day, year after year."

Only a very small part of management is organization and procedure; the largest part is making things happen on a timely basis, being sure that they are as well aligned with reality as possible, and embody the lessons of experience.

Our second myth is that consensus is necessary for decision. Our emphasis on extensive consultation stems from the uncertainty concerning the best way to proceed---given the

complexity of the social, political, and cultural aspects of almost any development decisions; let alone the differences among economists about the impact of measures or even among engineers about, say appropriate technology. But the essential skill of all decision-makers must be to identify the point of diminishing returns to discussion and decide. The consensus myth is, of course, a good protection against the dire prospect of having a conclusion changed or a decision overruled because we then have the psychological cushion of reduced personal responsibility for the decision.

The third myth is that if it is not done in the Bank---or at least under contract with the Bank---it is no good. This leads to enormous duplication of work and studies. We fail to build on what others have done and we see the deficiencies of their work but excuse our own. We simply cannot continue that way. It is intellectually arrogant. It is expensive. It defers action as we search for the optimal solution.

The fourth myth is that the higher you are in the Bank's grading structure, the more intelligent you are; the more you know. That this is a myth is obvious to all, no doubt. But as a result of that myth, we tend to have a duplicative decision-making process which is unduly protracted and boring. Each decision-making layer should concentrate on judging issues on the basis of knowledge not available at the previous level. This means introducing country context, or social factors, or Bank-wide interests----not duplicating technical technical judgments made earlier.

The last myth is, perhaps, the most important---it is that the Bank has lost a sense of purpose, has become irrelevant to the problems of today, is full of bureaucrats who prefer to sit in Washington pushing papers to solving problems in the field. There are two things which demonstrate that this is a myth. First, our record of performance and the appreciation of our borrowers for our work. Second, that those bureaucratic paper-pushers are always the other people---them. But the funny part is that everyone in the Bank thinks that. The problems of our borrowers are immense; our resources will always be inadequate; the climate sometimes is adverse; we are but one of many players and cannot control the outcome.

But if we can demythologize ourselves and look not only at the problems but also at our contribution---we will have done much to make ourselves more effective partners for our borrowers.

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International Bank for Reconstruction and Development

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FROM: The Deputy Secretary

November 19, 1985

COMMITTEE OF THE WHOLE MEETING - NOVEMBER 12, 1985

Statement by Mr. Stern

As requested by Executive Directors, attached hereto is a copy of the statement made by Mr. Stern at the meeting of the Committee of the Whole on November 12, 1985.

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COMMITTEE OF THE WHOLE MEETING - NOVEMBER 12, 1985

Remarks by Mr. Stern

Excerpts from Transcript of Proceedings

I reported two weeks ago on the initial meeting that was held by the International Institute of Finance to discuss the response of the commercial banks to the proposals made by U.S. Secretary Baker in his address to the Bank Governors in Seoul. Since then, as Mr. Clausen has indicated, there have been a number of other meetings, and we thought it might be useful to bring you up-to-date on those discussions and the work that is in progress in various fora.

All of you are familiar with Secretary Baker's speech in Seoul, which contained the proposal relating to the heavily-indebted middle-income countries. I just want to note, before we turn to the subject, that as Mr. Clausen indicated, the United States has proposed two different initiatives---one, relating to the middle-income countries, and I will turn to that in a moment; and the other relating to low-income countries which revolves around the availability of trust fund resources in the IMF, their use in support of adjustment programs for countries with continued acute balance-of-payment problems and the need to support those countries, in addition to the use of the trust fund resources, with other sources of funds.

Discussions on the latter proposal are also proceeding both in the Fund Board as well as bilaterally. The two proposals rest on the same two basic principles, namely that it is urgent to develop adjustment programs which contain a significant element of growth; and that it will require more external capital if the growth objectives are to be achieved.

We believe that both principles are vital.

Let me now turn to the discussions which have taken place regarding the middle-income countries.

In the middle-income highly-indebted countries, growth in the last several years has been very low. We think that there has been some recovery in 1985 but even so, for the period since the debt crisis started in the early 1980s, there has been a sharp reduction in disposable income; savings rates have dropped, although there is some recovery in 1985; investment programs have been cut substantially, in some cases emasculated, with heavy costs for future growth; and the adjustments which have been undertaken have had a serious impact on real wages and in some cases have led to increases in malnutrition and other manifestations of poverty.

We believe it is correct, as indeed we have argued for some time, that adjustment programs need to do two things: one, move beyond the adjustment measures which have been taken so far; and second, incorporate a significant resumption of growth.

As you know, Secretary Baker's proposal refers to a list of 15 middle-income countries, (Argentina, Brazil, Chile, Mexico, Venezuela, Nigeria, the Philippines, Bolivia, Colombia, Ecuador, Peru, Uruguay, the Ivory Coast, Morocco, and Yugoslavia). And it was proposed that, for this list of countries, the commercial banks ought to commit themselves to increase their net outstandings by some $20 billion over three years, and that the multilateral development banks should increase their disbursements to these countries by an approximately equal amount over this period. About 60 percent of this would be by the World Bank. I mention these numbers because they are relevant to the comments made in various meetings.

Since the IIF meeting two weeks ago, the commercial banks have established a coordinating committee, representing banks from the United States, Canada, Switzerland, Japan, France, Germany, and the U.K. This committee of approximately 17 banks---and there may be additional members later--- consists of chairmen of the Advisory Committees which have dealt with the rescheduling exercises in the last several years. It is the intention that this group be the principal conduit for negotiations with the U.S. Treasury in formulating the response to Secretary Baker's proposal. This group also wishes to discuss the role of the World Bank and the IMF in individual countries. The IIF would not serve as the channel for these discussions, but might provide technical support to the coordinating committee.

