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THE WORLD BANK
Washington, D.C.

JUNE 1981

B. BALASSA CHRON FILE JUN 1981'

Messrs. M. Wolf and O. Havrylyshyn June 26, 1981

Bela Balassa and Roger Bowden, DRC

Systems Analyst/Programmer for our Research Project on Trade RPO 672-32

As we have already indicated to Mr. Havrylyshyn, we will be happy to share Mr. Rozanski's services with you. At this point we would plan to contract him for two months following his four month assignment with you.

BBalassa:nc

Mr. John Magee Kieser, PMD June 26, 1981.

Bela Balassa and Graham Pyatt, DRC

Takashi Takayama

1. We interviewed Mr. Takayama and also participated at his seminar. Takayama is a first-rate scholar whose achievements are well-known. The paper presented at the seminar also showed his skills in dealing with a difficult problem in an original way.

2. Takayama is extremely competent technically and well-motivated. We have little doubt that he would be an effective researcher on energy at the Bank. He has general familiarity with the field and possesses the analytical skill necessary to carry out such a task. We highly recommend Takayama for a Bank appointment.

cc: Mr. Duloy, DRC

BBalassa:nc

26 juin 1981

France-Aide
28 rue Louis-le-Grand
75002 Paris
France

Messieurs,

Je vous prie de bien voulir m'envoyer des renseignements sur le modèle Peugeot 505, y compris le délai de livraison au départ de Paris, ainsi que le prix diplomatique pour exportation aux Etats Unis. En effet, en raison des fonctions que j'occupe à la Banque Mondiale je suis autorisé à bénéficier des privilèges diplomatiques en ce qui concerne l'achat d'un véhicule.

Je vous saurais gré de bien vouloir me faire parvenir les renseignements demandés, par voie aérienne, le plus rapidement possible. A cet effect, je joins à la présente lettre deux coupon-réponses destinés à couvrir les frais de port avion pour l'envoi de votre réponse.

Veuillez agréer, Messieurs, l'expression de mes sentiments distingués.

Bela Balassa

UNION POSTALE UNIVERSELLE

COUPON-RÉPONSE INTERNATIONAL C 22

Ce coupon est échangeable dans tous les pays de l'Union postale universelle contre un ou plusieurs timbres-poste représentant l'affranchissement minimal d'une lettre ordinaire, expédiée à l'étranger par voie de surface.

Empreinte de contrôle du pays d'origine (date facultative)	Prix de vente (indication facultative)	Timbre du bureau qui effectue l'échange
WASH. DC WEST END STA. USPO JUN 29 1981	42 CENTS	

UNION POSTALE UNIVERSELLE

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WASH. DC WEST END STA. USPO JUN 29 1981	42 CENTS	

DRC Professional Staff June 26, 1981.

Bela Balassa, DRC

World Bank Reprint Series

Please provide me by July 10th, any papers you wish to have included in the World Bank Reprint Series. I would need fifteen copies of the papers together with a short note indicating their importance to the study of economic development in general and for the World Bank in particular.

BBalassa:nc

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

TO: DRC Professional Staff

DATE: June 26, 1981.

FROM: Bela Balassa, DRC

SUBJECT: World Bank Reprint Series

Please provide me by July 10th, any papers you wish to have included in the World Bank Reprint Series. I would need fifteen copies of the papers together with a short note indicating their importance to the study of economic development in general and for the World Bank in particular.

BBalassa:nc

June 26, 1981

Ms. Kazuko Ogawa
Information Officer
The World Bank,
Tokyo Office
Kokusai Building, Room 916,
3-1-1 Marunouchi
Chiyoda-ku
Tokyo 100
Japan

Dear Kathy,

Thank you for your letter and the enclosures which reached me after my return from a Bank mission to Turkey. I wish to raise two questions concerning the methodology you have applied.

First, while in your letter of December 10, 1980 it was stated that you are "currently subtracting out unskilled wage from the wage bill," your note indicates that this has not been done. You suggest that the estimated regression coefficients using the log-linear form of the equation will not be affected if unskilled wages represent the same proportion of the average wage in all industries. This assumption does not conform to the facts as the ratio varies from 0.3 to 1.1 across industries and it would imply that human capital, properly defined, is proportional to unskilled labor. The failure to deduct the unskilled wage from the average wage thus leads to the misestimation of the stock of human capital and lack of comparability with physical capital

Second, you state to have derived the stock of physical capital as a product of output value and the capital-output ratio. Your letter of December 10, 1980 made no mention of this procedure. Had you done so, I would have told you that capital stock figures should be obtained from industrial surveys as it was done for the United States to Korea. Let me add here that from your note, it is not apparent what sources were used in deriving the capital-output ratios.

The inappropriateness of the data may explain the poor econometric results you have obtained. This is the case, in particular, as far as the physical capital coefficient is concerned.

These shortcomings of the dissertation will need to be remedied. The unskilled wage is clearly incorrect for the clothing and shoe industry group, comprising industries 2320, 2390, 2410, and 2430, as it exceeds the average wage for each of these industries. You should also try to get information on unskilled wages for industries 2311, 2314, and 2930, where this again exceeds the average wage.

As regards the physical capital stock, you should first find out how capital-output ratios have been derived. Once this is known, we can decide how to proceed further.

I read your paper with interest. At the same time, it is not clear if the dependent variable in the equations refers to export value or to my revealed comparative advantage index. The latter would need to be used in reformulating the independent variables in the form of capital-labor ratios as I have done it in the 'Stages Approach' paper.

With best regards,

Sincerely yours,

Bela Balassa

cc: Messrs. Bowden, DRC; Havrylyshyn, Wolf EPD
Mrs. Richards-Loup, OECD

June 26, 1981.

Professor Tansu Ciller
Bogazici University
Bebeh
Istanbul
Turkey

Dear Tansu,

I have, in the mean time, recalled the name of the Brookings scholar who would be a good choice for giving a paper at the Conference you are organizing. His name is Ralph Bryant. Bryant is the author of a recent book on international monetary problems, "Money and Monetary Policy in Interdependent Nations." You can reach him at the Brookings Institution, 1775 Massachusetts Avenue N.W., Washington, D.C. 20036, U.S.A.

Yours sincerely,

Bela Balassa

Mr. Arvind Virmani, DED

June 26, 1981.

Bela Balassa, DRC

Project Narratives

In response to your memo of May 22nd, I provide information on additional publications to be included with the abstracts of research projects 670 35 and 670 87.

Apart from adding these publications the only change relates to the dates of completion of the project. The date should be given as July 1982 for 671 35 and December 1981 for 670 87.

June 26, 1981.

Professor Jacob A. Frenkel
National Bureau of Economic Research
1050 Massachusetts Avenue
Cambridge, Massachusetts 02138

Dear Professor Frenkel:

I highly recommend the inclusion of Masahiro Kawai's paper "Trade Hedging, Capital Flows and Speculation in a Rational-Expectations Model of Forward Exchange," in the NBER's November Conference on Exchange Rates and International Macroeconomics. I have read the preliminary version of the paper and I find it represents a valuable contribution to literature.

Yours sincerely,

Bela Balassa

cc: Professor Kawai

Turkey Mission Members June 26, 1981.

Bela Balassa, DRC

Completion Report

Please send your report, typed double spaced in two copies to me, with an additional copy to Mr. Roy by July 3rd. It would further be useful if you provide copies to those working in the related areas.

BBalassa:nc

PINK

The World Bank / 1818 H Street, N.W., Washington, D.C. 20433, U.S.A. • Telephone: (202) 477-1234 • Cables: INTBAFRAD

June 26, 1981.

Mr. Antonio C. Lemgruber and
Director-Chefe
Centro de Estudos Monetarios
e de Economia Internacional
Fundaçao Getulio Vargas
Praia de Botafogo, 190 - 9º
CEP. 22250
Rio de Janeiro, RJ
Brazil

Mr. Roberto Fendt Jr.,
Director
Fundaçao Centro de Estudoes do Comércio Exterior
Av. Rio Branco 120, gr 707
Rio de Janeiro
BRAZIL

Dear Messrs. Lemgruber and Fendt:

I have sent you several telegrams which remained without a response. I hope, however, that you have received our printout of the Brazilian estimates. Should this not be the case, please let me know by telegram.

May I ask you to complete your studies by August 15th and send one copy to Ann Richards-Loup and one copy to me at the World Bank.

Yours sincerely,

Bela Balassa

V LD BANK / INTERNATIONAL FINANCE CORPC 'ION

OFFICE MEMORANDUM

TO: Turkey Mission Members

DATE: June 26, 1981.

FROM: Bela Balassa, DRC

SUBJECT: Completion Report

Please send your report, typed double spaced in two copies to me, with an additional copy to Mr. Roy by July 3rd. It would further be useful if you provide copies to those working in the related areas.

BBalassa:nc

Mrs. Jane Carroll, IPA

June 25, 1981.

Bela Balassa, DRC

Development Strategies in Semi-Industrial Economies

1. The papers referred to in Chapters 4 and 8 were both published by *World Development* that automatically gives the World Bank reprint rights. I am, nevertheless, writing them separately for permission.

2. I return Appendix Table 3.2, in which the full footnote reference, with "average" added, should be used. The tables of Chapter 8 are being retyped by Mr. Westphal's secretary who will provide them to you directly, Tables 6.11, 6.12, and 6.13 will be retyped within a week.

Enclosure
BBalassa:nc

Mr. J. Merriam (IPA) June 25, 1981

John H. Duloy, DRC

Receipt of News Summaries

With reference to Mr. Bell's memo of March 9, 1981, Mr Balassa did receive the News Summaries for about a month and now he no longer gets the summaries. Would you please have his name put back on the list.

Mr. John H. Duloy, DRC

June 25, 1981.

Bela Balassa, DRC

Economic Reform in Hungary

You may recall that, at the Chinese-US Conference on Alternative Strategies for Economic Development, held in November 1980, I was asked to make a presentation on economic reform in Hungary. (This was in addition to my paper on industrial development strategies that had been included in the program.) My presentation proved to be of considerable interest to the Chinese participants and I am now asked to write a paper on the subject for inclusion in the Proceedings of the Conference. The Proceedings will be published simultaneously in English and in Chinese. The outline of the volume is enclosed.

It will take me about 3 to 4 days to complete the paper on the Hungarian reform. I further plan to go to Budapest to clarify some points and to get additional information. I would do so on my way to the Conference of the International Economic Association, to be held in Athens, where I am presenting my paper on "Adjustment to External Shocks in Developing Economies."

Enclosure
BBalassa:nc

RESEARCHER: TERMS OF REFERENCE

The researcher will carry out economic analysis of international trade patterns and trends, utilizing econometric and programming techniques in the framework of the research project "Changes in the Pattern of Comparative Advantage in Manufactured Goods" (RPO 672-). She is expected to work largely independently under the supervision of Messrs. Bela Balassa and Roger Bowden.

June 24, 1981.

Hertz International
660 Madison Avenue
New York City, New York 10021

Dear Sir:

As a World Bank staff member, I am entitled to a discount on HERTZ rentals. Please let me know what the discount is in Hungary and let me have a list of rental cars available there.

Yours sincerely,

Bela Balassa

Mr. Peter E. Wright, VPD

June 24, 1981.

Bela Balassa, DRC

<u>Staff Working Paper</u>

This is a slightly revised version of the paper submitted with the May 12th memo.

Enclosure
BBalassa:nc

June 24, 1981.

Professor Ivan T. Berend
Karl Marx University of Economics
1093 Budapest
Dimitrov tér 8
Hungary

Dear Ivan,

Please excuse my writing in English but this will ensure that the letter goes out today.

Many thanks for your letter of May 21st which reached me after my return from a three week trip to Turkey. I apologize for not having answered your previous letter. I would be extremely happy if a collection of my papers would appear in Hungarian. May I suggest that you consider having the essays contained in my forthcoming book translated. The book is entitled "The Newly-Industrializing Countries in the World Economy" and it will be published by Pergamon Press within a few weeks. As the enclosed description indicates the book contains nine general essays as well as nine country essays including one on Hungary. Apart from the Hungarian essay they were all written in the years 1978 to 1980.

In your letter you did not make mention of the results of your conversations at the Woodrow Wilson Center. Carol and I very much hope that we will see you and your wife here in Washington next year. In the mean time, I will be going to Budapest the first three days of September and Carol will accompany me. Please let me know if you plan to be there at this time.

Yours sincerely,

Enclosure

Bela Balassa

June 24, 1981.

Avis International
900 Old Country Road
Garden City, New York 11530

Dear Sir:

As a World Bank staff member, I am entitled to a 25 percent discount on AVIS rentals in Europe. Last January, I rented an AVIS car in Budapest, Hungary where the discount was not honored. I will again be travelling to Hungary in August and would like to inquire as to how I could obtain the discount.

Yours sincerely,

Bela Balassa

June 24, 1981.

Mr. Anders Richter
Editorial Director
The Johns Hopkins University Press
Baltimore, Maryland 21218

Dear Mr. Richter:

This is in reply to your letter of June 18th. I will comment on Parts I to III first and will come to Part IV afterwards.

Parts I to III provide an excellent selection of papers that not only summarize recent thinking on various problems in development economics but often go beyond this. The papers should be read by all development economists and be used in courses on economic development. I would expect that the volume would have even better sales than the Adelman-Thorbecke book you published some fifteen years ago.

In turn, I doubt the usefulness of including the Chinese contributions in the volume. I found these rather ideological, apparently being written for outside audience. The papers by some of the same people written for home consumption are much more critical of the economic policies followed than the papers presented at the Conference. I would like to add that the papers written on China by Americans I did not find of great interest either. I hope that this will be helpful.

With best regards,

Yours sincerely,

Bela Balassa

P.S. I object to the subheading "Sectoral Policies" in Part I of the volume. The Ranis paper, as well as my own, deal with general issues of development strategy.

June 24, 1981.

Professor Mark Blaug
University of London
Institute of Education
Research Unit in the Economics of Education
56 Gordon Square
London WC1H ONT
England

Dear Mark,

Please excuse the delay in sending you the requested bibliography. I have been extremely busy in recent months and your reminder arrived just as I was leaving for a long trip abroad. I hope, however, that I am not too late.

Yours sincerely,

Enclosure

Bela Balassa

Mr. R. Barker - Personal Travel

June 24, 1981.

Bela Balassa

Family Travel

1. I would like to ask you to make reservations for my wife, Carol Balassa, and my children, Mara (10 years old) and Gabor (8 years old) for the flights listed in the enclosure. My wife has already reserved the outgoing flight directly with TWA but the remainder of the flight plan has changed.

2. Last year, I had an APEX ticket for my wife and half-price tickets for my children. I presume that we can have the same this year, unless there is a cheaper solution (my wife has already reserved the APEX).

3. I will be travelling with my family on Bank business and I am simultaneously submitting an official travel request.

Enclosure
BBalassa:nc

Oli Havrylyshyn and Martin Wolf, "Trade Among Developing Countries: Theory, Policy Issues, and Principal Trends," World Bank, Economic Analysis and Projections Department, International Trade & Capital Flows Division, Working Paper No. 1981-2, February 1981.

This paper examines the changing patterns of trade among developing countries in products other than fuels. The results reported in the paper are based on data for 33 countries that account for three-fifths of developing country exports of these commodities to one another. The countries of destination have been grouped as follows: developed countries (DCs) centrally-planned economies (CPEs), developing countries other than the capital-surplus oil exports (LDCs), and the capital-surplus oil exporters (CSCs). The latter group has been defined to include Iran, Iraq, Kuwait, Libya, Qatar, Saudi Arabia, and the United Arab Emirates.

Changing Shares of the LDCs in the Exports of Developing Countries

As shown in Table 1, the average share of the LDCs in the nonfuel exports of developing countries remained stationary at 22 percent between 1963 and 1973. Considerable differences are shown, however, among major commodity groups. While the LDC share in developing country exports rose from 16 percent in 1963 to 20 percent in 1973 in regard to nonfuel primary products, this share declined from 40 percent to 25 percent in the case of manufactured goods.

The results are explained by the increased importance of intra-Latin American trade in food as well as by the success of the newly-industrializing countries and, in particular, the Far Eastern countries in expanding their export of manufactured goods to the developed countries. The latter conclusion applies in particular to capital goods where the share of the LDCs in developing country exports declined by about one-half between 1963 and 1973, with commensurate increases in the share of the DCs.[1/]

The manufactured exports of the developing countries to the DCs and to the LDCs grew at equal rates between 1973 and 1977, leaving the LDC share in these exports unchanged at 25 percent But, the LDCs increased their share in the nonfuel primary exports of the developing countries from 20 percent in 1973 to 23 percent in 1977, raising their share in the total nonfuel exports of the developing countries from 22 percent to 24 percent.

Notwithstanding the increased importance of the developed countries as markets for the manufactured exports of the developing countries since 1963, these goods continue to account for a larger share of developing country exports to LDCs than to DCs. Between 1963 and 1971, the share of manufactured goods in the nonfuel exports of the developing countries increased from 41 percent to 51 percent in LDC markets and from 17 percent to 38 percent in DC markets. These trends continued afterwards, with the share of manufactured goods in exports to LDCs reaching 54 percent and to DCs 50 percent in 1977 (Table 2).

Changing Shares of the CSCs in the Exports of Developing Countries

The capital surplus oil exporters emerged as important markets for the developing countries only after 1973. The CSCs accounted for 2 percent of developing country exports in 1973; this share reached 5 percent in 1975 and remained at this level in 1977 (Table 3). Larger than average increases are shown for manufactured goods, from 2 percent in 1973 to 7 percent in 1977, with Asian countries and Greece accounting for much of the increase.

1/ In Table 1, the narrow definition of capital goods includes machinery and equipment; the broader definition also comprises consumer durables, such as automobiles.

By 1977, the CSCs provided markets for 15 percent of the manufactured exports of India while the corresponding figures were 13 percent for Korea, 22 percent for Pakistan, and 18 percent for Greece. The CSCs played an even more important role in the exports of capital goods by these countries, accounting for 22 percent of such exports in the case of India, 22 percent for Korea, 13 percent for Pakistan, and 13 percent for Greece in 1977. In the same year, the average for all developing countries was 9 percent as compared to 4 percent in 1973.

The increase of the CSC share in the exports of food and beverages by developing countries was smaller, from 2 percent in 1973 to 4 percent in 1977, and their share in industrial materials remained below 1 percent. However, the CSCs provided an important market for Pakistani exports of food and beverages, accounting for 41 percent of these exports in 1977. The corresponding share reached 10 percent only in the case of India and Tunisia.

Conclusion

Having remained constant in the preceding decade, the shares of the LDCs and CSCs in the nonfuel exports of the developing countries increased after 1973. In exports to the LDCs, the increase occurred in nonfuel primary products. In turn, the share of the LDCs in the manufactured exports of developing countries remained stationary, after having declined between 1963 and 1973.

The CSCs assumed importance as markets for the developing countries after 1973. Their share increased to a considerable extent in the exports of manufactured goods, and, in particular of capital goods. A smaller rise is shown for nonfuel primary products.

Nonetheless, the developed countries continued to provide important outlets for the developing countries, accounting for 64 percent of their exports of food and beverages and for 61 percent of manufactured exports in 1977. But these countries absorbed only 38 percent of developing country exports of capital goods, with LDCs accounting for 43 percent and CSCs for 9 percent of the total.

Table 1: TRADE AMONG DEVELOPING COUNTRIES AS SHARE OF THEIR TOTAL EXPORTS
(Percent)

	1963	1968	1971	1973	1975	1977
Food and Beverages	16	19	18	19	21	23
Non-food Agriculture	18	24	26	25	27	29
Metals and Minerals	11	9	10	11	11	12
Total Non-Fuel Primary	16	19	18	20	20	23
Manufactures	40	30	27	25	28	25
TOTAL Non-Fuel	22	23	22	22	24	24
Capital Goods - Broad	66	53	44	38	45	38
Capital Goods - Narrow	63	55	48	43	49	43

Source: Computations based on GATT trade data tapes, prepared by Systems Division, EPD. Definitions are given in Appendix B. Unless otherwise indicated, sources for all tables are the same.

Table 2: COMMODITY COMPOSTION OF EXPORTS FROM DEVELOPING COUNTRIES IN SELECTED YEARS

	Percent Exports from LDCs					
	To LDCs	To DCs	To LDCs	To DCs	To LDCs	To DCs
	--- 1963 ---		--- 1971 ---		--- 1977 ---	
Food & Beverages	36.8	52.8	29.8	39.9	32.3	35.1
Non-Food Agriculture	16.5	19.8	14.5	11.3	9.9	7.8
Metals & Minerals	4.0	9.8	3.8	10.0	2.7	6.3
Manufactures	41.0	17.1	50.7	37.9	54.4	49.9
Total Non-Fuels	100.0	100.0	100.0	100.0	100.0	100.0
Capital Goods - Broad	9.5	3.2	15.6	5.2	20.4	9.4
Capital Goods - Narrow	7.7	2.6	12.6	3.3	15.8	5.3
Fuels	45.0	28.0	50.4	30.6	22.3	19.1

Table 3: SHARE OF MAJOR MARKETS IN DEVELOPING COUNTRY EXPORTS BY MAIN COMMODITY GROUP, 1/ SELECTED YEARS

	LDC			CSC			DC		
	1973	1975	1977	1973	1975	1977	1973	1975	1977
Food and Beverages	19	21	23	2	6	4	72	63	64
Manufactures	25	28	25	2	6	7	66	58	61
Capital Goods (Narrow)	43	49	43	4	7	9	44	36	38
Total Non-Fuel	22	24	24	2	5	5	68	62	63

/1 Non-food agriculture and metals & minerals had less than 1% shares throughout the periods, and in fact these declined somewhat. In total exports to CSCs, these two categories had a weight of only 4.7% in 1977.

Mrs. Shirley Boskey, IRD and Mr. John E. Merriam, IPA June 23, 1981

Bela Balassa, DRC

Participation at Conferences and Publication of Papers

I plan to present the following papers at international conferences over the next several months. The papers will subsequently be published in the proceedings of the conferences. Your clearance is requested.

1. "Les tendances actuelles de la specialisation internationale de la production manufacturiere," to be presented at the Conference on "Internationalisation et autonomie de decision : les choix francais," in Bordeaux on June 29-30. The German version of this paper will be published in the Procedings of the Conference on De-industrialization held in Vienna in January 1981; the English version will appear in a Festschrift honoring Herbert Giersch.

2. "The Policy Experience of Newly Industrializing Countries After 1973 and the Case of Turkey," to be presented at the Conference on Turkish Exchange Rate Policy in Istanbul on July 1-2. (The text of the paper has been cleared by EMENA as per enclosed memo from Mr. Dubey.)

3. "Adjustment to External Shocks in Developing Economies," to be presented at the Conference of the International Economic Association in Athens on September 1-5. (This is a background paper to WDRIV and is scheduled to appear as a Bank Staff Working Paper.)

4. "Shifting Patterns of World Trade and Competition," to be presented at the 27th Congress of the International Chamber of Commerce in Manila on November 23-26. (This paper has been prepared in a private capacity at the request of the ICC who will bear the cost of travel.)

cc: Messrs. Chenery, Waide, VPD; Duloy, Pyatt, DRC

Enclosures
BBalassa:nc

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

TO: Prof. Bela Balassa

DATE: June 18, 1981

FROM: Vinod Dubey VD

SUBJECT: Istanbul Seminar

I have reviewed your paper "The Policy Experience of Newly Industrializing Economies After 1973 and the Case of Turkey," and particularly the last section as you requested. I have no objection to its presentation to the Istanbul Seminar.

cc: Messrs. Bart, Davar, Zaman (o/r)

VD:ll

June 23, 1981.

