

# Asia and Africa in the Global Economy



Edited by

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Asia and Africa

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*Edited by Ernest Aryeetey, Julius Court,  
Machiko Nissanke, and Beatrice Weder*

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# Introduction: Sub-Saharan Africa and Southeast Asia in the Global Economy

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## Background

Since the growth performance of Southeast Asia (SE Asia) and Sub-Saharan Africa (SSA) began to diverge markedly in the 1980s, the highly positive economic performance of Southeast Asia in the precrisis period had frequently been juxtaposed with the much less commendable achievements of Sub-Saharan Africa in the past. (See Table 1.1 and Figure 1.1 for comparative economic growth performance of Asia and Africa during this period). While the performance at both the macro- and micro levels show great disparity, one of the most obvious differences in the performance and economic structure of the two regions has been the extent of participation in the global economy. As Asia has increased its participation in the world economy so has Africa shrunk its participation. Prior to the onset of the Asian crisis in 1997, the economic performance of four Southeast Asian countries – Indonesia, Malaysia, Singapore, and Thailand – was popularly regarded as a “miracle” along with that of other high-performing economies of Northeast Asia, i.e., Japan, Hong Kong, South Korea, and Taiwan. Their development experiences were popularly presented to policy makers in Africa as attractive examples to draw lessons from.

Indeed, following aggressively the “outward-oriented development strategy,” many East Asian economies had not only accelerated the process of integration into the world economy but also upgraded their modes

## 2 INTRODUCTION

Table 1.1 Growth in GDP per Capita % per Annum for 1961–1996

	1961–72	1973–80	1981–90	1986–96
Africa	1.3	0.7	−0.9	−1.0
East Asia	7.0	7.1	9.4	7.2
Southeast Asia	3.2	4.9	4.3	6.6 <sup>a</sup>
South Asia	1.3	1.6	3.3	2.9

Source: World Bank, Economic and Social Database.

*a.* Malaysia, Indonesia, Thailand only for 1985–1995.

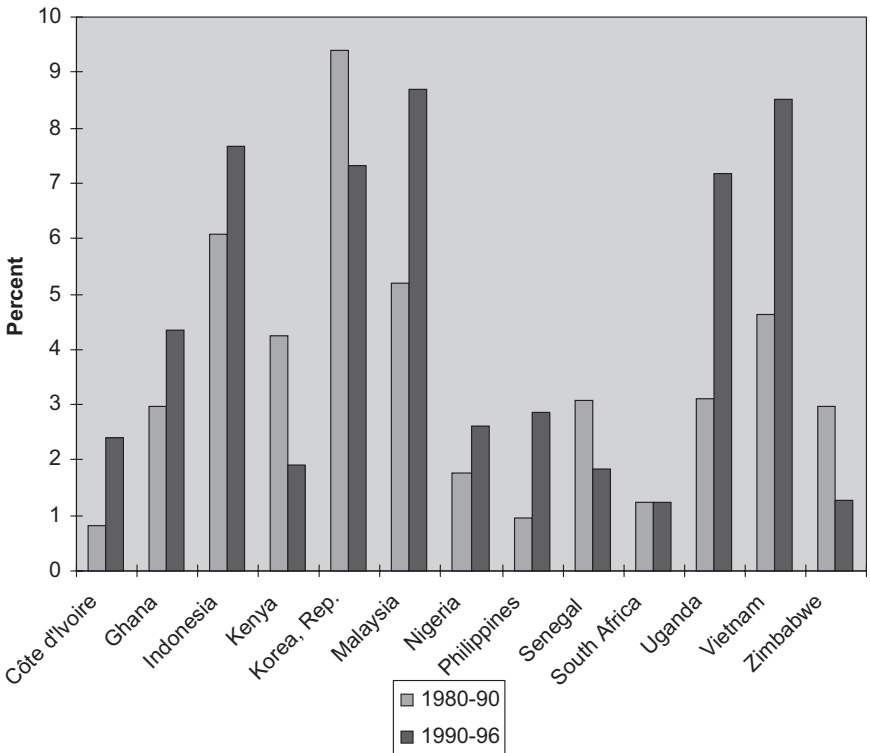


Figure 1.1 Average Annual Growth of GDP, 1980–1996

of linkages in the years of their rapid economic growth. In contrast, the majority of SSA countries had failed to take advantage of the opportunities provided by increasing international economic interactions. In the 1970s and 1980s, instead of becoming more integrated into the world economy, they were largely marginalised and experienced slow growth and stagnation. With growing recognition of their disadvantageous posi-

tions, over the past decade SSA countries have increasingly searched for ways to accelerate their participation in the global economy.

Interestingly, the East Asian crisis erupted in the wake of this gradual embrace of globalization by African countries.<sup>1</sup> The crisis, which started as a financial crisis arising primarily as financial *excess*, not a crisis of fundamentals, has clearly exposed the severe difficulties in managing national economies in the highly regionally integrated and globalizing environments. The event has helped to raise a critical question for Sub-Saharan Africa: how to manage the process of *strategic integration* into the global economy. As Senbet notes, the lessons from the Asian crisis, if drawn correctly, can help SSA countries to draw a strategy towards sustainable globalization.<sup>2</sup>

The question of strategic integration is important for several reasons. First, as globalization is not a process proceeding neutrally in a policy vacuum, there is a significant degree of discretion in policies towards integration. The forms of integration are likely to be greatly affected by national policies towards the multidimensional process of integration, including policies on trade, finance, technology, industrial structure, competition, and migration. The optimal level of openness may differ for each aspect, which itself depends critically on the stage of development among other factors. This leads to a strategic question: what is the best policy mix to achieve integration, or what is a measured and properly sequenced set of policies towards trade, foreign direct investment, and capital flows?

Certainly, the excessive pace and incorrect sequencing of liberalisation in an attempt to reap greater benefits from the globalization process can result in severe difficulties. The severity of problems that can arise from mismanagement of financial policies in particular has been amply demonstrated by the recent Asian and global financial crises. It has shown that the risks associated with financial globalization are high, as international capital flows are inherently volatile, which can expose vulnerable and fragile economies to highly volatile external forces.<sup>3</sup> Thus, opening up the economies to the powerful external forces shaping the globalization process requires careful strategic thinking with regard to the forms, pace, sequencing, phasing, and time frame for integrating the economy more fully into the global economy.

Secondly, the benefits from globalization are unevenly distributed. It has been observed that income levels tend to diverge rather than converge among participating national economies and across regions as globalization proceeds. There are winners and losers from the ongoing process and income inequality tends to be amplified. Moreover, net benefits from globalization are not necessarily guaranteed. Depending on the nature and forms of integration, countries may benefit from dynamism

and growth within the global economy, but integration into the international economy by itself does not ensure these benefits. Furthermore, the initial adjustment costs arising out of increased integration may include worsening poverty for some groups.

Thus, while potentially offering participating countries new opportunities for accelerating growth and development, increased integration also poses great challenges for economic management problems policy makers have to engage with. This is particularly the case since risks and costs involved in integration can be large for fragile low-income economies. Such risks and costs have sparked a heated debate on net gains/costs associated with the globalization trend and generated many theoretical and empirical studies on the *globalization-growth-income distribution nexus* and the *income convergence* thesis. They have also led to vibrant antiglobalization protests worldwide, reflecting a widespread unease with the globalization process.

Discussions of what accounts for the divergence of growth and development between Africa and Asia have so far been held in terms of factors including differences in economic policies, initial development conditions, and resource endowments; the geopolitical ties to the industrial economies; domestic governance arrangements; culture and its role in economic decision making; etc. While the scope of the list may vary considerably, depending on which countries are being compared, the fact that a combination of policy, institutional, and structural conditions explains crucial developmental differences is quite generally accepted. What is not in general agreement is the relative weight to be attached to each of these three categories and the manner in which they interacted.

On the policy front, the divergence of the growth performance in the two regions has been largely attributed to the contrasting policies adopted towards international trade and investment. In particular, the debate has been conducted in a sharply dichotomous way – between outward-oriented versus inward-oriented strategy, export promotion versus import substitution, or interventionist versus laissez-faire approaches. A consequence of these different policy orientations of the two regions is also reflected in their institutional developments. It has been argued that institutional environments which prevailed in East Asia are conducive to private investment, while African institutions often widened and deepened the state's role in all facets of economic decision making, in a way that minimised private risk taking and hence investments. Naturally, policies and institutions have interacted with other conditions, such as initial resource endowments or political, social, and cultural factors, to produce diverse savings-investment-growth nexuses in the two regions.

There are several studies, including the East Asian Miracle study,<sup>4</sup> which examine key conditions for success of economic management in



East Asian countries and draw lessons from the Asian experiences for the other developing countries. They suggest that policy choices that included maintaining sound fundamentals like a stable macroeconomy, high human capital, effective and secure financial systems, and openness to foreign technology were mixed with selective interventions that included export push, financial repression, directed credit, and selective promotion of industries. These policies worked within an institutional framework that was characterised by technocratic insulation, high-quality civil service, and sound monitoring. The outcome was the competitive discipline that led to accumulation of human capital, high savings, and high investment, as well as efficient allocation through the effective use of the human capital and high returns on investment. In addition to accumulation and efficient allocation, there was productivity change coming from productivity-based catching up and rapid technological change. The outcome of these processes is the achievement of rapid and sustained growth as well as a more equal income distribution.

However, the World Bank study rejects the replicability and appropriateness of interventionist policies for other developing countries and recommends that they focus on fundamentals and thereby create a market-friendly environment rather than on getting interventions to work. A similar position is taken by Lindauer and Roemer.<sup>5</sup> They suggest that Southeast Asia, in preference to East Asia, would be a good model for Africa on account of institutional legacies and human resource endowments. However, these policy conclusions have been severely challenged by a number of academics for failing to understand the interdependence between fundamentals and selective interventions as well as between economic policies and institutional factors.<sup>6</sup> Clearly, for more meaningful comparative studies, it is crucial to take one step back from such oversimplified generalised conclusions.

This book is a systematic attempt to decipher different experiences in Sub-Saharan Africa and Southeast Asia as they have interacted with an ever changing global economy, with a view to understanding economic policies and institutional environments in the two regions that could account for their diverse development outcomes. The book is a collection of the selected papers that were first presented at the International Conference, "Asia and Africa in the Global Economy," in Tokyo in August 1998, in the background of the unfolding Asian and global financial crisis. The Conference was organised jointly by the United Nations University and the African Economic Research Consortium (AERC), and it was the second workshop jointly hosted by the two institutions to discuss comparative development experiences in Africa and Asia.<sup>7</sup> While the first workshop covered both Northeast Asia and Southeast Asia concerning the wide-ranging macroeconomic and sectoral aspects in comparison with

those of Sub-Saharan African countries, the scope of the second workshop was narrower, with a focus on the comparison between Southeast Asia and Sub-Saharan Africa in the background of the globalization process. Many of the papers were revised subsequently, taking into account fast evolving events both in Southeast Asia and Sub-Saharan Africa.

## Book Outline

The book contains thirteen other chapters that focus on specific issues considered relevant to presenting the circumstances under which African nations were held back from active participation in global markets, while the Asian economies were fast expanding their participation. All contributors to this volume accept the key role that engagement with the global economy played in advancing the development paths of the high-performing Southeast Asian economies. This Southeast Asian experience is a sharp contrast with that of the countries in Sub-Saharan Africa. Thus, we proceed from the position that the integration of these economies into the global economy facilitated access to resources and markets that helped to transform production and improve productivity significantly. We all recognise the importance that both policies and institutional development played in facilitating this integration into the world economy. However, while sharing this common ground, each contributor tries to explore different aspects of the development path of the two regions from her or his own perspective.

### *The Dynamics of Globalization*

The book starts with a discussion of the extent of globalization by Laurence Harris (Chapter 2). The chapter presents what Harris calls “eight sceptical theses” on the dynamics of globalization. While Harris points out that the process that is today widely referred to as globalization has been significant over the last three decades, there is no need to believe that individual economies are no longer in a position to influence their own roles in the rapidly changing world economy. Harris first sees the so-called globalized economy as a *fractured* one, since international flows of trade and investment have formed regional blocs rather than a unified global economy. There is still no indication of a movement towards the law of one price, a hallmark of integration, a major indicator of globalization. What the recent trend in global flows suggests is therefore “an accentuated tendency towards greater interaction and integration, a tendency towards a greater degree of globalization.”

Harris also suggests that some trends that have been seen as leading inexorably towards more general globalization will not necessarily continue into the future; they may be seen, instead, as a temporary “catching up,” restoring international economic relations to a level of integration comparable to the pre-1914 world economy. He envisages that the recent trends may even be temporarily reversed by renewed protectionism, instability, or world depression anytime in the future. Furthermore, the progress of globalization will meet obstacles in the diversity of countries’ forms of organisation, economic structures, and economic behaviour. Therefore, the existence of cultural and historical specificity will create lasting obstacles to globalization and is not obliterated by international competition itself. Consequently, it cannot be expected that economic development will be based on a tendency for ever-fuller globalization. In the end, national economic sovereignty will prevail, as obstacles to further globalization are created by the specifics of the culture and history of countries.

### *Economic Policies and External Performances*

Chapter 3, by Ernest Aryeetey and Machiko Nissanke, presents a systematic comparison of a number of factors and conditions in Southeast Asia and Africa that influenced the integration or the lack of integration, as the case may be. In particular, it explores the critical interrelationships between the economic policies and the external performances of the two regions in a comparative perspective intent on identifying policies that worked best in different areas and the conditions under which their effectiveness was achieved. The chapter first compares East Asia and Sub-Saharan Africa in terms of initial conditions and resource endowments in order to set a context for comparative analysis of the two regions. It then proceeds with a discussion of summary statistics of external performance and the differences in the degree and forms of integration into the global economy and the internal and external conditions that influenced the development policy orientation of the two regions in relation to international transactions. On the basis of these detailed analyses of several critical factors and conditions, the chapter examines various economic policies that influenced the international linkages in the two regions.

Aryeetey and Nissanke present different strategies followed in the two regions, reflecting their respective internal and external conditions. They argue that Africa’s initial apparent disengagement from the global economy was the result of a deliberate effort to reduce its dependence, an approach that was driven in many nations by the political imperatives of the time soon after independence. That global economy was seen as be-

ing dominated by the same colonial governments that African nations had fought to free themselves of. Based on the pervasive clamour for independence and a fear of neocolonialism through private economic agents, the role of the state and its institutions for safeguarding independence became more important than any other consideration. It was this fear that did not encourage the development of institutions that would foster private participation in the economies of Africa. As private participation was reduced, the pressure to be innovative in production, seek productivity-enhancing technologies, search for international capital, and seek international markets for new sets of goods and services was reduced.

Yet, the capacity of African states as economic agents was severely compromised as the state machinery in many countries was captured by distinct interest groups. This condition, described as “urban bias” by Bates,<sup>8</sup> led to the maintenance of inappropriate macroeconomic and trade policies. In particular, the intervention by the state in the functioning of markets went beyond simple ownership of the capital stock. It affected adversely the interests of exporters through the maintenance of unhealthy producer prices for primary commodities, unrealistic exchange rates, and fiscal programmes that eventually broke the treasury and destabilised economies.

Turning to Southeast Asia, Aryeetey and Nissanke note both the similarities and differences in internal and external conditions. Nation states in Southeast Asia were, as in SSA, created as by-products of European colonialism, with the notable exception of Thailand. Compared to the Northeast Asian economies, they are far less homogeneous in terms of ethnicity, culture, and religious heritage, which has undermined the emergence and sustenance of economic nationalism. Consequently, the basis of developmental states is weaker in Southeast Asia than in Northeast Asia, and successive governments have found the process of policy reform hampered by the need to appease different constituencies based on regional, religious, or ethnic groups. Generally, while local entrepreneurs have not advanced effectively the national agenda of late industrialisation, the interests of foreign business have been promoted above those of the local business community.

However, importantly, in contrast to SSA, technocrats in Southeast Asia have had a considerable degree of autonomy in the area of macroeconomic management. Further, effective alliances were forged from time to time between technocratic advisors, key politicians, and business groups to foster economic growth and investment. Considerable investments were made in agricultural expansion and rural development in the early years, and a large number of labourers were absorbed into the industrial sector as industrialisation proceeded rapidly after the 1970s. Further, in the 1980s and 1990s, Southeast Asian economies have bene-

fited from positive regional effects. The growth and structural transformation of the Southeast Asian economies has been greatly facilitated by the pan-East-Asian dynamism associated with regional industrial restructuring. Direct investment flows by Northeast Asian firms have intensified and accelerated the process of widening and deepening manufacturing networks in the region. Overseas Chinese traders have also played a crucial role in generating dynamism in Southeast Asia.

Reflecting these differences in these historically evolved political and institutional conditions, Aryeetey and Nissanke argue that policies adopted towards international trade and investment in the two regions have varied considerably.

In SSA, the trade policy regimes that prevailed between the time of independence and the adoption of Structural Adjustment Programmes were truly inward looking on both the import and export sides, so that many economies were locked in a permanently de-linked position from the world economy. Protections provided were neither time bound nor performance linked. They could not be used as an effective means to graduate infant industries from protection. Little thought was given to a strategic dynamic path of the trade regimes which should be evolved as industrialisation and economic development proceeds. The need for raising the export-earning capacity was neglected, which was extremely detrimental for a foreign exchange-constrained economy, such as the economies of most of SSA countries with their high dependence on imports for intermediate and capital goods.

In the absence of appropriate coordination among trade, industrial, and technology policies, industrialisation strategies implemented in SSA did not have the required internal consistency and coherence, producing poor results. While trade and investment liberalisation carried a great weight in the Structural Adjustment Programmes, given the unfortunate past experience with the interventionist regimes, strategic visions for development embedded in sectoral policies have been altogether discarded.

In contrast, in Southeast Asia, import substitution strategies were not pursued in a manner as inward looking. Most Southeast Asian economies remained open to the global economy even at the height of the import substitution phase, through exports of primary commodities or processed products. The primary-commodity sector was encouraged to develop as a main source of earning foreign exchange and never penalised. Outward orientation was present throughout, maintaining strong trading links with the world economy. Besides, while industrial development was initially carried out under the regime of import substitution, the growth and diversification of industrial products were realised with the timely adoption of export-promoting measures. Undoubtedly, it is the success of export promotion of selective manufacturing activities that has changed the

industrial landscape of these economies. In short, export promotion and import substitution were the two, equally critical, pillars of their outward-oriented industrialisation strategy.

Moreover, import liberalisation was carried out in stages to ensure soft landing to import-substituting industries. While industrial policy lacked coherence compared with Northeast Asian economies and the dependence on FDI has been high, extensive proactive state interventions in facilitating export growth were instrumental for the remarkable success in trade and investment performance in Southeast Asia.

Aryeetey and Nissanke conclude that, despite some similarities, there are critical differences between the two regions in their policy design and implementation context. In particular, they emphasise the need for differentiating between strategic integration and laissez-faire liberalisation in formulating policies intended for achieving integration into the global economy.

### *Institutions and External Performance in Africa*

Chapter 4, by Beatrice Weder, uses internationally available data to look at the possible relationship between the performance of exports from Africa and the nature of Africa's institutions. The variables of interest include the accountability of rule-making, the security of property rights, the predictability of laws, corruption, and political instability. She finds that for a subset of her sample African countries, variations in export performance are best explained by differences in the security of property rights and the rule of law. Her results do not change even after controlling for differences in income, policy distortions, and other measures of political instability. It is also interesting that Weder does not find a relationship between the perceived security of property rights and ethno-cultural factors, including the extent of ethnic division.

The significance of property rights and economic performance in developing countries has been prominent in the literature in the last decade. The work of Knack and Keefer<sup>9</sup> and the recent piece by de Soto<sup>10</sup> have helped to push to the fore the issue of property rights security. While the intuitive nature of the relationship between poor security of property rights and the performance of an economy is appealing, particularly with respect to the likely impact on foreign investors, there is no clear agreement on the means by which the perception of poor security translates into specific investment decisions by different categories of investors, including local producers of export commodities. Even less clear is how this impacts directly on economic performance.

The need to take a more nuanced approach to the relationship between governmental actions and responses of private economic agents

and their impact on the economic activity underlies a lot of the discussion in this volume. While the volume accepts the need for governments to pursue strong measures that will secure property rights as a way of enhancing access to international resources and the integration of African economies into the global economy, it is recognised that the security of property rights needs to be a part of a broader institutional development process that builds on local cultural values and societal goals and the perceived direction of the future interaction between the domestic economy and the world economy. In this situation, secure property rights for foreign investors are as important as they are for small domestic producers. It is recognised that a lot of the governance improvement attempts of the last decade in Africa seek to achieve this objective. Obviously the impact of this will be deeper if other aspects of good governance are treated as complementary in this process.

### *Local Entrepreneurship in Southeast Asia and Sub-Saharan Africa*

Chapter 5, by Deborah Brautigam, is an attempt to show the underlying microlevel economic and institutional interactions that facilitated the different perspectives of private economic agents in the two regions. She suggests that the institutional differences have a longer history than recent literature would tend to suggest. A part of the industrial course that Southeast Asia has taken is derived from the fact that Southeast Asia was linked to the great maritime routes of the East, between China and India. Africa had not had an equally significant link to any major world trading routes until the beginning of the slave trade. The latter marked the beginning of the most important but largely negative trading link of Africa with the outside world.