Last week Mr. Erb and I met with the coordinating group in New York. My assessment is that the banks are making good progress in considering how to respond to Mr. Baker's request for a commitment of $20 billion in support of growth-oriented adjustment programs. Thinking is also progressing on how such a commitment might be implemented in individual country cases. Many issues are on the table and, as yet, there are few conclusions. Each group of banks on this committee is to be responsible for contact with their national groups of banks. In the United States that effort is being headed by Morgan Guaranty, which has already convened a meeting of U.S. regional banks to consult with them on how the U.S. banking community might respond to Secretary Baker's request for a commitment.

The non-U.S. banks at the meeting reiterated what they had said at the IIF meeting, namely that they had not yet heard from their governments and hence wanted to wait before considering in detail how to respond. Nonetheless, I think, there is general acceptance of the principle by these banks that in appropriate circumstances---that is, if there is a satisfactory program which both the Fund and the Bank can monitor and a growth-oriented adjustment program designed to enhance the creditworthiness of these countries over the medium-term---that they would be willing to participate in financing such programs.

Quite a lot of activity is in progress to expand the consultation with major capital exporting countries. There is a BIS meeting this week in Basel where, no doubt, the opportunity will be taken to discuss the objectives of the Baker proposal and the request for a commitment by the commercial banks.

There also will be two relevant meetings in Paris this week; Working Party III of the OECD which has on its agenda the debt problem and so will be a natural forum for further discussion of this initiative. The Deputies of the G-5 also will meet and are expected to discuss the U.S. proposal and any actions they might take to encourage their national banks to participate.

In addition, I am sure all of you have read that Mr. Mulford, the Assistant Secretary of Treasury, has gone to Argentina to discuss with one of the heavily indebted countries, which is in the middle of a major adjustment program, its reaction to the proposals. He will be followed, I think, either later this week or early next week, by Mr. Volcker, on a similar mission.

We would expect that, after the discussions in Basel and Paris, the non-American banks will be in a better position to judge how they might participate in responding to Mr. Baker's proposal.

At the Friday meeting with the commercial banks, there also was discussion about the list of countries and what it meant, and about how specific the $20 billion was. The general conclusion was that the list will need to be flexible over time. It is, of course, a list of countries which are highly indebted and which need to deal with their adjustment problems. But there may be other countries which should be added, and not all of the countries on the present list may act to formulate an appropriate adjustment program in the near future. But the prevailing view was that the list was a reasonable starting point, although some would, at the margin, have made different choices.

And from that, of course, it follows that the $20 billion commitment requested from the commercial banks is a general objective. While it is very important, in terms of conveying to the countries considering growth-oriented adjustment programs, that resources will be available to finance these programs and this is crucial---the exact amount required will have to be decided in each case.

The discussions also dealt with the nature of the adjustment programs, the nature of Bank/Fund collaboration, and the World Bank support of adjustment programs.

Let me cover these three aspects briefly. The nature of the programs that are implied in Mr. Baker's proposal are programs that we are

familiar with in this Board. The changes required are those that we have supported with our structural adjustment lending. And our lending as well as our policy work has had as its objective the resumption of growth. But I think what will be required beyond that is a more systematic approach, a more comprehensive approach, a more integrated approach.

Essentially, these programs should have two objectives: namely, a reduction in the debt service ratio over a period of time, and a development program which is based on a reasonable rate of growth. What a reasonable rate of growth is, and how rapidly the debt service ratio can be reduced will, of course, be determined in the context of each country situation. But both objectives need to be present.

And based on those two objectives, it will be possible to calculate a number of other major objectives; such as growth of exports; investment levels, both public and private; savings levels, expectations as to the budget requirements and so forth. The purpose of the projections would be to identify the policy measures that might be needed to achieve the objectives with a reasonable degree of certainty.

While these objectives, and the associated policy framework, can be defined broadly for a five-year period, they will need to be flexible and subject to regular review. Specific measures for the first year would be agreed. Flexibility to undertake mid-course corrections will be important because there are many changes in the international environment which are likely to occur and which the debtor countries cannot control. And any program with its associated financing package needs to be constructed with the flexibility to respond to unforseen developments, both internal and external.

But essentially, the kind of program framework built around the objectives of growth and enhanced creditworthiness is what we envisage and what is, I think, generally accepted.

In terms of Bank/Fund assessment of these programs, it implies a different approach than in the past in the sense that it will require an earlier assessment of resource availabilities. And that is why the indications of commitments from the commercial banks and from the MDBs is important. In order to formulate a program which has a specific growth objective as well as an objective to reduce the debt service ratio, it is crucially important to have a good understanding of the external resource envelope, as well as of the domestic resource mobilization effort. If one has an assessment of the external resources likely to be available early in the process, it facilitates constructing programs which incorporate an explicit growth objective rather than allowing growth to be calculated as the residual. If, as has occurred in the past, the availability of external resources is unclear at the outset, and one tries to strike the best possible deal in terms of new money packages, there is

a risk that the resources for growth are squeezed. So the shift implicit in the Baker proposal is a very important one.

On Bank/Fund collaboration, Mr Erb and I indicated that we did not believe that major changes in the system of collaboration would be necessary. As we have mentioned before, in the last several months the Fund has issued instructions to its staff on collaboration, and we have issued a parallel note to Bank staff. We believe that these two sets of guidelines are adequate. They formalize what has been going on for some time now---effective exchange of views before missions leave, participation in each other's missions whenever appropriate, debriefing upon return of missions and, where we are both engaged in supporting structural adustment programs, an active exchange of views throughout the processing of the Fund's papers on standbys or EFFs, and our processing of structural adustment lending. Obviously, we will need to give further thought to how we can best help develop integrated and comprehensive programs of growth oriented structural change on the basis of which Fund programs and Bank structural adjustment lending or sector adjustment lending could be based.

There are in the minds of commercial banks also, a number of issues relating to their collaboration with the World Bank. They relate to monitoring and to what we can call comfort issues.

On the monitoring side, I think the discussions have been very fruitful. We have been able to point to past activities where the commercial banks and the Bank and Fund have collaborated closely such as Costa Rica, Morocco, Chile and Colombia. There is now a better general understanding that World Bank loans have quite explicit performance objectives, that these are monitored regularly, and the countries concerned have been prepared in the past, and presumably will be in the future, to convey to the commercial banks the results of the assessments by the Bank and Fund of progress on agreed objectives. There probably will be issues in the country context to be worked out but I think at the general level the monitoring issue is no longer acute.