Professor Lance Taylor
Department of Economics
Massachusetts Institute of Technology
Cambridge, Massachusetts 02139

Dear Lance,

I am happy to accept your invitation to contribute to the volume honoring Hollis. I do not have a title yet, but it will be in the trade and development area. Please let me know when you need the title of the paper.

Yours sincerely,

Bela Balassa

June 23, 1981.

Dr. Donald G. Morrison
Director
Centre for Social Science
  Computation and Research
Savery Hall 145, DK-45
University of Washington
Seattle, Washington 98195

Dear Dr. Morrison:

We should have reports on the Western Africa project later this year. We will send them to you when they become available.

Yours sincerely,

Bela Balassa

June 23, 1981.

The Economist Bookshop
Mail Order Department
The Old Piano Factory
43 Gloucester Crescent
London NW1 7DL
England

Dear Sir:

Please send me the following:

Computers and Economic Planning: The Soviet Experience by Martin Cave (Cambridge: Cambridge University Press, 1980, pp. xi + 224 £11.50).

Trade Relations; Commercial Policy; International Economic Integration by Alexander J. Yeats.

Please send me your bill for the expenses involved.

Yours truly,

Bela Balassa

June 23, 1981.

Ms. S. W. Y. Kuo
Deputy Governor
The Central Bank of China
The Republic of China
Taipei, Taiwan

Dear Ms. Kuo:

Thank you for your letter of June 9th and for the data on Taiwan which I have just received.

I have made progress on the paper on Korea, but it took more time than I expected. I was, therefore, happy to hear from Mr. Lumiansky that the final version is due only on December 31st.

With best regards,

Sincerely yours,

Bela Balassa

June 23, 1981

Dr. Paul Streeten
Boston University
Center for Asian Development Studies
264 Bay State Road
Boston, Massachusetts 02215

Dear Paul:

Your letter of May 19th arrived during my mission to Turkey for discussion on medium-term policy issues, some of which are dealt with in the paper on structural adjustment policies. But while I could make specific recommendations to the Turkish government based on the particularities of the existing situation, this cannot be done in a general paper.

At the same time, judging from reactions at the Bank (Ernie Stern had the paper distributed to all Division Chiefs), the paper may offer some interest in indicating how overall policy prescriptions need to be adapted to a situation characterized by external shocks. In turn, I added a sentence disclaiming any intention to deal with factor market distortions.

My results on policy responses to external shocks in the LDCs are presented in two other papers, which will be distributed in August. I have limited my attention to the overall results in the structural adjustment paper in order to minimize overlap with these papers. At the same time, the section on Policies and Performance (pp. 10-13) will not be reproduced elsewhere. This section, incidentally, has been slightly changed and the estimates revised as four more countries have been added to the sample.

My replies to the specific points you have raised follow:

P. 2 external shocks are not likely to materially affect the poor. At the same time, as noted on p. 36, low-income groups would benefit as a result of the policies proposed in the paper.

P. 9 Changed wording.

P. 16 Changed wording, to include private capital flows.

P. 27 Accelerated depreciation provisions do create distortions in factor use by reducing the cost of physical capital to the firm.

P. 32 Turkey provides an example where setting monetary targets is fruitless and efforts to do so may only depress the economy. At any rate, I refer here to the problem of indeterminacy: you cannot simultaneously set the price and the quantity of money.

I do not know if this reply goes far enough in answering your queries. While I could elaborate on the numerical results for LDCs if you consider it absolutely necessary, I do not see what could be said in general terms on second-best solutions.

Sincerely,

Bela Balassa

Enclosed two copies of "Structural Adjustment Policies in Developing Economies"
June 20, 1981

Those listed June 23, 1981

Bela Balassa, DRC

Paper for Istanbul Conference

I enclose a copy of my paper "The Policy Experience of Newly Industrializing Economies After 1973 and the Case of Turkey," to be presented at the 2nd International Conference organized by Meban Securities in Istanbul on July 1-2. Mr. Bart agreed to my participation at the Conference and Mr. Dubey has cleared the paper.

cc: Messrs. Chaufournier, EMNVP; Bart, EM2; Karaosmanoglu, EM1; Picciotto, EMP; Dubey, EMNVP; Hume, EMP; Zaman, EM2; Davar, EM2; Gregory, EM2; Boorma, EM2; Hong, EM2; Noel, YP; Roy EM2; Ms. Saito, EM2

Enclosure
BBalassa:

WO BANK / INTERNATIONAL FINANCE CORPORA N

OFFICE MEMORANDUM

TO: Those listed

DATE: June 23, 1981

FROM: Bela Balassa, DRC

SUBJECT: Paper for Istanbul Conference

I enclose a copy of my paper "The Policy Experience of Newly Industrializing Economies After 1973 and the Case of Turkey," to be presented at the 2nd International Conference organized by Meban Securities in Istanbul on July 1-2. Mr. Bart agreed to my participation at the Conference and Mr. Dubey has cleared the paper.

cc: Messrs. Chaufournier, EMNVP; Bart, EM2; Karaosmanoglu, EM1; Picciotto, EMP; Dubey, EMNVP; Hume, EMP; Zaman, EM2; Davar, EM2; Gregory, EM2; Boonma, EM2; Hong, EM2; Noel, YP; Roy EM2; Ms. Saito, EM2

Enclosure
BBalassa:

June 22, 1981.

Ambassador Sükrü Elekdag
Turkish Embassy'
1606 23rd Street N.W.
Washington, D.C. 20008

Dear Mr. Ambassador:

This is to confirm our telephone conversation concerning my participation in the panel discussion about Turkey on the occasion of the Ataturk Centennial. Mr. Maurice Bart has given his agreement for my participation.

Looking forward to seeing you at the panel meeting, I remain,

Sincerely yours,

Bela Balassa

Personal Travel - American Express June 22, 1981.

Bela Balassa, DRC

Family Travel

1. I would like to ask you to make reservations for my wife, Carol Balassa, and my children, Mara (10 years old) and Gabor (8 years old) for the flights listed in the enclosure. My wife has already reserved the outgoing flight directly with TWA but the remainder of the flight plan has changed.

2. Last year, I had an APEX ticket for my wife and half-price tickets for my children. I presume that we can have the same this year, unless there is a cheaper solution (my wife has already reserved the APEX). I will be travelling with my family on official Bank business and would like to ask you to make my reservations first class, to be taken over by official travel once I have my travel request..

Enclosure
BBalassa:nc

June 22, 1981.

Mr. R. M. Lumiansky
President
American Council of Learned Societies
800 Third Avenue
(at 49th - 50th Streets)
New York, N.Y. 10022

Dear Mr. Lumiansky:

Thank you for your letter of June 3rd. In earlier correspondence, Mrs. Kuo indicated that the desired length of the paper is 50 pages double spaced. I have structured the paper accordingly and do not see the possibility to change its length at this time. I hope that this is acceptable to you.

I wish to add that I expect to have the paper in a draft form in the course of the summer; there will be no difficulty, therefore, in meeting your deadline of December 31st for the final manuscript.

My social security number is 047-32-2394.

Yours sincerely,

Bela Balassa

cc: Professor Galenson
Cornell University
Ithaca, New York

61991

ROBERTO FENDT JR., FUNDACAO CENTRO DE ESTUDOS DO COMERCIO EXTERIOR,

AV. RIO BRANCO 120, GR 707, RIO DE JANEIRO, BRAZIL

PLEASE CALL ME COLLECT ANY DAY THIS WEEK AT 202-676-1991. REGARDS,

BALASSA

Bela Balassa

Bela Balassa

BBalassa:nc DRC - Director's Office

Files June 21, 1981

Bela Balassa, DRC

JAMAICA: Development Issues and Economic Prospects

1. This is a good and informative report. It provides a well-balanced appraisal of the record of the Jamaican economy during the seventies and makes useful recommendations for the future. The following comments deal with past experience as well as with desirable policies.

Economic Performance

2. As regards past performance, the estimated 4.3 percent growth rate for domestic agriculture in the 1970-80 period (Para. v) may be on the high side. In particular, the reported two-thirds increase in the production of "other primary products" (Table 2.8) appears doubtful. The measurement of production in domestic agriculture, a considerable proportion of which is for self-consumption, is fraught with difficulties, and the estimate does not seem to accord with other reports on Jamaican agriculture.

3. The explanation of the decline in Jamaica's bauxite/alumina industry between for 1973 and 1979 in terms of "the tendency of aluminum producers to diversify the sources of alumina supply, the 1975 recession in the industrial countries, and the bauxite levy imposed by the Government of Jamaica in 1974" (Para vi) does not give sufficient emphasis to the last point. While this is rectified in the subsequent discussion of the 1974-1976 experience (Para. xii), it should be recognized that the effects of the high levy on production extend beyond its period of application.

4. As regards the future of the bauxite/alumina industry in Jamaica, the report suggests that "export growth will have to be mostly in the form of alumina" (Para. xxxi). It is further added that "since the government has attracted private investors' involvement in the expansion of Jamaica's alumina industry, it can be argued that Jamaica as a location, has passed the 'market test' (Para. xxxii). While the report qualifies this statement by reference to tax rebates provided for investment in alumina, the size of these rebates is not indicated. Also, more should be said about the pricing of energy used in the production of alumina. According to a study carried out under the direction of Ardy Stoutjesdijk, cheap hydro-electricity favors Guinea and Australia over Jamaica.

5. It would be instructive to calculate changes in GNP by excluding the obviously unproductive public administration as it has been done in several other countries (judging from complaints about public interventions, the productivity of this sector may well have been negative...) At the same time, the decline in private services may have been overestimated. This comment applies, in particular, to distributive trade where a 35 percent decline between 1970 and 1979 is reported as against a 6 percent decrease in GNP (Table 2.5). It does not appear likely that trade activities would have declined to such an extent in comparison to material production. The reported estimate may simply be the result of using an incorrect deflator; in fact, in

terms of current prices, distributive trade and GNP moved in a parallel fashion (Table 2.4).

6. The statement, according to which "nontraditional exports performed reasonably well" (Para xii) is incorrect. My calculations reported in "The Policy Experience of Twelve Less Developed Countries, 1973-1979" (March, 1981) indicate that Jamaica's share in the developing countries' exports of manufactured goods was 45 percent lower in 1974-78 than in 1971-73. And while a comparison of the two periods shows an increase in nontraditional primary exports, a decline of 75 percent is observed in 1978. In the same year, Jamaica's share in the manufactured exports of the developing countries was 60 percent smaller than in 1971-73. Throughout the period, above-average losses in market shares were experienced in the developed countries.

Future Policies

7. Against the backdrop of developments over the last decade, the projected export growth for 1980-85, with the volume of merchandise exports increasing at an average annual rate of 10 percent (Paras. lviii and 237), appears rather optimistic. Yet, this projection underlies the GNP and the balance-of-payments estimates.

8. To begin with, it is not apparent that the conditions are fulfilled for the quintupling of banana exports and the doubling of sugar exports between 1980 and 1985. Continued reliance on the public-owned Banana Company, the management of which has been repeatedly criticized, may not provide a guarantee for rapid export expansion. Also, it is not clear what role the state-sponsored sugar cooperatives will play in the future.

9. Further questions arise concerning the realism of the projected 16 percent annual increase in manufactured exports. The report makes reference to "the action program for export oriented production" (Para. xix), but the components of this program have not been specified. The mission (apparently regretfully) states that "the government considers Jamaica's exports to be competitive at the present exchange rate" (Para. xix) and recommends using incentive measures to promote exports in the absence of a devaluation. Thus, in the Summary and Conclusions, it is suggested that "an export rebate scheme, although subject to constraints imposed by the fiscal situation, would be a valuable interim device, while structural reforms are implemented gradually" (Para. xxvii).

10. It should be recognized that rebating indirect taxes does not represent an export subsidy but only re-establishes tax neutrality under the destination principle. Notwithstanding their fiscal cost, rebates of indirect taxes should be introduced without delay, irrespective of changes in the exchange rate and structural reforms. This should not involve the use of time certificates, which would provide only partial compensation. One should rather consider financing rebates by raising indirect taxes. At the same time, the loss to the budget should not be overestimated since increases in exports will add to total tax revenue.

11. Two additional measures, mentioned in the text of the report but not in the Summary and Conclusions, would not entail a fiscal cost. They include the introduction of a foreign exchange retention scheme (Paras. 137-38) and

the application of a system of temporary admissions for inputs used in export production that are on the restricted list (Para. 178).

12. The foreign exchange retention scheme has been used to good effect in countries characterized by foreign exchange stringency (most recently, Turkey). On the example of other countries, the retained foreign exchange should be made transferable. It would also be desirable to provide exporters with imported inputs even if high-priced (or low-quality) domestic substitutes exist. Finally, there would be need to provide credit incentives for export production and tax incentives to private export marketing as proposed in my aide-memoire "Incentive Policies in Jamaica" (December 15, 1980).

13. Proposals made in the aide-memoire for import liberalization have been incorporated in the report and do not require further discussion. At the same time, more attention would need to be given to tourism. According to the report the provisions of the Hotel Incentive Act of 1968 and the Resort Cottages Act of 1971 may be overly generous. However, the question needs to be raised if Jamaica could attain the projected growth rate of 17 percent a year in tourist receipts in terms of constant U.S. dollars between 1980 and 1985 (Para. 237) under present conditions. In this connection, reference may be made to the June 21, 1981 article in the Washington Post, according to which Jamaica may be pricing itself out of the market for tourism.

14. It would further be desirable to give appropriate consideration in the report to incentives to save and to invest, which have been briefly reviewed in my aide-memoire. In this connection, note that the proposed introduction of capital gains taxation and the elimination of differential between personal and company tax rate favoring incorporation (Para. 128) may adversely affect savings and investment.

15. Incentives to exports and incentives to save and to invest are necessary preconditions for restoring the Jamaican economy to a sustainable growth path. At the same time, these objectives are interrelated since, eventually, increases in capacity will be necessary to ensure continued export growth. In fact, the report suggests that new capacity would need to be created to reach the growth targets beyond 1981 (Para. xvii).

16. More generally, there would be need to examine the realism of the assumptions underlying the "growth scenario" (Chapter XI) and to present a consolidated view of the policy conditions for an export-led development strategy the government is proposing (Para. 115). This is the more important since, judging from Chapter V of the report, the government has not developed a policy framework for the pursuit of this strategy.

cc: Messrs. Gonzalez-Cofino, LC2; Meyer, LC2; Duloy DRC
Recipients of Report.

BBalassa:nc

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

TO: Files

DATE: June 21, 1981

FROM: Bela Balassa, DRC

SUBJECT: JAMAICA: Development Issues and Economic Prospects

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cc: Messrs. Gonzalez-Cofino, LC2; Meyer, LC2; Duloy DRC
Recipients of Report.

BBalassa:nc

CABLE

JUNE 19, 1981
61991

HUBERTUS MULLER-GROELING, INSTITUT FUR WELTWIRTSCHAFT

2300 KIEL 1, POSTFACH 4309, GERMANY

PLEASE LET ME KNOW THE DATES OF PUBLICATION OF MY NEWLY INDUSTRIALIZING DEVELOPING COUNTRIES AFTER THE OIL CRISIS AND INDUSTRIAL PROSPECTS AND POLICIES IN THE DEVELOPED COUNTRIES. ACKNOWLEDGE ALSO RECEIPT OF THE REVISED FIRST PAGE OF THE LATTER. REGARDS, BALASSA

Bela Balassa

Bela Balassa

BBalassa:nc

DRC - Director's Office

CABLE
MBAN 23111

june 19, 1981
61991

MEHMET GUN CALIKA, MEBAN SECURITIES, ODAKULE IS MERKEZI ISTIKLAL CADDESI, 286 BEYOGLU, ISTANBUL, TURKEY

PART III OF PAPER MAILED YESTERDAY. WILL ARRIVE 1555 FROM ZURICH ON SR324. REGARDS, BALASSA

Bela Balassa

Bela Balassa

DRC - Director's

BBalassa:nc

CABLE

JUNE 19, 1981
61991

ANTONIO LEMGRUBER, CENTRO DE ESTUDOS MONETARIOS, FUNDACAO GETULIO VARGAS, PRAIA DE BOTAFOGO, 190-9°, CEP 22250, RIO DE JANEIRO, BRAZIL

THIS IS TO REPEAT MY REQUEST THAT YOU CALL ME COLLECT IN WASHINGTON. MY TELEPHONE NUMBER IS 202-676-1991. REGARDS, BALASSA

Bela Balassa

Bela Balassa

BBalassa:nc

DRC - Director's Office

CABLE

JUNE 19, 1981
61991

MR. MICHEL DEMERS, 241 RUE DES ALPES PONT-VIAU,
LAVAL, QUEBEC, CANADA, H7G3V7

PLEASE CALL ME COLLECT AT 202-676-1991. REGARDS,
BALASSA

Bela Balassa

Bela Balassa

BBalassa:nc

DRC - Director's Office

June 18, 1981.

Mr. H. Robert Heller
Bank of America
Bank of America Center
Box 37000
San Francisco, California 94137

Dear Bob,

Thank you for your letter of May 20th which reached me on my return from a three week trip to Turkey. I will be happy to limit my discussion at the session to 15 minutes. I also noted that I should provide the paper to dicussants before December 10th.

Yours sincerely,

Bela Balassa

Mr. Vinod Dubey, EMNVP June 18, 1981.

Bela Balassa, DRC

Istanbul Seminar

Mr. Bart has agreed to my presenting a paper in Istanbul at a Conference organized by Meban Securities on July 1st. The first two sections of the paper are historical in character and they were transmitted to the organizers of the conference at the time I was in Turkey. The last section, dealing with medium term policies, would be sent to Istanbul at the end of this week following your clearance. I have eliminated all discussion of controversial issues, such as the over-valuation of the exchange rate and the SEE reform policies of the Ministry of Industry, in writing the sector.

CC: Messrs. Bart and Davar EM2

Enclosures
BBalassa:nc

CABLE JUNE 18, 1981

HENRI BOURGUINAT, UNIVERSITE DE BORDEAUX 1, FACULTE DES SCIENCES ECONOMIQUES, AVENUE LEON DUGUIT, 33604 PESSAC, FRANCE

PREPAID 22 WORD REPLY

ARRIVING IN BORDEAUX ON JUNE 28 AT 1710 ON IT5613. PLEASE LET ME KNOW BY RETURN TELEGRAM THE NAME OF THE HOTEL I WILL BE STAYING.

REGARDS, BABASSA

June 18, 1981.

Mr. Luc Fauvel
Secretary General
International Economic Association
4 rue de Chevreuse
75006 Paris
France

Dear Mr. Fauvel:

Your letter of May 26th reached me after my return from a trip abroad. I enclose the travel information you have requested. As I indicated in my letter of April 23rd, the Bank will pay my travel costs to Athens.

In the same letter, I asked you to send me the names and addresses of the participants so that we could mail the paper to them. I have not so far received this list and am, therefore, enclosing my paper in two copies. Needless to say, I am ready to undertake the mailing if you wish.

The French translation of the paper will be finished at the end of this month, at which time, it will be sent to you.

Yours sincerely,

Enclosures

Bela Balassa

Enclosed Adjustment to External Shocks in Developing Economies - June 1, 1981

June 18, 1981.

Dr. Il SaKong
Research Director
Korea Development Institute
P.O. Box 113, Cheongryang
Seoul
Korea

Dear Dr. SaKong:

I welcome the opportunity to include my papers on the fourth and fifth development plans and on the 15-year perspective plan in the volume you are editing. Among the papers on the enclosed list, numbers 1 and 2 appeared in my book, Policy Reform in Developing Countries, of which President Kim has a copy. Numbers 3 and 4 will be published within a few weeks in my Newly Industrializing Countries in the World Economy, a copy of which will be sent to President Kim immediately after publication. Number 5 is being revised and I will send you a revised version in the course of July.

Please let me know if you have any further questions.

Yours sincerely,

Enclosure

Bela Balassa

cc: Mr. Mahn Je Kim

Papers on the Fourth and Fifth Development Plans

and the 15-Year Perspective Plan

Bela Balassa

June 18, 1981.

Mr. Mehmet Gun Calika
General Manager
Meban Securities Brokerage
and Finance Corporation
Odakule Is Merkezi Istiklal Caddesi
286 Beyoglu
Istanbul
Turkey

Dear Mr. Calika:

I enclose the third part of my paper for the July 1st, 2nd Conference. I hope that it reaches you in time.

I wish to inform you that I will be arriving in Istanbul on SR324 from Zurich at 1555 on June 30th.

With best regards,

Yours sincerely,

Enclosure

Bela Balassa

June 18, 1981.

Mr. Yildirim Akturk
Undersecretary
State Planning Organization
(Devlet Planlama Teskilati)
Basbakanlik
Bakanliklar
Ankara
Turkey

Dear Mr. Akturk:

I enclose part III of the paper I will present at the July 1st, 2nd Conference in Istanbul. I gave several copies of parts I and II to Mr. Oral Akman.

I look forward to seeing you on my visit to Ankara on July 3rd.

Yours sincerely,

Bela Balassa

Enclosure

cc: Mr. Oral Akman

ORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

TO: Chief Economists

DATE: June 17, 1981.

FROM: Bela Balassa, DRC

SUBJECT: Turkey Mission

You may be interested in the enclosed aide-memoire that provides the preliminary conclusions of the mission I led to Turkey in May-June. The aide-memoire aims to provide a comprehensive view of medium-term policies to supplement the recent policy changes in Turkey. Energy and public investment are being covered elsewhere and were excluded from the purview of the mission.

Enclosure
BBalassa:nc

MEDIUM-TERM ECONOMIC POLICIES FOR TURKEY

Summary and Conclusions

The aide-memoire contains the preliminary recommendations of the Bank mission on industrialization and trade strategy for medium-term policies. These policies are intended to complement the measures taken since January 1980 in the pursuit of Turkey's newly-adopted development strategy, characterized by outward orientation and greater reliance on market forces. The recommendations aim at encouraging exports and efficient import substitution, increasing domestic savings and investment, promoting technological progress and labor training, and improving the operation of the state economic enterprises.

Exports and efficient import substitution would be encouraged by increasing the use of exchange rates as against export subsidies and import protection; simplifying the remaining export subsidies and linking them to value added in exports; gradually eliminating import licensing while lowering and rationalizing tariffs; and linking the prices of agricultural products and their inputs more closely to world market prices. Also, the marketing of the exports of manufactured and agricultural products and tourism would need to be improved. Finally, the exploitation of Turkey's agricultural potential would necessitate improvements in transportation and support to promising products, such as fresh and processed fruit and vegetables, whereas the expansion of tourism would require increased credit facilities for investment in hotel accommodations.

The recommendations made in regard to investment incentives, financial markets, and the tax system are designed to encourage private and corporate savings, improve financial intermediation, and ensure the financing of efficient investments in exports and import substitution. Increases in private savings may be attained by limiting the taxation of interest earnings and capital gains to real returns (i.e. making adjustment for inflation), eliminating the financial transactions tax, and reducing the cost of holding reserves with the central bank, while increasing competition among banks. In turn, revaluing balance sheets and reducing corporate income tax rates would contribute to business savings. At the same time, establishing floating interest rates on bonds, extending the scope of bond financing in the public sector, and revitalizing the bond and stock markets would improve financial intermediation. Finally, the use of funds in efficient investments would be promoted by simplifying the system of preferential credits, with reductions in its scope and the extent of interest subsidies; making investment incentives more automatic and neutral in their effects on capital intensity, with additional incentives provided to infant industries; and promoting foreign direct investment.

Technological development and labor training would be served by the establishment of specialized research institutes and training facilities in the framework of an overall plan for research and technology and by providing incentives to the private sector to undertake research, product development, and training. At their present stage of development, electrical and nonelectrical machinery, machine-tool and electronics industries would further require special incentives while the automotive sector would need to be rationalized.