In the era of colonialism Africans were prevented from accumulating capital in any significant way as European institutions acted in concert to concentrate capital in the hands of European trading businesses in Africa. They had no interest in manufacturing. In contrast, entrepreneurs from China, India, Europe, and Japan were already involved in serious manufacturing by 1941 in Southeast Asia. Foreign manufacturing entrepreneurs did not arrive in Africa until much later, indeed, not until later in the nineteenth century. It was therefore not surprising that Southeast Asia moved into manufacturing long before Africa introduced ISI after independence.

Brautigam looks at the processes for developing local entrepreneurship in the two regions in terms of entrepreneurial accumulation, network formation, and global linkages. She suggests that the Chinese and Indian networks in Southeast Asia are legendary, as are some of the networks of traders known in West Africa. The solidarity networks for

countering uncertainty and information networks for spreading knowledge are useful for developing links to the global economy in so far as they facilitate access to resources not immediately available in the local community. Such networks have historically been extremely useful in allowing resources and ideas to come from outside, as well as in facilitating access to the state, a fact that explains the ability of some groups to embark on dynamic industrialisation. In Asia, as new institutions emerged to provide some of the benefits that networks provide, a change in the dynamics also emerged to allow entrepreneurs to become more global in their dealings. Such institutions have been slower in emerging in Africa, thus leaving the networks to continue with the age-old practices of minimising risk in smaller geographical areas.

Brautigam further notes that the role played by local entrepreneurs in the development of foreign joint ventures has been much stronger in Southeast Asia than in Africa. In this respect, she emphasises the special role played by Japanese investors, often as minority partners and acting in concert with locals who controlled major distribution networks throughout the region. Their manner was different from European traders in Africa. The joint ventures brought newer technology and facilitated the transformation of small businesses into more modern commercial ventures on a scale much larger than in Africa. The obvious policy conclusion for Africa would be to develop institutions that create opportunities for indigenous networks to increasingly interact with the rest of the world and obtain access to technology, markets, and resources.

### *Resource Exports and Resource Processing for Export in Southeast Asia*

The Southeast Asia region has undergone considerable structural change over the last three decades, moving from economies dominated by primary exports to ones dominated by manufactured exports and other processed agricultural goods. Even in the area of primary agricultural exports, countries like Malaysia, Thailand, and Indonesia have witnessed a significant expansion in the range of exported goods. In Chapter 6 on the process of structural transformation in Southeast Asia, Jomo and Rock emphasise the significant role played by the state in achieving the desired diversification after several years of narrow export bases that had been developed on the lines of “natural protection.” They suggest that the capacity and ability of local entrepreneurs to take advantage of the natural protection offered by rich resources and geography created the flexibility that allowed the postcolonial governments to build on them for export diversification.

Particularly, they strongly argue that the neoliberal interpretation of the state in the second tier newly industrialising countries (NICs) in



Southeast Asia is, at best, an oversimplification. The latter interpretation suggests that selective interventions in these economies have been incoherent, subject to wasteful rent seeking, and irrelevant to their development successes in recent decades. It also regards the recent financial crises as evidence of the failure of such incoherent and rent-seeking micropolicies. However, in reality, governments in the three second-tier NICs, instead of simply relying on static comparative advantage or indulging in wasteful rent-seeking policies, all intervened selectively to diversify their economies away from primary exports. Selective interventions covered a range of activities. Initially, resource rents were used and distributed in the form of selective incentives to promote import substitution industrialisation (ISI). When the returns to ISI declined, selective incentives were put in place to promote export-oriented manufactures, including resource-based industries.

Jomo and Rock note the wide-ranging measures taken by the state in export diversification. The measures covered initiatives in research and extension which were crucial for crop diversification, as well as mineral exploration and geological surveys that have been essential for developing the minerals and oil sectors, especially in Indonesia. There have also been government subsidies, direct protection to support import-substituting industries as well as export-oriented industrialisation. In many cases, intervention took the form of the state seeking to reduce the private costs of entrepreneurs in selected areas and enhancing social benefits as private benefits rose. Rents were shared between the state and the private sector in many instances.

Thus, Jomo and Rock show how selective promotion of export-oriented resource-based industries yielded handsome returns in promoting new crops (such as oil palm in Malaysia and Indonesia and cassava in Thailand) or new resource-processing industries, such as the plywood industry in Indonesia and the prepared meat (primarily chicken exports) industry in Thailand. They emphasise that in each instance, selective incentives figured significantly in the development of internationally competitive industrial capabilities. Their nuanced microanalysis also identifies and critically examines failed government interventions in these countries. However, they emphasise that the recognition of wasteful rent-seeking behavior should be analytically distinguished from developmental interventions successfully offering rents as incentives to motivate desired economic responses.

### *Primary Exports and Primary Processing for Export in Sub-Saharan Africa*

SSA has lost its share of world exports by over 250% over the last thirty years. All categories of exports for all subregions in SSA, including South

Africa, have faced drastic falls in export earnings. As a result, SSA faced serious import compression particularly during the 1980s. While the exports of manufactures have not been anywhere near the targets that many countries have set for themselves, the performance of primary exports has steadily deteriorated, with a sharp decline in market shares for some major commodities. Chapter 7, by William Lyakurwa, argues that, while primary exports remain the most critical link to the global economy for many countries in Sub-Saharan Africa, the importance of the primary-sector exports were underplayed in the early postindependence periods, faced with the expected long-term decline in primary-commodity export prices. As Lyakurwa shows, however, the liberal economic reforms under the Structural Adjustment Programmes have not arrested the steady declining trend in primary exports, while export diversification has yet not taken place on a visible scale. Lyakurwa's econometric investigation of factors behind the discouraging export performance suggests that primary commodity exports have been affected significantly by unstable macroeconomic conditions. He further notes that the poor state of infrastructure in most of Africa, influenced by lagging gross domestic investment, turns out to be important and significant for explaining the poor trend in primary exports.

He concludes that it is crucial to account for institutional developments in order to appreciate more fully the obstacles to export diversification. Indeed, the Southeast Asian experience with export diversification suggests the importance of developing a strong private-sector capacity to respond to government incentives and initiatives. In addition to the broad policy support that is necessary for private-sector engagement, institutional developments will have to be those that can enhance private participation in the economy, particularly in new sectors that enhance exports. Rents accruing to governments will have to be distributed and used so as to encourage new productive areas.

### *Export-Oriented Industrialisation and Foreign Direct Investment in the ASEAN Countries*

While SSA countries continue to find it hard to diversify their exports through industrialisation, Southeast Asian countries have succeeded in the diversification process by effectively using foreign direct investment (FDI). Even though countries in both regions started out showing little or no interest in FDI, this changed rapidly in Southeast Asia, following the Singaporean experience in the early 1970s. Chapter 8, by Thee Kian Wie, discusses the rapid industrial growth and transformation which the ASEAN countries, particularly Indonesia, Malaysia, Singapore, and Thailand, experienced from the mid-1960s through the mid-1990s. In this

respect, he presents an interesting chronology of developments that led to the change in policy and attitudes towards FDI for export-oriented industrialisation in Singapore, Malaysia, Thailand, Indonesia, and the Philippines. He evaluates the role of FDI in the industrial development, which was facilitated by this policy shift. In particular, Thee Kian Wee emphasises the importance of foreign direct investment in promoting industrial and technological development by building up a pool of highly skilled managers, technicians, and workers. His analysis shows how foreign direct investment could facilitate the development of economically viable supporting industries, producing a wide range of intermediate inputs for the downstream assembling industries.

However, he also argues that, unlike Singapore and to some extent Malaysia, the other Southeast Asian economies have had difficulty in getting foreign technology applied in a broader spread of the industrial production chain. In this respect, he suggests the critical importance of enhancing the indigenous technological capabilities through the transfer of knowledge from MNCs to local SMEs for sustained economic growth.

### *Export-Oriented Industrialisation and Foreign Direct Investment in Africa*

Chapter 9, by Charles Soludo, argues that export-oriented industrialisation provides the best strategy that could potentially reinvigorate Africa's stalled industrialisation process. However, it is clear that, despite nearly two decades of trade and structural reforms at the behest of the BWIs, industrialisation buoyed by FDI and export orientation has yet to happen. In his view, despite concerted efforts at export orientation, FDI is also unlikely to become a significant African phenomenon in the near future unless some fundamental transformation of the socioeconomic, infrastructural, and institutional arrangements takes place. His arguments are based on his analysis of factors that provide explanations for the slow growth of industrialisation beyond the inadequacy of the macroeconomic environment. Many problems arise from the initial conditions, including infrastructure, capacity and institutional constraints, and other factors, both internal and external. He also highlights the relative absence of an appropriate sociopolitical environment.

After discussing the "accumulationist" and "assimilationist" explanations of the successful economic transformation in East Asia, Soludo raises the question of whether those experiences are replicable in Africa. He suggests that both the more interventionist experience of Northeast Asia and the more liberal Southeast Asia experience may offer lessons for Africa, so long as the obstacles to emulating those approaches effectively are removed. These obstacles centre on the capacity of the state

to develop and implement an appropriate policy regime. Importantly, he argues, something beyond “getting the fundamentals right” or “state interventions through industrial policy” is required to create the necessary locational and competitive advantages for industrialisation and FDI to happen. He notes that a majority of countries in SSA are preeminently at a preindustrial stage and are still waiting to establish the minimum set of conditions for private enterprise to flourish. For these kinds of economies, he argues that FDI will unlikely become part of the development story in the foreseeable future, except through forced locational advantages foisted by a successful regional integration scheme.

As a way forward for Africa, Soludo identifies three areas for action: (i) the need for capable states and effective institutions to articulate a long-term industrialisation vision, (ii) a competitive macroeconomic environment that supports the boosting of savings and investment, and (iii) a number of microlevel interventions to develop local competitiveness through an appropriate industrial policy. Such interventions would include the use of subsidies to boost R&D and the development of the infrastructural base. Also considered important for African industrialisation is an appropriate external environment that provides for the right level of regional dynamics in the development of markets, as well as calls for the levelling of the global trading field. He also suggests that an appropriate aid for the donor community is regional project aid, not the current haphazard and largely ineffective national aid.

### *Management of Financial Flows in Southeast Asia*

Chapter 10, by Pakorn Vichyanond, analyses the policy and institutional context of the evolution of the Asian financial crisis. Vichyanond takes the position that the significant growth in capital flows to Asia in the early part of the 1990s led to an overinvestment in the ASEAN countries in the midst of an underlying macroeconomic problem. The untreated macroeconomic problem was reflected by the rapid increase in the current account deficit by the mid-1990s. The fixed exchange rate regime in the midst of a rise in the value of the U.S. dollar affected the competitiveness of exports significantly. In addition, many of the new investments facilitated by the capital inflows suffered from a reduced productivity. After discussing the timeline and causes of the Asian crisis, he argues that formats and end uses of foreign borrowings are very crucial because they have immediate implications upon the vulnerability as well as the debt-servicing capacity of debtor countries.

The institutional issue of interest is the role of governments as rule makers and enforcers and their relations with the private sector. Vichyanond acknowledges the strong interventions of governments in creating

the overinvestment. In Indonesia and Korea, the role of the state in facilitating the rise of a number of large corporations that made use of the foreign capital is noted. Particularly in Indonesia, the absence of transparency in the relationship between state and business helped to muddy the waters even further. Governments failed to take corrective action early enough through appropriate macroeconomic policy changes, effective regulation, and sound enforcement of rules and laws. This was because they had become entangled in the web spun by the unusual collaboration between state and business in a number of places. While these failures offer a useful lesson to Africa, they certainly lead to questions about what kind of relationship is most appropriate between the state and the private sector in ensuring both an increased inflow of private capital and a more productive use of such capital in all sectors.

### *Globalization of African Financial Markets*

While the flow of international finance to Africa in the last decade has been negligible, particularly compared to flows to Southeast Asia, the trend in the middle of the 1990s appeared to suggest a possible turnaround. This was indeed widely believed to be the case until the onset of the Asian financial crisis. Lemma Senbet argues in Chapter 11 that the positive developments that Africa experienced for that brief period are the main reason for the optimism he expresses about Africa's future participation in financial globalization, which provides opportunities for risk sharing, liquidity provision, and transformation. He argues that the positive linkage between finance and economic development is of particular interest to African economies, pointing to a possible indirect linkage between capital market development and poverty alleviation, along with employment creation.

After identifying the benefits that Africa stands to gain from a greater integration into the world financial markets, Senbet outlines the challenges Africa faces in accessing the benefits of financial globalization while controlling globalization risks and the attendant financial crises. The challenges facing Africa in its financial globalization include the characteristics of the malfunctioning domestic markets, such as their thinness, illiquidity, and the weak disclosure and enforceability of rules; and the absence of risk-sharing mechanisms to cover macroeconomic and political risks, as well as foreign exchange risks, the risk of growing Afropessimism, and the attendant risks of financial crisis. Senbet attributes the Asian financial crisis to the institutional problems that have led to the dysfunctionality of the financial systems. The inappropriate relationships among governments, business, and financial institutions are blamed for the problems of moral hazard that characterised a number of significant

financial transactions, wherein debtors had an incentive to undertake excessive risks and channel capital to inefficient, yet high-risk, investments.

Senbet presents several suggestions on how to meet the challenges with respect to Africa. He focuses on capacity building in the development of local capital markets, including the design of efficient systems for capital market regulation that ensures fairness, full disclosure, and transparency. He emphasises further the need for building human resources and training programmes, as well as fostering an environment for good corporate governance. He also discusses how to promote capital markets development through privatisation and the design of efficient banking regulation. In his view, regional cooperation and the development of regional markets are particularly important in Africa as an effective means for addressing the thinness of individual national markets.

Considering the virtual absence of Africa's global participation as a manifestation of extreme risk and the resulting "marginalisation" of the region, Senbet warns against the wrong lesson to be drawn for Africa from the Asian financial crisis: advocating to avoid globalization in the pursuit of avoiding globalization risks. In his view, that is tantamount to continued "marginalisation," with no opportunity for Africa to access the potential benefits of globalization. Building a capacity for the efficient management of risk and the efficient resolution of crisis is suggested as the more appropriate alternative.

### *Aid and Development in Southeast Asia*

Khan develops in Chapter 12 an asymmetric loss function model to investigate the macroeconomic effects of foreign assistance, focusing on the effect of aid on public-sector variables as opposed to the usual studies of effects on growth. He argues that, for foreign aid to be effective, certain complementary domestic conditions should prevail, which include complementary private investment, human capital, and appropriate governance structures in administrative, political, and civil-society aspects.

Because of increased aid flows to Malaysia, Thailand, and Indonesia in the late 1970s and into the 1980s, Khan argues strongly about the gap-filling role that aid played. Indeed, aid to Indonesia was significant and ensured macroeconomic stability since it helped to close the financial gap throughout the 1980s, particularly when oil prices suffered a decline. The use of aid to finance shortfalls in development budgets was also significant in Malaysia and Thailand in the 1970s and 1980s. In particular, bilateral aid turned out to be more effective in these economies. For example, in Indonesia, aid has been effective in infrastructure projects funded by Japanese bilateral aid. Khan, however, notes that aid has been least effective in social-sector development or human-resource develop-

ment where the performance of the studied nations was less than predicted on account of their income growth.

In concluding that aid to the three countries has been generally effective, Khan attributes this effectiveness not only to a developmental approach to economic management in these countries but partially to the institutional structures, capacities, and practices at the political-administrative, economic, and civil-society levels. He also suggests that policies of export-led development have been significant, if not instrumental, in mobilising foreign aid for investment purposes. He sees the state as being relatively autonomous in the countries, much more so than in other developing nations, since it permits the adoption of broader-based development agendas. The effects of existing corrupt interest groups are therefore more easily contained, even if not as well as they are in Northeast Asia.

### *Foreign Aid, Debt, and Development in Africa*

For Sub-Saharan Africa, foreign aid has become the strongest link with the rest of the world. Hence, the effects of aid on economic development are one of the most studied and debated topics in recent years. Chapter 13, by Sam Wangwe, examines the trends of foreign aid, the experiences of aid effectiveness and aid management, the debt problem in SSA, and he draws some lessons from these experiences.

Noting the uncertainty associated with future flows as a result of budgetary pressures competing with claims on donor resources, Wangwe discusses the effectiveness of aid and its management in Africa. He claims aid has been effective as a project-funding gap filler. Aid has also helped to bridge the savings-investment gap and the foreign-exchange gap. However, he notes, when a yardstick of graduation is applied, unlike in Southern Asia, no country in SSA, except Botswana, has been weaned from aid. He further suggests that, with the onset of the adjustment regime in the 1980s, the goals of aid became a lot more blurred and the effectiveness of aid much more complicated to evaluate.

Wangwe notes, however, that alongside many disappointments, aid has financed numerous development projects and programmes which have achieved reasonably high internal rates of return, including schools, clinics, health posts, bridges, roads, and manpower training programmes. Emergency aid has been also decisive in helping many SSA countries. However, Wangwe notes the controversy surrounding the macroeconomic growth effects of foreign aid. While arguing for an accommodating macroeconomic environment, he criticises the well-known Burnside-Dollar arguments for greater selectivity in aid allocation, with a focus on the relevance of the policy indices applied and the implications for poor-policy countries. Other issues discussed are the management capacity and

the entire absorptive capacity problems of recipients, aid coordination, and the major questions of ownership and conditionality. Wangwe calls for improved aid relationships between donors and recipients in all these areas.

Further, Wangwe evaluates the recent rapid growth of debt as a result of reform processes and the new financing requirements. The chapter makes a strong case for debt relief, including relief under HIPC's on the basis of the nonsustainability of existing debt levels and debt service programmes. While supportive of HIPC's, Wangwe notes some reservations with respect to the criteria for selection, the depth of the measures, and the sequencing of eligible countries. In particular, he argues that a conditionality attached continues to have made it difficult to effectively have access to the facilities. He suggests that conditionality needs to be redefined to link more appropriately with agreed-upon criteria of performance by all partners.

### *Key Challenges of African Development*

Chapter 14, by Delphin Rwegasira, identifies key challenges facing Africa in the twenty-first century. Rwegasira notes that, for long-term growth, Africa will have to find ways and means of gainfully opening up and competing in the global economy. For this to be achieved, he suggests several key issues to be addressed. First, Africa will have to create a proinvestment climate, which will involve progress on several fronts: political, administrative, and narrowly economic. Progress on these fronts would importantly depend on the actual availability of resources and on incentives for private investment and a sustained proinvestment climate. Second, creating such a proinvestment climate would in turn require progressive establishment of what has been called "developmental states," that is, creating a competent and independent state bureaucracy and building closer ties between such a bureaucracy and the emerging private sector. In addition, a "developmental state" would need to address the broader imperative for capacity building, especially in respect to policy analysis and management.

Third, Rwegasira envisages an enhanced role for regional markets, arguing that regional cooperation and integration would help SSA in a sustained way if the cooperation framework would be conceived within the context of what has come to be called "open regionalism." An "open-regionalism" approach would caution against overreliance on the regional market in order to avoid the well-known limitations of import substitution strategies. At the same time it would facilitate greater macroeconomic and institutional coordination, coordination of investment



in infrastructure and natural resources, private-sector promotion, and, finally, alignment on bilateral and multilateral external assistance.

The last issue Rwegasira raises concerns diversification and agricultural growth. He notes the problem of the structural vulnerability of African countries, which originated from the very limited diversification. He argues that this is particularly relevant in the agricultural sector, which in a typical country in the region accounts for 70% of total employment, 40% of merchandise exports, and one third of GDP. Better policies to promote stronger agricultural growth would thus not only lead to general economic improvements arising from trade but would also create possibilities of diversification within agriculture. These policies would need to address the major weaknesses that have been identified with African agriculture: seriously inadequate public and private investment in the sector; a very weak physical and research structure; inadequate marketing and support systems; the basic issue of prices and other incentives. Apart from the domestic and external trade benefits that would result, a more diversified agriculture sector would make it easier to advance on the strategic objective of reducing poverty in a more conducive context of agricultural and rural development.

## Notes

1. Lemma W. Senbet, "Global Financial Crisis: Implications for Africa," *Journal of African Economies*, AERC Supplement 10 (2001): 104–40.
2. Ibid.
3. For a literature review of risk and cost associated with financial globalisation and a discussion of how to link global finance to economic development by building an institutional foundation, see Machiko Nissanke and Howard Stein, "Financial Globalisation and Economic Development: Toward an Institutional Foundation," *Eastern Economic Journal* (2003, forthcoming).
4. World Bank, *The East Asian Miracle: Economic Growth and Public Policy*, A World Bank Policy Research Report (Washington, D.C.: The World Bank, 1993).
5. David L. Lindauer and Michael Roemer, eds., *Development in Asia and Africa: Legacies and Opportunities* (Cambridge, Massachusetts: Harvard Institute for International Development, 1993).
6. For a critical literature review of the debate sparked by the World Bank Study, see Machiko Nissanke and Ernest Aryeetey, "Comparative Institutional Analysis: Sub-Saharan Africa and East Asia" (framework paper presented at the AERC-UNU Conference on Comparative Development Experiences in Africa and Asia, Johannesburg, November 1997), in *Comparative Development Experiences in Africa and Asia*, eds. Ernest Aryeetey and Machiko Nissanke (Aldershot: Ashgate, 2003).
7. The first workshop on the thematic topic of Comparative Institutional Analysis in Asia and Africa was held in Johannesburg, November 1997, and a collection of the selected papers of the first workshop can be found in Aryeetey and Nissanke, *Comparative Development Experiences in Africa and Asia*.