On the matter of comfort for the commercial banks, many questions were raised. While we made considerable progress in developing an understanding of what the nature of our collaboration could consist of, this issue will continue to be explored by the commercial banks.

Secretary Baker's proposal called for an increase in exposure by both the private commercial banks and the multilateral development institutions. That clearly means that the multilateral development institutions should not assume the risk of the increase in exposure which the commercial banks are being asked to undertake. To the extent we provide formal comfort---in the form of guarantees or pari passu sharing arrangements---that would be part of the increase in MDB exposure and not part of the $20 billion increase in commercial bank exposure.

Simply stated, that proposition is almost self-evident but it is by no means fully accepted yet and a lot of discussions still circle around it.

Because the provisioning which has taken place in the U.S. and in other OECD countries is quite different, the U.S. and non-U.S. banks take different views of their risks. This also leads them to take different views of expanding exposure in order to enhance the security of their current outstandings. This, in turn, leads the U.S. banks to be more concerned with additional comfort that the MDBs might be able to extend.

The issue of comfort has been neatly encapsulated in the slogan of "equal partners". That sounds good and it is hard to suggest one does not want to be an equal partner. Nonetheless, we pointed out that equality in a narrow financial sense is neither feasible nor desirable. We tried to explain what our concept of partnership is and I think we made a good deal of progress.

In addition to the basic proposition mentioned earlier, i.e., that it is not the intention that the MDBs take the risk of the incremental exposure of the commercial banks in addition to their own, we have tried to explain that equal partnership has to be seen in the context of what the respective institutions can contribute.

The commercial banks initially defined equal partnership to mean that equal remedial actions should be undertaken in case programs go off the track or delays in debt servicing occur. This meant to them explicit legal linkages to our lending, such as mandatory cross-default clauses. Other aspects would involve sharing of proceeds which would imply that we should give up our preferred creditor status, in case there are delays in debt servicing. And they defined equal partnership to mean that we ought to participate in rescheduling, at least insofar as the additional funds are concerned.

We stressed that this approach misconstrues how the World Bank can be most helpful. The initial approach of the commercial banks essentially suggests that the World Bank and the IDB should behave like commercial banks. The basic point is, of course, that if we do, we will have nothing of value to contribute to the partnership because it eliminates precisely what we bring to this partnership. We are central to the achievement of the objectives of growth oriented adjustment because we are an advisor to the developing countries, seen as reasonably impartial, not representing anyone's interest except that of its members, and with an independent professional judgment. If we lose that reputation and that capacity, then we immediately lose our ability to help countries formulate their programs. And the foundation of the increased security of the

commercial banks is precisely in having feasible growth oriented programs of structural change implemented effectively.

We also pointed out that the equal partnership concept, as contemplated by the commercial banks, would not help them very much in financial terms. The current outstandings of commercial banks are about 10 times as large as those of the MDBs together, and in cases of protracted delays in servicing, the servicing of the MDB debt, even if shared, would be an insignificant financial benefit compared to the costs. Similarly, in cases of rescheduling, the inclusion of the MDBs would not affect the financial position of the commercial banks significantly while we, having suspended disbursements, would lose our ability to consult with countries on how the causes for a delay in servicing could be remedied.

There are cases today, and there have been in the past, where the only effective channel of communication has been the World Bank or the IMF. If there is a delay in debt servicing, even in the context of these new adjustment programs, one wants to be able to distinguish the causes. If they require mid-course corrections in the program, and possibly mid-course corrections in the financing plan, it is important that the Bank and the Fund be able to assess that just as they did the original proposals. If the integrity of our independence is undermined, our ability to discuss and negotiate a revised approach with a country is impaired. In such cases, everyone's basic interest is served by having a revised program agreed to.

There can be cases, of course, where a failure to implement the program is within the control of the country and where the country does not want to take remedial action. But those cases do not pose any new policy issues for the Bank. Where we have a structural adjustment loan and the country fails to implement the program, we do not release the second tranche. If this occurs after the release of the second tranche, we do not continue with the next structural adjustment loan.

In short, we emphasized that the policies which are in place should be maintained and used flexibly if the benefit the commercial banks see in association with us---which is the effective implementation of programs to strengthen a country's creditwothiness through increasing its economic growth---are to materialize.

We, of course, also stressed the very important financial implications to us of changes in our perferred creditor status. If we should lose that status, it would adversely affect our ability to borrow in the market and affect our credit rating. It cannot be in the interest of the commercial banks to have a weakened World Bank at a time that we are being asked to play a major role in formulating and monitoring these adjustment programs.

Let me now mention briefly what we are doing internally---aside from going to a lot of meetings: Mr. Clausen already mentioned that we are preparing a paper for the April meeting of the Development Committee. Mrs. Krueger is coordinating that effort in which all parts of the Bank are participating. That paper will focus on the growth prospects of the highly indebted countries and give our assessments of what is feasible with appropriate policy measures.

Mr. Husain is chairing an effort to look at a number of the highly indebted countries and work with the regions, ERS and the Finance staff to see what adjustments in our country strategies and lending programs, may be necessary; what are the opportunities, and what kind of programs may be feasible in what timeframe. This work will be the basis for discussions with our borrowers. Some of these countries are likely to come to the market quite soon and we have defined our work program, taking this into account.

Third, we have established a group consisting of Finance, the Legal Department and the Cofinancing Unit, to work with Operations on the issues being considered by the coordinating group of banks.

I think, Mr. Chairman, that covers the main developments since our briefing two weeks ago. If there are any questions, I would be glad to try and answer them.