The measures to be taken to promote technological progress and training would permit exploiting Turkey's comparative advantages that will increasingly lie in skill-intensive products within the manufacturing sector. The development of the industries in question requires considerable flexibility to respond to changing world market conditions that can best be assured by relying on private initiative. This would necessitate reconsidering the implementation of government investments in these industries which, at any rate, would involve duplication of existing facilities.

In general, it would be appropriate to eventually limit the public sector to natural monopolies and basic industries. At the same time, existing preferences to state economic enterprises should be eliminated and authority for decision-making be vested in managers who would have responsibility for profitable operations in a competitive environment. Finally, investment projects in the public sector should be submitted to rigorous economic project evaluation, with the eventual application of banking principles.

The proposed measures would reverse recent tendencies that increased the size of the public sector as compared to the private sector. At the same time, increasing reliance on price signals and rationalizing the operation of public enterprises would improve efficiency in resource allocation, further contributing to economic growth.

Medium-Term Economic Policies for Turkey

The Policy Framework

The policy measures taken in the course of 1980 aimed simultaneously at re-establishing stability in an economy characterized by rapid rates of inflation and at changing the country's development strategy towards outward orientation and the greater use of the market mechanism. The decline in the rate of inflation has been remarkable. Also, there has been a considerable increase in time deposits in response to higher interest rates. Finally, exports have risen at a rapid rate, with manufactured exports exhibiting the largest increases.

The measures taken so far will need to be complemented by additional measures in order to fully implement Turkey's newly-adopted development strategy. This will require time; after the long period of inward orientation and limited use of the market mechanism, four to five years may be necessary until the shift in strategy is fully effective.

In this aide-memoire, recommendations will be made for medium-term policies aimed at improved resource allocation and rapid economic growth under increased outward orientation and the use of market methods. It should be emphasized that several of the measures are presently under consideration by the Turkish authorities. At the same time, their articulation in an overall framework, with well-defined objectives, appears desirable.

The policy objectivevs considered in the aide-memoire include encouraging exports and efficient import substitution, increasing domestic savings and investment, promoting technological change and labor training, and improving the operation of state economic enterprises. With the exceptions noted below, they may be implemented over a 4-5 year horizon. The recommendations will not concern short-term policy measures aimed at economic stablization.

The discussion will cover incentive policies as well as sectoral issues. The former comprise production incentives (the exchange rate, import protection, export subsidies, and price control), interest rates and financial markets, the tax system, and incentives to domestic and to foreign investment. In turn, the sectoral issues to be considered pertain to manufacturing industries, with special attention given to the SEEs, agriculture and agro-industries, and tourism. In the course of the discussion, reference will be made to recent policy changes.

A. Incentive Policies

Production Incentives

After a considerable depreciation between the fourth quarter of 1979 and the third quarter of 1980, the Turkish lira appreciated in real terms vis-a-vis the currencies of the major trading partners, regaining approximately its 1973 level. This result reflects largely the appreciation of the lira vis-a-vis the German mark; over the last nine months the mark-lira exchange rate remained practically unchanged, while prices rose by 5 percent in Germany and by over 25 percent in Turkey. At the same time, the exchange rate relationship with the German mark is of particular importance, in view of the fact that nearly one-half of Turkish exports are sold in the European Common Market, of which the mark is the representative currency, and that Turkey competes principally with EEC countries in the growing Middle Eastern markets.

As far as manufactured exports are concerned, the recent appreciation of the lira in real terms was largely compensated by increases in export subsidies. Since January 1981, export rebates on manufactured goods have been raised by five percentage points, and an additional 5 percentage points have been provided to firms whose exports exceeded $15 million a year 1/. Also, in conjunction with the rise in nonpreferential interest rates, the subsidy element of export credit has increased to a considerable extent.

The regular rebate rate is designed to compensate for indirect taxes paid at the preceding stages of manufacture and does not represent an export subsidy. In turn, foreign exchange retention schemes and the duty free importation of inputs place Turkish exporters on the same footing as exporters of other developing countries and are not considered export subsidies under GATT rules. Apart from preferential export credits, subsidy measures applied in Turkey include the additional rebate provided to large exporters as well as reductions in corporate income taxes for new exports and for increases in exports.

The incentive measures applied have been very effective in promoting manufactured exports in an environment characterized by excess capacity. In a longer time perspective, however, subsidy measures are subject to certain disadvantages that call for the increased use of the exchange rate as a policy instrument to promote exports.

To begin with, while the exchange rate affects all exports, most agricultural exports have not benefitted from subsidy schemes, although these products offer considerable promise for Turkey. Furthermore, with the proliferation of subsidies, their effects on various export products are difficult to gauge, whereas the impact of exchange rate changes is easily ascertainable. The effects of exchange rate changes are also automatic and do not require the administrative procedures involved in providing subsidies, which may discourage small and medium-sized exporters. At the same time, export subsidies are subject to retaliation under GATT rules and developed countries may apply retaliatory measures once Turkish exports substantially increase in value. Finally, subsidies to export value tend to encourage the use of imported inputs in export

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1/ In practice, this provision applies to four trading firms. It is additional to the 5 percent rebate that firms exporting at least $4 million a year receive over and above the regular rates paid to all exporters.

activities, while exchange rate changes affect value added in exports. This is because a devaluation raises the domestic currency equivalent of the export price, as well as that of the price of imported inputs, thereby encouraging the use of domestic inputs and limiting the budgetary cost involved.

In the case of some of the subsidy measures, it has been attempted to take account of differences in value added in exports on a case-by-case basis. With the increasing number of exporters, however, case-by-case decision-making encounters increasing difficulties and the simplification of the procedures applied becomes necessary.

Despite the provision of export subsidies, domestic markets in Turkey are generally more profitable than export markets, due to the combined effects of high tariffs and import licensing. Tariffs and other import taxes on manufactured goods generally range between 30 percent and 70 percent. Furthermore, notwithstanding the liberalisation measures taken in January 1981, import limitations tend to raise domestic prices above the tariff-inclusive import price.

As long as producers expect the maintenance of existing levels of import protection, they may undertake new investment or expand their capacity in activities which are not in the national interest, and will have little incentive to lower production costs. To remedy this situation, it would be desirable that government announce its intention to lower tariffs and to rationalize import protection. In order to prepare producers for such an eventuality, it is proposed that a timetable be made public on the reform of the system of protection, to be carried out over a period of, say, five years.

The reform should include replacing import licensing by tariffs, with the possible exception of certain luxuries, and reducing the extent and the dispersion of tariffs. A tariff ceiling of 30 percent may be established, to be attained in annual instalments. Also, the tariff structure would need to be revised in order to avoid cases of "reverse escalation", when the tariff is higher on the principal input than on the output, and interindustry differences in tariff rates would need to be reduced.

The liberalization of import licensing may take the form of annual transfers from Liberalization List II to Liberalization List I and the addition of the items presently excluded from both lists to Liberalization List II. A substantial liberalization of import licensing could be undertaken next January, with emphasis given to machinery and intermediate products.

As long as the protection of manufactured goods continues, the subsidization of manufactured exports could not be foregone. It would be desirable, however, to reduce the extent of these subsidies, <u>pari passu</u> with reductions in import protection, and to simplify the measures applied.

The first candidate for reducing export subsidies is the preferential export credit that provides a subsidy of over 30 percent for exporters who have access to such credit. At the same time, it would be desirable to establish a medium-term credit facility in the Central Bank, complemented by an export credit guarantee-scheme. This would permit Turkish firms to better compete abroad in exporting durable goods, where foreign firms generally provide medium-term credits and benefit from credit guarantee schemes.

Present regulations as to the partial deductability of the value of new exports and of increments in exports from taxable income would also need to be modified. The present system tends to discourage small exporters by imposing a minimum export value of $250,000 for manufactured exports. This conclusion applies a fortiori to the export rebate scheme, which has a higher minimum requirement for providing an additional rebate. Apart from the case of trading firms, to be discussed below, it would be desirable to eliminate over time the differential treatment based on the size of exports.

It would further be desirable to simplify the existing foreign exchange allocation schemes. Finally, in order to avoid the possible adverse consequences noted above and to minimize leakages, it would be advisable to link credit preferences to value added in exports and to grant the credit subsidy ex post rather than ex ante. This could be accomplished by providing export credits in the first place on a nonpreferential basis and granting credit subsidies once exportation has been undertaken on the basis of value added, by classifying commodities in several categories according to the ratio of value added to export value.

Parallel with reductions in export subsidies, it would be desirable to extend the free trade treatment of exports. This would entail making the importation of prohibited items for export production automatic, eliminating tariffs on machinery used in export production in cases where a separate application for investment incentives has not been made, and extending the privilege of duty-free importation to all producers of important domestic inputs used in export production. The implementation of these recommendations would permit increasing the domestic content of exports without unduly burdening export production; they are of particular importance in the engineering industries where vertical specialization can bring considerable benefits.

Reductions in import protection and in export subsidies would need to be offset by gradual changes in the real exchange rate, thus continuing the process begun in January 1980 but partially reversed in recent months. Such changes are also necessary in order to improve the balance of payments since Turkey's existing deficit would need to decline over time.

The proposed measures would improve the profitability of agricultural exports that are presently discriminated against in favor of manufacturing products. As discussed below, further changes in incentives to agriculture would be desirable to approach world market price relations with respect to products as well as inputs.

Remaining controls of industrial prices would also need to be abolished. This applies to products on which formal controls have been maintained, such as cement and newsprint, as well as to cases where informal controls have delayed increases in prices. Monopoly products require special rules, however, as discussed below.

Interest Rates and Financial Markets

The taxation of deposit interest rates and financial transactions, the reserve requirements of commercial banks, and the high costs of bank operations create a substantial spread between after-tax interest rates received by depositors and interest rates paid by borrowers. The withholding tax on time deposits is 25 percent, reducing the after-tax equivalent of the 50 percent interest rate on one-year time deposits to 37.5 percent. At the same time, the 15 percent liquidity requirement, earning an interest rate of about 9 percent, and the 30 percent legal reserve requirement, earning an interest rate of 12 percent, raise the cost of these funds to the commercial banks to 82 percent. Finally, non-interest bearing demand deposits have a 15 percent liquidity requirement and a 35 percent legal reserve requirement.

Interest rates charged on one-year non-preferential loans by commercial banks are at present 38 percent, which increases to 50 percent if account is taken of the 15 percent levy accruing to the interest rebate fund and the 15 percent financial transactions tax. Making further adjustments for compensating balances, the effective interest rate for non-preferential borrowers may reach 70 percent, exceeding the actual rate of inflation by 30 percentage points and the after-tax rate of interest to depositors by 32.5 percentage points.

Real interest rates of this magnitude impose a considerable burden on borrowers, especially in the present situation of low domestic demand that led to the accumulation of product inventories in several industrial branches in Turkey. At the same time, the large spread between interest rates paid by borrowers and received by depositors tends to discourage savings and investment.

To remedy this situation, it would be desirable to lower the taxes imposed on interest payments made to depositors, as discussed below, to eliminate the financial transactions tax, and to reduce the costs associated with reserve requirements by raising the interest rate paid on required reserve holdings for time deposits. While the financial transactions tax had a useful function in syphoning off part of the excess profits of the commercial banks under the system of fixed interest rates, excess profits have been substantially reduced as a result of the freeing of interest rates and increased competition among banks. Its elimination is particularly urgent on intra-bank deposits and on foreign loans, where double taxation is involved.

Under competition among banks, the described measures would reduce the existing wide interest rate spread by raising interest rates to depositors while lending rates are determined by the scarcity of available funds. Higher after-tax interest rates for depositors, in turn, would increase the amount of time deposits and thus the availability of funds for lending, thereby contributing to lower lending rates.

For this outcome to be fully realized, it would be desirable to further increase competition among banks. This could be accomplished by prohibiting the participation of state banks in cartel-type actions, allowing the establishment of more branches of foreign banks, and revitalizing bond and stock markets.

The revitalization of bond and stock markets would improve the system of financial intermediation, encourage savings through the availability of a greater array of financial instruments, and increase the scope of investment finance. As far as bond markets are concerned, the elimination of the 28 percent interest rate ceiling and the introduction of a system of floating interest rates would be desirable. The introduction of such a system would permit providing medium-term and long-term credits to enterprises, without locking them into high interest rates at times of rapid inflation, and reducing the cost of financial intermediation. One would also avoid the cashing-in of outstanding bonds while real interest rates to the purchasers of bonds would remain roughly constant over time without the risk of incurring large capital losses.

Medium- and long-term bonds should be traded in the securities market. The placement of bonds issued by the Treasury and the SEEs at competitive interest rates would also contribute to the revitalization of bond markets while ensuring a better control of the money supply.

The early promulgation of legislation affecting bond and stock markets would further be necessary in order to assure the modernization of the Turkish financial system and the availability of funds for productive investment. At the same time as noted below, tax regulations would need to be changed to increase the attractiveness of stocks.

Finally, it would be desirable to simplify the existing system of preferential credits. This would involve replacing the complex regulations on special reserve ratios, preferential rediscount rates and interest rates, differential rules on rediscounting, and tax exemptions on certain types of financial transactions by interest rate subsidies that are transparent, easy to administer, and minimize the possibility for irregularities. The extent of interest rate subsidies would also need to be reduced, both to minimize the possibility of leakages to unintended uses and to limit the risks of distortions in resource allocation.

In particular, it would be desirable to review systems of subsidization of export credits. The present regulations involve several simultaneous methods of subsidization whose combined impact is difficult to determine. At the same time, the dependence of preferential export credits on Central Bank rediscounts creates an upward pressure on the money supply while efforts made to avoid such undesirable consequences limit the availability of export credits and create inequities among exporters.

Finally, at the fact that subsidization through export credits is based on export value and not on value added creates a situation under which exports with a lower proportion of domestic value added receive proportionately greater benefits.

The subsidization of short-term agricultural credits would also need to be reviewed. The existing system absorbs a large part of the resources of the Central Bank, distorts competition in the market for agrigultural credits by giving special privileges to the Agricultural Bank, and practically limits the total amount of agricultural credit while conferring particular privileges on the recipients and encouraging the use of capital as compared to labor inputs.

Reducing the extent of interest subsidies would permit lowering the levy to the interest rebate fund. This, in turn, would give further encouragement to savings, thereby increasing the availability of funds and lowering interest rates for lenders, as described above.

The Tax System

The recent revision of the schedule of personal income taxes aims to make the tax system more equitable and to adjust tax rates for past inflation. An unskilled worker earning TL 240 a day, or roughly TL 60,000 a year, will be exempt from income taxes, while he paid TL 16,500 in taxes beforehand. However, tax obligations rise rapidly at higher income levels as the tax rate on wage and salary income in excess of the TL 61,200 tax-free allowance is 40 percent up to an income of TL 1 million. A worker earning TL 620 a day, the average for some of the higher-paying industries, will thus have an income tax obligation of TL 35,000.

The 40 percent minimum income tax rate on relatively low incomes will encourage continuing the past practice of payments in kind for the purpose of evading taxes and may not be conducive to increased work effort. Also, there is no economic rationale in setting lower marginal tax rates on annual incomes above TL 25 million (66 percent) than on incomes between TL 15 and 25 million (70 percent up to TL 20 million and 75 percent afterwards).

It would be desirable to adopt a more "modulated" tax structure and to reduce the extremely high rates applying to annual income between TL 10 and 25 million. Apart from discouraging work and risk-taking, such high rates invite evasion. The intention of the authorities to reduce the tax rates by 1 percent a year over the next five years is therefore appropriate. However, it would further be desirable to adjust tax rates for inflation in the future. This would permit avoiding the so-called bracket creep, i.e., the shift of taxpapers to higher brackets due to inflation. One may envisage making automatic adjustments for inflation as it is done in Canada and, in practice, also in France.

The taxation of interest income on time deposits and bonds would also need to be revised. Interest receipts are subject to a withholding tax of 25 percent under the new regulations and are included in personal income for the determination of income tax liabilities. These regulations do not take account of the effects of inflation on the value of the capital from which the income is derived. The 42 percent interest rate on six-months deposits, for example, corresponds to a zero real interest rate under present conditions, so that the tax is on the capital rather than on income derived from it.

In order to encourage savings and the development of financial markets, it would be desirable to modify these regulations. This could be done by adjusting interest receipts for inflation. It would further be desirable to modify existing tax regulations that include capital gains with personal income. In an inflationary environment, the taxation of capital gains will entail the taxation of capital which, again, discourages savings. One may consider eliminating capital gains taxes as it is done in most countries in Continental Europe or reducing capital gains taxes substantially below income tax rates as has been the case in the United States and the United Kingdom.

Corporate income taxes would also need to be adjusted for inflation. This would require the revaluation of balances, so as to avoid that firms are taxed on "phantom" profits due to inadequate allowance for depreciation based on historical values. Legislation on the revaluation of balances has considerable urgency and it should exclude revaluation profits from taxable income.

Recent changes in regulations raised corporate income taxes on retained profits from 43 percent to 50 percent, although encouraging corporate savings for purposes of reinvestment would have required a reduction. Such a reduction may be accomplished by equalizing the tax treatment of private and public enterprises which are subject to a corporate income tax of 35 percent, as suggested below.

The revenue effects of the proposed reductions in tax rates would be partly offset by increased revenues derived from higher incomes. It would further be desirable to reduce the share of public consumption and investment in the gross national product that has increased in recent years and is projected to rise further in 1981. These changes do not conform to the government's announced intention to increase the role of the private sector that would contribute to economic growth in an outward-oriented economy.

Finally, notwithstanding improvements made through the introduction of a uniform sales tax, the complicated and fragmented system of indirect taxes is at the source of considerable disturbance in production, investment, and trade. These disturbances would be eliminated through the implementation of the proposed comprehensive value added tax. Urgency should be given to preparing the introduction of this tax that will complement the other incentive measures proposed in this aide-memoire.

Incentive to Domestic and to Foreign Investment

Under present legislation, approved investments receive incentives in the form of duty-free entry of machinery and equipment (or payment of duties in instalments), an interest rebate of up to 25 percent on medium-term credit for investment on fixed assets and working capital, accelerated depreciation provisions for firms working two shifts, and the deduction of 30 percent of investment in fixed assets from taxable incomes, with one-third of the investment allowance added to tax liability; higher percentages apply to investments for exports and in less developed regions. Deductibility from taxable income is limited to investments above TL 20 million, except for designated priority sectors (Tl 10 million) and for agriculture (TL 4 million).

It would be desirable to review the system of tax incentives, which provide proportionately greater benefits to less profitable firms than to firms with higher profits. At the same time, in order to avoid giving encouragement to capital-intensive industries and production methods, it would be desirable to extend the deductibility of investment to working capital and to reduce the present minimum limit, which discriminates against smaller enterprises that tend to be labor-intensive. Finally, greater incentives may be provided to some "infant industries", such as electrical and non-electrical machinery, machine tools, electronics, and the processing of fruits and vegetables.

Further questions arise concerning the use of a "positive" list, which specifies the investments eligible for incentives. While some of the sectoral designations are quite broad and investors may apply for incentives also in sectors which are not included in the list, this involves additional administration and creates uncertainty. The rising number of rejections of applications for incentives increases uncertainty and may in particular discourage smaller firms from applying.

A more appropriate solution would be to establish a "negative" list that would designate a limited number of products, which do not receive incentives. This may include cases where foreign market limitations exist, e.g., cotton fabrics, or there is excess capacity in a sector that is oriented towards domestic markets, such as automobiles.

Foreign direct investment may play an important role in Turkey by increasing the availability of savings and foreign exchange and providing technological and marketing know-how. The recent liberalisation of regulations affecting foreign investment is, therefore, much welcome. At the same time, further measures would need to be taken to attract new foreign investors as well as investors from countries that are not as yet present in Turkey.

The first requirement would be to avoid delays in the repatriation of dividends derived from investments that were undertaken before the Framework Decree on Foreign Capital came into effect. More generally, liberal and unambiguous rules would need to be established on the repatriation of dividends and capital, providing treatment comparable to other countries that compete with Turkey for foreign capital. It would further be desirable to eliminate the requirement of co-operation with state economic enterprises as a condition for foreign direct investment in various engineering industries.

Changes in legislation and in its practical application would need to be accompanied by a promotional effort. This would involve publicising the advantages Turkey possesses in terms of natural resources, labor costs, proximity to Middle Eastern markets, and preferential entry to the European Common Market. Turkey may be particularly attractive for subcontracting in metal-working and engineering industries and for triangular arrangements, with the processing of inputs originating in the Common Market countries for exportation to the Middle East.

One may envisage establishing several investment bureaus abroad, which could be combined with trade promotion bureaus to be discussed below. Finally, on the example of Tunisia, an effort should be made to establish joint Arab-Turkish banks for investment in agriculture, food processing, machinery, and tourism. Such banks could bring much needed capital to develop the Turnish economy.

B. Sectoral Issues

Industrial Development

Over the past several decades, a wide range of industries have been established in Turkey, first in the public sector and subsequently in the private sector. Apart from increased outward orientation, a priority for the further development of Turkish industry should be to ensure technological progress and labor training. This is necessary in order to provide modern inputs for other industries and to shift towards skill-intensive activities, where Turkey's comparative advantage will increasingly lie in the future.

The principal source of technical support in Turkey is the Scientific and Industrial Research Institute (TUBITAK). TUBITAK is, however, oriented largely towards public sector and it has not been the source of technological innovations. Also, it lacks specialization and has made little effort to adapt foreign technology to Turkish conditions.

On the example of Korea, the government may contribute to the promotion of technological progress through the establishment of specialized institutes of applied research. Such institutes may play an especially important role in certain engineering branches and in the chemical industry.

The establishment of applied research institutes would need to be complemented to tax incentives to research and product development by private firms. This should be part of a medium-term plan of science and technology, which would also provide for the further development of technical universities.

Technical universities represent a link between research and the training of scientists and engineers. The training of technicians and skilled workers would also need to be promoted through the establishment of specialized schools and courses as well as through tax benefits to firms undertaking training. Tax incentives to research and training would promote a shift from hardware to software, which is necessary at Turkey's present state of development.

Efforts made to increase research and training would benefit, in particular, the electrical and non-electrical machinery, machine-tool, and electronics industries, which are relatively undeveloped in Turkey in comparison to metals where government investment played an important role and the automotive sector which expanded at high costs in the framework of protected domestic markets. These industries may receive further incentives on infant industry grounds. Rather than protection, such incentives should aim at reducing the cost of production, in order to provide low-cost inputs to other industries and to encourage exports.

Incentives to the electrical and nonelectrical machinery, machine-tool, amd electronics industries may take the form of medium-term credits and higher than average percentage deductions of new investments from taxable income. One should further examine the feasibility of establishing specialized industrial parks where ancillary activities would be available. Also, the services of foreign engineering consultants may be obtained to review plant layout and the organization of work, with a view to recommending productivity improvements. In Korea, this is done in the framework of an investment project financed by the World Bank.

In turn, there would be need to devise a long-term strategy for the automotive industry in order to avoid further duplication of production facilities and to ensure vertical specialization in efficient plants. In view of the difficulties of consolidating producers that manufacture different cars and belong to different business groups, this may be sought in the direction of specialization agreements involving the exportation of some parts and components and the importation of others. At the same time, the implementation of public investments in the production of tractors, diesel engines, and commercial vehicels, creating duplication with private facilities, would not be desirable. More generally, in the electrical and non-electrical machinery, machine-tool, and electronics industries reliance should be based on private initiative that can ensure the flexibility necessary to respond to changing world market conditions.

The export incentives discussed earlier could be usefully complemented by measures to promote marketing abroad, The Export Promotion Center (IGEME) engages in documentation on a limited scale and has neither the staff nor the budget for mounting an effective export promotion effort. A successful marketing effort would require establishing an institution that is engaged in the collection of market information, the provision of advice to exporters, and promotional activities, including the organization of trade fairs and foreign commercial missions. For such an organization to be effective, it should have branches abroad, both to identify markets and to solicit orders, on the example of KOTRA in Korea and CACEX in Brazil.