8. Robert Bates, *Essays on the Political Economy of Rural Africa* (Cambridge: Cambridge University Press; Berkeley, Los Angeles, and London: University of California Press, 1983).
9. Stephen Knack and Philip Keefer, “Institutions and Economic Performance: Cross-Country Tests Using Alternative Institutional Measures, *Economics and Politics* 7 (1995): 207–27.
10. Hernando de Soto, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (New York: Random House, 2002).

## The Dynamics of Globalization: Eight Sceptical Theses

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*Laurence Harris*

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Each individual economy in the world has undergone remarkable changes within the past three decades, and in the process the world economy as a whole has developed a new form. The international dimension of economic activity has become so significant and has related to individual economies in such new ways that these changes have been written about as producing a distinct new system, a globalized economy with the processes producing it named “globalization.” In its extreme versions the idea of globalization appears to imply that the concept of “each individual economy,” words that introduced this paragraph, is invalid, for every economic activity, wherever located, is simply an element of the global whole. More concretely, the extreme idea of globalization implies that national economic institutions are powerless in the face of global forces, such as multinational corporations and international financial markets.

The idea of globalization is problematic, for, like any concept attempting to categorise stages of world history, it can be interpreted in several ways. None of the versions directly offers analytical insights. Nevertheless, concepts of globalization can have some descriptive value, and the challenge of giving some precision to that enables us to engage with more specific problems.

In this chapter, while recognising the significance of the modern international economy’s changes, I put forward some sceptical views about the dynamic of globalization. They add up to eight theses:<sup>1</sup>

1. There are no grounds for conceiving the world economy as a globalized economy; at most it may be considered as the product of a process of fractured globalization.
2. Although international flows of trade and investment have grown and taken specifically new forms (such as multinational corporations' investments in cross-border manufacturing) they have formed regional blocs rather than a unified global economy.
3. Measures of integration of markets are more pertinent to the concept of globalization than measures of international flows, but evidence from tests of the law of one price indicates that such integration is not high.
4. Changes that have been seen as leading inexorably towards more general globalization will not necessarily continue into the future; they may be seen, instead, as a temporary "catching up," restoring international economic relations to a level of integration comparable to the pre-1914 world economy, but with different forms.
5. In the future those changes may even be temporarily reversed by renewed protectionism, instability, or world depression.
6. The progress of globalization tendencies meets obstacles in the diversity of countries' forms of organisation, economic structures, and economic behaviours. That diversity may usefully be encapsulated in the concept of countries' specific cultural and historical circumstances.
7. The existence of cultural and historical specificity creates lasting obstacles to globalization and is not obliterated by international competition itself. Consequently, it cannot be expected that economic development will be based on a tendency for ever fuller globalization.
8. Even countries that are highly integrated with the world economy have a significant degree of discretion in policy, contrary to the widespread view that globalization has abolished economic sovereignty.

## Fractured Globalization: Concepts and Reality of Globalization

The conceptual essence of globalization is greatly increased interaction and integration between economies, but that, in itself, is not a new phenomenon in the real world. Increasing integration has been a characteristic of economic growth since at least the early days of capitalism, but it has always been more than "interaction between national economies," the rather narrow definition in textbooks on international economics. Economic growth has been accompanied by interaction and integration

between different local regions within a country, whether or not the country is a sovereign state; between national economies, which, after the development of nation states, meant across national boundaries<sup>2</sup> and between different regimes of tax and regulation; and, thirdly, between global regions loosely defined, including, say, the growth of economic relations between Western Europe and East Asia.

To consider the specific dynamics of globalization, we should recognise that the long history of integration and interaction, between and within countries and regions, has not been a smooth, linear process.<sup>3</sup> In the time dimension, it has been uneven, progressing rapidly in some periods (such as the expansion of the Dutch trading empire or the growth of world trade and investment under the late nineteenth-century gold standard) and going backward in others (such as the protectionist period that began in the 1930s, reinforced by the wartime disruption of 1939 to 1945). In the space dimension it has been uneven, with different parts of the world undergoing transformations at different times. Most important for this chapter is that the form of interaction and integration differs in different periods and areas. The movement of factors of production, in the forms of labour migration and direct investment, has predominated in some periods (for example, the nineteenth-century railway construction boom across the world). The growth of international trade in primary, intermediate, and final products, as it occurred in the decades of high economic growth following 1950, has marked other periods. At other times, the international expansion of banking and finance has dominated.

What special features of the development of world economic relations over the last twenty-five or thirty years justify its being seen as “globalization” and different from other periods? Two, which are discussed below, are particularly salient: the internationalisation of production through multinational corporations and the growth of new types of international financial markets and institutions.

The starting point of the discussion is recognition that, even if the dynamic of recent decades can be characterised as a process of globalization, it can only be considered as a tendency or direction; the rather different notion that the world has now reached a globalized state has no basis. The remainder of this section demonstrates that.

More than simply the opening of a country to capital flows or foreign exchange convertibility, or the growth of its international trade owing to liberalisation, globalization means that the external markets that countries engage with through such openness are multilateral and dominated by global forces on which most individual countries’ transactions have little or no impact. In some writings the mark of globalization is the resulting world division of labour in production as corporations organise

their subprocesses across borders and on the basis of worldwide sourcing.<sup>4</sup> For others, the distinguishing feature is the large volume of highly mobile international funds, such as those controlled by “arbitrage funds” or “hedge funds” in the 1990s.

Globalization in those terms does not correspond to the reality of today’s markets. To make that judgement, it is useful to distinguish between the two concepts that I have so far used as if synonymous – interaction between national economies and their integration. Interaction occurs in all economic relations between countries whether in trade, production, or financial flows. Integration means that individual local or national economies are effectively nonautonomous parts of a single whole, a more rigorous form of interaction. The idea of a globalized economy, a pure globalized economy, is that national and subnational economies are integrated into a single whole that is global. That should be distinguished from integration within a region alone – Europe, say, or the Asian Pacific Region. And integration is distinct from a proliferation of interactions, for transactions, such as trade and investment, can take place between economies that are quite different, have different price structures, have growth paths that are independent, and, therefore, cannot be said to be integrated.

How can concepts of interaction and integration be operationalised to give us some measures against which to judge concepts of globalization? One type of measure is the quantities of international flows and assets. The second type is price data used to test the proposition that the “law of one price” holds. In the following paragraphs, I consider each of these. The conclusion they lead to is that the world does not have a globalized economy. At most there is a degree of fractured globalization. However, since the 1970s, there has been an accentuated tendency towards greater interaction and integration, a tendency towards a greater degree of globalization.

### *International Flows: Trade, Production, Investment*

The high rate of growth of international trade has been a salient feature of economic growth in the second half of this century, for it has been considerably higher than the growth of output itself. Whereas world output in 1991 was 3<sup>1</sup>/<sub>2</sub> times as high as in 1960, exports had grown to almost 6 times their 1960 level.<sup>5</sup> For many, the export-driven nature of the postwar boom, and the increased trade openness those figures illustrate, is a mark of globalization. But rather than global interaction, disaggregation shows that countries’ increased openness has led to concentration of trade in blocs instead of being fully global; trade patterns are clustered around a European bloc, a north American bloc, and an East Asian bloc.

In East Asia, for example, half of the region's countries' total trade in the first half of the 1990s was with each other rather than North America or Europe. Its largest economy, Japan, sold 40% of its exports within the region and bought almost the same proportion of its imports from them; its trade with the rest of East Asia was almost as great as its trade with the U.S. and European Union combined.<sup>6</sup> Similarly, the high growth of exports between western European countries, a major element in the growth of international trade, would have its weighting greatly reduced if the members of the European Union were treated as one "country."

Moreover, the growth in cross-border trade can coexist with a persistent "home bias" that prevents companies trading internationally as fully as they do within their own borders. Helliwell, using a gravity model of 1988–1990 merchandise trade flows, showed, for example, that the province of Quebec, Canada, traded twenty times more with other Canadian provinces than with U.S. states of similar size and distance<sup>7</sup> and, subsequently, that such "border effects" or "home bias" persisted in Canada's trade even after the development of a free-trade area.<sup>8</sup>

Whatever the rate of expansion of international trade in recent decades, its quantitative growth is not a unique characteristic of the modern period distinguishing a period of globalization from earlier periods of trade expansion, for trade has always been a principal engine of interaction and integration. However, the rise of a modern form of cross-border organisation of production within a single organisation, the multinational corporation (MNC), is a phenomenon characteristic of the modern period. Foreign direct investment (FDI), on which the cross-border organisation of production by MNCs is based, has shown an even more notable growth pattern than foreign trade, especially during the 1980s. From 1983 to 1990 the flow of FDI grew at the average rate of 34% per annum compared to a growth rate of 9% per annum for international trade.<sup>9</sup> That period witnessed an unprecedented boost to the internationalisation of production operations by corporations, a process that had begun in the 1960s and accelerated as the techniques of production themselves changed.<sup>10</sup>

The expansion of FDI in the 1980s led some commentators to conclude that we had reached the age of the borderless economy based upon corporations that are truly global in the sense that they need no national bases or ties.<sup>11</sup> In fact, however, the expansion of FDI has not created a globalized system of production or a borderless world economy in any meaningful sense. Tyson noted that U.S. multinational corporations have a strong "home country bias," tying them to the U.S. economy: "Within manufacturing, U.S. parent operations account for 78 percent of total assets, 70 percent of total sales, and 70 percent of total employment of U.S. multinationals in 1988,"<sup>12</sup> and Hirst and Thompson, using company

level data sets for 1987 and 1992–1993, find that the same is broadly true for multinationals with headquarters in the UK, Germany, and Japan.<sup>13</sup> Moreover, as significant as the home country bias is the regional concentration of FDI. The growth of European MNCs' direct investment in recent decades has been concentrated in facilities in Europe, first, as the European Union has been constructed and, second, as the previously centrally planned economies of Eastern Europe have been opened; as U.S. multinationals' direct investment has been concentrated on the Americas, especially in the context of the creation of NAFTA; and as Japanese MNCs' invested most strongly in East and South East Asia.<sup>14</sup> In other words, foreign direct investment has, like trade, increased the links within regional blocs rather than the world as a whole.

### *Integration: Synchronisation and Law of One Price*

Measurements of the flows of trade and investment indicate interactions between economies, but interaction is not the most significant indicator of globalization. Since globalization, in principle, means the creation of a single world economy, it implies there is a high degree of integration of its component parts: each part of the globe behaves as if it were part of a single entity. Two types of studies attempt to measure the extent of such integration: studies of the degree of commonality in the time paths economies follow and studies of pricing to determine whether similar goods or bads have equivalent prices across the world.

Starting from the proposition that any market economy experiences business cycles or growth cycles,<sup>15</sup> high commonality in the time paths of different economies can be conceived as a high degree of synchronisation among their cycles. As Oskar Morgenstern showed in 1959, industrialised economies had demonstrated a high degree of synchronisation among the phases of their business cycles from 1854 to 1938,<sup>16</sup> and it is a commonplace that there was a remarkable, high degree of synchronisation under the 1870–1914 gold standard.<sup>17</sup> Several studies have confirmed that the synchronisation identified by Morgenstern continued after World War II, although its comparative strength in the early postwar years is an unsettled issue.<sup>18</sup>

One indication of greater global integration is that the synchronisation of cycles has increased since 1970. Using broad-based measures of turning points, developed by the Economic Cycle Research Institute, Evans calculates a measure of synchronisation between the USA, Britain, Germany, and France comparable to that of Morgenstern. His results suggest that the countries' cycles were in the same phase for 72% of the time, higher than Morgenstern's finding for the 1870–1914 gold standard (54%) and Dornbusch and Fischer's comparable finding for the early



post-WW II period (35%). That finding from studying the timing of cycle phases or turning points, a distinctly greater degree of synchronisation since the early 1970s, is supported by numerous publications reporting statistical studies of time series of different sets of countries.<sup>19</sup> It is a relatively robust indication that since 1973 there has been a greater degree of integration among the world's major economies. The year 1973 is significant because it marks the end of the Bretton Woods system of relatively fixed exchange rates, and several of the studies have been concerned with that as the impetus for greater synchronisation, but the results are consistent with the notion that broader structural changes, implied by the concept of globalization, were responsible.

Studies of markets' conformity to the law of one price, however, fail to support the notion that a highly integrated world market exists. This can be considered in the context of financial asset markets, for they are plausibly assumed to be the most integrated, competitive, liquid, and efficient markets. But it is also worth noting that, in international product markets, the basic statement of the law of one price, the purchasing-power parity condition, fails to hold empirically.<sup>20</sup> On a financial market the most important prices are the price of time (a default risk-free interest rate) and the price of risk, which, in the Capital Asset Pricing Model, is the price of undiversifiable risk. In an integrated world market for default-free bonds, we would expect the former to conform to uncovered interest parity, adjusted for the expected value of exchange rate change, but, in fact, empirical studies are unable to support the existence of uncovered interest parity.<sup>21</sup> Similarly, the price of risk in an integrated world equity market should conform to the consumption-based International Capital Asset Pricing Model (ICAPM), but numerous studies have demonstrated that the model fails to hold empirically and that the price of risk in national equity markets diverges from the law of one price, whether measured by the ICAPM or an Arbitrage Pricing Model.<sup>22</sup>

The fact that equity risk does not have a common international market price, or, in other words, that expected returns on individual stock markets diverge from those determined by ICAPM, reflects the fact that people in individual countries do not hold portfolios that are as internationally diversified as they would be if they took full advantage of the opportunity for risk reduction through investing in world equity markets. This marked "home country bias" was highlighted by French and Poterba, noting the high share of domestic equities in the total equity portfolios of Japan (98%), the United States (96%), and the United Kingdom (82%) at the end of 1989.<sup>23</sup> Thus, in equity portfolios, a "home country bias" implies that a fully globalized equity market does not exist, just as multinational corporations' "home country bias" runs counter to the idea that they comprise a global, borderless economic system.

## The Dynamic of Globalization and the Logic of Diversity

The present state of the world, therefore, does not justify the description “globalized.” Although recent decades have seen increased interaction and integration between national economies, the outcome has primarily been increased links within regions, a system of regional blocs that might be described as “fractured globalization.” Even with such regionalisation national differences in economic behaviour and economic structures are significant, and we are far from having uniform, integrated economies, whether on a world or regional scale. Within East Asia, for example, economic systems and economic behaviour vary, as they do within Western Europe. Within regions and between them there is significant diversity in the role of the state, the structure of the financial system, corporate finance and corporate governance, and in whether individuals’ transactions are made on the basis of contract or on the basis of custom and social relations.

Insights into the dynamics of change can be gained by considering the forces that lead to such divergence. In order to do that, we need to have a perspective on globalization itself.

The view underlying most writing on the subject is that globalization is an ineluctable process destined to produce – or having already produced – a fully integrated world economy. With that underlying assumption, national and regional differences are seen as obstacles that will be swept away in the process of globalization. For example, the differences until the late 1990s between German and U.S. capital markets, encapsulated by the former’s low level of stock market activity, low shareholder reporting requirements, and absence of hostile takeovers on the market, have been significant obstacles to the creation of globally integrated equity markets. But economic change has provided an impetus for change towards common standards. The decision of Daimler-Benz to seek a listing on the New York Stock Exchange and change its reporting and accounting practices to conform to U.S. requirements, followed by a number of other large German companies, has been an example of such change and may be judged to be evidence of globalization changing national customs.

An alternative view is that the international changes seen in recent decades are more limited than the term globalization would imply, limited in both time and geographical scope. If one looks, first, at the time dimension, from a historical perspective economic growth and structural change always proceed in rapid bursts, followed by periods of stagnation or even reversal. Thus the fast pace of change in recent decades, the growth of multinational corporations and borderless financial markets, and other international developments would be seen as a singular phe-

nomenon limited in time and likely to face a period of stagnation instead of smoothly intensifying. In the next period, these changes may even be reversed to some degree if recession leads to new types of protectionism and controls being implemented by national states.

From that perspective it may be judged that the changes seen in recent decades, far from ushering in a new age, are simply “readjusting” or “correcting” the world economy, restoring in a new, more developed form the international integration that from 1914 until the 1980s had been interrupted and reversed.<sup>24</sup> The high degree of international integration experienced under the 1870–1914 gold standard could not simply be restored after the First World War, for in different ways political and economic forces combined then to promote protectionism, nonconvertible currencies and, for a large portion of the world economy, closed borders surrounding centrally planned economies. Several changes, marked in 1973 by the breakdown of the Bretton Woods system and culminating in the late 1980s in the reform and opening of Soviet bloc countries and China, reversed the arrangements that had restricted the scope of international financial markets, had segmented world production, and had limited the scope for direct investment. The speed with which international integration has proceeded in recent decades can be seen as analogous to water – previously pumped out of low level land – restoring the previous condition by rushing back into a Dutch field after a dyke falls. Rather than being an ongoing process, the flow of water will decline, and the level of water in the field may even recede again.

As for geographical scope, as argued above, the movements described as a process of globalization have created only a fractured globalization marked by regional blocs. Equally significant is that, however integrated are the major countries within those blocs, there are many countries both within and outside them that are poorly integrated. For example, much of Sub-Saharan Africa, many parts of the Indian subcontinent, or of the Middle East, or of Latin America are not well integrated into a world economy. Of course, almost every region, town, and village has some connection with the world economy, at least because the price of its local produce is affected by world markets to which it is ultimately linked by trade or, perhaps, because of migrants’ remittances. But that type of link has existed at least since the development of a world mercantile system in the early stages of capitalism, intensifying in the nineteenth century, and it is a long way from the type of integration accompanying modern “globalizing” changes.

Sub-Saharan Africa, excluding South Africa, may be considered as an example of a region not fully integrated into the processes that characterise globalization. Its capital markets are weak and not integrated into world capital markets, and, although multinational corporations have a

significant presence, few outside South Africa are homegrown. Sub-Saharan Africa did not share significantly in the 1990–1996 upsurge of private capital flows to developing countries. Between 1990 and 1995, twelve recipient countries accounted for 80% of net inflows of long-term private capital to developing countries, but those countries were mainly in East Asia and Southeast Asia or Latin America, and none were African.<sup>25</sup> Most significantly, the inward direct investment SSA countries do receive is predominantly directed into primary and service industries instead of being part of a new international division of labour in manufacturing. Thus, the MNC phenomenon so evident in East Asia,<sup>26</sup> the construction of networks giving the internationalisation of technology a key position, is largely absent from Sub-Saharan Africa.

It might be considered, as implied by strong forms of the globalization thesis, that the low degree of integration of some countries or regions and the marked regionalisation of those parts that are relatively integrated are transitional phenomena. The hypothesis advanced in this section is that they are not, for underlying differences between economic systems are significant, constituting obstacles to integration that are not dissolved by the pressure of increased international interaction.

Of the types of diversity listed at the start of this section, I concentrate on corporate finance and corporate governance, for full integration of a country into a world capital market, as implied by globalization, would require conformity in that sphere. To an economist reared on textbooks where production is organised within the uniform framework of “the firm,” the variety of types of enterprise in the real world is surprising. One example, “the Asian firm” or “Asian family firm,” which, in different forms, has underpinned growth in Taiwan, Hong Kong, and elsewhere, illustrates the obstacles to globalization. The paradigmatic character of such firms is that they are built on “obligational contractual relations” rather than the “arms length contractual relations” of the western model,<sup>27</sup> and, correlated with that, they have a different financial structure, relying on different types of credit arrangements from Western firms and having a lower degree of external equity financing because of the priority given to family control and long-term relationships. Moreover, the linking of production processes is, it is argued, achieved through networks rather than vertical integration. If such characteristics are real, mark a significant difference from “western” firms,<sup>28</sup> and are lasting, they impose a serious constraint on globalization, for they imply that foreign investment will be unable to achieve integrated ownership or common types of networks with such Asian firms.<sup>29</sup> Similarly, if the paradigmatic Asian firm bases its finances on relationship banking rather than arm’s-length contracts, the possibilities for expansion into Asia by global financial intermediaries that follow “Anglo-Saxon” rules are restricted accordingly.

One reason why such differences may exist and may be sufficiently robust to present a lasting obstacle to globalization is that they may be founded on deep cultural and historical roots. A large body of literature has examined the cultural and historical roots of the “Asian-firm” form of business organisation and argued that to be the case.<sup>30</sup> In fact, the concepts are controversial, partly because of their generality, which makes it difficult to give them testable precision, and partly because it is possible that, instead of relying on a loose idea of cultural and historical specificity, the characteristics of Asian firms can be explained by the same economic principles, such as transaction costs or agency costs, that are used in the analysis of “western” firms.<sup>31</sup> But I would advance the hypothesis that the obstacles to globalization created by the differences between types of firms are due in part, at least, to factors encompassed by the idea of “cultural and historical roots” and, as such, are lasting.