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DAC High Level Meeting
Collaboration between Aid Agencies and the IMF
Comments of Richard D. Erb
Deputy Managing Director
International Monetary Fund
December 2, 1985

I have been asked to discuss some of the practical aspects of coordination of financial flows to developing countries in the context of Fund-supported economic programs. I plan to draw heavily on the more recent experience of the Fund in working with developing countries and, in particular, low-income developing countries. Over the past five years the Fund's involvement with these countries has been particularly diverse and intense. The three main overlapping areas of activity include Fund financing of economic programs, Article IV consultations, and technical assistance.

Total Fund lending (including drawings under the Compensatory Financing Facility and Trust Fund) to low-income countries during 1980-84 amounted to SDR 12.4 billion or SDR 2.5 billion per annum, compared with SDR 0.6 billion per annum during 1975-79. As in the case of the Fund membership at large, Article IV consultations are being held on a more frequent basis--annually in most countries--than in the past, and the scope of the economic analysis is being broadened and deepened. The total number of missions providing technical assistance to low-income countries on fiscal matters, central banking, and external debt management and statistics has been rising at a steady pace. I mention the Article IV and technical assistance activities to underscore the broad-based and continuous involvement of the Fund with low-income countries.

The increase in Fund activity in low-income countries, especially Fund lending, reflected the serious economic imbalances in these countries arising from adverse external developments and domestic policy weaknesses. Associated with the increase in Fund activity has been greater collaboration with aid agencies and development finance institutions and, in particular, the World Bank. These contacts and collaboration occur not only in the context of the more formal consultative groups but also in special donor meetings that have been organized in what have come to be known as "gap filling" exercises. Collaboration between the Fund and the World Bank has intensified not only in the preparation for, and presentations at, consultations and donor groups but, more importantly, in the day-to-day working relationship of each institution with member countries.

I also need not elaborate on the important, and I would add healthy, differences in the mandates, expertise, financial structures, and relationships with countries that characterize each of our respective institutions, but from the perspective of the International Monetary Fund I would like to make some general observations on why collaboration between the Fund, the World Bank, and aid agencies is important and growing. First, our respective institutions share common objectives in seeking to help countries promote economic growth in the most efficient way and in the context of a balance of payments that can be financed over the short and medium term. Economic growth and a sustainable

balance of payments are not conflicting objectives but go hand in hand. The experience of many countries indicates that economic growth is not durable if domestic and external financial imbalances emerge.

This latter point leads to a second justification for close collaboration: aid agencies, development banks, and the Fund work with individual economies whose components are integrated. Although all of our institutions may work autonomously and focus on particular aspects or sectors of an economy, developments and prospects in one area or sector normally will have consequences in other areas or sectors. As recent experience in many countries has demonstrated, a well-prepared and executed project or investment program may be undermined by a deteriorating economic environment caused by rising inflation and a growing fiscal imbalance, or by price and exchange rate rigidities. At the same time, the achievement of broad fiscal, monetary and balance of payments targets may be jeopardized and growth prospects weakened if resources flow to unproductive investments. Through collaboration, a sharing of analyses enhances our mutual understanding of the complexities and interrelationships in an economy and improves the prospects that policy advice and financial support provided by our respective agencies will enhance economic growth and external stabilization.

A third factor that has indicated closer collaboration stems from the need to better coordinate and indeed reinforce the financing that is provided by each institution. The macroeconomic assessments of the IMF and the sectoral and investment program assessments of the World Bank provide a firmer base on which aid programs may be formulated and financing requirements evaluated. At the same time, the total magnitude of financing available from all sources has a significant impact on the policy choices and the short- and medium-term growth prospects of a country. This is particularly true for countries which have been hit by internal or external shocks, such as a drought or sudden decline in the terms of trade, and are being supported by IMF balance of payments assistance.

It is sometimes suggested that greater collaboration between the IMF and development finance institutions is needed in order to provide a better meshing of the perceived short-run perspective of the IMF and the perceived long-run perspective of development agencies. While I believe that different time horizons shape our respective activities and that this is another reason for closer collaboration if our institutions are to better serve low-income countries, the notion that the Fund is only short-run oriented and development agencies long-term oriented is misleading. I will come back to this issue shortly.

Issues for Future Cooperation

At this stage and in order to provide a basis for discussion, I would like to identify some concrete issues that I think would be useful to address as we look to the future and strengthen collaboration.

(1) Medium-term Analysis - In recent years, the Fund has been devoting more effort to providing analysis and policy advice within a medium-term context. Normally the staff attempts to put its analysis in a three- to five-year framework. This is done not only in the context of Extended Fund Facility programs but also one-year stand-bys and Article IV consultations. In a world of changing economic conditions and uncertainties, as well as some important unknowns, detailed policy targets are usually formulated for only one year ahead, with medium-term targets subject to a regular review and revision. In addition, medium-term scenarios are used to assess the growth and balance of payments implications of alternative assumptions about domestic developments, including different policy paths, and alternative assumptions about external developments, including the availability of foreign assistance.

Among the unknowns that often make it difficult to develop a firm medium-term outlook, there are two that I would like to mention, given the composition of this group. First, Fund missions often find that it is difficult to evaluate a country's public investment prospects because aid agencies and development institutions are not firm with respect to the projects or sectors they intend to support over a two- or three-year period. Even when projects or sectoral programs may be identified, often the timing of disbursements is uncertain.

A second factor that makes it difficult for the Fund to assist a country in setting a medium-term policy path is the uncertainties surrounding the form, magnitude, and timing of external financing flows. Low-income countries depend primarily on official sources of finance, but most official sources of finance, including those providing debt rescheduling, do not normally provide financing plans for a period beyond one year. Indeed, the Fund is subject to criticism if it goes too far in making assumptions about official financing and debt rescheduling beyond the immediate short run. In short, if the Fund is to make further progress in helping countries to develop their policies in a medium-term framework, aid agencies and development institutions will also need to be more forward looking and less short term in their orientation. The Fund could assist aid agencies in this regard by providing more detail in medium-term projections on the growth and balance of payments implications of different assumptions about the volume and timing of foreign assistance.