A public institution of export promotion can only play a supporting role, however, to private firms. Turkey's large business groups are capable of mounting an export promotion effort but small and medium size firms can rarely export directly. Correspondingly, trading firms may play an important role as they do in countries such as Japan and Korea. The tax benefits they presently receive are limited to large trading firms. However, small trading firms may be particularly effective in specialized areas and in exploring new markets.

State Economic Enterprises

While the state economic enterprises pioneered in the development of manufacturing industries in Turkey, their performance has deteriorated due to the effects of factors such as detailed and often conflicting central directions and interventions, the lack of financial discipline, the politically motivated choice and the inadequate compensation of management and technicians, and excessive wage and employment levels for production workers. At the same time, the complexity of financial arrangements, deficient accounting practices, and incomplete reporting have limited public accountability. Another major problem has been the virtual lack of economic analysis of new investment projects.

The control of prices before January 1980 affected but little the operation of the SEEs as they could get ready financing from the government. Nor have subsequent increases in prices affected their mode of operations in a fundamental way. At the same time, formal and informal price control persists in some areas. Such control has a rationale in the case of monopolies but not for firms that compete with the private sector.

In the case of natural monopolies, such as electricity, gas, and water, the price should cover the cost of operations. In the case of monopolies producing traded goods, such as steel and newsprint, the rule enunciated by the Ministry of Industry, to limit prices to the tariff inclusive cif import price plus a margin, should be consistently applied while reducing the margin from its present level of 30 percent. Import liberalization would, however, obviate the need for such control.

While apart from SEKA, the producer of pulp and paper, all industrial SEEs made operating profits, these results need to be adjusted for budgetary subsidies, preferential credit terms, differential corporate tax rates, and the use of historical depreciation in the accounts. In order to put the SEEs on the same footing with private industry, they should receive identical tax and credit terms, with borrowing from commercial banks replacing governmental credit allocations for operational needs.

There would also be need to reform the present system of decision-making in investments in the manufacturing sector. In an inward-oriented economy, this was based on the calculation of needs from projections of final demand in an input-output framework. Under outward orientation, it should be replaced by economic project evaluation utilizing world market prices. A possible solution is to give responsibility for the evaluation of investments to public investment banks, such as the State Investment Bank and a new industrial bank combining the banking subsidiaries of SUMERBANK AND ETIBANK, which is under discussion. Eventually, both private and public banks, as well as the capital markets, may be involved in the financing of both private and public enterprises. This, however, would require major improvements in the SEEs.

As regards the mode of operations of the SEEs, it has been proposed that the present sector-wide SEEs be replaced by holdings, the boards of which would supervise the individual production units that would have their own board of directros and managers. The sector-wide holdings, in turn, would be supervised by one or more Upper Boards having oversight responsibility for all industrial holdings, with the government having a minority role at all levels.

This solution has been advocated on the grounds that it would reduce governmental interference and contribute to the decentralization of decision-making. While the proposed alternative would indeed represent a step towards lesser government involvement and decentralization, it may give rise to conflicts between the various levels and limit the authority of managers. It would seem desirable, therefore, to go a step further and to vest authority for decision-making in managers while ensuring competition among the independent units.

In this connection, the experience of Hungary with state-owned firms offers an interest. In Hungary, large firms having plants producing similar commodities have been broken up and the managers of individual firms are not subject to production, employment, or export targets. Rather, they have responsibility for making profits in a competitive environment and are remunerated on the basis of the profits of the firm.

Turkey may learn from the example of Hungary in breaking up large, monopolistic SEEs and making the newly-established firms subject to market conditions, with the managers being given the freedom to decide on production, prices and, eventually, employment. The possibility of divesting public firms in sectors outside the basic industries would also need to be explored further.

After a long period of preparation, the move from centralized planning to decentralization was accomplished practically overnight in Hungary. In Turkey, too, careful preparation of the reforms is necessary, when the limitations of available cadres may not permit their immediate implementation in full. However, it would be desirable to reach early decisions as to scope of the reforms. Apart from the issues discussed above, these should provide for improved information and accountability of the SEEs.

Agriculture and Agro-Industries

The gradual shift from import protection and export subsidization for manufacture goods to the use of the exchange rate would benefit agriculture in Turkey and promote exports as well as import substitution in this sector. It would further be desirable to gradually move towards world market price relations for agricutural products and their major inputs, with the system of support prices limited to a minimum number of commodities and designed to play largely a stabilizing role. Alternatively, farmers' incomes may be stabilized by providing an adequate supply of credit, combined with the establishment of a credit insurance scheme.

Among agricultural products, the adoption of world market prices would not be appropriate for hazelnuts, raisins, and tobacco, where Turkey has an important market position and the elimination of export taxes would lead to the deterioration of the terms of trade. There is no economic rationale, however, for maintaining domestic cotton prices below world market levels that are unaffected by the amount Turkey exports.

With the price of wheat having been maintained above world market levels in earlier years, there has been substitution of wheat for cotton in some areas as well as a shift to the use of irrigated land in wheat production. The adoption of world market price relations would result in a lower rate of increase in wheat production and a more rapid rise in the production of alternative crops. Depending on the region, this may involve pulses, fodder, oilseeds, cotton, corn, as well as vegetables and citrus fruits. Similar considerations apply to barley.

The increased production of corn would be beneficial for animal husbandry. At the same time, it is not desirable to subsidize the use of concentrated feed and to provide investment incentives to broiler production that are not available to cattle and sheep, where natural advantages, in particular, the availability of pasture, favor Turkey. The exploitation of these natural advantages would be furthered by abolishing existing limitations on the exports of cattle, beef, lamb and mutton and permitting the slaughtering of livestock by private industry.

Available incentives appear sufficient in the case of meat processing where religious customs prevalent in the Middle East provide additional advantages to Turkey. However, fresh and processed fruits and vegetables encounter strong competition, with Turkish producers suffering the traditional disadvantages of an infant industry. It may be desirable, therefore, to provide preferential tax treatment to fruit and vegetable processing, encouraging in particular integrated operations, on a temporary basis. Also, an effort should be made to attract foreign investment in the industry, where multinationals offer technical expertise as well as marketing know-how.

As far as input prices are concerned, the subsidization of fertilizers and pesticides should be eliminated over time so as to avoid inefficient usage. Also, uneconomic mechanization and underutilization of tractors would be discouraged by eliminating any subsidies that may remain. Finally, water charges should be adjusted so as to ensure the use of water for higher-value crops. Exceptions may be made, however, for smaller farms that already utilize family labor for the intensive production of fruits and vegetables.

The efficient development of Turkish agriculture would also require taking institutional measures, among which improvements in research and extension services are of particular importance. Finally, the promotion of exports, in particular of fruits and vegetables, would necessitate improvements in transportation as well as in marketing. Turkey would need to improve, in particular, its railroad and port facilities. In turn, the implementation of the investment project financed by the World Bank would benefit the marketing of fruits and vegetables.

Tourism

Tourism is an important foreign exchange earner in Turkey, accounting for about one-tenth of the exports of goods and services. Although arrivals declined from a peak of 1.6 million in the late 1970s to 1.3 million in 1980 due to political uncertainties, Turkey should be able to reverse this trend and to increase its share of the Mediterranean tourism market which in total is expected to increase by about 7 percent a year during the 1980s. Turkey's assets include competitive prices (notwithstanding the higher cost of the air transport component), an attractive physical environment, an excellent climate and outstanding sightseeing.

At the same time, the expansion of tourism offers particular advantages to Turkey, given its favorable capital-labor ratio and the low rate of import leakage. Taking account of all tourist-related activities, it would appear that the cost of earning foreign exchange is relatively low.

The expansion of tourism would require increasing accommodation capacity as well as a marketing effort. While economic returns are high on non-hotel tourism activities, such as shopping, entertainment and internal transport, the profitability of hotels is traditionally modest and the pay-back period is long. Accordingly, capturing the potential benefits of tourism would necessitate providing adequate low-cost loan finance for hotel construction. Even with the proposed increase of its resources, the amount of loan funds the Tourism Bank will have available is small compared to requirements; it would provide financing for only 4,000 beds a year, representing an annual increase of less than 6 percent.

The domestic hotel construction effort could be complemented by foreign investment and one may welcome the proposals made to attract such investment. At the same time, it should be recognized that the major portion of tourism investment in Turkey will continue, as elsewhere, to be domestic. However, foreign management should be increased to obtain expertise and marketing experience.

The promotion of tourism should be concentrated in a limited number of areas, in order to capture economies of scale and to take advantage of existing, or nearly-completed, infrastructure. In Antalya, for example, infrastructure is available and only hotel investment is required at Side, while land tenure problems still need to be resolved in Kemer. In some other areas, such as Izmir and Bodrum, limited improvements in connecting roads, sewage and water, and/or telecommunications would have a high potential payoff.

A concentrated effort would need to be made in marketing, involving the upgrading tourism bureaus abroad and a major sales campaign. In cooperation with the private sector and the special tourist authorities to be established in priority zones, government authorities should play an important part in such an effort. For this purpose, consideration should be given to establishing a semi-autonomous national office, appointed by the Minister of Tourism, which would draw its staff from the travel trade and be suitably remunerated outside civil service regulations. Such an office would also enter into contracts with professional marketing firms in major market countries.

In order to ensure convenient and least-cost access, civil aviation policy should be reviewed. This would necessitate weighing the financial interests of Turkish Airlines (THY) against the economic returns in the tourism sector and the economy as a whole. Air charter operations, by both domestic and foreign airlines, should be encouraged and consideration should be given to granting continuation rights for foreign airlines.

Mr. Robert H. Cassen, PPR June 17, 1981.

Bela Balassa, DRC

<u>WDRIV Background Paper</u>

I sent the revised version of my "Adjustment to External Shocks in Developing Economies" to Mr. Winterbottom. This version incorporates results for four additional countries (Portugal, Turkey, Mauritius and Zambia) that adds to the interest of the comparisons made for country groups classified according to the level of development and policies followed.

cc: Messrs. Jaspersen, Mitra, PPR

Enclosure
BBalassa:nc

Mr. Goddard W. Winterbottom, IPA June 17, 1981.

Bela Balassa, DRC

<u>WDRIV Background Paper</u>

I enclose two copies of my "Adjustment to External Shocks in Developing Countries" which was prepared as a background paper for WDRIV. May I ask you to let me see the editing of the paper once it is completed. Apart from a short trip during the week of June 29th I will be in Washington until the end of July.

Enclosures
BBalassa:nc

Chief Economists

June 17, 1981.

Bela Balassa, DRC

Turkey Mission

You may be interested in the enclosed aide-memoire that provides the preliminary conclusions of the mission I led to Turkey in May-June. The aide-memoire aims to provide a comprehensive view of medium-term policies to supplement the recent policy changes in Turkey. Energy and public investment are being covered elsewhere and were excluded from the purview of the mission.

Enclosure
BBalassa:nc

CABLE

JUNE 17, 1981
61991

MR. RENE ØAURS, AFRICA MERIDIEN HOTEL

TUNIS, TUNISIA

PLEASE CALL ME COLLECT AT 202-676-1991 THIS WEEK CONCERNING

SEPTEMBER VISIT TO TUNIS. REGARDS, BALASSA

Bela Balassa

Bela Balassa

DRC - Director's Office

BBalassa:nc

Miss Marie Higginson, ADM June 16, 1981.

Bela Balassa, DRC

<u>French Translation</u>

I enclose the tables to my paper "Adjustment to External Shocks in Developing Countries" that is being translated by Mr. de la Renaudiere. Rather than reproducing the tables in French I would like to have a glossary containing the headings for each of the tables. In order to avoid repetition the glossary should be preceded by a list of the country groups that are referred to in Tables 1 to 5. In this connection, I would like to note that in my previous paper we have translated newly industrializing countries as "pays nouvellement en voie d'industrialisation" and less developed countries as "autres pays en développement."

Enclosures (9)
BBalassa:nc

Enclosed: Tables A, B, 1A, 1B, 2, 3, 4, 5, and Appendix Table 1.

CABLE

JUNE 16, 1981
61991

ANTONIO LEMGRUBER, CENTRO DE ESTUDOS MONETARIOS, FUNDACAO GETULIO VARGAS, PRAIA DE BOTAFOGO, 190-9°, CEP 22250 RIO DE JANEIRO, BRAZIL

PLEASE CALL ME COLLECT ANY DAY THIS WEEK. REGARDS, BELA BALASSA

Bela Balassa

Bela Balassa

BBalassa:nc

DRC - Director's Office

June 16, 1981.

Mr. Martin Wassell
Secretary to the Working Party
on the Manila Congress Programme
International Chamber of Commerce
38 Cours Albert 1er
75008 Paris
France

Dear Mr. Wassell:

I enclose, in two copies, my report "Shifting Patterns of World Trade and Competition," prepared for the Manila Congress of the ICC. Another copy was sent to Mr. Willis Armstrong.

Yours sincerely,

Enclosures

Bela Balassa

cc: Mr. Willis Armstrong

Mr. J. de Larosiere, IMF

Bela Balassa, DRC

Turkey Mission

June 16, 1981.

I enclose, on a confidential basis, a copy of the aide memoire "Medium-Term Economic Policies for Turkey" that contains the preliminary conclusions of the Bank mission I led to Turkey in May-June. An earlier version of the aide memoire was discussed with the government in the third week of our mission to Ankara.

cc: Mr. L.A. Whittome, IMF

Enclosure
BBalassa:nc

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Document Date	**Document Type**
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Correspondents / Participants
Mr. Jacques de Groote, EDS

Bela Balsassa

Subject / Title
Turkey Mission

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Mr. Ernest Stern, SVPOP June 15, 1981

Bela Balassa, DRC

Turkey Mission

I enclose a copy of the aide memoire "Medium-Term Economic Policies for Turkey" that was sent to the government of Turkey last Friday. An earlier version of the aide memoire was discussed the third week of our mission to Ankara.

I would like to have the opportunity to speak to you on some matters concerning Turkey that go beyond the aide memoire. My secretary will call yours to see if we can have lunch together, at your convenience.

Copies of the aide memoire have been given to Messrs. Please and Landell-Mills.

Enclosure
BBalassa:nc

Mr. Maurice P. Bart, EM2 June 15, 1981

Bela Balassa, DRC

Atatukk Centennial

The Middle East Institute of George Washington University is organizing a round table on Turkey on the occasion of the Centennial of Kemal Ataturk. I have been asked by the Ambassador to Turkey to briefly speak on economic issues. Other participatts are Ambassadors Sisco, Brown as well as Professor Frier. The meeting will be held at the International Club on Friday, July 26th at 5:30 p.m.

I have given my tentative agreement to participate at the round table, pending your approval. I trust that you do not have any objections to it. Let me add, that I will speak in a private capacity and identified as Professor of Political Economy at the Johns Hopkins University.

BBalassa:nc

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Withdrawn by	Date
Chandra Kumar	May 30, 2014

Mr. Maurice Bart, Director, EM2 June 12, 1981

Bela Balassa, DRC

TURKEY: Industrialization and Trade Strategy Mission

Enclosed is the revised aide-memoire of the mission that was sent to the Turkish government today.

cc: Messrs. Chaufournier, EMNVP; Karaosmanoglu, EM1; Picciotto, EMP;
Davar, EM2; Dubey, EMNVP; Gregory EM2; Hume, EMP; Sadove, EGY;
Saito, EM2; Zaman, EM2;
Mission members

Enclosure
BBalassa:nc

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

TO: Mr. Sawai Boonma, EM2

DATE: June 11, 1981

FROM: Bela Balassa, DRC

SUBJECT: TURKEY - Public Sector Investment Review

1. The authors of this report should be congratulated for having collected much useful information on the public sector in Turkey and having provided a well-reasoned evaluation of the major proposed investment in the sector. While a further effort is necessary to synthetize the findings, the report will undoubtedly be a valuable aid to Bank work in Turkey and to the Turkish government itself. Time does not permit me to comment on the report in detail and I will deal with some general issues in the following.

2. The first question concerns the level of public sector investment. According to the report "within the macroeconomic framework analyzed by the mission, the level of public investment that appears to be sustainable in 1981 is somewhat lower than the figure put forth in the 1981 Annual Program" (p. 44). However, the macroeconomic framework for 1981 apparently takes private investment as exogenous and obtains public investment as a residual. This procedure does not recognize the "crowding-out" effect of public investment on the private sector, which is elsewhere recognized in the report.

3. In his comments, dated June 5, 1981, Mr. Zaman criticizes the crowding-out thesis, on the grounds that "the private sector has always had a bigger share" (p. 2) in the distribution of credit. But, it is not the absolute figures but rather changes over time that are relevant in judging the existence of crowding-out. As the enclosed table shows, the share of the private sector in domestic financial assets has declined continuously from 1975 to 1980. It is noteworthy that this decline occurred in the period of an increasing ratio of domestic financial assets to GNP (1975-1977) as well as in the period characterized by a decline in this ratio (1977-80). At the same time, crowding-out has assumed increased importance in recent months when the brunt of deflationary policies has been borne by the private sector in terms of the availability and the cost of credit. (Inclusive of compensating balances, interest rates on nonpreferential loans to private business have reached 70 percent, exceeding the actual rate of inflation by 30 percentage points.)

4. Data on domestic financial assets, however, provide only partial evidence on crowding-out as this is also affected by fiscal transfers between the private and the public sectors as well as by the terms of trade between the two. Increases in SEE prices and, more recently, the rise in tax collection have led to increases in the share of the public sector in claims on resources. This is apparent from the enclosed table on the supply and use of resources, which shows increases in the shares of public consumption and public investment in total consumption and investment in 1980 as well as in 1981.

5. Mr. Zaman also raises the question of planning. I see the usefulness of a medium-term plan that would focus on policy issues for the next five years or so, but see little use for indicative planning. This does not exclude, however, the preparation of plans for rehabilitating some basic sectors in the framework of macro-economic projections. But, as suggested in the aide-memoire of our mission, in the manufacturing sector the emphasis should be on decentralizing decision-making and on the application of economic project evaluation in public investment.

6. A further question concerns the public investment program itself. The report does an excellent job in evaluating the proposed large investments in steel, fertilizer, petrochemicals, petroleum refining, and power generation. It has less to say, however, about investment in the engineering sector. These investments are not discussed in Chapter 3, they are not included among investments of questionable value (marked with a star) in Table 3.4 and the short discussion in Chapter 5 is limited to the Tumosan complex. However, public investment in these industries require careful consideration.

7. After having concluded that "the prima facie evidence suggests that the Tumosan projects would not be economical, and would indeed impose an unacceptable burden on the Turkish agricultural and transportation sectors" (p. 240), the report introduces some rather weak qualifications and takes an ambiguous position in regard to these projects. Yet, apart from their high cost, the Tumosan projects would create duplication with private facilities and would discourage further efforts by the private sector, establishing effectively a monopoly position as noted in the report. This is undesirable since the efficient production of tractors, diesel engines, and commercial vehicles would require exporting that, in turn, can best be done by private enterprises which possess the necessary flexibility to respond to changing world market conditions. At the same time, "technology partnership with Mitsubishi, Mercedes, and MAN (or Volvo) [and] three-way partnership with the private sector (Annex pp. 242-49) is pie in the sky since foreign and domestic private firms show little inclination to enter into such arrangements with the SEEs. The latter comment applies to the entire engineering sector, hence the proposal made in the aide-memoire of our mission to abolish the requirement that makes foreign direct investment conditional on co-operation with SEEs in some engineering industries.

8. I suggest introducing these considerations in the report in regard to Tumosan and for the engineering sector in general. Comments would further need to be offered on the other public projects in the engineering sector, which are listed in Table 3 but receive no consideration in the report.

9. I come finally to discussion of policies affecting the private sector and in the early chapters, in Chapter 6. Export Industries, and in Annex I on the private manufacturing sector. While these analyses are competently done and they had been used with profit by members of our mission in preparing for their visit to Turkey, they have in many cases been clarified further and even superseded in the work we carried out in Ankara. Questions arise further on the utility of discussing issues relating to the private sector in two World Bank reports prepared in rapid succession.

10. A possible solution is to delete Chapter 6 and Annex 1 from the Public Sector Investment Review report and to limit the attention given to the private manufacturing sector in the other chapters of the report. There are undoubtedly other solution which we should discuss, along with the particular modifications to be made in the text, in the near future.

cc: Messrs. Sadove, EGY; Davar, EM2; Hume, EMP; Edelman, PPR; Roy, Zaman, EM2

Enclosures
BBalassa:nc

Table __

DISTRIBUTION OF THE TOTAL DOMESTIC FINANCIAL ASSETS OF THE BANKING SECTOR

(year end)

	1975	1976	1977	1978	1979	1980
	Percentages of the total financial assets of the banking sector					
Claims on Public Administrations	19.7	18.3	22.5	26.6	28.7	35.9
Claims on Public Enterprises	28.1	32.9	33.0	31.1	31.1	24.9
Claims on Private Enterprises and Households	52.1	48.7	44.4	42.3	40.1	39.2
Total	100.0	100.0	100.0	100.0	100.0	100.0
	Percentages in relation to GNP					
Claims on Public Administrations	9.0	9.5	12.5	13.4	13.1	14.0
Claims on Public Enterprises	12.8	17.1	18.5	15.7	14.2	9.7
Claims on Private Enterprises and Households	23.7	25.3	24.8	21.4	18.3	15.2
Total	45.5	51.9	55.7	50.5	45.7	38.9

Source: Central Bank of Turkey

Table:II.2 SUPPLY AND USE OF RESOURCES

(At 1980 Prices, in billions of TL.)

	1979	1980 1/	1981 2/	198
1. GNP	4.076,1	4.109,5	4.234,6	0,
2. External Deficit	149,3	203,8	223,3	36,
3. Total Resources	4.225,4	4.313,3	4.457,9	2,
4. Fixed Capital Investments	774,1	722,9	790,0	- 6,
- Public	443,3	422,9	472,1	- 4,
- Private	330,8	300,0	317,9	- 9,
5. Stock Changes	118,0	151,7	132,6	28,6
- Public	89,0	103,4	89,1	16,2
- Private	29,0	48,3	43,5	66,6
6. Total Investments	892,1	874,6	922,6	- 2,0
- Public	532,3	526,3	561,2	- 1,1
- Private	359,8	348,3	361,4	- 3,2
7. Total Consumption	3.333,3	3.438,7	3.535,3	3,2
- Public	489,2	522,3	544,2	6,8
- Private	2.844,1	2.916,4	2,991,1	2,5
8. Private Disposable Income	3.444,4	3.440,4	3.265,5	-0,1
- Savings	600.3	524.0	274.4	-12.7

Source : SPO

1/ Estimate

2/ Program

Mr. Sawai Boonma, EM2

June 11, 1981

Bela Balassa, DRC

TURKEY - Public Sector Investment Review

1. The authors of this report should be congratulated for having collected much useful information on the public sector in Turkey and having provided a well-reasoned evaluation of the major proposed investment in the sector. While a further effort is necessary to synthetize the findings, the report will undoubtedly be a valuable aid to Bank work in Turkey and to the Turkish government itself. Time does not permit me to comment on the report in detail and I will deal with some general issues in the following.

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cc: Messrs. Sadove, EGY; Davar, EM2; Hume, EMP; Edelman, PPR; Roy, Zaman, EM2

Enclosures
BBalassa:nc

June 11, 1981

Mr. Balassa's Preferred Itinerary

June 27	Washington	18:10	Paris	07:35	TW890
June 28	Paris - Orly	16:10	Bordeaux	17:10	IT5613
June 30	Bordeaux	08:00	Geneva	09:15	AF 1678
	Geneva	10:45	Zurich	11:30	SR 657
	Zurich	12:10	Istanbul	15:55	SR 324
July 3	Istanbul	08:00	Ankara	08:50	TK 108
July 4	Ankara	10:15	Geneva	12:55	SR 355
	Geneva	13:55	London	14:30	SR 816
	London	18:30	Washington	17:55	BA 189

June 11, 1981

Mr. Yildirim Akturk
Undersecretary
State Planning Organization
Bakanliklar
Ankara
Turkey

Dear Mr. Akturk:

You will receive today a letter from Mr. Bart, together with the aide-memoire of our mission. I would like to thank you again for the assistance you have given us and look forward to meeting with you again on July 3rd.