That argument may be extended beyond the specific example of the “Asian firm” to a more general view that cultural and historical differences generate forms of organisation that are inimical to international integration. Without making the case in detail, it is arguable that the particular forms of colonialism experienced in Africa led to forms of economic organisation and an inherited economic structure that have made it difficult to devise new ways of integrating into the world economy.

Against that hypothesis, scholars who believe that globalization is an inexorable tendency can argue, with considerable intuitive appeal, that the force of competition will increasingly standardise forms of economic organisation, for the more efficient forms of enterprise, banking, or other structures will generate changes that lead to the alteration or demise of less efficient forms and lead to economic convergence. The problem is that there are cultural and historical differences in the very notion of efficiency; it has long been argued that the “Asian firm” is the basis for long-term efficiency even if other forms are superior from the point of view of comparative static allocative efficiency (or from the point of view of maximising shareholder value in the short term).<sup>32</sup> Moreover, even when definitions of efficiency and all other structural features are shared between two economies (or regions), it can be shown formally that a difference in, say, the modes of operation of banks in the two economies can lead to continuing nonintegration and nonconvergence of the two economies even though cross-border competition between the two types of banks occurs.<sup>33</sup>

The discussion above can be focused when one considers the problem of “home bias.” As I have indicated, both international trade and international portfolio investment have been judged to have a home bias, either a bias toward the home country or toward the home region. “Home bias” notionally measures the degree to which international trade and investment fail to be as globally spread as models of compara-

tive advantage and efficient portfolio diversification suggest they should be.

If lasting cultural differences are responsible for differences in economic organisation and economic behaviour, they would account for “home bias.” One alternative explanation might be the existence of distance-related asymmetric information, but, in a world of advanced information technology, it is, in principle, implausible to assume that the quality of information decays with distance.<sup>34</sup> But if lasting cultural differences exist, the concept of “home bias” is itself questionable, for the concept rests on a comparison with a fully globalized “ideal,” whereas the existence of lasting cultural differences puts in question the possibility, in principle, of a fully globalized world.

## Globalization and Policy

A widespread conception of globalization is that it has robbed national governments of the possibility of policy autonomy; effectively, the argument is that individual economies are driven by world markets that leave no room for governments’ policy interventions. In fact, the processes experienced in recent decades leave national governments with considerable scope for policy initiatives, as can be seen at two levels.

One level of policy concerns structural changes, policies that can underlie long term growth, and there is no reason to think that all such policies are subject to the constraints of international markets. Government expenditure, transfers, or regulation directed towards such fundamentals of economic growth as education, research, and development; control of monopoly; or the promotion of small and medium enterprises are not subject to constraints resulting from being an open economy in an integrated world. And the mode of implementing such policies is locally determined and conditioned by the specifics of the culture.

More broadly, theories of the growth-promoting role of social capital have led to the argument that national policies to strengthen social capital are an important area for autonomous national policy. According to Helliwell the promotion of institutions and structures that provide a beneficial environment, including education, research, the rule of law, and elements of social capital is a strong continuing role for nation states in a world partly shaped by globalization.<sup>35</sup>

Those arguments for the continuing role for autonomous policy roles of nation states contrast with an important body of literature that, in parallel with popular conceptions, identifies or foresees the intensification of globalization and a consequent withering of nation states. For Ohmae the fundamental elements of the new world economy are multi-

national corporations and individual regions rather than nation states.<sup>36</sup> Rodrik argues that nation states with their separate jurisdictions are an obstacle to economic integration. He argues that three major forces are increasingly in conflict – economic integration, the power of nation states, and mass politics – and that one of the three must disappear. Rodrik predicts that the problem will be resolved by nation states being subsumed into “global federalism,” but the assertion emerges from a crystal-ball-gazing exercise that is based on too few parameters and implicit behaviour functions to justify it.<sup>37</sup>

If nation states have a continuing role in structural, institutional, and “social-capital-building” policies, there exists considerable evidence that fast-growth economies have been based upon policies addressing such structural needs and, in particular, putting them in a framework of institutions designed to promote growth in the context of the country’s historical and cultural circumstances. Most policies were put into place when global markets were less developed than now and economies less open, but, even in a world where market opinion can force the exchange rate down and interest rates up if it judges policies unfavourably, markets do not directly constrain such institution-building and structural policy.

It may be that an overall constraint on such policies exists because international markets impose macroeconomic constraints and determine key prices such as the exchange rate and interest rate. In other words, at a second level of policy, macroeconomic policy, international constraints intensified by globalization come into play. But those constraints are not binding. In a fully globalized world, characterised by a high degree of capital mobility, the Mundell-Fleming model predicts that interest rate policy is tied to exchange rates. For example, a loose monetary policy that reduces the positive difference between local interest rates and the world rate would inevitably be associated with exchange rate depreciation; such considerations have underpinned high-interest-rate policies in countries as diverse as South Africa and, in December 1997, South Korea. However, since empirical studies of OECD countries’ exchange rates have not shown the existence of such a relationship,<sup>38</sup> Mundell’s and Fleming’s findings imply that monetary policy can target interest rates separately from the exchange rate.

## Conclusion

It is undoubtedly the case that all countries today are more highly integrated into an international economy, and in more complex ways than they were three decades ago. But, this chapter has argued, the present situation cannot meaningfully be considered as a globalized international

economy. Moreover, the processes of change that have occurred and that have been considered as a tendency towards globalization will unlikely continue to generate such rapid change in the future and will face the prospect of potentially being reversed. The existence of locally specific cultural and historical features produce economic diversity that acts to slow and limit forces of globalization. National policies, such as institutional development related to those cultural and historical specifics, can be the basis for growth within the international economy. Those specifics, however, may also contribute to marginalisation and slow growth.

## Notes

1. The arguments I put forward in support of these theses owe much to insights gained from the work of SOAS PhD students on subjects that are only indirectly related to this chapter. I draw especially upon the work and ideas of Trevor Evans, Johanna Boestel, Luca Deidda, and Bassam Fattouh, to whom I express gratitude while retaining responsibility for errors, misinterpretations, and the conclusions drawn.
2. The geographic expansion of trade that occurred through the development of mediaeval fairs, for example, occurred both between local regions and between areas within different countries.
3. D. Rodrik, "Symposium on Globalization in Perspective: An Introduction," *Journal of Economic Perspectives*, 12, no. 4 (1998): 3–8; M. Obstfeld, "The Global Capital Market: Benefactor or Menace?" *Journal of Economic Perspectives* 12, no. 4 (1998): 9–30; R.C. Feenstra, "Integration of Trade and Disintegration of Production in the Global Economy," *Journal of Economic Perspectives* 12, no. 4 (1998): 31–50.
4. P. Dicken, *Global Shift*, 2<sup>nd</sup> ed. (London: Paul Chapman Publishing, 1992), Chapters 3, 4, 7, 8, 9, 10; F. Frobel, J. Heinrichs, and O. Kreye, *The New International Division of Labour* (Cambridge: Cambridge University Press, 1980).
5. P. Hirst and G. Thompson, *Globalization in Question* (Cambridge: Polity Press, 1996), 54, fig. 3.1.
6. The earlier stages of the development of this trade bloc are detailed in E. Chen, "Economic Interdependence in the Western Pacific Basin: A Hong Kong Perspective," (paper presented at Institute for Developing Economies Workshop, Tokyo, December 1983).
7. J. F. Helliwell, "Do National Borders Matter for Quebec's Trade?" *Canadian Journal of Economics* 29, no. 3 (1996): 507–22.
8. J. F. Helliwell, *How Much Do National Borders Matter?* (Washington, D.C.: Brookings Institution, 1998).
9. OECD, *International Direct Investment: Policies and Trends in the 1980s* (Paris: OECD, 1992), 12; Hirst and Thompson, *Globalization in Question*, 55, fig. 3.2.
10. Dicken, *Global Shift*.
11. K. Ohmae, *The Borderless World* (London: Collins, 1990).
12. L. Tyson, "They Are Not Us: Why American Ownership Still Matters," *The American Prospect* Winter (1991): 37–49.
13. Hirst and Thompson, *Globalization in Question*, Chapter 4.
14. The concentration of Japan's foreign investment in eight developing economies of the



- Pacific Basin in the early years is documented by Tsao Yuan, "Capital Flows Among Pacific Basin Economies," in *Pacific Growth and Financial Interdependence*, eds. A. H. H. Tan and B. Kapur (Sydney: Allen & Unwin, 1986).
15. Here I distinguish between "business cycles," in which the downturn involves a decline in economic activity, and "growth cycles," in which it involves a lower rate of growth than trend (but equal to or greater than zero).
  16. O. Morgenstern, *International Financial Transactions and Business Cycles* (Princeton NJ: Princeton University Press, 1959).
  17. The entire discussion here of synchronisation of business cycles and growth cycles is based on discussions with Trevor Evans, whom I thank, and on an unpublished paper by him (1998).
  18. P. A. Klein and G. H. Moore, *Monitoring Growth Cycles in Market-Oriented Countries: Developing and Using International Economic Indicators* (Cambridge, MA: Ballinger, 1985); G. Moore and V. Zarnovitz, "The Development and Role of the National Bureau of Economic Research's Business Cycle Chronology," in *The American Business Cycle: Continuity and Change*, ed. R. J. Gordon (Chicago: University of Chicago Press, 1986); R. Dornbusch and S. Fischer, "The Open Economy: Implications for Monetary and Fiscal Policy," in *The American Business Cycle: Continuity and Change*, ed. R. J. Gordon (Chicago: University of Chicago Press, 1986). Michael Artis and colleagues demonstrate the degree and pattern of synchronisation from 1961 through 1993 in M. Artis, Z. G. Kontolems, and D. R. Osborn, "Business Cycles for G7 and European Countries," *Journal of Business* 79, no. 2 (1997): 249–79.
  19. A. K. Swoboda, "Exchange Rate Regimes and European-US Policy Interdependence," *IMF Staff Papers* 30 (1983): 75–102; A. MacEwan, "Interdependence and Instability: Do The Levels of Output in the Advanced Capitalist Countries Increasingly Move Up and Down Together?" *Review of Radical Political Economics* 16, nos. 2/3 (1984): 57–79; D. Checchi, "Economic Interdependence and Structural Change: An Investigation on Business Cycle Transmission," *International Review of Applied Economics* 3, no. 1 (1989): 57–88; S. Gerlach, "World Business Cycles Under Fixed and Flexible Exchange Rates," *Journal of Money, Credit and Banking* 20, no. 4 (1988): 621–32; W. D. Lastrapes and F. Koray, "International Transmissions of Aggregate Shocks Under Fixed and Flexible Exchange Rate Regimes: United Kingdom, France and Germany 1959 to 1985," *Journal of International Money and Finance* 9 (1990): 402–23. One study which, unusually, does not identify the existence of increased synchronisation since 1973 is M. Baxter and A. C. Stockman, "Business Cycles and the Exchange Rate Regime: Some International Evidence," *Journal of Monetary Economics* 23 (1989): 377–400.
  20. The degree of divergence between purchasing power parity (PPP) and actual real exchange rates can be measured by the speed of adjustment to new PPP values after a shock, which has been calculated as being as slow as a reaction with a half-life of 4.2 years. K. A. Froot and K. Rogoff, "Perspectives on PPP and Long Run Real Exchange Rates," in *Handbook of International Economics*, eds. G. Grossman and K. Rogoff (Amsterdam: North Holland, 1995); K. Rogoff, "Traded Goods, Consumption Smoothing, and The Random Walk Behaviour of the Real Exchange Rate," *Bank of Japan Monetary and Economic Studies* 10 (1992): 1–29; K. Rogoff, "The Purchasing Power Parity Puzzle," *Journal of Economic Literature* 34 (1996): 647–88.
  21. However, in a study of 15 developing countries from 1969 to 1987, Haque and Montiel find that the divergence from perfect uncovered interest parity is low; in 10 out of the 15 the coefficient measuring the degree of uncovered interest parity is not significantly different from full parity but is significantly different from no parity. However, their results are not direct estimates relating actual interest rates to uncovered interest parity values, but are sensitive to the specification of the money market. The country sample consisted

- of Brazil, Guatemala, India, Indonesia, Jordan, Kenya, Malaysia, Malta, Morocco, Philippines, Sri Lanka, Tunisia, Turkey, Uruguay, Zambia. N. U. Haque and P. Montiel, "Capital Mobility in Developing Countries: Some Empirical Tests," *World Development* 19, no. 10 (1991): 1391–98.
22. For a survey of tests of ICAPM, see J. A. Frankel, "Introduction," in *The Internationalization of Equity Markets*, ed. J. A. Frankel (Chicago: University of Chicago Press, 1994), 1–20; for measures of divergence from the law of one price using an Arbitrage Pricing Model, see R. A. Korajczyk, "A Measure of Stock Market Integration for Developed and Emerging Markets," *The World Bank Economic Review* 10, no. 2 (1996): 267–89; for an overall assessment, see L. Harris, "International Financial Markets and National Transmission Mechanisms," in *Managing the Global Economy*, eds. J. Michie and J. Grieve-Smith (Oxford: Oxford University Press, 1995).
  23. K. R. French and J. M. Poterba, "Investor Diversification and International Equity Markets," *American Economic Review* 81 (1991): 222–26. Similar figures for 1990 are presented in L. Tesar and I. Werner, "Home Bias And High Turnover," *Journal of International Money and Finance* 14 (1995): 467–92.
  24. Jeffrey Williamson also compares the globalization of the pre-1914 period with that of the late twentieth century and contrasts both with the years in between, when economies were more divided. However, he dates the recent processes of globalization as beginning in 1950. J. G. Williamson, "Globalization, Convergence, and History," *Journal of Economic History* 56, no. 2 (1996): 277–306.
  25. World Bank, *Private Capital Flows to Developing Countries: The Road to Financial Integration* (New York: Oxford University Press, 1997), 12. The twelve main recipients in decreasing order were China, Mexico, Brazil, Korea, Malaysia, Argentina, Thailand, Indonesia, Russia, India, Turkey, Hungary.
  26. IDE/JETRO, *Can Asia Recover Its Vitality? Globalization and the Roles of Japanese and US Corporations* (Tokyo: Institute of Developing Economies, 1998).
  27. M. Sako, *Prices, Quality, and Trust: Inter-Firm Relations in Britain and Japan* (Cambridge: Cambridge University Press, 1992).
  28. Johanna Boestel has noted that several studies show similar types of firms existing in western industrial clusters, as in Emilio Romana, for example. For a discussion of their prevalence elsewhere, see J. Humphrey and H. Schmitz, "Trust and Inter-Firm Relations in Developing and Transitional Economies," *Journal of Development Studies* 34, no. 4 (1998): 32–61. However, the argument in the text rests on the assumption that such forms are not typical of advanced industrialised economies in the West.
  29. IDE/JETRO, *Can Asia Recover Its Vitality?* compares the networks of Asian firms and the rather different type of relations built by U.S. firms in Asia.
  30. S. Greenhalgh, "Families and Networks in Taiwan's Economic Development," in *Contending Approaches to the Political Economy of Taiwan*, eds. E. A. Winkler and S. Greenhalgh (Armonk, NY: ME Sharpe, 1998); G. G. Hamilton, "Organization and Market Processes in Taiwan's Capitalist Economy," in *The Economic Organization of East Asian Capitalism*, eds. M. Orru, N. Woolsey-Biggart, and G. G. Hamilton (Thousand Oaks, CA: Sage Publications, 1997); Siu-lun Wong, "The Chinese Family Firm, a Model," *British Journal of Sociology* 36, no. 1 (1985): 58–72; G. Redding, "Weak Organization and Strong Linkages: Managerial Ideology and Chinese Family Business Networks," in *Business Networks and Economic Development in East and South East Asia*, ed. G. Hamilton (Hong Kong: University of Hong Kong, Centre of East Asian Studies, occasional papers and monographs, no. 99, 1991.)
  31. I am indebted to Johanna Boestel for discussion of these points.
  32. R. Dore, "Goodwill and the Spirit of Market Capitalism," *British Journal of Sociology* 34, no. 4 (1983): 459–82.

33. An example, within a single country, might be the continued nonintegration of Italy's Mezzogiorno with Northern Italy, for absence of economic convergence is mirrored by continuing differences in the modes of operation of firms and other organisations. The formal model referred to in the text is contained in an unpublished paper by Luca Deidda, "Endogenous Interregional Disparities in Banking Efficiency and Regional Long-Run Development," SOAS, 1998. I am indebted to Luca Deidda for many discussions of this and related issues.
34. I am indebted to Bassam Fattouh for discussions on this point and a comparison of alternative models of the economics of distance, such as "gravity models."
35. J. F. Helliwell, "The Scope for National Policies in a Global Economy," working paper, 1 July 1999; available at <http://www.arts.ubc.ca/econ/helliwell/pages/papers.htm>.
36. K. Ohmae, *The End of the Nation State: The Rise of Region Economies* (New York: The Free Press, 1995).
37. D. Rodrik, "How Far Will International Economic Integration Go?" *Journal of Economic Perspectives* Winter (2000).
38. The main studies that have not been able to reject the null hypothesis that no such relationship exists are R. A. Meese and K. Rogoff, "Was It Real? The Exchange Rate-Interest Differential Relation over the Modern Floating Rate Period," *Journal of Finance* 43 (1988): 933-48; H. J. Edison and B. D. Pauls, "A Re-assessment of the Relationship between Real Exchange Rates and Real Interest Rates: 1974-1990," *Journal of Monetary Economics* 31 (1993): 165-76; and others evaluated by P. Isard, *Exchange Rate Economics* (Cambridge: Cambridge University Press, 1995).

# Economic Policies and External Performance in Southeast Asia and Sub-Saharan Africa

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## Introduction

The trade structure of four Southeast Asian countries – Indonesia, Malaysia, Singapore, and Thailand – has been dramatically transformed in the last three decades to reflect their evolving comparative advantages. Radelet and Sachs<sup>1</sup> note that, despite the recent turmoil in these economies, the basic structure for participating in world trade remains essentially sound. It was the form and scale of financial integration into international capital markets that triggered the recent currency and general economic crisis and exposed the vulnerability and fragility of these Southeast Asian economies.

In Sub-Saharan Africa, on the other hand, although optimistic views regarding the future of the continent emerged in the 1990s,<sup>2</sup> many countries have not succeeded in laying a solid foundation for long-term sustainable growth and development. Probably, the weak foundation of these economies can be more vividly shown in their modes of international linkages. By the early 1990s, the failure to diversify export structure and attract foreign direct and portfolio investment flows had left the continent virtually bypassed by the dynamic forces that have swept the international trading and financial systems with the aid of advanced information and telecommunication technology. Fears have been frequently expressed that Africa will continue to be “marginalised” in the process of global integration and formation of a new international order.

Numerous factors, encompassing diverse internal and external conditions as well as the spectrum and implementation context of economic policies, must have given rise to the divergent paths of economic development and differential external performances of the two regions. An in-depth comparative study is required to examine and discern clearly these factors and conditions.<sup>3</sup> This is particularly so in view of the fact that some of the policies that are reputed to have worked in East Asian countries have also been applied in Sub-Saharan African (SSA) countries, with different outcomes. Indeed, before the adoption of Structural Adjustment Programmes in response to severe economic crises in the 1980s, SSA countries had had a mixed bag of various liberal and interventionist policies. Intervention in the industrial sector was widespread, as was the case with the financial sector in the 1960s and 1970s. In the case of SSA, however, intervention has never been so positively evaluated as it has been in East Asia, where it has been now explicitly acknowledged that government interventions have been systematically applied to address market failures, as exemplified by the World Bank's *East Asian Miracle* study.<sup>4</sup>

However, as Jomo et al.<sup>5</sup> correctly stress, the *East Asian Miracle* study distinguishes subtly between the "success story" of the Southeast Asian economies and that of the Northeast Asian economies. In contrast to the prevalence of selective intervention in achieving late industrialisation over a short-time horizon in the Northeast Asian economies, the second-tier Southeast Asian NICs are seen to have achieved rapid growth and industrialisation without resorting to interventionist industrial policy, as in Thailand, or by abandoning it, as in Malaysia and Indonesia.

Furthermore, the *East Asian Miracle* study rejects the replicability and appropriateness of interventionist policies, as applied in some "successful" Northeast Asian economies, in other developing countries. It argues that the success of the interventionist models in these economies was owed to special initial conditions such as human resource endowments. In particular, the study emphasises that an essential prerequisite for pursuing contest-based resource allocation, i.e., a high-quality civil service with the capacity to monitor in isolation from political interference, is typically absent in other settings. Instead, the study attaches a lot of importance to "getting the basics right" with emphasis on macroeconomic fundamentals, while keeping "price distortions within reasonable bounds" and keeping the economies "open to foreign ideas and technology."<sup>6</sup>

This chapter examines the critical interrelationships between economic policies and external performance of the two regions in a comparative perspective for the period 1965–96, in search for answers to such questions as: "What works when, where, and under what conditions?"<sup>7</sup> Here we focus our analysis on the period 1965–96, for which the differences in

economic performance of the two regions are specifically attributed to policy “differences.”<sup>8</sup>

The chapter is structured as follows: In Section 2 we compare East Asia and Sub-Saharan Africa in terms of initial conditions and resource endowments in order to set a context for comparative analysis of the two regions in the subsequent sections. In Section 3, we provide some statistics of external performance, as well as the differences in the degree and forms of integration into the global economy for the period 1965–96. In Section 4, we discuss the internal and external conditions that have historically influenced the development policy orientation of the two regions in relation to international transactions. In Section 5, we examine trade policies, policies towards foreign investment, and industrial and technology policies in a comparative perspective.<sup>9</sup> Section 6 presents some concluding remarks.