(2) Adjustment Program Design - I would like to turn to another area where collaboration is important and where a number of issues deserve further discussion between our respective agencies. As I indicated earlier, the Fund has supported a number of economic adjustment programs implemented by low-income developing countries over the past five years. In many countries faced with a deteriorating current account position—and sometimes accompanied by deteriorating external financial flows—major policy adjustments were necessary to reduce public sector demand, to constrain money and credit growth, and to establish appropriate price incentives through changes in exchange rates, domestic prices, and interest rates. The magnitude of those adjustments depended importantly on the magnitude of additional official assistance, a subject I will turn to shortly. But whatever the magnitude of adjustment

required to live within external resources, an effort was made by Fund missions to encourage governments to cut budget deficits to help reduce imbalances between aggregate demand and supply. Where possible, missions encouraged governments to cut consumption expenditures or raise revenues rather than cut investment expenditures. To the extent that a government found it necessary to cut investment expenditures because of inadequate domestic savings or foreign assistance, Fund missions encouraged a government to work closely with the World Bank to set investment priorities and cut investments that were less productive or unproductive. Regarding the latter, I should add that many coumntries suffer from poorly designed and unproductive investments that were promoted by external sources of finance and assistance.

I realize that in the course of such adjustments some bilateral and multi-development assistance programs were curtailed. In some cases, investments were cut because a government's total resources were not adequate and the government had alternative priorities. In other cases the development assistance was cut because the investment projects no longer were productive in light of the changed economic conditions. From this experience I draw a conclusion that is relevant to our discussion of collaboration: while it is important for the Fund to encourage a country faced with the need to adjust to changed economic circumstances to protect investment projects conducive to long-term development and growth, it is also important for aid agencies to reassess periodically whether a project or a development program makes sense in light of changed economic circumstances. This brings me to a related point.

Most countries faced with the need to adjust to domestic imbalances or changed economic circumstances must consider structural changes, including not only changes in exchange rates and prices but also, for example, the elimination or restructuring of state enterprises. Although such adjustments lead to more efficient use of resources and have a positive impact on economic growth, the experience of the Fund suggests that such structural adjustments are often more difficult for governments to implement than overall cuts in government expenditures or monetary restraint. This occurs because sometimes the negative impact of such adjustments is felt by some sectors before the positive effects are experienced in other sectors. To be sure, an adjustment in an exchange rate and producer prices may produce an immediate and favorable impact on economic growth, but the full force of that favorable impact may take time to emerge. However, to the extent that aid flows can be quickly redirected toward activities or sectors of an economy that have become more efficient because of a structural adjustment in exchange rates and prices, the quicker and more dramatic the growth impact. The availability of raw materials and spare parts and infrastructure repair in a sector favorably affected by an exchange rate change will accelerate the productive response in that sector. This leads me to another conclusion that I would like to suggest for discussion: while it is important for development assistance agencies to frame their assistance within a medium-term framework, it is also important to be flexible and responsive to new development opportunities which may arise because of changing economic conditions. In this context aid agencies might consider linking a certain proportion of their aid to support improved policies rather than projects in low-income countries.

(3) Financing Adjustment Programs - Fund supported adjustment programs are sometimes criticized for being too harsh and for forcing governments to sacrifice economic growth and subject their citizens to austerity. Unfortunately, the adjustments faced by many countries are difficult and a cause of political and social tensions. But it is the build-up of economic imbalances and the inability of a country to live within available foreign resources that ultimately forces an adjustment. The objective of the Fund's policy advice is to encourage changes that will restore the conditions for economic growth as quickly as feasible. But in forming its economic policies, a government cannot ignore the existence of the external finance constraint. Since the severity of an adjustment can be alleviated with additional external financing in an appropriate form, the Fund must pay close attention to the availability of external financing. In providing support, the Fund itself is able to help alleviate the external financing constraint by providing quick-disbursing, untied balance of payments assistance. Relative to aid agencies and development assistance institutions, the monetary role and character of the IMF enables the Fund to play a major financing role in the early years of an adjustment period and thus ease the adjustment process for countries.

When expected aid flows, World Bank assistance, and Fund assistance are not adequate to meet a country's immediate financing needs in the early years of adjustment, the Fund and the World Bank usually make an effort to help a country seek additional assistance in special donor meetings. For aid to have the desired short-run impact on an economy, particular attention must also be paid to the form and financing of the assistance. If additional foreign assistance is tied to meeting the import requirements of a particular activity, the additional financing is not likely to reduce the country's existing financial gap. In such circumstances, the country needs to obtain additional financing from another source or make additional cuts and reduce its growth expectations. If the additional foreign assistance is disbursed irregularly and over a longer period of time, the detrimental impact on an economy's short-run and long-run development and growth prospects is severe. Thus, I would draw yet another conclusion that I believe is relevant to our discussion of collaboration: in order to promote economic growth and development, development assistance agencies need also to consider ways of providing some quick-disbursing, untied aid in a short-run framework.

Over the coming years it will be important to ensure that external financing is available to sustain the adjustment efforts low-income countries have been undertaking in recent years. The Fund is willing to continue supporting these efforts, but Fund financing on a growing and sustained basis would not be consistent with the monetary character of the Fund, the already high debt-service burdens of many of the low-income countries, or with the protracted nature of their problems. In some developing countries there is indeed a need to restore gradually their reserve position in the Fund. Great care will be taken to apply Fund policies in a flexible way so that such an adjustment will not be abrupt.

Low-income countries have little access to additional commercial bank lending and, in any case, substantial bank lending would not be compatible with their debt-carrying capacity. Thus, the bulk of external financing for low-income countries will need to be provided on concessional terms either directly from bilateral aid agencies or through multilateral development institutions. Of course, there is some trade-off between an increase in the volume of aid and an increase in aid efficiency. However, I believe it will be necessary for donor countries to try and find ways of increasing the volume of aid to low-income countries to facilitate the difficult adjustment measures that are needed and to ensure that such adjustment does not come at the cost of a further decline in living standards in the short run and more quickly restores the basis for economic growth and a sustainable balance of payments.