On the occasion of our meeting with Professor Hic, we discussed the question of the ownership of materials derived from the research project on Protection and Incentive System in Turkey. Following inquiries made in Washington, it is suggested that you write a letter addressed to Mr. Shankar Acharya, Research Adviser at the World Bank, in which you state your understanding that, in view of cofinancing by the Turkish government, the clause concerning the Bank having exclusive ownership over project materials does not apply in the present case.

I would like to use the opportunity to restate our understanding that the SPO would provide the project with $20,000 for interview expenses, $2,800 for domestic travel, and $16,800 for indirect costs that include the salary of the day-to-day project manager. I would like to give particular emphasis to the latter since without daily supervision the project can hardly be carried out successfully. I hope that Professor Hic will soon make recommendations to you on the choice of a day-to-day manager; I am copying this letter to him.

With best regards,

Yours sincerely,

Bela Balassa

cc: Professor Hic

June 11, 1981.

The Economist Bookshop
Mail Order Department
The Old Piano Factory
43 Gloucester Crescent
London NW1 7DL
England

Dear Sir:

Please send me the following:

Computers and Economic Planning: The Soviet Experience by Martin Cave (Cambridge: Cambridge University Press, 1980, pp xi + 224 £11.50).

The Economics of International Integration by Peter Robson (London: George Allen and Unwin, 1980, pp ix + 197, £ 4.95, paperback).

Please send me your bill for the expenses involved.

Yours truly,

Bela Balassa

June 11, 1981.

Georgetown Dutch Inn
1075 Thomas Jefferson N.W.
Washington, D.C. 20007

Dear Sir:

I would like to make reservations for Mr. and Mrs. Robert Solyom and their 14 year old son starting on July 23, Thurday, and ending July 31, Friday. My secretary has been told on the phone that the cost of accommodations including bedroom, living room and kitchen would be $60. a day. May I ask you to confirm this reservation by return mail.

Yours sincerely,

Bela Balassa

cc: Mr. Robert Solyom
7 rue Servandoni
Paris 6e
France

Messrs. John A. Holsen, ASNVP; Benjamin B. King, VPD June 9, 1981.

Bela Balassa, DRC

Research on Trade

In reference to our discussion, I enclose the following:

1. My memorandum to Mr. Duloy, dated January 18, 1980, which provides a brief description of the world trade model to be estimated.

2. Mr. Duloy's memo of October 3, 1980 to Mr. Chenery, entitled "Fall Review -- October 1980," para. 8 of which describes projected work on trade.

3. Mr. Acharya's memo to me, dated May 8, 1981.

Enclosures
BBalassa:nc

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

(F

TO: Mr. John H. Duloy, DRC DATE: January 18, 1980

FROM: Bela Balassa, DRC

SUBJECT: Meeting with Victor Ginsburgh

1. I met with Victor Ginsburgh in Paris on January 17th to discuss possible dates when he would be joining the Bank and the work he may be doing here. Victor told me that, due to his teaching obligations, he would not be able to join us before January 1981. January would be convenient for him as he could do a year's teaching in the first semester.

2. Victor indicated to me that his main interest in a macro-model with exhaustible resources would have been to combine a world commodity model with a country model. He noted that Jamaica, the country that was earlier proposed for estimation, is not a price taker in the world bauxite market and hence some representation of world market conditions would have been called for. He has little interest in modelling a country with exhaustible resources that is a price taker in world markets.

3. We have further discussed possible joint work on a world trade model that attracted Victor to the DRC in the first place. I briefly described the structure of a static model, in which factor endowments are taken as exogenous and one would attempt to explain the net trade of particular countries in individual commodity categories. The model would use the assumption of fixed input-coefficients for physical and human capital and for labor, to vary among countries with relative factor prices. Trade would be generated by differences in relative factor endowments that affect relative factor prices and input coefficients.

4. Lydall's results relating technical coefficients to factor prices could be used to generate the input-coefficient matrix by taking a single country's coefficients as the point of departure. I would expect to use data for Japan, an intermediate country, as a point of departure rather than U.S. data as I have earlier done. A Japanese student of mine would be able to generate the data and a re-estimation of my equations in the Stages Approach paper could be done before Victor's arrival here.

5. The described model makes *ceteris paribus* assumptions as far as consumption patterns are concerned and assumes constant returns to scale. These assumptions would permit avoiding the estimation of relationships in the domestic economy and would thereby limit the size and complexity of the model. Nevertheless, the model would be quite large as we would envisage using the 2-digit SIC classification scheme (20 industries) together with the Bank's regional classification scheme.

6. Victor will give thought to possible ways of estimating the proposed world trade model and will explore the possibility of combining econometric estimates with programming and simulation techniques. We would plan to meet again in May, either in Washington or in Europe where I will attend a conference in the early part of the month.

cc: Messrs. Chenery, VPD; and Pyatt, DRC

BBalassa:nc

agreed on this basis
JD Jan 28

OFFICE MEMORANDUM

TO: Mr. H. B. Chenery (VPD)

DATE: October 3, 1980

FROM: John H. Duloy (DRC)

SUBJECT: Fall Review -- October 1980

1. During this year's Fall Review, I would like to concentrate on the evolution of the DRC's work program since its reorganization, and upon how it might evolve in the future.

2. The documentation consists of a table showing main areas of work FY78 through FY82, and notes on the LSMS, on macro-modelling, and on applications, together with this memo which summarizes the main issues.

Trends

3. The main trends can be seen in the table, which are aggregates of the manpower matrices for the various years. Some caution needs to be exercised in examining these data, because the underlying matrices were prepared in the Fall of the year in question, and realizations did not always coincide with the expectations at that time. A prime example is FY79, in which 20 m.m. of new starts were envisaged. Because of personnel turnover, and recruiting lags, these did not eventuate. Nevertheless, the main trends are clear.

4. There was a gradual run-down of distribution work [column (1)] from FY77 (21 m.m.) to FY79 (16 m.m.) associated with the completion of the original work program. This was followed by an expansion in FY80 (24 m.m.), projected to go to 35 m.m. in FY82. Work in this area is now concentrated on LSMS (separate report attached) and a set of longitudinal studies along the lines of the prospectus drafted by Clive Bell. Actual progress on this second strand will depend upon recruiting a senior person to manage it (in place of Raj Krishna, who was our first choice). This project will lend itself ideally to collaboration with developing country institutes.

5. Work on macro-modelling [column (2)] showed some decline from FY77 (36 m.m.) to FY80 (32 m.m.), associated with the running-down of Prototypes and the SAM projects, which constituted our initial portfolio. Macro-modelling work is expected to expand to 60 m.m. in FY81 and 70 m.m. in FY82. A report on this work is attached.

6. Work on industrial planning [column (3)] declined precipitously with Ardy Stoutjesdijk and Yung Rhee's departure for DED over the period FY77 to FY78. Work has continued at the level of a few man-months, being Alex Meeraus' involvement in several applications of the methodology.

7. Work on agriculture [column (4)] peaked in FY80 (60 m.m.), coinciding with four large projects (India, Indus, NE Brazil, Muda). The last two of these are completed and Indus is near completion. The India project will continue over the next few years, along with an important new project involving Gershon Feder and focussing on the Benor/Harrison extension methodology (T and V). The net effect of these changes is that DRC work on agriculture will decline from 60 m.m. in FY80 to 35 m.m. in FY81, and to 18 m.m. in FY82 unless new projects are launched.

8. Work on trade-related issues [column (5)] has remained more or less constant at about 20 m.m. However, its content is changing as earlier projects are completed. In particular, we intend to start a new project in FY81, based upon Balassa's earlier work on the stages approach to comparative advantage. This new project should provide useful conceptual and empirical results to complement the more aggregative analysis in EPD global modelling. It should also provide some insights into the N-S dialogue issues.

9. The less said about management [column (6)] the better, apart from noting some tendency for a slight decline in the m.m. involved. This is due mainly to a more streamlined organization.

10. "Other" [column (7)] is a catch-all category which showed some increase over the period, followed by projected declines.

11. Finally, and most importantly, some "new start" possibilities are shown for FY81 and FY82. One component of the new starts is work in the political economy area, with Geoff Lamb's having joined the DRC.

Issues

12. First, there is scope for new starts in FY81 and FY82. I suggest that first priority should be given to developing a new work program in the area of energy planning and policy, building upon the modelling expertise developed in the DRC over past years. With the expansion of lending in this area, the need for such research is clear. If it is agreed in principle that the DRC should enter this field, then the next steps would be to familiarize ourselves with the state of the arts, to produce an outline of a work program, and to initiate discussions with CPS and EPD.

13. Second, there is an urgent need to develop new RPOs in the DRC. Without these, it will not be possible to realize the work program in any of the areas. This need has been apparent for some time, but no new RPOs have been forthcoming. The meeting might focus on the reasons for this, and upon what changes are necessary in order to have more RPOs developed.

14. Third, the issue of research applications remains not fully resolved. Successful research generates large demands for replications and applications. But successful researchers are also in demand to launch and lead new research projects. The issue is one of balance among these activities.

cc: DRC Staff
DPS Directors
Messrs. Wright, Waide (VPD)
Mrs. Cleave (VPD)
Ms. San Jose (PAB)

OFFICE MEMORANDUM

TO: Mr. Bela Balassa, DRC

DATE May 8, 1981

FROM: Shankar Acharya, VPD

SUBJECT: Research Proposal - Changes in Pattern of Comparative Advantage in Manufactured Goods

I have just received the attached memorandum from Mr. Colaco. It raises some serious issues. I would appreciate your reaction.

cc with attachment: Messrs. H. Chenery
J. Duloy
B. Kavalsky
B. Waide

cc without attachment: Messrs. J. Baneth
F. Colaco
Mrs. H. Hughes

SA:lt

MAY 8 1981

OFFICE MEMORANDUM

TO: Mr. Shankar Acharya, Research Adviser, VPD

DATE May 8, 1981

FROM: Francis X. Colaço, Chief, EPDIT

FXC

SUBJECT: Research Proposal - Changes in Pattern of Comparative Advantage in Manufactured Goods

As you know, my colleague, Mr. Riedel, will participate in the panel which has been set up to review the above research proposal. As required by the terms of reference of such panels, Mr. Riedel will confine his comments strictly to the technical aspects of the proposal.

There are a couple of additional issues which I would like to raise. First, the attached note shows that there is still some overlap between the Havrylyshyn/Wolf proposal which was approved by the Research Committee only a few weeks ago and the present proposal. The earlier version of our proposal would have shown a much larger overlap as discussed below. In my view, it would be an extravagance for the Research Committee to approve two projects (for a sum total of over $600,000 if all costs are properly accounted for) in quick succession which deal with similar sorts of questions, albeit with slightly different approaches.

This, of course, raises the question which perplexes my colleagues and me, and others who have been involved in the four-month long discussions leading to the Havrylyshyn/Wolf proposal: why was there during this period <u>no overt indication given</u> that there was another and overlapping proposal that was in the works?

After all, one of the authors of the present proposal was the chairman of the review panel of our research proposal. In his capacity as the chairman of the review panel, and without revealing his vested interest, one of the authors of the present proposal recommended to Messrs. Havrylyshyn and Wolf that issues they intended initially to deal with be removed or get limited attention; these issues have now surfaced as a major part of the present proposal.

Is this consistent with established Research Committee procedures? I would be grateful for a response.

Attachment

cc: Mrs. Hughes
Messrs. Baneth
Havrylyshyn
Riedel
Wolf

The questions dealt with in this note are two: (1) what is the overlap between the Balassa-Bowden proposal and items initially in the Havrylyshyn-Wolf proposal of January 27th, (which were subsequently removed from the final proposal of February 23rd)? (2) what is the overlap betwen the Balassa-Bowden proposal and the current Havrylyshyn-Wolf outline?

What does the Balassa-Bowden Proposal Include that was Left out of the Havrylyshyn-Wolf Proposal?

The original Havrylyshyn-Wolf proposal contained four elements:

i. a brief description of some salient features of the pattern of trade among developing countries;

ii. an examination of the determinants of the commodity characteristics of trade in different directions;

iii. a review of the effects of relative market size and overall barriers to trade on the level of trade flows in different directions;

iv. a simplified synthesis of ii and iii for purposes of simulation and projection.

At the suggestion of participants in the Workshop items (ii) and (iv) were removed from the final proposal. In the Balassa-Bowden proposal the item that corresponds to Havrylyshyn-Wolf's (ii) is (4) on p.7. In that proposal the item that corresponds to (iv) is a part of "II. International Specialization in a Multilateral Framework" on pp. 10-12.

How does the Balassa-Bowden Proposal overlap with the Current Havrylyshyn-Wolf Outline?

The main surviving overlap is with (iii) above, which is discussed in its present form on pp. 25-8 of the Havrylyshyn-Wolf outline of 23rd February. The gravity approach is a part of Stage II of the Balassa-Bowden proposal (see pp. 10-12).

There are now major differences between the proposals in terms of coverage (Havrylyshyn-Wolf also looks at primary commodities); techniques, (Havrylyshyn-Wolf now largely stresses certain descriptive techniques), and technical sophistication, (Balassa-Bowden have a strong emphasis on the integration of theory and econometric technique).

June 9, 1981.

Mr. John Fay
Special Adviser to the Secretary General
OECD
2, rue Andre-Pascal
75775 Paris
France

Dear Mr. Fay:

As agreed on the telephone, I will put on paper our understanding of work to be done on the "Policy Responses to External Shocks volume."

As I mentioned on the telephone, other obligations do not permit me to undertake the kind of revision you suggest in paragraph 3 of your memorandum. The following comments, therefore, pertain to what you consider the "absolute minimum" to be done.

1. Mr. Sabourin asked Mr. van Arkadie to have the text edited. (I am afraid that after 25 years I still have problems in deciding on the use of "that" and "which".)

2. Mrs. Ann Richards-Loup will eliminate the repetitions referred to in paragraph 7 of your memorandum. They will be replaced by footnote references to the earlier text.

3. The expression "negative import substitution" will be replaced by "increases in import shares," with a footnote added indicating that this should be interpreted to mean an increase in the income elasticity of import demand. Also, the expression "negative additional net external financing" will be replaced by appropriate phrasing. Both these changes will be made by Mrs. Ann Richards-Loup.

4. Mrs. Ann Richards-Loup will review the table of contents.

May I repeat my conviction that Pergamon Press will do a good job in publishing the volume. I was highly satisfied with their production of my "Policy Reform in Developing Countries" which appeared in 1977. They are currently publishing a volume of essays for me entitled "The Newly Industrializing Countries in the World Economy."

It was good to talk to you. I hope that we will have the opportunity to meet in Paris in late August.

With best regards,

Yours sincerely,

Bela Balassa

cc: Messrs. Sabourin, Barsony, Fossi, van Arkadie, Mrs. Ann Richards-Loup

W LD BANK / INTERNATIONAL FINANCE CORPOR ON

OFFICE MEMORANDUM

TO: Mr. Shankar N. Acharya, VPD

DATE: June 8, 1981

FROM: Bela Balassa, DRC

SUBJECT: Research on Trade

No useful purpose would be served in my replying to Mr. Colaco's recent memorandum. I trust that the senior staff members Mr. Chenery has selected will review questions of overlapping, level of sophistication, and any other relevant issues.

cc: Messrs. Baneth, EPD; Chenery, VPD; Colaco, EPD; Duloy, DRC;
Kavalsky, EM1; Waide, VPD; Mrs. Hughes, EPD

BBalassa:nc

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

TO: Mr. Hollis B. Chenery, VPD

DATE: June 8, 1981

FROM: Bela Balassa, DRC

SUBJECT: WDR IV

1. Mr. Cassen asked my agreement to deleting my "The Newly-Industrializing Countries After the Oil Crisis" from the reference list to WDR IV, on the grounds that the title of the paper may give rise to misgivings on the part of oil-exporting countries. I agreed subject to the proviso that the decision be reconsidered for the public version of WDR. I am now asking you to do so.

2. The findings of the paper are extensively used in chapter 6 and I doubt that its inclusion in a long list of background papers will be objected to by any reader. Also, the paper has been given considerable publicity as a result of the publication of the enclosed article in The Economist. It will further be cited in an article to be published in Fortune Magazine.

3. The Economist article also refers to the OECD Development Centre study. I understand that Mr. Cassen wrote to the Centre asking for permission to cite the study. It would be desirable to reference it in Table 6.2.

cc: Mr. Cassen, WDR; Mr. Duloy, DRC

Enclosure
BBalassa:nc

ers who want import quotas.

Total Japanese sales in Canada last year were about 142,000—almost exactly the same as the amount by which their United States sales will be cut this year. With the threat of more European restrictions hanging over them, Japan's car firms may start to take a new interest in Canada.

Swedish papermakers

Contested marriage

STOCKHOLM

Sweden is getting more unSwedish by the hour. Not only do governments collapse and clerks go on strike (although that was quickly settled on Monday, May 11th), but businessmen are getting nastier towards each other. The contested takeover bid has arrived.

Two of Sweden's biggest paper companies, Stora Kopparberg and Billerud, have launched a joint SKr850m (about $175m) bid to buy a smaller one, Iggesund. Snag is that a rival papermaker, MoDo, has built up a 13% stake in Iggesund and has not taken kindly to the advances by the other two.

The resulting contest pits two of Sweden's most powerful business families against each other. In one corner stands Mr Jan Wallander, the chairman of Svenska Handelsbanken which, through subsidiaries and interlocking shares, is linked to MoDo. These interests, and its interest in MoDo, give Handelsbanken altogether, a 26% stake in Iggesund. In the other corner is Mr Marcus Wallenberg, honorary chairman of Skandinaviska Enskilda Banken and former head of Stora Kopparberg.

In the bad (good?) old days one family would have quietly informed the other before making a bid, but not this time. The joint bid was announced a few days before Mr Wallander and the managing director of MoDo, Mr Matts Carlgren, joined the Iggesund board. The stuffier Swedes have denounced the tactics of Stora and Billerud as ungentlemanly, but others welcome the arrival of free, open competition. The banking families are being forced to explain publicly their motives. At the annual general meeting last Friday, Stora was subjected to some unwelcome questioning on the takeover bid by its biggest shareholder.

Iggesund has two main attractions for the hardpressed pulp and papermakers, being both diversified and integrated. Stora would like to get its hands on

Fingers in the paper pie

The Swedish industry's top ten

1980	Sales $m	Pre-tax profits $m	Bank with large stake
Svenska Cellulosa	1,600	163	SH
Stora Kopparberg	970	144	SE
MoDo	900	66	SH
Assi	850	−1	State
Billerud	790	45	SE
Södra Skogsägarna	760	−25	Co-operative
NCB	650	−18	State
Papyrus	550	36	SE
Holmen	520	30	SE
Iggesund	500	27	SH

SH= Svenska Handelsbanken; SE= Skandinaviska Enskilda Banken
Source: Sweden Business Report

Iggesund's 716,000 acres of forest, plus its hydropower stations. Billerud is interested in its chemical offshoot, Eka, and its manufacture of cigarette packets (of which Iggesund is the leading European supplier). Both fancy the company's European distribution network.

In order to fend off the moves by its two rivals, MoDo will probably have to swallow Iggesund itself. So the increasing concentration of the big Swedish paper industry is far from over. In 1969 there were 50 companies making paper and pulp in Sweden. Now the fourth largest producer in the capitalist world contains only a dozen or so big firms.

The tortoise and the hare

How did some developing countries boost their growth in the stagflationary 1970s? Answer: by exporting for all they were worth, and keeping domestic interest rates positive in real terms. Uncomfortable moral for bankers: not many of those countries wanted to borrow much.

Five years ago, bankers worried about South Korea's debt just as much as about Brazil's. Today they rarely mention South Korea, but Brazil is still a big worry, though a receding one. How come? Recent work* in the World Bank and OECD suggests some answers.

The size of the external shock does not matter much. Higher oil prices and slower worldwide growth carved the equivalent of 7.3% a year out of South Korea's gnp between 1974 and 1978, only 2.8% a year out of Brazil's. The difference between the two countries was in the way they responded.

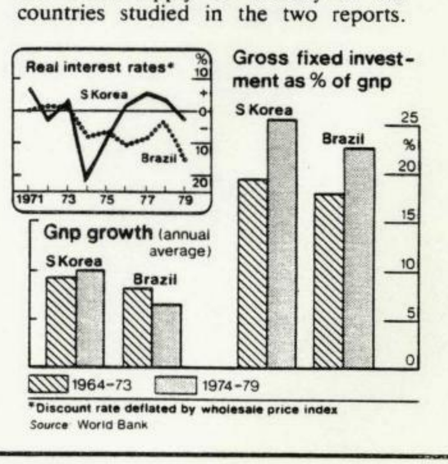
To cut its current-account deficit, Korea hit the export trail. It introduced medium- and long-term export credits, and bounced domestic firms out of their home market by reducing import quotas and tariffs in 1973 and 1977. Meanwhile, Brazil was tightening up import quotas, raising tariffs, and making importers pay an advance deposit.

By 1977-78 South Korea had boosted its export earnings by 41.5% compared with what they would have been had it simply maintained its 1972 market shares. On the same measure, Brazil managed only an extra 8%. Even though it benefited from soaring coffee prices, Brazil's net foreign debt rose from $11.9 billion (1974) to $24.7 billion (1977); South Korea's rose hardly at all, from $4.5 billion to $6.0 billion. The difference between the two countries would have been bigger still had South Korea not let its real exchange rate appreciate (ie, competitiveness deteriorate) by about 7% between 1974 and 1977. Brazil kept its real exchange rate more or less stable, but this was swamped by the effects of import-substitution measures.

Investment policies were intertwined with trade policies. South Korea increased the share of investment in gnp more than Brazil did, and concentrated on investing in export industries. To replace imports, Brazil had to invest in capital-intensive plant. As a result, the efficiency of its investment declined dramatically. Its incremental capital-output ratio—the amount of extra investment needed to produce an extra unit of output—rose from 2.3 (1964-73) to 3.6 (1974-79). In South Korea, the ratio rose by less, from 2.1 to 2.9.

Another reason for Brazil's wasteful investment was its level of real interest rates. They were positive until the end of 1973, but then turned negative, while South Korea's started moving the other way (see chart). Positive rates not only ensure that borrowers make sensible investment decisions but also encourage domestic saving.

The contrasts between South Korea and Brazil apply to virtually all the countries studied in the two reports.



*Discount rate deflated by wholesale price index
Source: World Bank

* The newly-industrialising developing countries after the oil crisis, by B. Balassa, World Bank Staff Working Paper No 437.
Developing countries and the oil-price shock, by B. Balassa and A. Barsony, OECD Development Centre.

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

TO: Mr. M. Bart, Director, EM2

DATE: June 8, 1981

FROM: Bela Balassa, DRC

SUBJECT: TURKEY Mission: Back-to-Office Report

1. The Industrialization and Trade Strategy mission was in the field between May 18 and June 5. In accordance with its terms of reference, the mission reviewed the policies applied by the Turkish authorities after January 1980 and analyzed policy actions that may be taken in the framework of a medium-term industrialization and trade strategy.

2. The mission presented its preliminary conclusions during a six-hour session with the Deputy Prime Minister, Mr. Turgut Ozal. It further discussed these conclusions with the Ministers of Agriculture, Finance, Industry, and Tourism, the Governor of the Central Bank and other government officials. Mr. Davar participated in these discussions.