## Initial Conditions and Endowments<sup>10</sup>

There are a number of differences and similarities between East Asia and Sub-Saharan Africa in initial conditions and endowments. In relation to natural resource endowments, the following conditions could be noted:

- East Asia covers one of the most densely populated areas, while on average Sub-Saharan Africa is among the least densely populated, resulting in a considerable difference in people-to-land ratios with significant implications for farming techniques and agricultural development in the two regions.<sup>11</sup> The agricultural sector in East Asia is characterised by elaborate irrigation systems and the use of high yielding techniques and crops. In contrast, in Africa the increase of food supply has been met largely by expanding sown acreage.
- In both regions, small farmers dominate agriculture. However, rural infrastructure is more developed in Asia, where ecological conditions are also more favourable. As Collier and Gunning note, in SSA “soil quality is poor and much of the continent is semiarid, with rainfall subject to long cycles and unpredictable failure.”<sup>12</sup>
- A large number of countries in both regions initially specialised in export crops. However, unlike many African countries, Southeast Asian economies invested resource rents in agricultural research and extension and rural development projects.
- Several countries in SSA and Southeast Asia are also endowed with rich mineral resources. At independence, their export earnings were mainly from primary commodities. However, export structure is presently very different between the two regions. In 1996 manufacturing exports accounted for 51%, 76%, 73% in Indonesia, Malaysia, and

Thailand, whereas structural changes on such a scale have hardly been observed in SSA.

These stylised facts lead to some observations. First, as in most of SSA economies, Southeast Asian economies are relatively rich in natural resources in contrast to resource-poor economies of Northeast Asia. This difference in relative resource endowments has had a pronounced effect on the choice of development strategies in the two subregions. Resource-poor Northeast Asian countries faced a much more compelling urgency to upgrade a skill and knowledge base of human resources in order to participate in international trade with viable balance-of-payments positions. In contrast, in Southeast Asia, a strong urge for industrialisation was slower to emerge. Resource rents captured by governments from exporting primary commodities were long available to finance infrastructural development and social services and to legitimise the role of states in redistribution and “nation building.”

Furthermore, the availability of resource rents has invariably given rise to conditions of soft-budget constraints leading to inefficient deployment of resources. In Southeast Asia, the process of allocation and distribution of rents has proliferated political patronage and clientelism as well as unproductive resource-based rent politics, such as timber politics and land politics.<sup>13</sup> Eventually, the high volatility and the subsequent sharp decline of commodity prices in the 1970s and 1980s shook this sense of complacency and induced a push towards labour-intensive, export-oriented industrialisation. In SSA, Collier and Gunning<sup>14</sup> suggest that the availability of large mineral resource rents has turned politics into a contest for rents, encouraged “loot-seeking” activities, and increased the risk of civil war in some cases.

Nonetheless, the Southeast Asian experiences refute a naïve version of the “resource curse” thesis, which postulates that rich natural-resource endowments could be a curse rather than blessing. According to this thesis, natural resource-rich economies are subject to large external shocks through terms of trade volatility and tend to suffer from a Dutch-Disease phenomenon during the boom period because of real exchange rate appreciation. The experience of resource-rich Southeast Asian economies, however, suggests that, while the difficulty in managing the resource-based economies over the commodity price cycle is real, the “curse” could be turned into a blessing if resource rents were cycled into productive investment to upgrade human resources and infrastructure or rural development, all of which should expedite the process of diversification of economic structure. Clearly, the postulated negative relationship between resource endowments and economic growth is neither unconditional nor universal.

Second, while both Southeast Asia and SSA adopted import sub-

stitution policies soon after independence, the trade-and-production structure today is very different between the two regions. This can be largely explained in terms of the subtle variance in the overall trade-and-investment regimes as discussed in Section 5 below.

Third, the interregional comparison of initial conditions repudiates most of the “destiny” factors listed by Broom and Sachs<sup>15</sup> and Sachs and Warner<sup>16</sup> for explaining Africa’s slow growth. Southeast Asia and SSA are easily comparable in such conditions as their location in the “tropics,” relative resource endowments, life expectancy, growth of the working age population, and total population. Yet economic growth in Southeast Asia has been much higher. On the other hand, whilst some SSA countries were disadvantaged in terms of being landlocked, the majority of them were constrained by their small market size. These conditions made the affected countries handicapped in high transport costs or political barriers for accessing export markets, or in achieving the minimum scale of production on their own.

When one turns to human-resource endowments, SSA countries certainly lag behind East Asian countries, in terms of either the level of formal education or the experience of “learning by doing.” In Northeast Asia, education at all levels has expanded rapidly, and a universal primary education had been attained by the early 1960s. Southeast Asian economies had to start with the lower level of endowments.<sup>17</sup> In Indonesia, near-universal primary education was achieved only by the mid-1980s, while the enrolment ratio for secondary school reached 42% in 1995. Thailand and Malaysia reached universal primary education earlier than Indonesia, while gross enrolment ratios at the secondary level remained low, at 37% in Thailand and 56% there in the early 1990s.

SSA countries also made an impressive expansion in primary education in the 1960s and 1970s from the very basic level attained under colonial rule. However, this progress has been hampered by fiscal retrenchments required for stabilisation objectives in the 1980s. By 1989 the enrolments in primary school and secondary school had reached 69% and 18% of the grade school population, respectively.

In terms of accumulated experiences of running governments, enterprises, and commerce, initial conditions in SSA are seen as disadvantaged, again more comparable to those that prevailed in Southeast Asia, where Chinese (and Indian in Malaysia) ethnic groups dominated key economic sectors at independence. Africa faced similar conditions as local ethnic minorities, such as Indians in East Africa and Lebanese in parts of West Africa, had a dominant position in commerce and industry. In contrast, conditions in Northeast Asian countries were characterised by a high degree of ethnic homogeneity.<sup>18</sup>

With regard to social development, such as infant mortality and life expectancy, the difference in initial conditions between SSA and the most



dynamic Northeast Asian economies was considerable, and the advances made in SSA in this area over the last four decades have to be duly recognised.<sup>19</sup>

Referring to institutional legacies and human resource endowments, which are partly reflected in these indicators, many tend to dismiss the relevance of the development experience of Northeast Asian economies for Africa in one stroke, as discussed above in reference to the *East Asian Miracle* study.<sup>20</sup> Other studies, such as those by Lindauer and Roemer,<sup>21</sup> argue that Southeast Asia, in preference to East Asia, would be a good model for Africa. Similarly, Perkins and Roemer argue that the natural and human resource endowments of Southeast Asia a few decades ago and those of Sub-Saharan Africa today have enough in common to make the comparisons meaningful, while the two regions also share common features with respect to inherited political institutions and systems. They argue, on these grounds, that African countries should emulate Southeast Asian economies that have followed market-based economic policies.

These inferences are misleading on several accounts, however. First, as Chang<sup>22</sup> argues, an interpretation of initial conditions requires great care. Many arguments made so far depend partly on the cutoff date for comparison. After examining a large number of different “endowments” indicators over the longer historical period, he concludes that, except for a few indicators, the East Asian countries were not exceptionally well placed to have more successful development subsequently than other countries.<sup>23</sup>

What emerges from historical data since 1945 is the fact that the initial insignificant gap between East Asia and SSA in human-resource endowments has widened at the accelerated rate over the last five decades. These divergent historical experiences have to be explained by a careful empirical examination of the complex interactions in the two regions between policies, on the one hand, and, on the other, institutional governance structures and environments.

Secondly, equating Southeast Asian economies with a market-based laissez-faire model is simply not correct and would not stand a careful scrutiny, as we argue below in Section 5.

## External Performance and the Scope of Globalization in the Two Regions

Over the three decades since 1966, SSA and Southeast Asia have developed contrasting balance-of-payments profiles. While many countries in both regions have, from time to time, experienced significant deficits in their current account balances, the remarkable growth of manufacturing

exports and the accompanying significant changes of export trade structure are unique to Southeast Asia.

### *Trade Performance of Countries*

The average annual growth of exports over the period 1965–96 for selected countries of the two regions is shown in Figure 3.1. The divergence in export performance between the two regions became most pronounced in the period 1980–95, during which the role of rapid export growth in the industrialisation of Southeast Asia is widely acknowledged.<sup>24</sup> While the export of goods and services grew by only 1.9% in 1980–90 and by 2.5% in 1990–95 for SSA, the export growth rates in Southeast Asia were 8.8% and 13.5% in the respective periods. The current figures for SSA show a significant drop from the 1960s, when they grew by an average of 6% per annum. The average annual drop of 0.7% per year for SSA has been a sharp contrast to the performance of Southeast Asia.

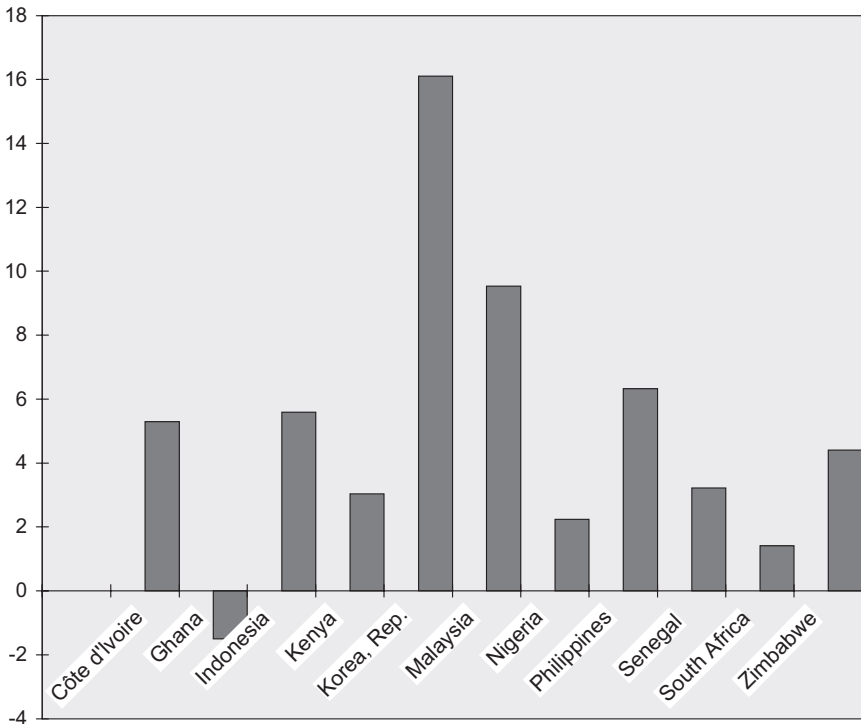


Figure 3.1 Average Annual Growth of Exports, 1965–1996

A number of the Southeast Asian economies managed to move from being primary export producers in the 1960s and 1970s to becoming major exporters of manufactured goods. Indonesia, Malaysia, and Thailand raised the share of manufactured exports from less than 6% in 1965 to 41%, 61%, and 77%, respectively, in 1992. For the period of 1980–95 these three economies sustained the average growth rate of manufacturing exports in an impressive range of 9% to 13% per annum (Table 3.1). In contrast, the share of manufactured exports for SSA countries hardly changed – 7% in 1965 and 8% in 1990.

What is indeed remarkable about the poor external performance of SSA economies is that they also lost ground with the export of primary commodities, as SSA's competitiveness in world markets decreased. The export of traditional export commodities such as cocoa, coffee, rubber, spices, tin, and tropical vegetable oils declined throughout the 1970s and 1980s. This happened at the same time as Malaysia, Indonesia, and Thailand raised their shares in the export markets for these commodities. While the export of primary commodities has declined in value for many SSA countries, they continue to dominate their external trade, accounting for 83% of all exports in 1970 and 76% in 1992. (See Table 3.2.) Since the rate of growth in trade for manufacturing goods and services was much faster than that for primary commodities (twice as fast for mining products and four times as fast for agricultural products), Africa's overall share in world exports fell from 2.4% in 1970 to 1% in 1992.

One of the critical factors responsible for the unchanging structure of SSA trade patterns has been the lack of openness in economic policies pursued over a much longer time span. SSA did not invest in enhancing export performance in the 1960s and 70s, when many countries followed inward looking import substitution policies. Because they did not invest in infrastructure to facilitate exports and did not develop appropriate export-enhancing policies, the competitiveness of the marginal SSA exports became completely eroded by the early 1980s, when various countries began to undertake economic reform programmes.

On the other hand, the rapid expansion of merchandise exports allowed East Asian countries to increase importing capacity. By selectively allowing in foreign products, they above all encouraged the introduction of new technologies, regarded as essential for supporting the exports drive. In contrast, despite the diminishing import capacity of SSA countries, their dependence on imported spare parts, equipment, and raw materials remains high, while the level of food self-sufficiency is alarmingly low.

### *World Integration: Globalization through Growing Trade Links*

The world has integrated the market for goods and services in several ways. The ratio of world trade to GDP has doubled since the 1960s. With

Table 3.1 ASEAN Industrialisation in Comparative Perspective

Country	Manufacturing Value Added (MVA), US Millions		Manufacturing Annual Growth Rate (%)		MVA as % of GDP		Manufacturing Export as % of Total Exports		Resource Gap	
	1980	1994	1980–1990	1990–1995	1980	1995	1980	1993	1981–1990	1991–1995
Indonesia	10,133	41,186	12.6	11.2	13	24	2	53	1.7	1.2
Malaysia	5,054	22,387	8.9	13.2	21	33	19	65	2.6	-1.3
Philippines	8,354	14,917	0.2	1.8	26	23	37	76	0.5	-7.4
Singapore	3,415	18,119	6.6	8.3	29	27	50	80	1.7	13.3
Thailand	6,960	40,791	9.5	11.6	22	29	28	73	-2.9	-5.3

Table 3.2 Structure of Merchandise Exports

Country	Merchandise Exports (\$ Millions)		Fuels, Minerals, and Metals % of Total		Other Primary Commodities % of Total		Machinery and Transport Equipment % of Total		Other Manufactures % of Total		Textile Fibres, Textiles, and Clothing % of Total	
	1980	1995	1980	1993	1980	1993	1980	1993	1980	1993	1980	1993
Côte d'Ivoire	3,130	3,939	–	15	–	68	–	2	–	15	–	–
Ghana	1,260	1,227	17	25	82	52	–	0	1	23	0	–
Indonesia	21,900	45,417	76	32	22	15	1	5	2	48	1	17
Kenya	1,250	1,878	36	16	52	66	1	2	12	17	3	3
Korea	17,500	125,058	1	3	9	4	20	43	70	51	30	19
Malaysia	13,000	74,037	35	14	46	21	12	41	8	24	3	6
Nigeria	26,000	11,670	97	94	2	4	0	0	0	2	–	–
Senegal	477	340	39	25	46	54	3	2	12	19	3	4
South Africa	25,500	27,860	33	16	28	11	4	8	36	66	4	3
Thailand	6,510	56,549	14	2	58	26	6	28	22	45	10	15
Uganda	345	461	1	–	97	100	3	1	0	–	2	–
Zimbabwe	1,415	1,885	23	16	39	48	2	3	36	34	1	11

Source: World Bank, 1997, World Development Indicators.

this expanding international trade, the ratio of merchandise exports to GDP rose from 11% to 18%, while the share of primary products in total world trade was halved and that of manufactures rose. Among manufactured goods, there has been a decisive shift towards trade in intermediate goods and a major growth in intraindustry trade. About 20% of the imports of many growing economies are for parts and components. It is estimated that close to a half of the world trade in manufactures passes through multinational corporations. The trade in services has grown even faster, as commercial service exports accounted for about 20% of world trade in 1996.

While these developments have taken place, the share of SSA in world trade has fallen from over 3% in the 1960s to less than 2% currently. If one takes out South Africa, this share is only 1.2%. As we discussed earlier, there has also been very little diversification. It is estimated that for SSA the erosion of its world trade share between 1970 and 1993 has meant a loss of \$68 billion, or 21% of GDP.<sup>25</sup> The poor integration of SSA economies into the global economy is reflected in Table 3.4 below, where we compare a number of SSA and Southeast Asian economies. In Korea, Thailand, and Malaysia, the various indicators of trade integration suggest greater integration, as the economies of these countries grew much faster than those in any SSA country. Trade as a percentage of GDP was as high as 70.2% in Malaysia in 1996 and only 21.5% and 20.7% in Nigeria and South Africa, respectively, two of SSA's largest economies.

As Table 3.3 indicates, the growth in real trade as a percentage of GDP was fastest in Malaysia and Thailand. Only Kenya recorded an impressive growth rate among the SSA countries. For SSA, real trade as a share of GDP declined by an average of 0.35 percentage points annually between 1980 and 1993, while it went up by 1.4 points for East Asia and the Pacific. However, export growth in Southeast Asia began to slow down in the mid-1990s. Except in the Philippines, export growth dropped sharply in 1996. The worst case was in Thailand, where the nominal dollar value of exports actually fell. This has been attributed by Radelet and Sachs<sup>26</sup> to overvaluation of exchange rates, the appreciation of the Japanese yen against the dollar after 1994, the competitive effects of Mexico's participation in NAFTA and the peso devaluation, and the worldwide glut in semiconductor production. It is important to emphasise the point, however, that the basic infrastructure for expanding output still exists in SE Asia.

### *Changing Tariff Structures*

A number of multilateral trade arrangements that emerged in the last three decades had the goal of encouraging and assisting nations to bring

Table 3.3 Integration with the Global Economy

	Trade % of PPP GDP		Trade in Goods % of goods GDP		Growth in Real Trade Less Growth in Real GDP percentage points	Mean Tariff All Products %	Gross Private Capital Flows % of PPP GDP		Gross Foreign Direct Investment % of PPP GDP	
	1986	1996	1986	1996	1986–96	1990–96 /a	1986	1996	1986	1996
Côte d'Ivoire	36.0	32.0	118.5	151.6	0.7	4.8	4.9	3.4	0.5	0.1
Ghana	11.0	15.3	44.6	126.6	2.4	–	1.9	2.4	0.0	0.4
Indonesia	10.7	13.6	55.0	69.7	1.3	13.2	2.0	2.1	0.1	0.8
Kenya	16.8	17.9	67.1	115.2	5.5	–	2.9	2.5	0.2	0.0
Malaysia	33.6	70.2	163.5	269.0	7.8	9.1	2.8	4.6	0.7	2.0
Nigeria	17.2	21.5	65.0	98.6	–2.0	–	11.2	12.4	0.4	1.4
Senegal	22.6	16.1	108.6	98.9	–0.6	–	7.7	4.5	0.3	0.4
South Africa	17.4	20.7	93.4	105.4	3.8	8.8	2.2	3.5	0.1	0.1
Thailand	14.7	31.3	85.8	138.2	6.9	–	1.6	5.0	0.2	0.8
Uganda	10.1	6.3	28.9	32.6	–0.2	–	6.0	1.8	0.0	0.6
Zimbabwe	13.8	19.8	76.1	139.1	3.6	24.3	2.0	3.8	0.1	0.2
Korea	33.6	46.7	115.0	118.0	4.5	11.3	3.5	11.1	0.8	1.1

Source: World Bank, 1998, World Development Indicators.

down trade barriers. Industrial economies were encouraged to reduce tariffs and open up their markets for exports from developing nations through a general system of preferences (GSP) and a number of other privileges under the special and differential (S&D) status. However, as a rule, SSA countries played rather passive roles in most of the negotiations leading to such agreements in the past.<sup>27</sup> This is attributed to the fact that “African countries have largely subsumed their own interests in multilateral trade negotiations under those of the global (G-77) coalition of developing countries.”<sup>28</sup> That approach, it is argued, led to SSA and other developing nations arguing for the privileges that went with special, differential status. But those benefits are observed to have accrued largely to the more advanced of the developing nations.<sup>29</sup>

As a consequence, for the Uruguay Round, SSA nations were reluctant to be bunched together with other developing nations, particularly the Southeast Asian economies, in the negotiation of privileges. While generally expressing a desire to liberalise trade, they still sought a special status, even if this was expressed in a confusing manner, with significant variations among countries. The end result has been that trade regimes vary extensively across SSA, and the degree of openness is lower than in other regions. Subsequently, “despite considerable reductions in trade barriers over the past decade, most African countries impose fairly high barriers through tariffs and export taxes or through managed exchange rate arrangements.”<sup>30</sup> Tariff levels in many SSA countries have been some of the highest in world trade. Even though there has been significant rationalisation of tariffs and the number of tariff categories, nominal average tariffs have not declined much in SSA, averaging 40% in the 1990s. In South Asia, these average 30%. Whereas the mean tariff on all products was 24.3% in Zimbabwe for 1990–96, it was only 9.1% in Malaysia, 13.2% in Indonesia, and 11.3% in the Republic of Korea. Côte d’Ivoire has one of the lowest in SSA, at 4.8%.