Conclusion

Given the economic and financial problems facing the developing countries, I have no doubt that the efforts of all our institutions will need to be intensified. Strengthening collaboration among our respective institutions is necessary if each is to provide the best possible advice and assistance to developing countries. Although I have identified some issues as subjects for discussion, I regret that time has not permitted me to talk about specific ways or modalities for strengthening collaboration in the areas I have cited.

DAC MINISTERIAL MEETING

Paris, December 2, 1985

STATEMENT BY MR. ERNEST STERN

Senior Vice President, World Bank

Agenda Item 2 - Agenda of Unfinished Business

Mr. Chairman,

let me thank you and the members of the DAC for inviting us to participate in this 24th High Level Meeting of the DAC. This meeting reflects a quarter century of collaboration on behalf of development and your Annual Report is a fitting description of the successes and the failures, of how much has been accomplished and how much still remains to be done.

The discussion today focusses, rightly, not on the past but on the future. The Agenda of Unfinished Business which you have listed is daunting - in its scope, its complexity and its duration. I agree with the three imperatives you have stated, as well as the functional objectives, and I listened with interest to the comments of the German and U.S. delegations. There is little I would want to add on the general subject of structural adjustment and the link to external financing. I will deal with some of the issues in more detail, and focus more explicitly on Sub Saharan Africa when we discuss item 3, Operational Lessons for Programming and Coordination.

But let me quickly comment on three vital lessons we can draw from the past to apply the future.

First, adjustment and development are neither antithetical concepts nor separable ones. Development means, and has always meant,
adjustment to new economic realities,
to changing technologies
to the introduction of new knowledge
to different incentives and policies.

Perhaps this is obvious but these days we often sound as if it were not. The issue has never been, and is not now, whether adjustment is necessary for development but the nature of that adjustment; its scope; its pace; and who pays the costs and who reaps the benefits.

Second, what we face today is an accumulated failure to adjust, together with increased volatility in the world economy, increased uncertainty and very rapid technological change. All of us - bilateral donors, multilateral institutions, commercial banks, export credit agencies and developing countries - have contributed to this accumulation of overdue adjustments. While it certainly was not the intention, policies of developed and developing countries alike have sought to insulate economics against adjustments or, at a minimum to buffer such economies unduly. A few examples will illustrate the point:

- The large scale borrowing of the 1970's is often cited in this regard, and rightly so. The scale was unprecedented. Some of the funds were put to effective use but much resources were used to support consumption, substitute for domestic savings and support unsustainable exchange rates. This latter lesson, while abundantly clear analytically, has still not been universally accepted.

- Aid flows sustained development strategies and exchange rate practices which were obviously flawed well beyond the point where they could have been maintained independently.

- Development strategies caused high prices by prohibiting competition; generated stagnation by refusing remunerative incomes to farmers; and promoted the inefficient use of scarce capital, all in an effort to avoid the consequence of changes.

- It is more than 30 years since the changes in medicine and health delivery technology dramatically changed population dynamics. Since that time many, but by no means all, countries have adjusted to the profound social and economic implications of this. As a consequence the world environment faces major, and perhaps, irreparable, degradation - not only in Africa - and savings, domestic and foreign, are needed in increasing volumes merely to maintain inadequate incomes.

The list could easily be expanded, but suffice it to say that one lesson we surely must extract from the past is that the failure to adjust on a timely basis can have catastrophic costs and that a development effort which seeks to avoid adjustment cannot be sustained.

Third, the growth of the international economy is vital to the prospects of the developing countries. I.e. economic growth is not easily compartmentalized. This is well known and often stated. But the same is true for the adjustment process. Without adjustment in OECD economies, without adjustment in the world trading system, without adjustment in international institutions, growth will be impeded - severely for some. Capital flows are important but they are not a substitute for adjustment in the capital importing countries and neither are they a satisfactory response to global development efforts by the industrialized countries.

It is in this context that we strongly welcomed the concensus that emerged in Seoul. It recognizes that adjustment is consistent with sustainable growth - indeed it is essential for that growth. It also stressed the need for all the participants in the process - developed and developing countries, international lending institutions, and commercial sources of finance - to actively collaborate if current dangers are to be avoided, and sustained growth restored. This consensus is a first, essential step for grappling effectively with the three imperatives on your Agenda of Unfinished Business, Mr. Chairman. But it is only a first step - I do not believe any of us have fully internalized the lessons of the past. There are still many anomalies in our behaviour.

- Protectionism has not declined in the last year.

- Sound adjustment programs are not being adequately supported while untimely projects or projects of doubtful utility are easy to finance.

- The costs of adjustment are recognized but relevant ODA flows are virtually stagnant while commercial financing actually declined.

In this connection we believe the proposal to augment the resources available under the IMF Trust Fund should be pursued. The availability of the Trust Fund resources for low income countries with protracted balance of payments difficulties is very welcome. But these resources should be supplemented so that there can be adequate support for effective growth oriented adjustment programs. This will require an enlarged IDA, in which greater weight is given to performance. And it will require a commitment by bilateral donors to earmark a share of their funds in the form of quick disbursing assistance to support adjustment related operations in countries undertaking such an effort.

But let me come back to these and other issues later. Let me conclude by saying that it is essential the adjustment programs include satisfactory growth objectives. Neither is sustainable without the other. This requires appropriate domestic policies and it requires an early agreement on the resource envelope. But it also involves basic issues of design - issues which can only be resolved if governments are prepared to undertake basic structural changes, realistically reassess their objectives and change them where necessary. This is no easy political task and our expectations should be realistic.

Over the last few years we in the Bank, together with the Fund and with many of you, have helped countries in precisely this endeavour. Colombia and Malawi, Morocco and Togo, Zambia, and Chile, Turkey and Uruguay, all are cases in point. But more needs to be done in these countries and in many others. We consider this our top priority - in low and middle income countries alike. We are prepared to expand our capacity to assist countries in formulating appropriate programs, to expand our lending in support of these programs, and, together with the members of the DAC, the UNDP and, where appropriate the commercial banks, to make the coordination which is necessary for the success of these programs of growth - oriented adjustment more effective.