3. A note containing the preliminary conclusions of the mission is enclosed. Its early review is requested so that a revised version can be sent to Ankara in advance of discussions to be held there on July 2nd and 3rd.

cc and cleared with Mr. Davar, EM2

cc: Messrs. Chaufournier, EMNVP; Karaosmanoglu, EM1; Picciotto, EMP; Dubey, EMNVP; Carmignani, EMP; Haynes, EMP; Asfour, EM2; Bachmann, EM2; Hume, EMP; ffrench-Mullen, EMP; Zaidan, EMP; Zaman, EM2; Fuchs, IPD; Kohli, IPD; Wackman, IPD; Tolbert, IDF; Moore, IDF; Thadani, IDF;
DPS Directors, DRC Senior Staff, Colaco, EPD; Westphal DED
Mission members

Enclosure
BBalassa:nc

The Composition of the Mission

1. Bela Balassa, (DRC)	Mission Chief
2. Jayanta Roy, (EM2)	Deputy Mission Chief, industrial structure
3. Seok Hyun Hong, (EM2)	macroeconomics
4. Jose da Silva Lopes (consultant)	financial sector
5. Sheetal K. Chand, (IMF)	investment incentives
6. Michel Noel, (YP)	incentives in private industry
7. Martin Wolf (EPD)	incentives in public industry
8. Turgut Ogmen (consultant)	mineral based chemical exports
9. H. S. Sethi (IPD)	engineering industries
10. Tony Bell (consultant)	engineering industries
11. Pasquale Scandizzo, (AGR)	agricultural exports
12. G. Swamy (EPD)	exports of processed food
13. Isabelle Girardot-Berg (AGR)	agriculture and processed food
14. David Davis (URB)	tourism
15. Helen Chin, (EMP)	administrative assistant and secretary

Provisional

Medium-Term Economic Policies for Turkey

Summary and Conclusions

This note makes recommendations for medium-term policies affecting industrialization and trade that complement the measures taken since January 1980 in ensuring the implementation of Turkey's newly-adopted development strategy, characterized by outward orientation and greater reliance on market forces. The recommendations aim at encouraging exports and efficient import substitution, increasing domestic savings and investment, promoting technological progress and labor training, and improving the operation of the state economic enterprises.

Exports and efficient import substitution would be encouraged by increasing the use of exchange rates in the place of export subsidies and import protection; simplifying the remaining export subsidies and linking them to value added in exports; gradually eliminating import licensing as well as lowering and rationalizing tariffs in the framework of a five-year program; and linking the prices of agricultural products and their inputs more closely to world market prices. Also, the marketing of the exports of manufactured and agricultural products and tourism would need to be improved. At the same time, the exploitation of Turkey's agricultural potential would necessitate improvements in transportation, and special support to some promising products, including fresh and processed fruit and vegetables, while the expansion of tourism would require mainly increased credit facilities for investments in hotel accommodations.

The recommendations made in regard to investment incentives, financial markets, and the tax system are designed to encourage private and corporate savings, improve financial intermediation, and ensure the financing of efficient investments in exports and import substitution. Increases in private savings may be attained by limiting the taxation of interest earnings and capital gains to real returns (i.e., with adjustment made for inflation), eliminating the financial transactions tax, and reducing the cost of holding reserves with the central bank, while increasing competition among banks. In turn, revaluing balance sheets and reducing corporate income tax rates would contribute to business savings. At the same time, establishing floating interest rates on bonds, extending the scope of bond financing in the public sector, and revitalizing the bond and stock markets would improve financial intermediation. Finally, the use of funds in efficient investments would be promoted by simplifying the system of preferential credits, with reductions in its scope and the extent of interest subsidies; making investment incentives more automatic and neutral in its effects on capital intensity, with additional incentives provided to infant industries; and promoting foreign direct investment.

Technological development and labor training would be served by the establishment of specialized research institutes and training facilities in the framework of an overall plan for research and technology, with incentives being provided to the private sector to undertake research, product development, and training. At their present stage of development, the machinery, machine-tool and electronics industries would also require special incentives while the automotive sector would need to be rationalized.

The measures to be taken to promote technological progress and training would permit exploiting Turkey's comparative advantages that will increasingly lie in skill-intensive products within the manufacturing sector. The development of the industries in question requires considerable flexibility to respond to world markets that can best be assured by relying on private initiative. This would necessitate reconsidering the implementation of government investments in these industries which, at any rate, would involve duplication of existing facilities.

In general, it would be appropriate to eventually limit the public sector to natural monopolies and basic industries. At the same time, existing preferences to state economic enterprises should be eliminated and authority for decision-making be vested in managers who would have responsibility for making profits in a competitive environment. Finally, investment projects in the public sector should be submitted to rigorous economic project evaluation, with the application of banking principles.

The measures aimed at encouraging private savings and investment would reverse recent tendencies that increased the size of the public sector. At the same time, increasing reliance on price signals and rationalizing the operation of public enterprises would improve efficiency in resource allocation that would further contribute to economic growth.

Medium-Term Economic Policies for Turkey

The Policy Framework

The policy measures taken in the course of 1980 aimed simultaneously at re-establishing stability in an economy characterized by rapid rates of inflation and at changing the country's development strategy towards outward orientation and the increased use of the market mechanism. The decrease in the rate of inflation has been remarkable. Also, there has been a considerable increase in time deposits in response to higher interest rates. Finally, exports have risen at a rapid rate, with manufactured exports exhibiting the largest increases.

The measures taken so far will need to be complemented by additional measures in order to fully implement Turkey's newly-adopted development strategy. This will require time; after the long period of inward orientation and limited use of the market mechanism, four to five years may be necessary until the shift in strategy is fully effective.

In the following, recommendations will be made for medium-term policies aimed at improved resource allocation and rapid economic growth under increased outward orientation and the use of market methods. The proposed measures aim at encouraging exports and efficient import substitution, increasing domestic savings and investment, promoting technological change and labor training and improving the operation of state economic enterprises. Apart from the exceptions noted below, they may be implemented over a 4-5 year horizon. The recommendations will not concern short-term policy measures aimed at stabilization.

The discussion will cover incentive policies as well as sectoral issues. The former comprise production incentives (the exchange rate, import protection, export subsidies, and price control), interest rates and financial markets, the tax system, and incentives to domestic and to foreign investment. In turn, the sectoral issues to be considered pertain to manufacturing industries, with special attention given to the SEEs, agriculture and agro-industries, and tourism. In the course of the discussion, attention will also be given to recent and proposed policy changes.

A. Incentive Policies

Production Incentives

After a considerable depreciation between the fourth quarter of 1979 and the third quarter of 1980, the Turkish lira appreciated in real terms vis-a-vis the currencies of the major trading partners by about 15%, regaining approximately its 1973 level. This appreciation vis-a-vis the German mark has been even larger; the mark buys 44.4 Turkish lire today as compared to 44.8 lira nine months ago, while prices rose by 5% in Germany and by about 30% in Turkey during this period. At the same time, the exchange rate relationship with the German mark is of particular importance for Turkey, in view of the fact that nearly one-half of its exports are sold in the European Common Market, of which the mark is the representative currency, and that Turkey competes principally with EEC countries in the growing Middle Eastern markets.

As far as manufactured exports are concerned, the appreciation of the lira in real terms was in part offset by increases in export subsidies. These increases brought the average ratio of subsidies to the value of manufactured exports to about 26% in 1980 as compared to 15% in 1979, with export rebates and interest subsidies increasing further in 1981[1].

The subsidies applied have been very effective in promoting manufactured exports in an environment characterized by excess capacity. In a longer time perspective, however, subsidy measures are subject to certain disadvantages that call for the increased use of the exchange rate as a policy instrument to promote exports.

To begin with, while the exchange rate affects all exports, most agricultural exports have not benefitted from subsidy schemes and processed foods only partly so, although these products offer considerable promise for Turkey. Furthermore, with the proliferation of subsidies, their effects on various export products are difficult to gauge whereas the impact of exchange rate changes is easily ascertainable. The effects of exchange rate changes are also automatic and do not require the administrative procedures involved in providing subsidies that may discourage small and medium-sized exporters. At the same time, most export subsidies are subject to retaliation under GATT rules and retaliatory measures may be applied once Turkish exports substantially increase in value. Finally, subsidies to export value tend to encourage the use of imported inputs in export activities, while exchange rate changes affect value added in exports since a devaluation raises the domestic currency equivalent of the export price, as well as that of the price of imported inputs, thereby encouraging the use of domestic inputs and limiting the budgetary cost involved.

1/ The estimates include export rebates, unadjusted for indirect taxes paid on inputs with export production, the subsidy element of preferential export credits, and the benefits derived from the duty-free entry of inputs. However, the scarcity value of foreign exchange retained by exporters, the subsidy implicit in easier access to credit and to imported inputs, in reductions in corporate income taxes for new exports and for increases in exports, have not been estimated.

In the case of some of the subsidy measures, it has been endeavored to take account of differences in value added in exports on a case-by-case basis. With the increasing number of exporters, however, case-by-case decision-making encounters increasing difficulties and the simplification of the procedures applied becomes necessary.

Despite substantial export subsidies, domestic markets in Turkey are generally more profitable than export markets, as a result of the joint effects of high tariffs and import licensing. Tariffs and other import taxes on manufactured goods average 50% and show considerable dispersion. Furthermore, notwithstanding the liberalisation measures taken in January 1981, import limitations tend to raise domestic prices above the tariff-inclusive import price.

As long as producers confidently expect the maintenance of existing levels of import protection, they may undertake new investment or expand their capacity in activities which are not in the national interest, and they have little incentive to lower production costs. To remedy this situation, it would be desirable that government announce its intention to lower tariffs and to rationalize import protection. In order to prepare producers for such an eventuality, it is proposed that a timetable be made public on the reform of the system of protection, to be carried out over a period of, say, five years.

The reform should include replacing import licensing by tariffs, with the possible exception of certain luxuries, and reducing the extent and the dispersion of tariffs. A tariff ceiling of 30% may be established, to be attained in annual instalments. Also, the tariff structures would need to be revised to avoid cases of "reverse escalation", when the tariff is higher on the principal input than on the output and interindustry differences in tariff rates should be reduced.

The liberalisation of import licensing should take the form of annual transfers from Liberalisation List II to Liberalisation List I and the addition of the prohibited items to Liberalisation List II. A substantial liberalisation of import licensing could be undertaken next January, with emphasis given to machinery and intermediate products.

As long as the protection of manufactured goods continues, the subsidization of industrial exports could not be foregone. It would be desirable, however, to reduce the extent of these subsidies, pari passu with reductions in import protection and to simplify the measures applied.

The first candidate for reducing export subsidies is the preferential export credit that provides a subsidy of over 30% for exporters who have access to such credit. At the same time, it would be desirable to establish a medium-term credit facility in the Central Bank, complemented by an export credit guarantee-scheme. This would permit Turkish firms to better compete abroad in durable goods, where foreign firms generally provide medium-term credits and benefit from credit guarantee schemes.

Present regulations as to the partial deductibility of value of new exports and of increments in exports from taxable income would also need to be modified. The present system benefits large exporters by imposing a minimum export value of $250,000 for manufactured exports and it invites irregularities in the calculation of export increments. One may envisage the eventual elimination of this form of export subsidies. Foreign exchange allocation schemes should also be simplified and the existing duplication between foreign exchange retention and retrospective foreign exchange allocation eliminated.

Also, in order to avoid the possible adverse consequences noted above, on the example of Greece and Israel one should consider linking export rebates and credit preferences to value added in exports by classifying commodities in several categories according to the ratio of value added to export value.

Parallel with reductions in export subsidies, it would be desirable to extend the free trade treatment of exports. This would entail making the importation of prohibited items for export production automatic, eliminating tariffs on machinery used in export production in cases where a separate application for investment incentives was not made, and extending the privilege of duty-free importation to all producers of important domestic inputs used in export production. This would permit increasing the domestic content of exports without unduly burdening export production; it is of particular importance in the engineering industries where vertical specialization can bring considerable benefits.

Reductions in import protection and in export subsidies would need to be offset by gradual changes in the real exchange rate. Such changes are also necessary in order to improve the balance of payments since Turkey's existing deficit would need to decline over time.

The proposed measures would improve the profitability of agricultural exports that are presently discriminated against in favor of manufacturing products; this conclusion also applies, albeit to a lesser extent, to processed food. As discussed below, further changes in incentives to agriculture would be desirable to approach world market price relations with respect to products as well as inputs.

Remaining controls of industrial prices should also be abolished. This applies to products on which formal controls have been maintained, such as cement and newsprint, as well as to cases where informal controls have delayed increases in prices. Monopoly products require special rules, however, as discussed below.

Interest Rates and Financial Markets

The taxation of deposit interest rates and financial transactions, the reserve requirements of commercial banks, and the high costs of bank operations create a substantial spread between after-tax interest rates received by depositors and interest rates paid by borrowers. The withholding tax on time deposits is 25%, reducing the after-tax equivalent of the 50% interest rate on one-year time deposits to 37.5%. At the same time, the 15% liquidity requirement, earning an interest rate of about 9%, and the 30% legal reserve requirement, earning an interest rate of 12% after taxes, raises the cost of these funds to the commercial banks to 82%. By contrast, non-interest bearing demand deposits have a 15% liquidity requirement and a 35% legal reserve requirement.

Interest rates charged on one-year non-preferential loans by commercial banks are at present 38%, which is raised to 50%, if account is taken of the 15% levy accruing to the interest rebate fund, and the 15% financial transactions tax. And, making adjustments for compensating balances, the effective interest rate for non-preferential borrowers often reaches 70%, exceeding the present rate of inflation by 30 percentage points and the after-tax rate of interest to depositors by 32.5 percentage points.

Real interest rates of this magnitude impose a considerable burden on borrowers, especially in the present situation of low domestic demand that led to the accumulation of product inventories in several industrial branches in Turkey. At the same time, the large spread between interest rates paid by borrowers and received by depositors tends to discourage savings and investments.

To remedy this situation, it would be desirable to lower the taxes imposed on interest payments made to depositors, as discussed below, to eliminate the financial transactions tax, and to reduce the costs resulting from reserve requirements by raising the interest rates paid on required reserve holdings for time deposits. While the financial transactions tax had a useful function in syphoning off part of the excess profits of the commercial banks under the system of fixed interest rates, excess profits have been substantially reduced as a result of the freeing of interest rates and increased competition among banks. Its elimination is particularly urgent on intra-bank deposits and on foreign loans, where double taxation is involved.

Under competition among banks, the described measures would reduce the existing wide interest rate spread by raising interest rates to depositors while lending rates are determined by the scarcity of available funds. Higher interest rates to depositors, in turn, would increase the amount of time deposits and thus the availability of funds for lending, thereby lowering lending rates.

For this outcome to be fully realized, it would be desirable to further increase competition among banks. This could be accomplished by prohibiting the participation of state banks in cartel-type actions, allowing the establishment of more branches of foreign banks, and revitalizing bond and stock markets.

The revitalization of bond and stock markets would improve the system of financial intermediation, encourage savings through the availability of a greater array of financial instruments, and increase the scope of investment finance. As far as bond markets are concerned, the elimination of the 28% interest rate ceiling and the introduction of a system of floating interest rates would be desirable. The introduction of such a system would permit providing medium-term and long-term credits to enterprises without locking them into high interest rates at times of rapid inflation and reducing the cost of financial intermediation. One would also avoid the cashing-in of outstanding bonds while maintaining real interest rates to the purchasers of bonds roughly unchanged without the risk of increasing large capital losses.

Medium- and long-term bonds should be traded in the securities market. The placement of bonds issued by the Treasury and the SEEs at competitive interest rates would also contribute to the revitalization of bond markets while ensuring a better control of the money supply.

Furthermore, the early promulgation of legislation affecting bond and stock markets would be necessary to assure the modernization of the Turkish financial system and the provision of funds for productive investment. As noted below, tax regulations would also need to be changed to increase the attractiveness of stocks.

Finally, it would be desirable to simplify the existing system of preferential credit. This would involve replacing the complex regulations on special reserve ratios, preferential rediscount rates and interest rates, differential rules on rediscounting, and tax exemptions on certain types of financial transactions by interest rate subsidies that are transparent, easy to administer, and minimize the possibility for irregularities. Furthermore, the extent of interest rate subsidies would need to be reduced, both to minimize the possibility of leakages to unintended uses and to limit the risks of distortions in resource allocation.

In particular, systems of subsidization of export credits should be reviewed. The present regulations involve several simultaneous methods of subsidization whose combined impact is difficult to determine. At the same time, its dependence from Central Bank rediscounts creates considerable upward pressure on the money supply. Finally, the fact that the subsidization through export credits is based on the export value and not on value added creates a situation under which exports with a lower proportion of domestically value added receive proportionately greater benefits.

The subsidization of short-term agricultural credits should also be reviewed. The existing system absorbs a large part of the resources of the Central Bank, distorts competition in the market for agricultural credits by giving special privileges to the Agricultural Bank, and practically limits the total amount of agricultural credit while conferring particular privileges on the recipients and encouraging the use of capital as compared to labor inputs.

Reducing the extent of interest subsidies would permit lowering the levy to the interest rebate fund. This, in turn, would give further encouragement to savings, thereby increasing the availability of funds and lowering interest rates for lenders, as described above.

The Tax System

The recent revision of the schedule of personal income taxes aims to make the tax system more equitable and to adjust tax rates for past inflation. An unskilled worker earning TL 240 a day, or roughly TL 60,000 a year, will be exempt from income taxes, while he paid TL 16,500 in taxes beforehand. However, tax obligations rise rapidly at higher income levels as the tax rate on wage and salary income in excess of the TL 61,200 tax-free allowance is 40% up to an income of TL 1 million. A worker earning TL 620 a day, the average for some of the higher-paying industries, will thus have an income tax obligation of TL 35,000.

The 40% minimum income tax rate on relatively low incomes will encourage continuing the past practice of payments in kind to evade taxes and may not be conducive to increased work effort. Also, there is no economic rationale in setting lower tax rates on annual incomes above TL 25 million (66%) than on incomes between TL 15 and 25 million (70% up to TL 20 million and 75% afterwards).

It would be desirable to adopt a more "modulated" tax structure and to reduce the extremely high rates applying to annual incomes between TL 10 and 25 million. Apart from discouraging work and risk-taking, such high rates invite evasion.

Modifications could be made by adjusting tax rates for inflation in years to come. Reductions in tax rates by 1% a year over the next five years will not be sufficient for this purpose as they offset only in part the so-called bracket creep, i.e., the shift of taxpayers to higher brackets due to inflation. Rather, it would be desirable to make automatic adjustments for inflation as it is done in Canada and, in practice, also in France.

The taxation of interest income on time deposits and bonds would also need to be revised. Interest receipts are subject to a withholding tax of 25% under the new regulations and are included in personal income for determination of income tax liabilities. These regulations do not take account of the effects of inflation on the value of the capital from which the income is derived. The 42% interest rate on six-months deposits, for example, corresponds to a zero real interest rate under present conditions. Correspondingly, the tax is on the capital, rather than on income derived from it.

In order to encourage savings and the development of financial markets, it would be desirable to modify these regulations. This could be done by adjusting interest receipts for inflation. Similar adjustments would need to be made in the case of dividends. Should this encounter administrative difficulties, a scheme of income tax credits may be introduced.

It would further be desirable to modify existing regulations that include capital gains with personal income. In an inflationary environment, the taxation of capital gains will entail the taxation of capital which, again, discourages savings. One may consider eliminating capital gains taxes as in the case in most countries in Continental Europe or reducing capital gains taxes substantially below income tax rates as has been the case in the United States and the United Kingdom.

Corporate income taxes would also need to be adjusted for inflation. This would require the revaluation of balances, so as to avoid that firms are taxed on "phantom" profits due to inadequate allowance for depreciation based on historical values. Legislation on the revaluation of balances has considerable urgency and it should exclude revaluation profits from taxable income.

Recent changes in regulations raised corporate income taxes on retained income from 43% to 50% although encouraging corporate savings for purposes of reinvestment would have required a reduction. Such a reduction may be accomplished by equalizing the tax treatment of private and public enterprises, which are subject to a corporate income tax of 35%, as suggested below.

The revenue effects of the proposed reductions in tax rates would be partly offset by increased revenues derived from higher incomes. Also, it would be desirable to reduce the share of public consumption and investment in the gross national product that has increased in recent years and is projected to rise further in 1981. These changes do not conform to the government's announced intention to increase the role of the private sector that would contribute to economic growth in an outward-oriented economy.

Finally, notwithstanding improvements made through the introduction of a uniform sales tax, the complicated and fragmented system of indirect taxes is at the source of considerable disturbance in production, investment, and trade. These disturbances would be eliminated through the implementation of the proposed comprehensive value added tax. Urgency should be given to preparing the introduction of this tax that will complement the other incentive measures proposed in this note.

Investment Incentives

Under present legislation, approved investments receive incentives in the form of duty-free entry of machinery and equipment (or payment of duties in instalments), an interest rebate of up to 25% on medium-term credit for investment on fixed assets and working capital, accelerated depreciation provisions for firms working two shifts and the deduction of 30% of investment in fixed assets from taxable incomes, with higher percentages applying to investments for exports and in less developed regions. Deductibility from taxable income is, however, limited to investments above TL 20 million, except for designated priority sectors (TL 10 million) and for agriculture (TL 4 million).

These incentives are quite generous compared to other developing countries and one may envisage reducing the percentage share of investment deductible from taxable incomes, with higher rates applying to some "infant industries", such as machinery, machine tools, electronics, and the processing of fruits and vegetables. At the same time, in order to avoid giving encouragement to capital-intensive industries and production methods, it would be desirable to extend the deductibility of investment to working capital and to reduce the present minimum limit, which discriminates against smaller enterprises that tend to be labor-intensive.

Questions arise concerning the use of a "positive" list which specifies the investments eligible for incentives. While some of the sectoral designations are quite broad and investors may apply for incentives also in sectors which are not included in the list, this involves additional administration and creates uncertainty. The rising number of rejections of applications for incentives, some of which have a questionable economic rationale, increases uncertainty and may in particular discourage smaller firms from applying.

A more appropriate solution would be to establish a "negative" list to include a limited number of products that do not receive incentives. This may include cases where foreign market limitations exist, e.g., cotton fabrics, or there is excess capacity in a sector that is oriented towards domestic markets, such as automobiles.

Foreign direct investment can play an important role in Turkey in increasing the availability of savings and foreign exchange and providing technological and marketing know-how. The recent liberalisation of regulations affecting foreign investment is, therefore, much welcome. At the same time, further measures would need to be taken to attract new foreign investors as well as investors from countries that are not as yet present in Turkey.

The first requirement would be to liberalise regulations on the repatriation of dividends derived from investments that were undertaken before the Framework Decree on Foreign Capital came into effect. More generally, liberal rules would need to be established in the repatriation of dividends and capital on all foreign investment, providing treatment comparable to that existing in countries such as Ireland, Egypt, and Tunisia.

Ireland also provides an example for attracting foreign direct investment. This would necessitate publicising the advantages of Turkey in terms of natural resources, labor costs, proximity to Middle Eastern markets, and preferential entry risks to European Common Market, as well as the liberal treatment of foreign direct investment. Turkey may become particularly attractive for subcontracting in metal-working and engineering industries and for triangular arrangements, with the processing of inputs originating in the Common Market countries for exporting to the Middle East.

One may envisage establishing several foreign investment bureaus abroad that may be combined with trade promotion bureaus, to be discussed below. Finally, on the example of Tunisia, an effort should be made to establish joint Arab-Turkish banks for investment in agriculture, food processing, machinery, and tourism. Such banks would bring in much needed capital to develop the Turkish economy.