A major obstacle to unilateral trade liberalisation is the likely loss of tax revenue in the short run, which makes such a move appear tantamount to shooting oneself in the foot. In a number of countries, trade taxes provide more than 30% of fiscal revenue. Such revenues will remain crucial as long as the economy remains small and undiversified and a country is unable to undertake generalised tax reforms.

### *Globalization through the Flow of Private Capital*<sup>31</sup>

Table 3.3 shows significant growth in the flow of private capital to Southeast Asia as a percentage of PPP GDP in 1986–96. For Malaysia,



Korea, Thailand, the Philippines, and Indonesia, capital inflows increased from an average of 1.4% of GDP in 1986–90 to 6.7% in 1990–96. Table 3.4 shows some disaggregated data on private capital flows to selective countries in the two regions. In Thailand, banks borrowed as much as \$2,898 million in 1995, up from \$1,692 million in 1990. In Indonesia, while bank borrowing actually dropped dramatically in 1990–95, the growth of portfolio investments was significant, as investment in equities shot up from \$312 million in 1990 to \$4,873 million in 1995. The influence of the private sector in attracting these flows must be emphasised. Malaysian inflows averaged 9% of GDP and jumped to 15% in 1992 and 1993. Most of this was FDI, however. Malaysia attracted the largest amount of FDI among the Southeast Asian economies. While China is not shown in Table 3.4, we may note that China was the largest recipient of foreign direct investment (FDI) flows in 1995, attracting as much as \$35,849 million, when the entire developing world took in \$95,489 million.

Both push (global/external) and pull (domestic/internal) factors played a role in the surge in the flows into Southeast Asia.<sup>32</sup> For the world capital markets, financial innovation and capital account liberalisation in the industrialised countries facilitated a greater flow of funds to emerging markets all over. “New bond and equity mutual funds, new bank syndicates, increased Eurobond lending and other innovations allowed capital to flow across borders quickly and easily.”<sup>33</sup> Also low interest rates in the U.S. and Japan made the outward movement of investments rational and attractive. On the domestic front, the most important factor was the high economic growth achieved in the Southeast Asian region, making investors overconfident. Further, the attempts to deregulate banking systems in various countries made it easier for banks to tap into foreign capital markets. Additionally, the pegged exchange rates of the various countries ensured that investors could easily predict returns on investments with reduced exchange rate risks. All these conditions, however, turned out to be contributing factors towards the Asian crisis, with a massive capital outflow from the region in 1997–98.

In SSA, Nigeria is the largest recipient of FDI, but the investment is not diversified and is mainly restricted to the extractive sector of the economy, as is the case in Ghana. Africa’s inability to attract private capital is derived from the fact that it has not been “structurally able to assimilate these large flows.”<sup>34</sup> From the mid-1970s through the 1980s, monetary and fiscal policy in many SSA countries continued to be loose, while trade and exchange controls prevented the adjustment of the exchange rate. Unlike the situation in Southeast Asia, the deterioration in terms of trade, coupled with high inflation, ensured that the real exchange rates appreciated rapidly, resulting in significant macroeconomic instability.

Table 3.4 Private Capital Flows in 1990 and 1995

Country	Net Private Capital Flows \$ millions		Foreign Direct Investment \$ millions		Portfolio Investment Bonds \$ millions		Equity \$ millions		Bank- and Trade-Related Lending \$ millions	
	1990	1995	1990	1995	1990	1995	1990	1995	1990	1995
Côte d'Ivoire	57	36	48	19	-1	0	0	3	10	14
Ghana	-5	525	15	230	0	0	0	267	-20	29
Indonesia	3235	11468	1093	4348	26	2248	312	4873	1804	180
Kenya	124	-42	57	32	0	0	0	0	67	-74
Korea										
Malaysia	1799	11924	2333	5800	-212	2240	293	2299	-614	1585
Nigeria	469	453	588	650	0	0	0	6	-119	-203
Senegal	42	-24	57	1	0	0	0	0	-15	-25
South Africa	-	-	-5	3	-	-	0	4571	-	-
Thailand	4498	9143	2444	2068	-87	2023	449	2154	1692	2898
Uganda	16	112	0	121	0	0	0	0	16	-10
Zimbabwe	85	99	-12	40	-30	-30	0	18	128	71

Source: World Bank, 1997, World Development Indicators.

### *Aid in the Absence of Private Capital*

An issue of aid effectiveness has been debated in recent years, centred on the claim made by Burnside and Dollar<sup>35</sup> that aid has a positive impact on growth only in developing countries with good fiscal, monetary, and trade policies. Based on their cross-country regression analysis, Collier and Gunning<sup>36</sup> advanced the proposal for *selectivity* in aid allocation. While the findings by Burnside and Dollar have been subsequently challenged by Hansen and Tarp<sup>37</sup> on the technical ground, the rationale and implication of the “selectivity proposal” has also been seriously questioned.<sup>38</sup> In Africa, for example, Uganda and Ghana both achieved fast growth with a strong dose of structural adjustment and other reform measures, which acted as a catalyst for attracting aid. Indeed, without those substantial aid inflows, Ghanaian economic reforms could not have been pursued.<sup>39</sup> Aid facilitated considerable public investments in infrastructure and limited improvements in production and policy-making capacity. In an evaluation of aid effectiveness in Ghana, Aryeetey<sup>40</sup> suggests that the effect of aggregate aid on growth after putting in place a structural adjustment programme was significant, even if this effect was of a short-term nature. However, while showing a high “correlation” between aid flows and short-term growth, he concludes that aid was useful for the reform process but did not result in sustainable growth and long-term development.

Considering that the high-performing East Asian economies were once large recipients of ODA, the argument would follow that they were better able to make use of aid received than SSA countries. Japanese aid to Malaysia, in particular, has been credited for significant expansion of the infrastructural and industrial base of that country. That expansion helped Malaysia to be integrated into the global economy by facilitating the expansion of manufactured exports.

### *Technological Improvements and Globalization*

Attempts to increase and maintain international competitiveness exert constant pressure on exporters to search for new technologies as well as on governments to facilitate the process of introducing those technologies. The World Bank’s *East Asian Miracle* study stressed that “an important factor in East Asia’s successful productivity-based catching up was openness to foreign ideas and technology.”<sup>41</sup> Governments have encouraged improvements in technological performance by keeping a number of channels of international technology transfer open. In some countries, this was achieved through FDI, as in Malaysia at certain times in the 1970s and 1980s, while Japan and Korea had selective approaches

to FDI but aggressively pursued the transfer of most advanced technology through purchasing technology licenses and importing equipment, often in the form of patent rights, detailed drawings, operating instructions, etc.<sup>42</sup> “This selectively permissive attitude toward the acquisition of knowledge of international best practice was a reflection of the view that the world market for goods and services provided an opportunity not a threat.”<sup>43</sup>

In Malaysia, it has been suggested that flexibility in trade policy after the recession of 1985–86 had a dramatic effect on foreign investment. The new investments were directed toward electrical and electronic products, chemical products, rubber products, basic metal products, and petroleum. “In 1985, the thirteen American semiconductor manufacturers in Malaysia spent more than \$100 million training Malaysian workers, mostly engineers and technicians. Local value added has been rising as established firms upgrade their technology to keep up with world markets, and firms have added testing of semiconductors to their assembly activities.”<sup>44</sup>

The attitude of the East Asian economies is often contrasted with that of other developing regions that had a less open regime towards foreign technologies and ideas. “Suspicion of external trade was often reflected in a mistrust of FDI and licensing. Even where FDI was permitted in inward-oriented economies, it was not viewed as providing access to international best practice but rather as a source of additional domestic production.”<sup>45</sup> In many SSA countries, multinational corporations were treated with a great deal of suspicion throughout the 1970s and 1980s. They were regarded as being exploitative, seeking cheap labour to produce goods that would only be sold in Europe and America, with all or most of the benefits accruing to those companies. Quite a bit of the antipathy towards foreign investment was ideological as countries fought to expunge themselves of the memories of colonialism. Indeed, Kwame Nkrumah in the 1960s labelled the entry of multinational firms into African economies as “neocolonialism,” whereby the new firms operated as surrogates of colonial powers in maintaining their domination over the economies of Africa.<sup>46</sup>

## Internal Conditions and External Environments

Most countries in both SSA and Southeast Asia inherited previously colonised territories. The way they responded to this common condition varied a great deal, depending on a number of domestic and external pressures. Thus, the fact that SSA countries largely chose to limit their interaction with the world economy after independence in the 1960s was

a consequence of the general desire to reduce the dependence on the colonial powers and other powerful external economic forces.

### *Development Strategy and the Internal and External Conditions in SSA*

The typical African state has gone through a number of transitions with economic policy making since the 1960s. Aron<sup>47</sup> has described it as having evolved from the small but interventionist state at independence into the large socialist state from the mid-1950s to the mid-1970s. It then became the unsustainable state in the rest of the 1970s, suffering from external shocks that it was not equipped to deal with. In the 1980s, with structural adjustment, the state diminished in size, as reforms required fiscal prudence and the Bretton Woods institutions ensured this. In the 1990s the state became very fragile, having failed to achieve a number of the goals of reforms and being unable to deliver various services and resources to its people, leading to a loss of credibility.

Why did the small state at independence find it necessary to expand rapidly, and how did this affect its participation in world trade? Falola suggests that “the struggle for independence was at the same time a struggle for economic development. New leaders had to be judged by their performance in liberating people from poverty.”<sup>48</sup> There were two sets of ideas that were offered to new governments on how to achieve this, namely pragmatism and ideology.

### *Agricultural Transformation and Development*

Based on the fact that SSA was highly endowed with natural resources, in particular agricultural resources, many economists were for the idea of African economies investing in developing their agriculture to make it modern and competitive on the world market as the first stage in development. As part of the new development process, they were also expected to diversify their range of agricultural products. Processing manufactures and diversification into them were expected to come at a later stage. It is important to emphasise the point that for most traded primary commodities, such as cocoa, coffee, rubber, sisal, tobacco, gold, copper, bauxite, manganese, etc., SSA produced a major part of the total world output. Its comparative advantage in the production of these was beyond doubt. What remained crucial was how to add value to these commodities in the short-to-medium term without losing the comparative advantage in production. That process called for considerable human resources that had not been developed in the colonial era and major investments in technology. Envisaging that rising agricultural incomes would reduce the mass rural poverty, Arthur Lewis advised on the need

to build human capital through appropriate educational investments, as well as through other social commitments of the state, in order to achieve the agricultural transformation required. At the time many people were indifferent to the question of the ownership of the capital to be used in modernising agriculture.

While accepting the need for enlarged social expenditures in order to make up for what colonial governments had not delivered, many political leaders saw Lewis's first step, developing agriculture, as too slow a process. While exposed to low and volatile international prices for primary commodities, countries would still have to import essential capital, as well as intermediate and other expensive consumer goods from the former colonial powers. They therefore often only paid token attention to agriculture. To them, it made more sense to go into import substitution production.

### *Reducing Dependency through Import Substitution*

Import substitution production was important for creating amongst the broad masses of various countries a feeling of being on the path to self-sufficiency and modernisation. In addition, any suggestion for the gradual advancement of agriculture for exports was "severely attacked by 'the Marxists' who argued that international trade, dependency and capitalism were the primary constraints to development."<sup>49</sup>

In many countries, import substitution industrialisation was undertaken with state ownership of the capital. This was essential since dependence on foreign capital had to be avoided, except in cases where avoidance was not feasible. Even in those countries that were classified as capitalist, including Kenya, Nigeria, and Côte d'Ivoire, the state's participation in production was not marginal. In many instances the state went into partnership with the foreign companies that previously owned the enterprises, as did the Nigerian government with banks. In Ghana, the state nationalised all major foreign production and distribution enterprises and set up even more. The state found itself involved in mining, manufacturing, services, and sometimes in agriculture. It financed these by running down reserves, borrowing from private and public sources abroad, and obtaining technical assistance. The state's investment in agriculture in most countries was minimal, as it devoted more resources to manufacturing. The irony of the import substitution approach was that many of the firms established were highly dependent on imported raw materials, capital, and intermediate goods, leading to precariously high import dependence. Yet, as the firms were not intended to produce for exports, they could not generate adequate foreign exchange to finance the importation of inputs; consequently, they experienced significant difficulties with the operation of plants and major balance-of-payments

problems. The growth in exports that SSA recorded at the time came from the old investments in agriculture.

### *Economic Developments after 1970 and Reforms*

Over time the state has been weakened in most of SSA. It has become fragile, not trusted, and lacking in credibility in many places. Its fragility began in the 1970s when it failed to respond adequately to oil price shocks. Despite the commodity price rises in the latter part of the 1970s, the export earnings of most of SSA contracted in real terms as the terms of trade turned against agricultural exporting countries. These affected foreign exchange earnings and fiscal revenue. With this came the growing inability of the state to finance its investments as well as other public expenditures. While public expenditure was generally curtailed, recurrent expenditures on defence, public debt service, and pensions grew strongly. The subsidies paid to SOEs continued since employment levels had to be maintained. The difficulty in meeting these obligations undermined the state's authority extensively as economic growth slowed down.

By the beginning of the 1980s, per capita GDP in SSA of under \$450 was less than the figure of \$500 for the mid-1970s. Even though net transfers to the region had been higher than for other regions, SSA had to borrow more to feed the overbloated public-sector budgets. Increased borrowing to meet the continuing effects of oil price shocks and deteriorating terms of trade following commodity price dips created a significant debt problem. The problem with a large part of that borrowing was that it was not efficiently utilised. The macroeconomic problems with overvalued exchange rates and how they hurt exports are quite well documented. The erection of various tariff and nontariff barriers was often simply a means to take the allocation of foreign exchange and other productive resources away from the market and place it in the hands of the eroding state.

Structural Adjustment Programmes sought to correct the imbalance in most economies and put them back on a path to growth and development. Despite the fact that most countries undertook reforms in one form or another, many countries have had difficulty doing this on as comprehensive a scale as, perhaps, in Ghana and Uganda. Exchange rate realignment is pursued with a lot of support from the Bretton Woods institutions in many places. Fiscal deficits have come down by an average of 4% of GDP in many countries since the late 1980s. Restrictions on currency convertibility have been relaxed in a number of countries, and the share of foreign exchange allocated to the private sector has grown. To some extent, controls on markets and trade have been relaxed. Governments have sought to improve their capacity to manage their economies with reformed public sectors.

The World Bank's evaluation of the outcome of the reform effort indicated that no country had achieved a good macroeconomic framework by 1994. The fiscal stance remained fragile despite the improvements recorded. Regarding the monetary situation, the thin markets in most countries made indirect monetary management so difficult that tight monetary policies often meant very limited availability of credit to the private sector. While major improvements had been made in the price and trade reforms, a number of reversals had occurred in some countries, notably Nigeria.

The limited outcomes of the reforms of many countries have left the state, in some cases, even more fragile than before. Aid dependency has grown tremendously.<sup>50</sup> To ensure that aid continues to flow from both bilateral and multilateral sources, governments have had to accept conditionalities that effectively have reduced further the power of the state. Public institutions that are expected to manage the reforms are generally perceived to be very weak, therefore leaving significant room for the engagement of technical assistance to oversee regular tasks of the public services. Weak governments find themselves subject to pressures to appoint persons to run economic management institutions based mainly on political considerations. In the end, while the governments simply cannot do as they wish with foreign resources coming in as aid, their own ability to generate substantial returns is limited by the inefficient utilisation of human capacity. Weak governments find themselves inundated with "policy advice" from several sources but lack a mechanism for sifting through the advice in order to make optimal choices. They are therefore likely to make the wrong policy choices, since short-term political considerations are the main motivating factors. They have not developed mechanisms for restraining themselves in the misuse of the resources under their control. So parliaments and the legal system remain ineffective. The direction of economic policy has been left to small but politically active groups who are averse to the competitive environment.

### *Internal Economic and Political Conditions*

There were a number of sociopolitical factors that put pressure on governments to make the choices they made. Note that, by the policy choices, there developed an antiexport bias with heavier taxation of agricultural and mineral exports than was the case earlier. Also, agricultural producers were forced to sell crops through marketing boards and received real prices that were only a fraction of what were available to farmers in other regions. The private sector in a number of countries felt discouraged and frustrated, as the allocation of credit favoured state-owned enterprises and other rent seekers. The allocation of dwindling foreign exchange, as well as import licenses, seemed to follow the same pattern.



The above patterns were the result of various influences that distinct groups had on governments.

The main source of pressure on postindependence SSA governments has been urban workers. This has not been too surprising, as many of the early postindependence governments drew their strength from urban working populations that had greater expectations from independence. They had provided the support that was essential to resist colonial governments. For many, therefore, it was "pay-back" time. The state-owned enterprises were intended to employ many of them. Restrictions on the prices of agricultural products protected their consumption. Limiting trade with the rest of the world initially did not harm the workers so long as controls on domestic prices could be used to cushion them and they were more or less guaranteed their jobs. They drew support from left-wing political analysts and intellectuals who suggested that the only way to reduce dependence was to sever all trade links with the colonial powers. Increasingly, the workers' influence on ruling political parties was tightened and ideology became the main guiding principle in economic policy making.

The position of industrial entrepreneurs and traders has been quite ambiguous in a number of SSA countries. Most indigenous businessmen were simply involved as redistribution agents of foreign firms in the pre-independence days. Indeed, there is hardly any history of organised industrial production of goods beyond informal production, such as that by woodworkers and blacksmiths. This is partly to do with the fact that the old colonial businesses themselves did not produce any industrial goods. There was, therefore, no economic structure for developing a local modern entrepreneurial class. After independence, the early governments were in no hurry to develop such a class, particularly since it was considered to be exploitative under the Marxist doctrine that prevailed in a number of countries. The traders who had always dominated urban economic activity simply became agents of nationalised foreign concerns. When foreign exchange difficulties limited the importation of goods, they often became anxious, but they never reacted overtly. The allocation of import licenses became a tool for dividing their ranks, as those that supported the ruling parties found it easier to obtain such licenses and retail goods through other party supporters.

One way in which ethnicity has been used to influence SSA participation in world trade has been the extension of it into nationalism and its use to divide citizens of countries on the basis of "indigenes" versus "outsiders."<sup>51</sup> In Uganda, Idi Amin was able to ostracise Asian businessmen through a number of arbitrary means, leading to a collapse of entrepreneurship and participation in economic activity. In many countries ethnicity has led to conflicts that have made it impossible for proper

economic policy planning to take place. Ethnicity has often been used by politicians to hold on to power.

### *External Economic and Political Conditions*

From outside the continent, SSA's involvement in global trade has been influenced first by geopolitical considerations and ideological influences, external shocks of all kinds, multilateral trade agreements, and the kinds of regional groupings that countries have found themselves in.

The geopolitical considerations that influenced SSA's involvement in global trade came out of the East-West confrontation in the 1960s and 1970s. The conflict was played out in SSA in the form of ideological confrontations that later were reflected in divisions between military and civilian regimes, a division which often led to chaos in the development of economic and social policies. The colonial powers had sought to influence the types of governments that would replace them, planting less radical regimes that were likely to want to continue with established liberal policies that had favoured the status quo in trade relations. Where this practice failed, as in Guinea and Ghana, the early postindependence governments were superficially strongly opposed to the colonial powers, a factor which made it relatively easy for them to form alliances with Eastern-bloc countries. Such alliances marked the introduction of the several variants of Marxism that SSA came to be associated with two decades ago, e.g., in Tanzania.

The more protracted the struggle for independence the greater the likelihood of its attracting the participation of western and eastern interests, as in Angola, Mozambique, and Namibia. In places where radical pro-Eastern forces took over from the colonial powers, it did not take long for the West to attempt to exploit social and economic tensions that emerged in new nation states, as in Ghana and Zaire (Congo). Unattractive radical governments were often forcefully replaced by more pro-Western regimes. The worst example of this was Mobutu's Zaire. In francophone Africa, governments were likely to survive if they were strongly pro-France. The consequence was that francophone Africa's participation in world trade was dictated by its relationship with France, which determined its exchange rate under the CFA arrangements.

The entry of the military into SSA politics marked a new dimension in the East-West confrontation in the region. Several of the military governments that emerged in the 1960s and 1970s, often with western support, devoted little attention to the development of key institutional structures for effective economic policy making that would take into account the positions of their countries in relation to others, beyond the traditional colonial arrangements.

In effect, the outcome of the East-West confrontation was major polit-

ical instability in most of SSA for long periods, which was translated into significant economic instability, as the appropriate institutions for policy making were hardly developed. In a number of cases, the ideological confrontations became entangled with the ethnic divisions that led to civil wars and other ethnic strife. The civil war in Nigeria was a classic example. The long-drawn-out confrontations in Angola and Mozambique have been the results of similar divisions.