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DAC HIGH LEVEL MEETING

Paris, December 2, 1985

STATEMENT BY MR. ERNEST STERN

Senior Vice President, World Bank

Agenda Item 3 on Operational Lessons for Programming and Coordination

Mr. Chairman,

I referred earlier to the concensus which emerged at Seoul which recognized the integral relation between adjustment and accelerated growth. Let me comment on how this relates to the low income developing countries, most of which are in Africa.

Last year, Mr. Chairman, I outlined the Bank's Joint Program of Action for Sub-Saharan Africa. This program was widely endorsed in 1984 by both African governments and donors and, in the last year, there have been many encouraging developments. I would like to comment on that progress and on some of the things that remain to be done.

African Governments have demonstrated an increasing willingness to undertake difficult structural and sectoral policy and institutional measures. There is a realization that the exchange rate must be seen as a policy instrument to promote development. African countries on the whole have stayed the real effective appreciation observed in the 1970's. In 1984, six countries managed real devaluation in excess of 10%, and several have shown that it is possible to engineer substantial real depreciations and gradually re-establish viable levels. Zaire and Zambia have adopted innovative, market-determined exchange allocation systems.

There is also growing recognition of the need to increase incentives to the agricultural sector, often at the expense of the urban elite and civil servants. In most African countries, the real value of producer incentives has been maintained in the 1980's, which has meant that rural incomes have increased relative to urban incomes. In Madagascar, Ghana, and Zaire, market or producer prices of food and export crops have increased much faster than urban wages. While there is a long way to go to restore

agricultural incentives, including improved institutions, research, infrastructure and technology, the general deterioration witnessed during the 1970's is being arrested in more and more countries, and preliminary indications for 1985 indicate that the process is accelerating.

With regard to public sector management, fiscal deficits in Sub-Saharan Africa are at the lowest level since 1980. In the parapublic sector, the first steps at divestiture are occuring (during 1980-84, roughly 5% of public enterprises have been divested or closed) and governments have strengthened monitoring and improved parastatal policies.

Since last year some 16 donors have made generous contributions to the Special Facility for SSA. We now have about $ 1.3 billion, not counting the contributions of some special joint cofinanciers for the second and third years.

As of November 30, seven projects in four countries - Ghana, Togo, Zaire, Zambia - had been approved, totalling about $200 million. There also have been some actions by bilateral donors to increase the flexibility of their programs and the responsiveness to the special needs of Sub-Saharan Africa.

The composition of aid has improved by including a larger share of non-project assisstance and debt rescheduling agreements are increasingly generous and flexible.

But more needs to be done. For example, in Ghana about 3/4ths of such program aid continues to come from multilateral donors. Additional support is needed in the volume of program aid by more donors and in many cases program aid continues to be provided on a haphazard basis - i.e., without a meaningful planning horizon for recipients.

Despite this progress, Mr. Chairman, we have left much undone. I do not want to take the time to review once again the policy measures and program actions African governments must decide on, implement effectively and sustain. The major burden rests on them and the task is excruciatingly difficult since it involves dealing with needs for adjustment accumulated over two decades, in the face of still weak institutions, fragile political systems and major long-term development problems. Nor do I want to take

the time to comment on the external environment, which has been particularly hostile for Africa. In the limited time available I want to focus on the donor community and the actions it might take. There are three topics on which I would like to comment:

- resource availability
- effectiveness of resource use, and
- donor coordination.

Resource availability

One of the points in Seoul was that growth oriented adjustment required net additional external capital. One of the lessons of the past 25 years of development is that money helps. It does not solve all problems and it can be misused. But few countries have been able to mount effective programs of development if their domestic savings efforts are not supplemented by external savings. And yet we continue to ignore this basic proposition in the hope that it is easier to change this relationship rather than national aid budgets. I do not believe this is possible.

Over the period 1980-84, net ODA flows to Sub-Saharan Africa increased by about 5%; not enough to offset the decline in non-concessional assistance. The drop in net flows was most dramatic in middle income countries, but net flows also declined by over 10% in low-income countries. This simply cannot be consistent with greater efforts of adjustment and accelerated growth. It reflects the interaction between debt repayments and stagnant or declining aid budgets. But it leads me to two basic propositions:

First, no provider of development assistance, individual country or multilateral institution, should be allowed to be in a net negative disbursement situation to any Sub-Saharan Africa country with a satisfactory development program. Whether this is done through retroactive terms adjustment, rescheduling or increases in gross commitments on concessional terms could be left to each donor, depending on the circumstances.

Second, aid budgets must increase, if African growth prospects are to improve - an objective we are all committed to.

Just as an increase in net commercial bank lending is vital to the growth of the heavily indebted middle income countries so is a net increase in financing from official sources to the growth of the low income countries. We continue to believe that a 50% increase in gross disbursements in 1986-90, over the 1980-84 period is essential. A first step, surely is to maintain recent aid levels although the drought is now over. But the crisis in Africa is not. Moreover, as the Chairman's report notes, part of the increase for Sub-Saharan Africa thus far has come not from increased aid budgets, nor from reallocation from middle income to low income countries but from reallocations among low income countries. This is not sustainable.