B. Sectoral Issues

Industrial Development

Over the past several decades, a wide range of industries have been established in Turkey, first in the public sector and, subsequently, in the private sector. Apart from increasing outward orientation, a priority for the further development of Turkish industry is to ensure technological progress and labor training. This is necessary to provide modern inputs into other industries and to shift towards skill-intensive industries, where Turkey's comparative advantage will increasingly lie in the future.

The principal source of technical support in Turkey is the Scientific and Industrial Research Institute (TUBITAK). TUBITAK is, however, oriented largely towards public sector and it has not been the source of technological innovations. Also, it lacks specialization and has made little effort to adapt foreign technology to Turkish conditions.

On the example of Korea, the government may contribute to the promotion of technological progress through the establishment of specialized institutes of applied research. Such institutes may play an especially important role in certain engineering branches and in the chemical industry.

The establishment of applied research institutes would need to be complemented by providing incentives to research and product development by private firms. Such incentives may take the form of tax benefits and, in well-defined cases, preferential credits. They should be part of an overall plan of science and technology, with a horizon of at least five years, which would also encourage the further development of technical universities.

Technical universities provide a link between research and training of scientists and engineers. The training of technicians and skilled workers would also need to be promoted through the establishment of specialized schools and courses and through tax benefits to firms undertaking training. In conjunction with reductions in incentives to investment in fixed capital, tax incentives to research and training would represent a shift from hardware to software that is necessary at Turkey's present state of development.

Efforts made to increase research and training would benefit, in particular, the machinery, machine-tool, and electronics industries, which have been neglected in the past by comparison to metals where government investment played an important role and the automotive sector that expanded at high costs in the framework of protected domestic markets. These industries may receive further incentives on infant industry grounds. Rather than protection, such incentives should aim at reducing the cost of production, in order to provide low-cost inputs to other industries and to encourage exports.

Incentives to the machinery, machine-tool, and electronics industries may take the form of preferential credits and higher than average percentage deductions of new investments from taxable income. One should also examine the feasibility of establishing specialized industrial parks where ancillary activities would be available. Also, the services of foreign engineering consultants may be obtained to review plant layout and the organization of work, with a view to suggesting productivity improvements. In Korea, this is done in the framework of an investment project financed by the World Bank.

In turn, there would be need for developing a long-term strategy for the automotive industry in order to avoid further duplication of production facilities and to ensure vertical specialization in efficient plants. In view of the difficulties of consolidating producers that manufacture different cars and belong to different business groups, this may be sought in the direction of specialization agreements involving the exportation of some parts and components and the importation of others. At the same time, the implementation of public investments in the production of tractors, diesel engines, and commercial vehicles, creating duplication with private facilities, would not be desirable. More generally, in the machinery, machine-tool, and electronics industries reliance should be based on private initiative that can ensure the flexibility necessary to respond to changing world market conditions.

The export incentives discussed earlier should be complemented by measures to promote marketing that needs considerable development in Turkey. The Export Promotion Center (IGEME) engages in documentation on a limited scale and has neither the staff nor the budget for mounting an effective export promotion effort. Such an effort would require establishing an institution that is engaged in the collection of market information, the provision of advice to exporters, and promotional activities, including the organization of trade fairs and foreign commercial missions. For such an organization to be effective, it should have branches abroad, both to identify markets and to solicit orders, on the example of KOTRA in Korea and CACEX in Brazil.

A public institution of export promotion can only play a supporting role, however, to private firms. Turkey's large business groups are capable of mounting an export promotion effort but small and medium size firms can rarely export directly. Correspondingly, trading firms may play an important role as they do in countries such as Japan and Korea. To promote the establishment of trading firms, the tax benefits they presently receive may be complemented by credit preferences. At the same time, one may object to recent proposals to limit tax benefits to firms of a certain size as small trading firms may be particularly effective in specialized areas and in exploring new markets.

State Economic Enterprises

While the state economic enterprises pioneered in the development of manufacturing industries in Turkey, their performance has deteriorated due to the effects of factors such as detailed and often conflicting critical directions and interventions, the lack of financial discipline, the politically motivated choice and the inadequate compensation of management and technicians, and excessive wage and employment levels for production workers. At the same time, the complexity of financial arrangements, deficient accounting practices, and incomplete reporting have limited public accountability. Another major problem has been the virtual lack of economic analysis of new investment projects.

The control of prices before January 1980 affected but little the operation of the SEEs as they could get ready financing from the government. Nor have subsequent increases in prices affect their mode of operation in a fundamental way. At the same time, formal and informal price control persists in some areas. Such control has a rationale in the case of monopolies but not for firms that compete with the private sector.

In the case of natural monopolies, such as electricity, gas, and water, the price should cover the cost of operations. In the case of monopolies producing traded goods, such as steel and newsprint, the rule enunciated by the Ministry of Industry, to limit prices to the tariff inclusive cif import price plus a margin, should be consistently applied while reducing this margin from its present level of 30%. Import liberalization would, however, obviate the need for such control.

While apart from SEKA, the producer of pulp and paper, all industrial SEEs made operating profits, these results need to be adjusted for budgetary subsidies, preferential credit terms, differential corporate tax rates, and the use of historical depreciation in the accounts. In order to put the SEEs on the same footing with private industry, they should receive identical tax and credit terms, with borrowing from commercial banks replacing governmental credit allocations for operational needs.

There would also be need to reform the present system of decision-making in investments in the manufacturing sector. In an inward-oriented economy, this was based on the calculation of needs from projections of final demand in an input-output framework. Under outward orientation, it should be replaced by economic project evaluation utilizing world market prices. A possible solution is to give responsibility for the evaluation of investments to state investment banks, when SUMERBANK AND ETIBANK may be joined to form an industrial bank. Eventually, private and public banks may be involved in the financing of both private and public enterprises, but this would require major improvements in the SEEs.

As regards the mode of operations of the SEEs, it has been proposed that the present sector-wide SEEs be replaced by holdings, the boards of which would supervise the individual production units that would have their own board of directors and managers. The sector-wide holdings, in turn, would be supervised by a Council having overseeing responsibility for all industrial holdings, with the government having a minority role at all levels. This solution is advocated on the grounds that it would reduce governmental interference and would contribute to the decentralization of decision-making. While it may indeed represent a useful step towards decentralization, a further step would be desirable in order to avoid conflicts between the various levels and to vest authority for decision-making in managers while ensuring competition among independent units.

In this connection, the experience of Hungary with state-owned firms offers an interest. In Hungary, large firms having plants producing similar commodities have been broken up and the managers of individual firms are not subject to production, employment, or export targets. Rather, they have responsibility for making profits in a competitive environment and are remunerated on the basis of the profits of the firm.

Turkey may learn from the example of Hungary in breaking up large, monopolistic SEEs and making the newly-established firms subject to market relations, with the managers being given the freedom to decide on production, prices and, eventually, employment. Consideration may also be given to the possibility of divesting public firms in sectors outside the basic industries.

The move from centralized planning to decentralization was accomplished after a long period of preparation practically overnight in Hungary, but it was followed by a period of adaptation. In Turkey, careful preparation of the reforms in necessary, when the limitations of available cadres may necessitate postponing their full implementation. However, it would be desirable to reach early decisions as to scope of the reforms. Apart from the issues discussed above, these should provide for improved information and accountability of the SEEs.

Agriculture and Agro-Industries

The gradual shift from import protection and export subsidization for manufactured goods to the use of the exchange rate would benefit agriculture in Turkey and promote exports as well as import substitution in this sector. It would further be desirable to gradually move towards world market price relations for agricultural products and their major inputs, with the system of support prices limited to a minimum number of commodities and playing a stabilizing role. Alternatively, farmers' incomes may be stabilized by providing an adequate supply of credit, in conjunction with the establishment of a credit insurance scheme.

Among agricultural products, exceptions may be made for hazelnuts, raisins, and tobacco where Turkey has an important market position and the elimination of export taxes would lead to the deterioration of the terms of trade. There is no economic rationale, however, for maintaining domestic cotton prices below world market levels that are unaffected by the amount Turkey exports.

With the price of wheat being maintained above world market levels in earlier years, there has been substitution of wheat for cotton in some areas as well as to the use of irrigated land in wheat production. A movement towards world market prices would result in a lower rate of increase in wheat production and a more rapid rise in the production of higher-value crops, including cotton, corn, soybeans, as well as vegetables and citrus fruits. Similar considerations apply to barley.

The increased production of corn would be beneficial for animal husbandry. At the same time, it is not desirable to subsidize the use of concentrated feed and to provide investment incentives to broiler production that are not available to cattle and sheep, where natural advantages, in particular, the availability of pasture, favor Turkey. To exploit these natural advantages, existing limitations on the exports of cattle, beef, lamb and mutton should be abolished and the slaughtering of livestock by private industry permitted.

Available incentives appear sufficient in the case of meat processing where religious customs prevalent in the Middle East provide additional advantages to Turkey. However, fresh and processed fruits and vegetables encounter strong competition, with Turkish producers suffering the traditional disadvantages of an infant industry. It may be desirable, therefore, to provide preferential tax treatment to fruit and vegetable processing, encouraging in particular integrated operations. Also, an effort should be made to attract foreign interests in the industry where multinationals offer technical expertise as well as marketing know-how. In turn, among crops, oilseeds may be considered an infant activity that would deserve preferential treatment through favorable support prices on a temporary basis.

As far as input prices are concerned, the subsidization of fertilizers and pesticides should be removed over time so as to avoid inefficient usage. Also, uneconomic mechanization and the underutilization of tractors should be discouraged by eliminating any subsidies that may remain. Finally, water charges should be adjusted so as to ensure the use of water for higher-value crops. Exceptions may be made, however, for smaller farms that already utilize family labor for intensive production of fruits and vegetables.

The efficient development of Turkish agriculture would also require taking institutional measures, among which improvements in research and extension services are of particular importance. Finally, the promotion of exports, in particular of fruits and vegetables, would necessitate improvements in transportation as well as in marketing. Thus, Turkey would need to improve its road, railroad, and port facilities. The marketing of fruits and vegetables, in turn, may benefit from the implementation of the investment project financed by the World Bank.

Tourism

Tourism is an important exchange earner in Turkey, although tourist arrivals declined from a peak of 1.6 million to 1.3 million due to political uncertainty in recent years. With competitive prices, notwithstanding, the higher cost of air transport, an attractive physical environment, and archeological sites, Turkey should be able to increase its share of the Mediterranean market for tourism that is expected to rise about 7% a year.

At the same time, the expansion of tourism provides particular advantages to Turkey, given its favorable capital-labor ratio and the low rate of import leakage. Taking account of all tourist-related activities, it would seem that the cost of earning foreign exchange is relatively low in tourism.

The expansion of tourism would require increasing available accommodations as well as a marketing effort. With much of the advantages derives from tourism accruing to ancillary activities, such as restaurants and shops, the profitability of hotels is traditionally low and the period of investment is long. Correspondingly, capturing the potential benefits of tourism would necessitate providing low cost credits to hotel building. Even with the proposed increase of its resources, the amount of such credits the Tourism Bank will have available is small compared to requirements; it would provide financing for only 2,000 beds a year, representing an annual increase of less than 3%. This would be complemented by foreign investment, where the present minimum limitation of 200 beds may further be reduced in order to encourage tourism.

At the same time, the promotion of tourism should be concentrated in a limited number of areas, in order to capture economies of scale in transportation and in ancillary activities. In Antalya, the touristically most attractive area, infrastructure is available and only hotel investment is required in Side, while land tenure problems would need to be resolved in Kemer. In some other areas, such as Izmir and Bodrum, some improvements in connecting roads, sewage and water, and/or telecommunications would have a high potential payoff.

Finally, a concentrated effort would need to be made at marketing. Upgrading tourism bureaus abroad and a major sales campaign would be necessary for this purpose. In cooperation with local authorities, the government should play an important part in this effort in cooperation with the private travel trade sector.

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SECRETARY TO MR. BALASSA

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Bela Balassa

Bill McGreevey

DRC

MEDIUM-TERM ECONOMIC POLICIES FOR TURKEY

Summary and Conclusions

The aide-memoire contains the preliminary recommendations of the Bank mission on industrialization and trade strategy for medium-term policies. These policies are intended to complement the measures taken since January 1980 in the pursuit of Turkey's newly-adopted development strategy, characterized by outward orientation and greater reliance on market forces. The recommendations aim at encouraging exports and efficient import substitution, increasing domestic savings and investment, promoting technological progress and labor training, and improving the operation of the state economic enterprises.

Exports and efficient import substitution would be encouraged by increasing the use of exchange rates as against export subsidies and import protection; simplifying the remaining export subsidies and linking them to value added in exports; gradually eliminating import licensing while lowering and rationalizing tariffs; and linking the prices of agricultural products and their inputs more closely to world market prices. Also, the marketing of the exports of manufactured and agricultural products and tourism would need to be improved. Finally, the exploitation of Turkey's agricultural potential would necessitate improvements in transportation and support to promising products, such as fresh and processed fruit and vegetables, whereas the expansion of tourism would require increased credit facilities for investment in hotel accommodations.

The recommendations made in regard to investment incentives, financial markets, and the tax system are designed to encourage private and corporate savings, improve financial intermediation, and ensure the financing of efficient investments in exports and import substitution. Increases in private savings may be attained by limiting the taxation of interest earnings and capital gains to real returns (i.e. making adjustment for inflation), eliminating the financial transactions tax, and reducing the cost of holding reserves with the central bank, while increasing competition among banks. In turn, revaluing balance sheets and reducing corporate income tax rates would contribute to business savings. At the same time, establishing floating interest rates on bonds, extending the scope of bond financing in the public sector, and revitalizing the bond and stock markets would improve financial intermediation. Finally, the use of funds in efficient investments would be promoted by simplifying the system of preferential credits, with reductions in its scope and the extent of interest subsidies; making investment incentives more automatic and neutral in their effects on capital intensity, with additional incentives provided to infant industries; and promoting foreign direct investment.

Technological development and labor training would be served by the establishment of specialized research institutes and training facilities in the framework of an overall plan for research and technology and by providing incentives to the private sector to undertake research, product development, and training. At their present stage of development, electrical and nonelectrical machinery, machine-tool and electronics industries would further require special incentives while the automotive sector would need to be rationalized.

The measures to be taken to promote technological progress and training would permit exploiting Turkey's comparative advantages that will increasingly lie in skill-intensive products within the manufacturing sector. The development of the industries in question requires considerable flexibility to respond to changing world market conditions that can best be assured by relying on private initiative. This would necessitate reconsidering the implementation of government investments in these industries which, at any rate, would involve duplication of existing facilities.

In general, it would be appropriate to eventually limit the public sector to natural monopolies and basic industries. At the same time, existing preferences to state economic enterprises should be eliminated and authority for decision-making be vested in managers who would have responsibility for profitable operations in a competitive environment. Finally, investment projects in the public sector should be submitted to rigorous economic project evaluation, with the eventual application of banking principles.

The proposed measures would reverse recent tendencies that increased the size of the public sector as compared to the private sector. At the same time, increasing reliance on price signals and rationalizing the operation of public enterprises would improve efficiency in resource allocation, further contributing to economic growth.

Medium-Term Economic Policies for Turkey

The Policy Framework

The policy measures taken in the course of 1980 aimed simultaneously at re-establishing stability in an economy characterized by rapid rates of inflation and at changing the country's development strategy towards outward orientation and the greater use of the market mechanism. The decline in the rate of inflation has been remarkable. Also, there has been a considerable increase in time deposits in response to higher interest rates. Finally, exports have risen at a rapid rate, with manufactured exports exhibiting the largest increases.

The measures taken so far will need to be complemented by additional measures in order to fully implement Turkey's newly-adopted development strategy. This will require time; after the long period of inward orientation and limited use of the market mechanism, four to five years may be necessary until the shift in strategy is fully effective.

In this aide-memoire, recommendations will be made for medium-term policies aimed at improved resource allocation and rapid economic growth under increased outward orientation and the use of market methods. It should be emphasized that several of the measures are presently under consideration by the Turkish authorities. At the same time, their articulation in an overall framework, with well-defined objectives, appears desirable.

The policy objectivevs considered in the aide-memoire include encouraging exports and efficient import substitution, increasing domestic savings and investment, promoting technological change and labor training, and improving the operation of state economic enterprises. With the exceptions noted below, they may be implemented over a 4-5 year horizon. The recommendations will not concern short-term policy measures aimed at economic stablization.

The discussion will cover incentive policies as well as sectoral issues. The former comprise production incentives (the exchange rate, import protection, export subsidies, and price control), interest rates and financial markets, the tax system, and incentives to domestic and to foreign investment. In turn, the sectoral issues to be considered pertain to manufacturing industries, with special attention given to the SEEs, agriculture and agro-industries, and tourism. In the course of the discussion, reference will be made to recent policy changes.

A. Incentive Policies

Production Incentives

After a considerable depreciation between the fourth quarter of 1979 and the third quarter of 1980, the Turkish lira appreciated in real terms vis-a-vis the currencies of the major trading partners, regaining approximately its 1973 level. This result reflects largely the appreciation of the lira vis-a-vis the German mark; over the last nine months the mark-lira exchange rate remained practically unchanged, while prices rose by 5 percent in Germany and by over 25 percent in Turkey. At the same time, the exchange rate relationship with the German mark is of particular importance, in view of the fact that nearly one-half of Turkish exports are sold in the European Common Market, of which the mark is the representative currency, and that Turkey competes principally with EEC countries in the growing Middle Eastern markets.

As far as manufactured exports are concerned, the recent appreciation of the lira in real terms was largely compensated by increases in export subsidies. Since January 1981, export rebates on manufactured goods have been raised by five percentage points, and an additional 5 percentage points have been provided to firms whose exports exceeded $15 million a year 1/. Also, in conjunction with the rise in nonpreferential interest rates, the subsidy element of export credit has increased to a considerable extent.

The regular rebate rate is designed to compensate for indirect taxes paid at the preceding stages of manufacture and does not represent an export subsidy. In turn, foreign exchange retention schemes and the duty free importation of inputs place Turkish exporters on the same footing as exporters of other developing countries and are not considered export subsidies under GATT rules. Apart from preferential export credits, subsidy measures applied in Turkey include the additional rebate provided to large exporters as well as reductions in corporate income taxes for new exports and for increases in exports.

The incentive measures applied have been very effective in promoting manufactured exports in an environment characterized by excess capacity. In a longer time perspective, however, subsidy measures are subject to certain disadvantages that call for the increased use of the exchange rate as a policy instrument to promote exports.

To begin with, while the exchange rate affects all exports, most agricultural exports have not benefitted from subsidy schemes, although these products offer considerable promise for Turkey. Furthermore, with the proliferation of subsidies, their effects on various export products are difficult to gauge, whereas the impact of exchange rate changes is easily ascertainable. The effects of exchange rate changes are also automatic and do not require the administrative procedures involved in providing subsidies, which may discourage small and medium-sized exporters. At the same time, export subsidies are subject to retaliation under GATT rules and developed countries may apply retaliatory measures once Turkish exports substantially increase in value. Finally, subsidies to export value tend to encourage the use of imported inputs in export

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1/ In practice, this provision applies to four trading firms. It is additional to the 5 percent rebate that firms exporting at least $4 million a year receive over and above the regular rates paid to all exporters.

activities, while exchange rate changes affect value added in exports. This is because a devaluation raises the domestic currency equivalent of the export price, as well as that of the price of imported inputs, thereby encouraging the use of domestic inputs and limiting the budgetary cost involved.

In the case of some of the subsidy measures, it has been attempted to take account of differences in value added in exports on a case-by-case basis. With the increasing number of exporters, however, case-by-case decision-making encounters increasing difficulties and the simplification of the procedures applied becomes necessary.

Despite the provision of export subsidies, domestic markets in Turkey are generally more profitable than export markets, due to the combined effects of high tariffs and import licensing. Tariffs and other import taxes on manufactured goods generally range between 30 percent and 70 percent. Furthermore, notwithstanding the liberalisation measures taken in January 1981, import limitations tend to raise domestic prices above the tariff-inclusive import price.

As long as producers expect the maintenance of existing levels of import protection, they may undertake new investment or expand their capacity in activities which are not in the national interest, and will have little incentive to lower production costs. To remedy this situation, it would be desirable that government announce its intention to lower tariffs and to rationalize import protection. In order to prepare producers for such an eventuality, it is proposed that a timetable be made public on the reform of the system of protection, to be carried out over a period of, say, five years.

The reform should include replacing import licensing by tariffs, with the possible exception of certain luxuries, and reducing the extent and the dispersion of tariffs. A tariff ceiling of 30 percent may be established, to be attained in annual instalments. Also, the tariff structure would need to be revised in order to avoid cases of "reverse escalation", when the tariff is higher on the principal input than on the output, and interindustry differences in tariff rates would need to be reduced.

The liberalization of import licensing may take the form of annual transfers from Liberalization List II to Liberalization List I and the addition of the items presently excluded from both lists to Liberalization List II. A substantial liberalization of import licensing could be undertaken next January, with emphasis given to machinery and intermediate products.

As long as the protection of manufactured goods continues, the subsidization of manufactured exports could not be foregone. It would be desirable, however, to reduce the extent of these subsidies, pari passu with reductions in import protection, and to simplify the measures applied.

The first candidate for reducing export subsidies is the preferential export credit that provides a subsidy of over 30 percent for exporters who have access to such credit. At the same time, it would be desirable to establish a medium-term credit facility in the Central Bank, complemented by an export credit guarantee-scheme. This would permit Turkish firms to better compete abroad in exporting durable goods, where foreign firms generally provide medium-term credits and benefit from credit guarantee schemes.

Present regulations as to the partial deductability of the value of new exports and of increments in exports from taxable income would also need to be modified. The present system tends to discourage small exporters by imposing a minimum export value of $250,000 for manufactured exports. This conclusion applies a fortiori to the export rebate scheme, which has a higher minimum requirement for providing an additional rebate. Apart from the case of trading firms, to be discussed below, it would be desirable to eliminate over time the differential treatment based on the size of exports.

It would further be desirable to simplify the existing foreign exchange allocation schemes. Finally, in order to avoid the possible adverse consequences noted above and to minimize leakages, it would be advisable to link credit preferences to value added in exports and to grant the credit subsidy ex post rather than ex ante. This could be accomplished by providing export credits in the first place on a nonpreferential basis and granting credit subsidies once exportation has been undertaken on the basis of value added, by classifying commodities in several categories according to the ratio of value added to export value.

Parallel with reductions in export subsidies, it would be desirable to extend the free trade treatment of exports. This would entail making the importation of prohibited items for export production automatic, eliminating tariffs on machinery used in export production in cases where a separate application for investment incentives has not been made, and extending the privilege of duty-free importation to all producers of important domestic inputs used in export production. The implementation of these recommendations would permit increasing the domestic content of exports without unduly burdening export production; they are of particular importance in the engineering industries where vertical specialization can bring considerable benefits.

Reductions in import protection and in export subsidies would need to be offset by gradual changes in the real exchange rate, thus continuing the process begun in January 1980 but partially reversed in recent months. Such changes are also necessary in order to improve the balance of payments since Turkey's existing deficit would need to decline over time.

The proposed measures would improve the profitability of agricultural exports that are presently discriminated against in favor of manufacturing products. As discussed below, further changes in incentives to agriculture would be desirable to approach world market price relations with respect to products as well as inputs.

Remaining controls of industrial prices would also need to be abolished. This applies to products on which formal controls have been maintained, such as cement and newsprint, as well as to cases where informal controls have delayed increases in prices. Monopoly products require special rules, however, as discussed below.