While SSA was embattled with problems of governance in the 1960s and 1970s, the situation became worsened by the oil price shock of the 1970s. SSA countries initially responded to the oil price shocks in one of two ways. Treating the situation as a temporary terms-of-trade shock, some borrowed from the international capital markets to support their balance of payments right from the beginning. The effect of this on their economies often depended on how open their systems were and how quickly the countries were able to adjust their export flows to the new foreign exchange requirements. For a larger group of countries, however, the initial response to the shock was to run down their reserves. How well they performed depended on the quantum of reserves they held before the shock and how quickly they adjusted exports. Balassa<sup>52</sup> has shown in studies of several developing countries that those countries that borrowed early and adjusted their export volumes and exchange rates appropriately were better able to deal with the shock in terms of overall impact on balance of payments. Most of the SSA countries studied did not fall into this category, however. Many first began to borrow from the reserves of the petrodollar holders after running down their reserves, which were scanty anyway. By the time their short-term debts became due, they had already been dragged deeper into a balance-of-payments crisis than had been the case earlier.

In the face of poor management of external reserves, mishandling of exchange rates, dwindling export volumes and values, and rapidly accumulating debt, the debt crisis marked a new development in SSA's economic history. As we saw in Section 2, the magnitude of the debts and the difficulties of their management were enormous. Governments sought rescheduling of debt as a means of gaining temporary respite from repayment problems. Arrears on debt repayment kept mounting. These difficulties prompted the private sector to cease lending to SSA countries by the beginning of the 1980s. The absence of such facilities forced many countries to withdraw even further from world trade. They simply lacked the means to sustain imports while their export capacity had diminished.

The absence of private capital in the 1980s increased the reliance on multilateral and bilateral government lending. It was this growing reliance and the growing threat of default on official multilateral and bilateral debt in many countries that prompted the Bretton Woods institutions to

change the conditions of lending. IMF lending, which had been processed according to very short-term standby agreements that incorporated stabilisation policies as well as project loans, in which conditionality was targeted at project preparation and evaluation, institution building, procurement, technical pricing, and marketing issues, was restructured to provide for more medium-term programmes and adjustment lending. It was this new structure that forced governments to pay greater attention to budget deficits, exchange rate policies, trade policies, etc., under reforms in the 1980s. But when halfhearted reforms or inadequate institutional setups for genuine reforms did not generate the expected supply response early enough, policy reversals became common without further contracting adjustment loans. Those countries whose reforms were underpinned by the favourable aid allocation, such as Ghana and Uganda, have accumulated a large enough external debt to be eligible subsequently for the HIPC initiative.

### *Development Strategies, Internal and External Conditions in Southeast Asia*

#### *Internal Sociopolitical and Economic Conditions in Southeast Asia – The Nature of State and State-Business Relationships*

The Southeast Asian economies were predominantly agrarian economies, endowed well with natural resources but with little experience of manufacturing during the colonial period, as in SSA. At the end of the war or at the time of independence, they did not carry out major agrarian reforms on the scale observed in Japan, Taiwan, and South Korea. Consequently, the agricultural sector is characterised by a peasant economy experiencing high population growth and inequalities in ownership as well as access to land and incomes. However, considerable investments were made in agricultural expansion and rural development in the subsequent years, and large amounts of labour were absorbed into the industrial sector as industrialisation proceeded rapidly after the 1970s.

Like SSA countries, nation states in Southeast Asia were also created as by-products of European colonialism, with the notable exception of Thailand, which was never formally colonised. Compared to the Northeast Asian economies, they are far less homogeneous in terms of ethnicity, culture, and religious heritage, which have undermined the emergence and sustenance of economic nationalism. This can be contrasted with the conditions found in Northeast Asia, where strong impulses and collective goals for catching up were well supported by economic nationalism and the sense of unity.<sup>53</sup> As Jomo et al.<sup>54</sup> argue, in Northeast Asian countries, industrial policy has been a variant instrument of economic nationalism used by developmental states, and nationalism, combined with their

strategic geopolitics in the postwar era, has long served as a key legitimising ideology for late industrialisation projects.

In comparison, in Southeast Asia, Booth argues, “[S]ubsidy allocations have seldom been tied to any credible performance criteria, but are usually made either on the basis of political cronyism, or to achieve noneconomic goals such as the promotion of indigenous (i.e. non-Chinese) business.”<sup>55</sup> Thus, the basis of developmental states is weaker in Southeast Asia, though successive governments in the region, as a rule, had to draw support on a developmental platform.

Booth also suggests that, while in Northeast Asia the success of the state has been due, in considerable measure, to the very active guidance provided by government agencies, in Southeast Asia successive governments have found the process of policy reform hampered by the need to appease different constituencies based on different regional, religious, or ethnic groups.<sup>56</sup> This need is similar to some of the pressures that SSA governments have had to contend with. She argues that the process through which states evolve away from the predatory model to produce an efficient, growth-promoting regime with property rights has not been completed; further she gives a verdict for Indonesia, “[T]he developmental state may in fact be simply a front for a predatory state.”<sup>57</sup>

Booth<sup>58</sup> presents other characteristics of governance structures in Indonesia, Malaysia, and Thailand. First, technocrats have had a considerable degree of autonomy in the area of macroeconomic management. Before the Asian crisis, the three economies were widely praised for maintaining macroeconomic stability in the presence of large external shocks. Second, effective alliances were forged from time to time among technocratic advisors, key politicians, and business groups to advance economic policy reforms.<sup>59</sup> Third, government “interventions in both capital and labour markets were crucial and often carried through at the instigation of, and with the full cooperation of, powerful industrial groups.”<sup>60</sup>

Against this general background, the transformation of resource-based agrarian economies to fast industrialising economies has taken place in the region. In Indonesia, the Suharto government, which consolidated itself on the basis of a developmentalist ideology and programmes, has been active and successful in rural development and agricultural extension programmes in achieving rice self-sufficiency and lower fertility rates. It has also been highly praised by the Bretton Woods institutions for its record in maintaining macroeconomic stability in the presence of large external shocks. It is well known that macroeconomic management was left to the “Berkeley Mafia,” i.e., the group of the technocratic elite who were well insulated from political pressures. However, industrialisation in Indonesia has always proceeded with strong state intervention and a large public sector.

Despite government promotion of a nationalist-corporatist-developmental ideology since the 1980s, “the overwhelming presence of the state and the power of politically influential business interests are seen to have constrained the emergence of more democratic and participatory corporatist processes.”<sup>61</sup> Rather, “the military leaders allowed politically marginalised and vulnerable Chinese to run very profitable private business enterprises to their mutual advantage.”<sup>62</sup> Despite a series of selective economic liberalisation policies implemented since the mid-1980s, it is observed that the degree of state intervention in economic activities has been increased rather than reduced in the 1990s, in association with a number of ambitious heavy industrialisation projects and Habibie’s highly publicised hi-tech projects.

In Thailand, governments were successively run by military-led regimes before a civilian-led government was installed in the 1990s. Shimomura<sup>63</sup> describes how General Sarit, who came to power by coup d’état in 1958, revitalised the economy by giving the top priority to the developmental mission with the strong support of Chinese businessmen. While political conditions continued to be fragile, the Thai bureaucracy, in the presence of the constitutional monarchy, served the continuity of the developmental mission. Private business interests have been promoted through the operations of the Board of Investment and influential business associations. Further, an effective governance structure was evolved, for example, under the Prem administration (1980–88), whereby mutual checks of five main power groups in Thailand (the army, the political parties, the technocrats, business, and the media) were effectively in operation to prevent serious abuse of power or corruption.<sup>64</sup> However, Jomo et al.<sup>65</sup> note that, while there has been little significant public antagonism to the economically powerful ethnic Chinese in Thailand, rival business interests are closely connected to politicians and generals, resulting in considerable clientelism in the political and economic decision-making processes.

In Malaysia, the government, dominated by the United Malays National Organisation, inherited a highly open trade-dependent economy with the relatively developed infrastructure from the British colonial administration. It encouraged natural resource-based industrialisation in rural areas by establishing public institutions for increasing the planting of rubber, palm oil, and other crops in the 1950s and 1960s. In the 1970s the government switched to more interventionist policies, actively using resource rents, which were significantly augmented by rents from petroleum and natural gas, to create a larger public sector with emphasis on state-led heavy industrialisation. Resource rents were also deployed explicitly for interethnic, redistributive purposes through the New Economic Policy. Therefore, the drive for state-led heavy industrialisation

was also seen as an effort to marginalise the ethnic Chinese business community.

Thus, reviewing the state-business relations, Jomo et al.<sup>66</sup> note the absence of strong corporatist arrangements in Southeast Asia compared to the prevalence of the national- and firm-level corporatism in Northeast Asia. More recently, notably after the economic and political crisis of the mid-1980s across the region, emphasis has shifted towards promotion of some corporatism involving private business interests. An example can be found in the establishment of the Malaysian Business Council in 1991, which was viewed as one of the manifested efforts to consolidate the “Malaysia Incorporated Policy” adopted in the early 1980s. Similar efforts to promote some corporatism are found in Singapore, where the private sector is increasingly consulted and represented in various consultative institutions and is on the boards of state-owned enterprises in the semblance of tripartisan structures involving employers and the ruling party and controlled trade unions.<sup>67</sup>

Economic liberalisation and privatisation policies implemented since the mid-1980s have served to limit some powers of the state in relation to the private sector. However, in the process, the interests of foreign business have been promoted above those of the local business community, while the privatisation programme in Malaysia was “captured” by dominant political interests and transferred to a small group of powerful businessmen.<sup>68</sup> In Indonesia and Malaysia, large conglomerates emerged, owned by individuals whose success owed far more to their political connections.<sup>69</sup> Generally, it is assessed that local entrepreneurs have not grown strong enough to advance effectively the agenda of late industrialisation.

While the power of local business enterprises remain rather weak, it is widely believed that Overseas Chinese traders have played a crucial role in generating dynamism in Southeast Asia.<sup>70</sup> They have developed extensive business networks and accumulated substantial capital, heavily relying on informal credit and contracts based on personal trust and kinship, rooted in culture and community sanction. Having networked well among themselves, they have managed to reduce transaction-, information- and other costs, as well as risks involved in cross-border economic transactions. At the same time, in relation to nationalist economic projects, their capital may be footloose, more integrated into the international circuit of Overseas Chinese or foreign capital. Since their business activities do not receive definite protection from the laws and regulations of nation states, the pattern of their investment is often governed by “short-termism,” stemming from insecurity against the general background of anti-Chinese sentiments. They tend to invest more either in financial markets, real estate, and other speculative, fast, and high-yielding

activities or in import-substituting manufacturing that receives state protection with certainty. As witnessed in recent months, adverse economic and political circumstances could lead to large-scale flight of ethnic Overseas Chinese capital.

*Contiguous Factors and External Conditions: Regional Dynamics and Regional Contagion Effects*

There is no doubt that one of the important external sources of simultaneous growth and structural transformation of the Southeast Asian economies is found in the pan-EastAsian “contiguous effects.” The Southeast Asian economies in recent decades have greatly benefited from dynamism associated with regional industrial restructuring. Industrial relocation within the East Asian region has definitely contributed a great deal to the export-oriented manufacturing boom of these economies. It has been driven by the response of Japanese firms, and, later, Korean, Taiwanese, and Singaporean firms, as well as European and U.S. multinationals, to a rapidly shifting comparative advantage and other differential regulatory conditions within the whole East Asian region.

In the 1970s, faced with rising domestic labour costs and energy-intensive, high-pollution industries, Japanese firms began to relocate labour-intensive and environmentally less acceptable industries to Southeast Asia. Hence, the first wave of Japanese investments in the region was mostly in resource-based activities, to secure resource supply, and in manufacturing, either to substitute imports in protected host markets or for labour-intensive activities to reduce wage costs. Together with large firms, small subcontracting firms in a *keiretsu* network began to relocate their production overseas.

In the mid-1980s, however, the new phase of relocation of Japanese firms was triggered and subsequently accelerated by the sharp yen appreciation and the increasingly publicised trade frictions that Japan experienced with the U.S. and European Union countries. Accordingly, this second wave of Japanese outward investment was directed much more into export-market-oriented manufacturing activities. Japanese large firms have become active in forming a regional manufacturing network as part of their characteristically outward-looking internationalisation and globalization strategy. A large-scale relocation of small firms to Southeast Asia continued, participating in this manufacturing network. Consequently, production lines have been increasingly organised across countries in the region, involving large intraregional flows of parts and components. The shares of Japanese investments in total foreign direct investments in Indonesia, Malaysia, and Thailand reached 32%, 29%, and 54%, respectively, by the early 1990s.



The other first-tier NICs have followed a similar path. After liberalisation of outward foreign investments by the government in the late 1980s, Taiwanese overseas investment accelerated, driven by its “southbound policy” to encourage relocation of labour-intensive SMEs to Southeast Asia. Taiwan was also motivated by its desire to gain access to the enlarged regional markets envisaged under the AFTA agreements. It has rather successfully localised its operations with ethnic Chinese firms in the host economies. South Korea also increased its foreign investment in Southeast Asia, as well as Vietnam and northeast China, in response to the won appreciation of 1987 and the repeal of restrictive labour regulation in 1987, with the resulting marked wage hike. Within Southeast Asia, investment by South Korean firms has been particularly concentrated in Indonesia’s export-oriented manufacturing sector.

It is clear in all cases that the relocation process has been under the explicit encouragement of governments in their effort to reshape and upgrade the industrial landscape of the home economies. For example, the relocation of Japanese firms has been congruent with their private business interests, as well as the planned sequence of phasing out “sunset” industries and supporting “sunrise” industries and technologies. Japanese official aid and loans were actively utilised to facilitate and finance the process of regional cross-border migration of industrial sites under the official “economic cooperation” programme.

Therefore, as Jomo et al. stress, the rapidly reshaping regional division of labour associated with FDIs by East Asian firms has not been simply a market-driven phenomenon but has been very much influenced by industrial and investment policies of the host economies, as well as their official aid allocation.

Indeed, the “flying-geese” thesis, advanced by Akamatsu in the 1930s as an economic explanation for Japan’s prewar foreign policy in East Asia, has been popularly used to provide an analytical perspective to the pattern of these recent regional development changes in East Asia. According to the thesis, each nation involved constantly cultivates “new areas of comparative advantage, resulting in a hierarchical, yet fluid division of labour among economies all striving to industrialise.”<sup>71</sup> This thesis is very much a variant of the product-cycle-trade theory, with emphasis on national location rather than industrial firms’ decisions as the unit of analysis.

Rowthorn<sup>72</sup> points out that this thesis exaggerates Japan’s role as a benign leader of flying geese, which portrays the East Asian development as an overly harmonious process of cooperation. However, there is no disagreement that direct investment flows by Northeast Asian firms have intensified and accelerated the process of the widening and deepening of

regional manufacturing networks within the context of regional economic integration and globalization. They have certainly been a strong force in creating regional dynamism in Southeast Asia.

However, this regional dimension of East Asian development can be a liability to economic management of countries involved in the downturn phase of economic activities. As witnessed in the current Asian crisis, a downturn has manifested itself as adverse regional *contagion* effects. Nidhiprabha<sup>73</sup> notes that when the Thai baht experienced a high volatility with its sharp devaluation in July 1997, a number of the Southeast Asian currencies were under severe attack by currency market dealers. This widespread contagion effect on currencies is explained by the similar export structure, the high volume of intraregional trade among these economies, and a fear of competitive devaluation. All countries in the region could not escape this adverse effect, plunging together into a crisis condition. The crisis affected countries such as Singapore, which did not exhibit problematic macroeconomic and financial indicators similar to those of Thailand. As Nidhiprabha notes, while the correlation between movements of the Southeast Asian currencies was low before the crisis, the correlation coefficients among them increased sharply to over 0.9 once the crisis set in, making it difficult for traders and investors to diversify risks by using regional currencies and assets in their portfolio.

## Differences and Similarities in Economic Policies towards International Trade Transactions

### *Sub-Saharan African Trade Policies*

#### *Inward-looking Strategies in the Pre-SAP Period*

The trade policy regimes that prevailed between the time of independence and the adoption of Structural Adjustment Programmes in SSA were generally highly interventionist and protectionist.<sup>74</sup> Imports were restricted by a web of inhibiting licensing systems; high tariffs were erected; escalated or cascading tariff structures made up of several layers, as well as varying degrees of import prohibitions and tight foreign exchange controls, were instituted. Exports were discouraged by substantial implicit and explicit taxes, including the adherence to exceedingly overvalued exchange rates, as well as the frequent use of nontariff barriers such as prohibition of certain export items. The regimes were truly inward looking, both on the import and export sides, so that many economies were locked in a permanently de-linked position from the world economy. The extent of SSA's integration into the global economy was kept to a minimum. Protections provided were neither time bound nor

performance linked. They could not be used as an effective means to graduate infant industries from protection. Little thought was given to a strategic dynamic path of the trade regimes, which should be evolved as industrialisation and economic development proceed. Further, trade policies were implemented in a “rather haphazard, incoherent, and internally inconsistent” manner.<sup>75</sup>

The overriding economic justification for adopting and maintaining such highly protective inward-looking trade regimes is twofold: fiscal imperatives and balance-of-payment considerations. With the extremely narrow tax base and the weak tax-collecting capacity, governments have been overly dependent on tax on international trade transactions for their fiscal revenue. Furthermore, politically locked into unrealistically overvalued, fixed-exchange-rate regimes, a burden of adjustment to recurrent balance-of-payment crises has tended to fall on the use of trade policy instruments. Thus, trade policy instruments have been overwhelmingly used for macroeconomic management, i.e., for attaining both internal and external balances. Since governments have been faced with repeated balance-of-payment and fiscal crises, the short-term double requirements of compressing imports while increasing trade tax revenue have dictated trade policies. Nontariff import barriers and controls have been extensively applied to reduce the import bill, while the level of tariffs and export tax has been kept high. Ironically, many reckon that the rates of international trade tax in SSA have far exceeded the revenue-maximising level.<sup>76</sup>

Importantly, under such conditions, the need for raising the export-earning capacity has been neglected. The omission of this long-term developmental perspective is extremely detrimental and, in many cases, fatal for foreign-exchange-constrained economies such as those of most SSA countries with their high dependence on imports for intermediate and capital goods. Thus, antiexport bias in this kind of trade regime was particularly damaging in having stifled the incentives of exporters, such as export cash crop farmers. This bias is one of the crucial factors behind SSA’s low degree of openness, measured as an export/GDP ratio. The share of exports for a medium-sized country in SSA declined from 24% in the 1960s to 22% in the 1990s, while this ratio doubled from 19% to 38% for countries in East Asia.<sup>77</sup> SSA’s share in world exports dropped from 3% in the mid-1950s to 1% in the mid-1990s, in contrast to the unprecedented expansion of world trade.<sup>78</sup>

While SSA countries failed by and large to participate in, and benefit from, one of most dynamic aspects of the postwar world economy, they could not shield themselves from the turbulence of the international economic system. Many cross-country studies on the long-term growth<sup>79</sup> found the low degree of openness to be the main reason for the slow-

growth performance of African economies. Further, Rodrik<sup>80</sup> reports that export taxation was a significant factor for explaining growth in his regression analysis, separately conducted for the worst growth performers in Africa.

Even though the choice of protective trade regimes was certainly made within the context of the import substitution development strategy, the absence of comprehensive, well-phased industrialisation programmes made trade policy instruments almost ineffective in achieving their developmental objectives. Except for Mauritius, whose performance is generally comparable to that of East Asia, it is hard to find a national programme which coordinated successfully and coherently trade policy with other complementary sectoral policy instruments, such as technology development policy, financial policy, or industrial/competition policy.

In the absence of appropriate coordination among trade, industrial, and technology policies, industrialisation strategies implemented in SSA did not have the required internal consistency and coherence, producing quite poor results. Despite the fact that industrial policy was supposed to address various forms of market failure, it was implemented without clearly identifying the sources and nature of market failure in the local/specific context. Rents were distributed without being tied to any objective-performance indicator. In reality, almost every form of rent, such as import licences, allocation of foreign exchange, subsidised credit, was mistakenly viewed and used as instruments for political favouritism. In practice, the *selectivity* embedded in industrial policy was not always decided according to developmental criteria. Rather, it often created opportunities for corruption and rent-seeking activities. Naturally, import-substituting industrialisation implemented under such environments failed to achieve the stated objective, i.e., technological development and dynamic competitiveness of indigenous industrial firms.

Without creating a congenial environment for indigenous industrial firms and entrepreneurs to emerge and grow, many African states turned to inward-looking, pan-African regional integration schemes to address the constraints posed by the small size of the domestic market. Indeed, the largest number of regional integration schemes is found in SSA.<sup>81</sup> Regional integration has been regarded as a viable way to achieve the benefits of economies of scale and greater specialisation without having strong links to world markets. However, many schemes suffer from the dearth of the prerequisites for their success, such as preexisting high levels of intragroup transactions; complementarities among member states in goods and factors of production; and potentials for product differentiation among member states. Consequently, so far, very modest increases in intraregional trade have been achieved through regional integration schemes. Having failed to establish appropriate compensation and en-

forcement mechanisms, member states are constantly engaged in negotiations without producing regional dynamics.