Effectiveness of Resource Use

But it is, of course, necessary to ask resources for what. Effectiveness of aid has been a major preoccupation of the DAC and any request for an increase in aid resources must be based on reasonable assurance that aid resources will be, can be, utilized effectively. There are several points in connection with this.

a) As the Chairman has indicated there must be more effective country programs. Development plans must include realistic 3-year investment programs, realistic assumptions about recurrent expenditures and revenues and an appropriate balance between maintenance and new investments. That is the country's responsibility but donors ought to insist that this criteria is met. We in the World Bank, the UNDP and bilateral donors can help to formulate these programs.

b) Effective use of aid also requires longer term commitments by donors. Despite our efforts we are still unable to obtain at CGs and RTs any indications of commitments or disbursements. Frankly, it baffles me how we can insist on forward planning by recipients and fail to do so ourselves. Precision is not essential; bur reasonable orders of magnitude are.

c) Effective use of aid means more discipline in support of agreed investment programs. And here the story is very mixed. Today the rate of investment in Sub-Saharan Africa is the lowest in the world. A growth oriented adjustment program will require a gradual increase in public and private investment.

but project selection must be based on rigorous economic evaluation criteria and governments and donors must work together to formulate and implement coherent investment programs based on sound priorities and realistic assumptions concerning resource availability and institutional capacity. Many African governments are only beginning to prepare 2-3 year rolling public investment programs which seem to be based on appropriate sectoral priorities. The Bank will support this effort by increasing the number and improving the coverage of its own public investment reviews. But the efforts of the Bank to improve the quality of public investment programs and to strengthen the competence and the authority of central investment planning and budgeting agencies will be useless if donors and contractors continue to negotiate in secret with technical ministries and public enterprises, and continue to be willing to finance overdesigned projects and uneconomic investments. The staff and political costs to the Bank of its constant fight against potential white elephants are very large. There are many examples of lack of adherence to agreed investment plans and to acceptable investment criteria. But let me mention a few. In Niger, construction of a large, luxurious overdesigned stadium was started, financed by highly concessional capital. It now has been scaled down but it still would not seem the highest priority in so seriously constrained an investment program. In Somalia, the recent CG discussed a core public investment program of $ 700 million, for 1986-88, but there are already indications that large projects outside this investment program are being considered for aid financing. Whether it is railways in Burkina, sugar mills in Burundi, or iron mines in Senegal, there is constant pressure on countries to undertake projects which are not suitable. Let me stress, Mr. Chairman, that this is not exclusively a DAC problem, there are other donors active in this too. Moreover, not all of these projects are unviable - though some are. Some projects may be sound but to undertake them today would be premature, given the reductions in investment programs which have taken place and the well-known problems of recurrent costs and idle capacity.

d) To assure more effective use of aid there needs to be more effective discipline in balance of payments support. The Bank and the Fund play a key role in analyzing resource needs and assisting governments in designing programs consistent with resource availabilities. But it is not enough to view non-project assistance only in the context of annual balance of payments problems, nor to view it in isolation from the overall financial plan associated with the medium term development program. Non-project assistance is not a panacea; it can too easily be wasted; and it can too easily be a substitute for efforts that others should be making to increase their net flows. Moreover, the undoubtedly urgent need for program aid to support efforts to rehabilitate infrastructure and improve production incentives should not be at the expense of other development expenditures which are critical for the longer term. Thus, while it is essential to increase the flow of vital imports for the public and private sectors, program aid should be based on a critical assessment of real needs and both commitments and disbursements should be closely linked to implementation of agreed adjustment measures. Substantial progress has been made; in Senegal for instance close collaboration between the IMF, the Bank, and the two main bilateral suppliers of program aid (France and the US) has had a decisive influence on the willingness of the government to undertake major policy reforms. The same is true in Malawi and in Togo a non-project coordination meeting is planned for 1986. In many cases, however, program aid continues to be provided in haphazard fashion. We should work towards multi-year projections of needs, multi-year commitments of non-project assistance and appropriately phased disbursements based on rigorous monitoring - by multilateral institutions - of the adjustment process.

e) And finally, effective use of aid requires more explicit recognition of good performance. External capital is scarce and concessional capital particularly so. Yet we find the allocation procedures of aid donors remains inadequately responsive to changing circumstances. Too often we are told that a country undertaking satisfactory programs of adjustment is not a target country, or a country of concentration, and that therefore no resources can be made available. Yet, in many cases, the selection of target countries dates back many years and reflects quite different circumstances. As we stress the need for developing countries to establish clear priorities within a constrained environment so we must urge ourselves to establish priorities in the allocation of aid which reflect performance. That is the best way to assure the effectiveness of aid.

The third issue - coordination - also has been the subject of many discussions in the DAC and, as a result of these, much progress has been made. The basis for action, as we indicated in the JPA, should be the medium-term adjustment and investment programs drawn up by the country with the active participation of the Bretton Woods institutions. These programs should contain multi-year financing plans from bilateral and multilateral donors in support of agreed policy reforms. These programs will include cost-effective programs in sectors basic to long-term growth prospects of Africa - education, reforestation, agricultural research and resource management. Let me raise three important issues in regard to coordination. First let me stress that we still need to do more to make CGs and RTs fully effective; we need to deepen and extend collaboration between the Bank, the Fund, the UNDP and the regional development banks; these are well established objectives. But second, we need to improve intra-governmental coordination in DAC countries. There is still much to be done to bring

export credit agencies within the development framework. What they finance needs to be part of the agreed investment programs; rescheduling terms must be an integral part of the overall financing plan associated with the medium term planning framework; and they should be part of the additional resources to be provided even when a country has rescheduled. To take a country off cover, precisely at the time it has put its house in order is counterproductive. And country level coordination would be much improved if the general principles would be more consistently applied to decisions on individual operations. Third, the coordination effort must be extended to other donors. Some of the principles accepted by the DAC are not yet accepted by the Arab funds or other donors. The multilateral institutions have a role in improving such coordination but so, Mr. Chairman, has the DAC and individual donors.

Mr. Chairman, let me conclude. The lessons of the past point clearly to the actions for the future:

- The low income countries, particularly those in Sub-Saharan Africa, must continue the realignment of their policies and incentive frameworks. But they need help;
- They need additional resources which support effective programs;
- They need support for long term and institutional issues;
- They need assurances of aid commitments and disbursements for the medium term;
- They need more disciplined responses from the donors;
- They need more effective donor coordination, and their prospects depend on the institutional and policy adjustments in the donor countries as much as on these changes in their own economies.

As you know, we in the Bank have substantially expanded the share of our financial and staff resources to Africa. We will continue to do so because we believe this is the world's greatest development challenge. I do not think that we know what needs to be done, but we know how, together, we can help Africa make much better use of the resources available to it and reverse its decline.

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