Interest Rates and Financial Markets

The taxation of deposit interest rates and financial transactions, the reserve requirements of commercial banks, and the high costs of bank operations create a substantial spread between after-tax interest rates received by depositors and interest rates paid by borrowers. The withholding tax on time deposits is 25 percent, reducing the after-tax equivalent of the 50 percent interest rate on one-year time deposits to 37.5 percent. At the same time, the 15 percent liquidity requirement, earning an interest rate of about 9 percent, and the 30 percent legal reserve requirement, earning an interest rate of 12 percent, raise the cost of these funds to the commercial banks to 82 percent. Finally, non-interest bearing demand deposits have a 15 percent liquidity requirement and a 35 percent legal reserve requirement.

Interest rates charged on one-year non-preferential loans by commercial banks are at present 38 percent, which increases to 50 percent if account is taken of the 15 percent levy accruing to the interest rebate fund and the 15 percent financial transactions tax. Making further adjustments for compensating balances, the effective interest rate for non-preferential borrowers may reach 70 percent, exceeding the actual rate of inflation by 30 percentage points and the after-tax rate of interest to depositors by 32.5 percentage points.

Real interest rates of this magnitude impose a considerable burden on borrowers, especially in the present situation of low domestic demand that led to the accumulation of product inventories in several industrial branches in Turkey. At the same time, the large spread between interest rates paid by borrowers and received by depositors tends to discourage savings and investment.

To remedy this situation, it would be desirable to lower the taxes imposed on interest payments made to depositors, as discussed below, to eliminate the financial transactions tax, and to reduce the costs associated with reserve requirements by raising the interest rate paid on required reserve holdings for time deposits. While the financial transactions tax had a useful function in syphoning off part of the excess profits of the commercial banks under the system of fixed interest rates, excess profits have been substantially reduced as a result of the freeing of interest rates and increased competition among banks. Its elimination is particularly urgent on intra-bank deposits and on foreign loans, where double taxation is involved.

Under competition among banks, the described measures would reduce the existing wide interest rate spread by raising interest rates to depositors while lending rates are determined by the scarcity of available funds. Higher after-tax interest rates for depositors, in turn, would increase the amount of time deposits and thus the availability of funds for lending, thereby contributing to lower lending rates.

For this outcome to be fully realized, it would be desirable to further increase competition among banks. This could be accomplished by prohibiting the participation of state banks in cartel-type actions, allowing the establishment of more branches of foreign banks, and revitalizing bond and stock markets.

The revitalization of bond and stock markets would improve the system of financial intermediation, encourage savings through the availability of a greater array of financial instruments, and increase the scope of investment finance. As far as bond markets are concerned, the elimination of the 28 percent interest rate ceiling and the introduction of a system of floating interest rates would be desirable. The introduction of such a system would permit providing medium-term and long-term credits to enterprises, without locking them into high interest rates at times of rapid inflation, and reducing the cost of financial intermediation. One would also avoid the cashing-in of outstanding bonds while real interest rates to the purchasers of bonds would remain roughly constant over time without the risk of incurring large capital losses.

Medium- and long-term bonds should be traded in the securities market. The placement of bonds issued by the Treasury and the SEEs at competitive interest rates would also contribute to the revitalization of bond markets while ensuring a better control of the money supply.

The early promulgation of legislation affecting bond and stock markets would further be necessary in order to assure the modernization of the Turkish financial system and the availability of funds for productive investment. At the same time as noted below, tax regulations would need to be changed to increase the attractiveness of stocks.

Finally, it would be desirable to simplify the existing system of preferential credits. This would involve replacing the complex regulations on special reserve ratios, preferential rediscount rates and interest rates, differential rules on rediscounting, and tax exemptions on certain types of financial transactions by interest rate subsidies that are transparent, easy to administer, and minimize the possibility for irregularities. The extent of interest rate subsidies would also need to be reduced, both to minimize the possibility of leakages to unintended uses and to limit the risks of distortions in resource allocation.

In particular, it would be desirable to review systems of subsidization of export credits. The present regulations involve several simultaneous methods of subsidization whose combined impact is difficult to determine. At the same time, the dependence of preferential export credits on Central Bank rediscounts creates an upward pressure on the money supply while efforts made to avoid such undesirable consequences limit the availability of export credits and create inequities among exporters.

Finally, at the fact that subsidization through export credits is based on export value and not on value added creates a situation under which exports with a lower proportion of domestic value added receive proportionately greater benefits.

The subsidization of short-term agricultural credits would also need to be reviewed. The existing system absorbs a large part of the resources of the Central Bank, distorts competition in the market for agrigultural credits by giving special privileges to the Agricultural Bank, and practically limits the total amount of agricultural credit while conferring particular privileges on the recipients and encouraging the use of capital as compared to labor inputs.

Reducing the extent of interest subsidies would permit lowering the levy to the interest rebate fund. This, in turn, would give further encouragement to savings, thereby increasing the availability of funds and lowering interest rates for lenders, as described above.

The Tax System

The recent revision of the schedule of personal income taxes aims to make the tax system more equitable and to adjust tax rates for past inflation. An unskilled worker earning TL 240 a day, or roughly TL 60,000 a year, will be exempt from income taxes, while he paid TL 16,500 in taxes beforehand. However, tax obligations rise rapidly at higher income levels as the tax rate on wage and salary income in excess of the TL 61,200 tax-free allowance is 40 percent up to an income of TL 1 million. A worker earning TL 620 a day, the average for some of the higher-paying industries, will thus have an income tax obligation of TL 35,000.

The 40 percent minimum income tax rate on relatively low incomes will encourage continuing the past practice of payments in kind for the purpose of evading taxes and may not be conducive to increased work effort. Also, there is no economic rationale in setting lower marginal tax rates on annual incomes above TL 25 million (66 percent) than on incomes between TL 15 and 25 million (70 percent up to TL 20 million and 75 percent afterwards).

It would be desirable to adopt a more "modulated" tax structure and to reduce the extremely high rates applying to annual income between TL 10 and 25 million. Apart from discouraging work and risk-taking, such high rates invite evasion. The intention of the authorities to reduce the tax rates by 1 percent a year over the next five years is therefore appropriate. However, it would further be desirable to adjust tax rates for inflation in the future. This would permit avoiding the so-called bracket creep, i.e., the shift of taxpapers to higher brackets due to inflation. One may envisage making automatic adjustments for inflation as it is done in Canada and, in practice, also in France.

The taxation of interest income on time deposits and bonds would also need to be revised. Interest receipts are subject to a withholding tax of 25 percent under the new regulations and are included in personal income for the determination of income tax liabilities. These regulations do not take account of the effects of inflation on the value of the capital from which the income is derived. The 42 percent interest rate on six-months deposits, for example, corresponds to a zero real interest rate under present conditions, so that the tax is on the capital rather than on income derived from it.

In order to encourage savings and the development of financial markets, it would be desirable to modify these regulations. This could be done by adjusting interest receipts for inflation. It would further be desirable to modify existing tax regulations that include capital gains with personal income. In an inflationary environment, the taxation of capital gains will entail the taxation of capital which, again, discourages savings. One may consider eliminating capital gains taxes as it is done in most countries in Continental Europe or reducing capital gains taxes substantially below income tax rates as has been the case in the United States and the United Kingdom.

Corporate income taxes would also need to be adjusted for inflation. This would require the revaluation of balances, so as to avoid that firms are taxed on "phantom" profits due to inadequate allowance for depreciation based on historical values. Legislation on the revaluation of balances has considerable urgency and it should exclude revaluation profits from taxable income.

Recent changes in regulations raised corporate income taxes on retained profits from 43 percent to 50 percent, although encouraging corporate savings for purposes of reinvestment would have required a reduction. Such a reduction may be accomplished by equalizing the tax treatment of private and public enterprises which are subject to a corporate income tax of 35 percent, as suggested below.

The revenue effects of the proposed reductions in tax rates would be partly offset by increased revenues derived from higher incomes. It would further be desirable to reduce the share of public consumption and investment in the gross national product that has increased in recent years and is projected to rise further in 1981. These changes do not conform to the government's announced intention to increase the role of the private sector that would contribute to economic growth in an outward-oriented economy.

Finally, notwithstanding improvements made through the introduction of a uniform sales tax, the complicated and fragmented system of indirect taxes is at the source of considerable disturbance in production, investment, and trade. These disturbances would be eliminated through the implementation of the proposed comprehensive value added tax. Urgency should be given to preparing the introduction of this tax that will complement the other incentive measures proposed in this aide-memoire.

Incentive to Domestic and to Foreign Investment

Under present legislation, approved investments receive incentives in the form of duty-free entry of machinery and equipment (or payment of duties in instalments), an interest rebate of up to 25 percent on medium-term credit for investment on fixed assets and working capital, accelerated depreciation provisions for firms working two shifts, and the deduction of 30 percent of investment in fixed assets from taxable incomes, with one-third of the investment allowance added to tax liability; higher percentages apply to investments for exports and in less developed regions. Deductibility from taxable income is limited to investments above TL 20 million, except for designated priority sectors (Tl 10 million) and for agriculture (TL 4 million).

It would be desirable to review the system of tax incentives, which provide proportionately greater benefits to less profitable firms than to firms with higher profits. At the same time, in order to avoid giving encouragement to capital-intensive industries and production methods, it would be desirable to extend the deductibility of investment to working capital and to reduce the present minimum limit, which discriminates against smaller enterprises that tend to be labor-intensive. Finally, greater incentives may be provided to some "infant industries", such as electrical and non-electrical machinery, machine tools, electronics, and the processing of fruits and vegetables.

Further questions arise concerning the use of a "positive" list, which specifies the investments eligible for incentives. While some of the sectoral designations are quite broad and investors may apply for incentives also in sectors which are not included in the list, this involves additional administration and creates uncertainty. The rising number of rejections of applications for incentives increases uncertainty and may in particular discourage smaller firms from applying.

A more appropriate solution would be to establish a "negative" list that would designate a limited number of products, which do not receive incentives. This may include cases where foreign market limitations exist, e.g., cotton fabrics, or there is excess capacity in a sector that is oriented towards domestic markets, such as automobiles.

Foreign direct investment may play an important role in Turkey by increasing the availability of savings and foreign exchange and providing technological and marketing know-how. The recent liberalisation of regulations affecting foreign investment is, therefore, much welcome. At the same time, further measures would need to be taken to attract new foreign investors as well as investors from countries that are not as yet present in Turkey.

The first requirement would be to avoid delays in the repatriation of dividends derived from investments that were undertaken before the Framework Decree on Foreign Capital came into effect. More generally, liberal and unambiguous rules would need to be established on the repatriation of dividends and capital, providing treatment comparable to other countries that compete with Turkey for foreign capital. It would further be desirable to eliminate the requirement of co-operation with state economic enterprises as a condition for foreign direct investment in various engineering industries.

Changes in legislation and in its practical application would need to be accompanied by a promotional effort. This would involve publicising the advantages Turkey possesses in terms of natural resources, labor costs, proximity to Middle Eastern markets, and preferential entry to the European Common Market. Turkey may be particularly attractive for subcontracting in metal-working and engineering industries and for triangular arrangements, with the processing of inputs originating in the Common Market countries for exportation to the Middle East.

One may envisage establishing several investment bureaus abroad, which could be combined with trade promotion bureaus to be discussed below. Finally, on the example of Tunisia, an effort should be made to establish joint Arab-Turkish banks for investment in agriculture, food processing, machinery, and tourism. Such banks could bring much needed capital to develop the Turnish economy.

B. Sectoral Issues

Industrial Development

Over the past several decades, a wide range of industries have been established in Turkey, first in the public sector and subsequently in the private sector. Apart from increased outward orientation, a priority for the further development of Turkish industry should be to ensure technological progress and labor training. This is necessary in order to provide modern inputs for other industries and to shift towards skill-intensive activities, where Turkey's comparative advantage will increasingly lie in the future.

The principal source of technical support in Turkey is the Sçientific and Industrial Research Institute (TUBITAK). TUBITAK is, however, oriented largely towards public sector and it has not been the source of technological innovations. Also, it lacks specialization and has made little effort to adapt foreign technology to Turkish conditions.

On the example of Korea, the government may contribute to the promotion of technological progress through the establishment of specialized institutes of applied research. Such institutes may play an especially important role in certain engineering branches and in the chemical industry.

The establishment of applied research institutes would need to be complemented to tax incentives to research and product development by private firms. This should be part of a medium-term plan of science and technology, which would also provide for the further development of technical universities.

Technical universities represent a link between research and the training of scientists and engineers. The training of technicians and skilled workers would also need to be promoted through the establishment of specialized schools and courses as well as through tax benefits to firms undertaking training. Tax incentives to research and training would promote a shift from hardware to software, which is necessary at Turkey's present state of development.

Efforts made to increase research and training would benefit, in particular, the electrical and non-electrical machinery, machine-tool, and electronics industries, which are relatively undeveloped in Turkey in comparison to metals where government investment played an important role and the automotive sector which expanded at high costs in the framework of protected domestic markets. These industries may receive further incentives on infant industry grounds. Rather than protection, such incentives should aim at reducing the cost of production, in order to provide low-cost inputs to other industries and to encourage exports.

Incentives to the electrical and nonelectrical machinery, machine-tool, amd electronics industries may take the form of medium-term credits and higher than average percentage deductions of new investments from taxable income. One should further examine the feasibility of establishing specialized industrial parks where ancillary activities would be available. Also, the services of foreign engineering consultants may be obtained to review plant layout and the organization of work, with a view to recommending productivity improvements. In Korea, this is done in the framework of an investment project financed by the World Bank.

In turn, there would be need to devise a long-term strategy for the automotive industry in order to avoid further duplication of production facilities and to ensure vertical specialization in efficient plants. In view of the difficulties of consolidating producers that manufacture different cars and belong to different business groups, this may be sought in the direction of specialization agreements involving the exportation of some parts and components and the importation of others. At the same time, the implementation of public investments in the production of tractors, diesel engines, and commercial vehicels, creating duplication with private facilities, would not be desirable. More generally, in the electrical and non-electrical machinery, machine-tool, and electronics industries reliance should be based on private initiative that can ensure the flexibility necessary to respond to changing world market conditions.

The export incentives discussed earlier could be usefully complemented by measures to promote marketing abroad, The Export Promotion Center (IGEME) engages in documentation on a limited scale and has neither the staff nor the budget for mounting an effective export promotion effort. A successful marketing effort would require establishing an institution that is engaged in the collection of market information, the provision of advice to exporters, and promotional activities, including the organization of trade fairs and foreign commercial missions. For such an organization to be effective, it should have branches abroad, both to identify markets and to solicit orders, on the example of KOTRA in Korea and CACEX in Brazil.

A public institution of export promotion can only play a supporting role, however, to private firms. Turkey's large business groups are capable of mounting an export promotion effort but small and medium size firms can rarely export directly. Correspondingly, trading firms may play an important role as they do in countries such as Japan and Korea. The tax benefits they presently receive are limited to large trading firms. However, small trading firms may be particularly effective in specialized areas and in exploring new markets.

State Economic Enterprises

While the state economic enterprises pioneered in the development of manufacturing industries in Turkey, their performance has deteriorated due to the effects of factors such as detailed and often conflicting central directions and interventions, the lack of financial discipline, the politically motivated choice and the inadequate compensation of management and technicians, and excessive wage and employment levels for production workers. At the same time, the complexity of financial arrangements, deficient accounting practices, and incomplete reporting have limited public accountability. Another major problem has been the virtual lack of economic analysis of new investment projects.

The control of prices before January 1980 affected but little the operation of the SEEs as they could get ready financing from the government. Nor have subsequent increases in prices affected their mode of operations in a fundamental way. At the same time, formal and informal price control persists in some areas. Such control has a rationale in the case of monopolies but not for firms that compete with the private sector.

In the case of natural monopolies, such as electricity, gas, and water, the price should cover the cost of operations. In the case of monopolies producing traded goods, such as steel and newsprint, the rule enunciated by the Ministry of Industry, to limit prices to the tariff inclusive cif import price plus a margin, should be consistently applied while reducing the margin from its present level of 30 percent. Import liberalization would, however, obviate the need for such control.

While apart from SEKA, the producer of pulp and paper, all industrial SEEs made operating profits, these results need to be adjusted for budgetary subsidies, preferential credit terms, differential corporate tax rates, and the use of historical depreciation in the accounts. In order to put the SEEs on the same footing with private industry, they should receive identical tax and credit terms, with borrowing from commercial banks replacing governmental credit allocations for operational needs.

There would also be need to reform the present system of decision-making in investments in the manufacturing sector. In an inward-oriented economy, this was based on the calculation of needs from projections of final demand in an input-output framework. Under outward orientation, it should be replaced by economic project evaluation utilizing world market prices. A possible solution is to give responsibility for the evaluation of investments to public investment banks, such as the State Investment Bank and a new industrial bank combining the banking subsidiaries of SUMERBANK AND ETIBANK, which is under discussion. Eventually, both private and public banks, as well as the capital markets, may be involved in the financing of both private and public enterprises. This, however, would require major improvements in the SEEs.

As regards the mode of operations of the SEEs, it has been proposed that the present sector-wide SEEs be replaced by holdings, the boards of which would supervise the individual production units that would have their own board of directros and managers. The sector-wide holdings, in turn, would be supervised by one or more Upper Boards having oversight responsibility for all industrial holdings, with the government having a minority role at all levels.

This solution has been advocated on the grounds that it would reduce governmental interference and contribute to the decentralization of decision-making. While the proposed alternative would indeed represent a step towards lesser government involvement and decentralization, it may give rise to conflicts between the various levels and limit the authority of managers. It would seem desirable, therefore, to go a step further and to vest authority for decision-making in managers while ensuring competition among the independent units.

In this connection, the experience of Hungary with state-owned firms offers an interest. In Hungary, large firms having plants producing similar commodities have been broken up and the managers of individual firms are not subject to production, employment, or export targets. Rather, they have responsibility for making profits in a competitive environment and are remunerated on the basis of the profits of the firm.

Turkey may learn from the example of Hungary in breaking up large, monopolistic SEEs and making the newly-established firms subject to market conditions, with the managers being given the freedom to decide on production, prices and, eventually, employment. The possibility of divesting public firms in sectors outside the basic industries would also need to be explored further.

After a long period of preparation, the move from centralized planning to decentralization was accomplished practically overnight in Hungary. In Turkey, too, careful preparation of the reforms is necessary, when the limitations of available cadres may not permit their immediate implementation in full. However, it would be desirable to reach early decisions as to scope of the reforms. Apart from the issues discussed above, these should provide for improved information and accountability of the SEEs.

Agriculture and Agro-Industries

The gradual shift from import protection and export subsidization for manufacture goods to the use of the exchange rate would benefit agriculture in Turkey and promote exports as well as import substitution in this sector. It would further be desirable to gradually move towards world market price relations for agricutural products and their major inputs, with the system of support prices limited to a minimum number of commodities and designed to play largely a stabilizing role. Alternatively, farmers' incomes may be stabilized by providing an adequate supply of credit, combined with the establishment of a credit insurance scheme.

Among agricultural products, the adoption of world market prices would not be appropriate for hazelnuts, raisins, and tobacco, where Turkey has an important market position and the elimination of export taxes would lead to the deterioration of the terms of trade. There is no economic rationale, however, for maintaining domestic cotton prices below world market levels that are unaffected by the amount Turkey exports.

With the price of wheat having been maintained above world market levels in earlier years, there has been substitution of wheat for cotton in some areas as well as a shift to the use of irrigated land in wheat production. The adoption of world market price relations would result in a lower rate of increase in wheat production and a more rapid rise in the production of alternative crops. Depending on the region, this may involve pulses, fodder, oilseeds, cotton, corn, as well as vegetables and citrus fruits. Similar considerations apply to barley.

The increased production of corn would be beneficial for animal husbandry. At the same time, it is not desirable to subsidize the use of concentrated feed and to provide investment incentives to broiler production that are not available to cattle and sheep, where natural advantages, in particular, the availability of pasture, favor Turkey. The exploitation of these natural advantages would be furthered by abolishing existing limitations on the exports of cattle, beef, lamb and mutton and permitting the slaughtering of livestock by private industry.

Available incentives appear sufficient in the case of meat processing where religious customs prevalent in the Middle East provide additional advantages to Turkey. However, fresh and processed fruits and vegetables encounter strong competition, with Turkish producers suffering the traditional disadvantages of an infant industry. It may be desirable, therefore, to provide preferential tax treatment to fruit and vegetable processing, encouraging in particular integrated operations, on a temporary basis. Also, an effort should be made to attract foreign investment in the industry, where multinationals offer technical expertise as well as marketing know-how.

As far as input prices are concerned, the subsidization of fertilizers and pesticides should be eliminated over time so as to avoid inefficient usage. Also, uneconomic mechanization and underutilization of tractors would be discouraged by eliminating any subsidies that may remain. Finally, water charges should be adjusted so as to ensure the use of water for higher-value crops. Exceptions may be made, however, for smaller farms that already utilize family labor for the intensive production of fruits and vegetables.

The efficient development of Turkish agriculture would also require taking institutional measures, among which improvements in research and extension services are of particular importance. Finally, the promotion of exports, in particular of fruits and vegetables, would necessitate improvements in transportation as well as in marketing. Turkey would need to improve, in particular, its railroad and port facilities. In turn, the implementation of the investment project financed by the World Bank would benefit the marketing of fruits and vegetables.

Tourism

Tourism is an important foreign exchange earner in Turkey, accounting for about one-tenth of the exports of goods and services. Although arrivals declined from a peak of 1.6 million in the late 1970s to 1.3 million in 1980 due to political uncertainties, Turkey should be able to reverse this trend and to increase its share of the Mediterranean tourism market which in total is expected to increase by about 7 percent a year during the 1980s. Turkey's assets include competitive prices (notwithstanding the higher cost of the air transport component), an attractive physical environment, an excellent climate and outstanding sightseeing.

At the same time, the expansion of tourism offers particular advantages to Turkey, given its favorable capital-labor ratio and the low rate of import leakage. Taking account of all tourist-related activities, it would appear that the cost of earning foreign exchange is relatively low.

The expansion of tourism would require increasing accommodation capacity as well as a marketing effort. While economic returns are high on non-hotel tourism activities, such as shopping, entertainment and internal transport, the profitability of hotels is traditionally modest and the pay-back period is long. Accordingly, capturing the potential benefits of tourism would necessitate providing adequate low-cost loan finance for hotel construction. Even with the proposed increase of its resources, the amount of loan funds the Tourism Bank will have available is small compared to requirements; it would provide financing for only 4,000 beds a year, representing an annual increase of less than 6 percent.

The domestic hotel construction effort could be complemented by foreign investment and one may welcome the proposals made to attract such investment. At the same time, it should be recognized that the major portion of tourism investment in Turkey will continue, as elsewhere, to be domestic. However, foreign management should be increased to obtain expertise and marketing experience.

The promotion of tourism should be concentrated in a limited number of areas, in order to capture economies of scale and to take advantage of existing, or nearly-completed, infrastructure. In Antalya, for example, infrastructure is available and only hotel investment is required at Side, while land tenure problems still need to be resolved in Kemer. In some other areas, such as Izmir and Bodrum, limited improvements in connecting roads, sewage and water, and/or telecommunications would have a high potential payoff.

A concentrated effort would need to be made in marketing, involving the upgrading tourism bureaus abroad and a major sales campaign. In cooperation with the private sector and the special tourist authorities to be established in priority zones, government authorities should play an important part in such an effort. For this purpose, consideration should be given to establishing a semi-autonomous national office, appointed by the Minister of Tourism, which would draw its staff from the travel trade and be suitably remunerated outside civil service regulations. Such an office would also enter into contracts with professional marketing firms in major market countries.

In order to ensure convenient and least-cost access, civil aviation policy should be reviewed. This would necessitate weighing the financial interests of Turkish Airlines (THY) against the economic returns in the tourism sector and the economy as a whole. Air charter operations, by both domestic and foreign airlines, should be encouraged and consideration should be given to granting continuation rights for foreign airlines.

June 1, 1981.

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