### *Trade Liberalisation Experiences and Policy Issues*

Given these historical experiences, it is not surprising to find that trade liberalisation carried a greater weight in the Structural Adjustment Programmes. Trade liberalisation aimed at shifting away from an inward-looking stance to a “neutral regime” without incentive-discrimination between “importables” and “exportables,” or, further, to an outward-oriented regime that could actively promote exports as well as attract foreign investment and facilitate technology transfer. In SSA the superiority of an outward-oriented regime over an inward-looking one has been increasingly accepted as a realistic, all-encompassing, growth-enhancing development strategy. In the absence of sufficient capital inflows, export expansion and the promotion of foreign direct investment (FDI) are increasingly viewed as the critical vehicles of technology transfer to individual firms and of technological spillover to the wider economy. They are also the primary source for financing the indispensable bottleneck-breaking and technology-bearing imports.<sup>82</sup> However, given the unfortunate past experience with industrial policy, they were discarded altogether. Neither industrial policy nor technology policy formed an essential part of the new “outward-oriented strategy.”

Oyejide also notes that there are four categories of trade liberalisation attempts in SSA:

- a) Trade liberalisation attempts induced by positive external shocks. They were typically temporary and partial shocks, caused by a commodity price boom, as found in Tanzania and Kenya during the coffee price boom of 1976–77 and in Nigeria during the oil boom of 1970–76. These experiences were often followed by more severe import controls to cope with the commodity price collapse that ensued immediately.
- b) “Own initiatives” that reflected internal policy dynamics. Examples of this type were found in Zambia and Tanzania during 1984–86 and in Ghana in 1967–72. They were based on the Own-Funded Import Schemes, under which importers were allowed to bring in goods without official foreign exchange allocation and any questioning about sources of financing. The “own initiatives” were instituted to ameliorate the generalised shortage of essential goods and to control inflation induced by illegal underground trade.
- c) Those liberalisation attempts associated with Structural Adjustment Programmes. They have been carried out across the continent, the single exception being South Africa. The pace, scope, and sequence of liberalisation were designed and shaped by the SAPs.

d) Those attempts designed and implemented in the context of specific regional integration schemes. These are multilateral attempts to reduce trade barriers and create preferential trade areas. Despite persistent attempts, these schemes have not been successfully implemented, as observed in the trade liberalisation schemes of ECOWAS and the PTA/COMESA. The member countries have been involved in more intense unilateral liberalisation embedded in the SAPs at the expense of the implementation of regional initiatives.

Trade liberalisation carried out as part of the SAPs is the most comprehensive and longest-sustained attempt in African postindependence history. Attempts have been made to compress and rationalise tariff structures with a sharp reduction of the average number of tariff categories and less-varied tariff rates. Consequently, the scope for discretion has been cut with the enhanced transparency of tariff policy. Nontariff barriers and quantitative restrictions have been eliminated in several countries and partly or fully ratified in many cases. The traditional reliance on trade policy instruments for balance-of-payments management has been reduced with shifts to flexible exchange rate systems to take the burden-of-payment adjustments. However, in many countries, trade procedures continue to be characterised by red tape and corruption, while trade monopolies continue to exist and export crops continue to be taxed.

Moreover, in the process of implementation, many reforming countries found it difficult to adhere consistently to trade liberalisation. The sustainability and credibility of trade reforms have become a worrisome issue in Africa. Frequent reversals have been observed in many countries. Either removed restrictions were reinstated, or some existing barriers were strengthened to offset reductions. For example, Nigeria, which eliminated the most quantitative restrictions (quotas and licensing), increased dramatically the number of import bans. Ghana, which previously made great strides in cutting formal tariffs, introduced large special taxes on imports. Indeed, both Nigeria and Kenya experienced virtually total reversals in 1994 and in 1986, respectively, while Kenya and Ghana have had a history of frequent reversals since the early 1970s. All these reversals are traced, by and large, to fiscal and balance-of-payments incompatibility.

Viewed from a political-economy perspective, the difficulties encountered in implementing trade liberalisation are attributed to the redistributive politics prevalent in Africa, i.e., the political imperatives to transfer wealth and rents from politically unorganised rural groups to vocal urban groups.<sup>83</sup> Beinen,<sup>84</sup> however, argues that self-interested government officials, rather than urban producers in import-substituting sectors, are the main opponents of trade liberalisation. Rodrik<sup>85</sup> offers an alternative thesis, arguing that a prime political factor explaining the re-

sistance to trade reform lies in the governments' inability to discipline themselves, rather than redistributive imperatives per se. He suggests that another factor is the uncertainty surrounding the identity of gainers from a new trade regime because of incomplete information.

While it is difficult to escape the political reality, it shows how important it is, in designing credible and sustainable trade reforms, to take into account conditions prevailing in Africa. A number of pressing issues should be addressed. For example, a practical issue arises from the difficulties of finding alternative secure sources of tax revenue and instituting efficient tax-collecting systems in the short-to-medium term, difficulties leading to perpetual fiscal imbalance. Further, balance-of-payments may worsen with a deep, generalised, and sudden import liberalisation, as witnessed already in many SSA countries.

Further, given this African reality, the pace, sequencing, and phasing of trade liberalisation have an important bearing on the sustainability of reforms. In view of the need to have a sustainable export revenue base in order to avoid recurrent balance-of-payments crises, export promotion policies should be instituted at an early stage of trade liberalisation before deep import liberalisation is implemented. For SSA, an immediate task for export expansion involves naturally rebuilding the primary commodity export sector and creating a capacity for processing export commodities. At the same time, raising competitiveness and technological capability of industrial and agroindustrial firms has to be addressed due to the pressing need for export diversification.

In this context, an issue of time phasing and sequencing of export promotion and import liberalisation measures should be considered in a medium-to-long-term perspective. For example, both Brazil and Argentina implemented reforms in two stages. During the first stage, lasting two to three years, commercial policies were geared to export liberalisation and promotion rather than competitive tariff reduction. After completing this phase only, tariffs were allowed to fall competitively in the second stage, yet still in a gradual and discriminatory fashion over two years. In this relation, Nash argues that "introducing export policy reforms shortly before, or at least at the same time as, import reforms permits an early export supply response and allows unification of the tariff structure to proceed without burdening exporters."<sup>86</sup>

Importantly, a premature de-industrialisation and an unsustainable high-import dependence for essential goods could set in if trade liberalisation is carried out without regard to the competitiveness of otherwise dynamic, successful domestic enterprises or farmers. A temporary and strictly time-bound protection for selective sectors and industries is surely justified for the "learning-by-doing" period on the infant-industry grounds, if industries and sectors are carefully selected in view of SSA's

dynamically evolving comparative advantage. Trade reform programmes have to be designed in the light of these practicalities as well as in the context of forward-looking development strategy. A well-formulated and coherently executed development strategy is called for in this context. Trade policy should be formulated and implemented as part of such strategy in conjunction with various sectoral policies such as technology development policy, financial policy, industrial and competition policy, as well as agricultural policy.

Given the unfortunate past experience with interventionist sectoral policies, most governments in SSA have opted for all-encompassing deregulation and liberalisation measures under Structural Adjustment Programmes. In the process, many critical sectoral policies were discarded altogether. Neither industrial policy nor technology policy formed an essential part of Africa's outward-oriented policy. In this aspect, SSA can draw direct lessons from the Southeast Asian experience, wherein export promotion and import substitution policies have been executed in a complementary manner, as discussed below.

### *Southeast Asian Trade Policies*

#### *Outward Orientation*

Most Southeast Asian countries started their quest for economic development at the end of the Second World War as open-traded economies, having long been linked to the world economy mainly as primary commodity exporters.<sup>87</sup> Thee Kian Wie notes that "whatever manufacturing activities there were in the ASEAN countries in the 1950s, they consisted mainly of resource-processing activities and light consumer goods industries catering to the domestic market."<sup>88</sup>

Following the example set by the Philippines earlier, Malaysia, Singapore, and Thailand initially adopted an import substitution industrialisation policy as their development strategy. Indonesia also introduced an ambitious state-directed industrialisation plan with the establishment of several large-scale, state-owned industrial plants. While Malaysia and Singapore relied mainly on tariff protection, other countries extensively used tariff as well as nontariff protection. However, as they were historically very open trading economies, import substitution strategies in Malaysia, Singapore, and Thailand were not pursued in an inward-looking a manner as in SSA or Latin America. In Malaysia, the anti-export bias of its trade regime was less, and tariff rates on manufacturing were low and relatively simple. Thailand's import substitution policy was known to be mild. The primary commodity sector was encouraged to develop as main sources of earning foreign exchange and was never penalised. Furthermore, while keeping import substitution policies for



industries catering to domestic markets, these three countries began, in parallel fashion, to shift a policy focus onto export promotion in the 1960s (Singapore and Malaysia) and 1970s (Thailand), when it was clear that an easy phase of import substitution was completed.

In contrast, Indonesia pursued a most inward-looking industrialisation. Backed with enhanced oil revenue and vast other natural resources, it made a strategic decision in the mid-1970s to pursue the second stage of import substitution, i.e., a heavy industrialisation involving the development of the basic resource-processing industries as well as engineering industries predominantly based on public-sector initiatives. Thee Kian Wie also notes that it was only after the end of the oil boom in the early 1980s that the Indonesian government felt compelled to shift to a more export-oriented strategy. However, substantial import protection was maintained, particularly for the ten designated state-owned “strategic industries,” including the high-tech aircraft industry.

Thus, the trade policy regime of these Southeast Asian economies remained open to the global economy even at the height of the import substitution phase, through exports of primary commodities or processed products. In contrast to governments in SSA, Southeast Asian governments actively intervened to diversify the range of primary exports and develop processing capacities to increase the exports’ value. By this intervention, these economies acquired new capabilities through learning, productivity growth, externalities, and scale economies.

Outward orientation was present throughout, maintaining strong trading links with the world economy. While industrial development was initially carried out under the regime of import substitution, the growth and diversification of industrial products were realised with the timely adoption of an array of export-promoting measures. Undoubtedly, it is the success of export promotion of selective manufacturing activities that has changed the industrial landscape of these economies.

However, it is important to note that the policy of export promotion was pursued at the same time that these economies maintained considerable protection for import-substituting activities. Therefore, it can be argued that export promotion and import substitution were the two equally critical pillars of their increasingly outward-oriented industrialisation strategy. By the time import liberalisation was commenced in the 1980s as part of trade reforms and economic liberalisation, many leading industries had been exposed to the best available technology, while some managed to acquire a critical mass of some sort of technological capability. Moreover, import liberalisation was carried out in stages to ensure soft landing for import-substituting industries. Clearly, import liberalisation was a much less painful exercise for the Southeast Asian economies than for SSA countries.

Furthermore, Hill<sup>89</sup> notes that in most of Southeast Asian countries, trade liberalisation was first applied to the export sector. He shows that “a dual trade regime has operated in which exporters have been placed on some sort of quasi free-trade footing, at least as it affects their raw material and capital goods imports, while maintaining substantial import protection. . . . They have been used as a transitional device *en route* to more general liberalisation.”<sup>90</sup>

#### *Export Promotion Efforts and Foreign Direct Investment*

A variety of policy instruments and measures were used to pursue export-oriented industrialisation in Southeast Asian economies, often involving extensive government intervention. As shown in Table 3.5, both Singapore and Malaysia opted for FDI-led industrialisation for export growth. Jomo et al.<sup>91</sup> explain this in terms of the political economy that prevailed in these two countries. Singapore wanted to attract foreign investment to ensure a continued international stake in the security and future of the country, even at the expense of discriminating against predominantly ethnic Chinese domestic capital. Malaysia invited foreign investors to limit and circumvent the expansion and accompanying influence of ethnic Chinese Malaysian capital.

Singapore not only was the first country to pursue a consistent export-oriented industrialisation strategy based on foreign direct investment, but it also made a determined effort to upgrade the country’s industrial structure and comparative advantage by encouraging foreign MNCs to invest in high-value-added industries. It also invested in upgrading technical skills to meet specific requirements by high-skill- and technology-

Table 3.5 Ratio of FDI Inflows to the Gross Domestic Capital Formation 1971–1993 (Annual Average)

Country	71–75	76–80	81–85	86–90	91–93
China	0.0	0.1	0.9	2.1	10.4
Hong Kong	5.9	4.2	6.9	12.9	5.7
India	0.3	0.1	0.1	0.3	0.4
Thailand	3.0	1.5	3.0	6.5	4.7
Korea	1.9	0.4	0.5	1.2	0.6
Malaysia	15.2	11.9	10.8	11.7	24.6
Philippines	1.0	0.9	0.8	6.7	4.6
Singapore	15.0	16.6	17.4	35.0	37.4
Taiwan	1.4	1.2	1.5	3.7	2.6
Indonesia	4.6	2.4	0.9	2.1	4.5

Source: Jomo et al., *Southeast Asia’s Misunderstood Miracle*, 14, Table 2.1, originally from UNCTAD, *World Investment Report* (various issues).

intensive industries.<sup>92</sup> As a result, Singapore managed to transform its industrial and export structures into high-value-added industries.

Malaysia has followed Singapore's footsteps by relying heavily on foreign direct investment in its efforts, consciously trying to upgrade and diversify its industrial and export structure by shifting its comparative advantage. For this purpose it introduced Export-Processing Zones (EPZs) on the west coast of peninsular Malaysia, i.e., on the island of Penang. These Zones usually allow firms to import on a duty-free basis, subject to the requirement that their entire output is exported. Firms in the Zones benefit from special infrastructure pricing and provision, relaxed labour laws, no restrictions on foreign ownership, and all-encompassing institutionalised protection for investors. As Hill notes in the case of Malaysia, the establishment of EPZs coincided with the rapid global growth of internationally integrated electronics production by a few MNCs. Since their inception, Malaysian EPZs have attracted a number of Japanese and U.S. MNCs to set up consumer electronics assembly plants as part of the relocation of their labour-intensive processes of the vertically integrated electronics industry to lower-wage countries such as Malaysia and Singapore, as discussed above.

However, Malaysian governments have consistently made strategic interventions to promote further upgrading into technology-based production with high-skill contents. As a result, in the 1990s, electronics and electrical products accounted for nearly 60% of Malaysia's manufactured exports, and Malaysia has emerged as the world's largest exporter of semiconductors and among the largest exporters of other electrical goods and electronics, such as disk drives, telecommunication apparatus, and audio and video equipment.

Nevertheless, it should be noted that, although EPZs were very successful operations for export-led industrialisation and generating employment opportunities for labour surplus economies, they have several drawbacks.<sup>93</sup> They tend to form "export enclaves" with few local linkages to the domestic economies. Furthermore, the manufactured exports of these enclaves are highly import intensive with a generally low level of local value added. There is always a danger of their becoming specialised in only assembly activities.

Thee Kian Wie<sup>94</sup> also points out that the Singaporean experience shows that these EPZs could, over time, develop local linkages with the domestic economy in line with the development of the technical capabilities of local supplier firms. In the case of the electronics industry in Singapore, since the early 1980s, the export-oriented MNCs have been able to establish vertical linkages with local input suppliers. In this respect, Malaysia's EPZs remained for some time export enclaves consisting largely of assembly operations, as Malaysia has been less successful in

fostering vertical linkages between the MNCs and local supplier firms, since the latter have not acquired sufficient capability in design and R&D. In this condition, Malaysia's industrial structure has long been dualistic, with limited linkage and technology transfer to local enterprises.

Before the mid-1980s, Indonesia and Thailand relied far less on FDI for export-oriented industrialisation. Indeed, in the early years, Indonesia openly adopted a hostile attitude and policy towards FDIs. After a brief period of open-door policies from 1967 to the mid-1970s, the Indonesian government placed restrictions again on FDIs, in the light of its embarked second stage of import-substituting industrialisation, led by a number of state-owned enterprises.

With less reliance on foreign investment, both Indonesia and Thailand opted for other measures for promotion of manufactured exports. Among them, duty exemption and drawback schemes were successfully used to create free-trade conditions for exporters. Bonded warehouses in Thailand enjoyed similar conditions through double tax exemption from both input and output, so long as the goods were destined for exports. Hill<sup>95</sup> notes a number of advantages of these schemes over the EPZs. They are relatively simple to administer. While firms are free to locate anywhere, there is no temptation for governments to either over- or underprice physical infrastructure.

Thus, in all cases, trade liberalisation was first applied to the export sector. A dual trade regime has operated, in which exporters have been placed on some sort of quasi free-trade footing for their raw material and capital goods imports, while maintaining substantial import protection. This regime was used as a transitional device en route to more general liberalisation.

In the case of Indonesia, the adjustable exchange rate system installed has been geared towards keeping the real effective exchange rate competitive. Thus, the Central Bank of Indonesia allowed the Indonesian rupiah to depreciate by 4–5% annually to offset the differential between Indonesia's higher inflation and the inflation rates of its major trading partners.<sup>96</sup> Also, in order to increase the value of exports, the Indonesian government banned exports of natural resources in unprocessed form. Under this enforced "export substitution," log exports and rattan exports were banned, and Indonesia has become a significant exporter of both plywood and rattan furniture.

Finally, in both Indonesia and Thailand, successive deregulation of investment in the 1980s led to a surge in FDI in export-oriented industries, initially mainly labour-intensive, low-skill industries, such as garment and footwear industries. This deregulation was largely facilitated by the beginning of a large-scale relocation of export-oriented, footloose, labour-intensive industries from South Korea, Taiwan, and Singapore. The FDI

in medium-technology goods also increased in the late 1980s, an increase induced by the second wave of Japanese foreign investment in the region. In this respect, regional dynamism, created by a region-wide industrial restructuring by East Asian MNCs and the deepening of regional manufacturing networks, is probably the most important factor for the boom of export-oriented manufacturing industries in Southeast Asia since the late 1980s.

Nevertheless, our discussion above confirms that, in all cases, extensive state interventions in facilitating export growth were instrumental in the remarkable success in trade- and investment performance in Southeast Asia.

### *Weakness in the Industrialisation Pattern*

In contrast with the undisputed success brought about by export promotion policy in the region, many tend to agree with the unfavourable verdicts frequently made regarding the record of industrial policy. Hill concludes that industrial policy lacked coherence in all three countries examined: Indonesia, Malaysia, and Thailand. Thus, he argues that “promotional measures have been prone to abuse; implementation has been sporadic and often short-lived; and there has been little systematic attempt to prescribe conditionality, in the sense of linking incentives to tightly defined performance criteria.”<sup>97</sup>

The poorer performance and the fragmented character of industrial policy in Southeast Asia, compared to those policies found in Northeast Asia, surely reflect the limited institutional capacity for effective and sophisticated sectoral interventions, as well as the sociopolitical conditions that prevailed in these economies. In the absence of a coherent industrial and technology policy, Thailand and Indonesia were not well equipped to seize the opportunities offered by potential dynamic comparative advantages. Malaysia has developed a dualistic industrial structure, as Jomo et al. claim: “Manufacturing was often disembodied from the rest of the national economy, and the ISI-EOI divide within the sector came to be reflected in a certain industrial dualism.”<sup>98</sup>

However, Jomo et al.<sup>99</sup> argue that the failure of industrial policy has a lot more to do with the fact that the policy has been generally misused for meeting a hidden agenda, i.e., for redistributive ends, mainly at the behest of politically influential business interests and interethnic redistribution, as the authors observed in Malaysia and Indonesia. Jomo et al. summarise well the conditions that support their argument:

In Malaysia and Indonesia since independence, the regimes have been preoccupied with constraining Chinese wealth expansion and enhancing accumulation by

politically influential “indigenous” rentiers. Regime stability in both Malaysia and Indonesia has also enhanced the opportunities for wealth accumulation by the politically well connected. In Thailand, both military and elected regimes have been [affected] by varying degrees and types of rentier activity, characterised as clientelist patrimonialism. It can be argued that these circumstances compromised policy priorities, which have compromised the contribution that state intervention, especially industrial policy, might otherwise have made to late industrialisation.<sup>100</sup>

Thus, in Southeast Asia, as everywhere else, the nature and purpose of state intervention in general, and industrial policy in particular, have been largely compromised by political and economic considerations.

All in all, indigenous firms in the second-tier NICs have not developed the industrial technological capabilities which are required for a more self-sustainable path of industrialisation. Certainly, the process of industrialisation in the Southeast Asian economies has been generally shallower than in the Northeast Asian economies for the lack of a well-coordinated and coherent national strategy. Indeed, the serious financial crisis which hit the region in 1997–98 has exposed these fundamental weaknesses in their economic policies and structures.

## Conclusion

In the past, the contrasting growth performances between SSA and Southeast Asia have been popularly attributed to the differences in economic policies. While the success of high-performing economies in Southeast Asia is claimed to be due to their reliance on market-friendly economic policies, the poor record of SSA countries is often explained in terms of their dirigiste economic policies and large-scale government failures before the adoption of more liberal economic policies. This line of argument is most frequently and extensively used to explain the differences in external trade and investment performance between SSA and Southeast Asia.

We argued that the above interpretation of policies and their outcomes is overly simplified and, indeed, misleading. In order to support our arguments, we examined in detail the main characteristics of the economies in the two regions in terms of initial conditions, resource endowments, and other internal and external conditions. Then we presented a critical review of the policy experiences of the two regions. Our comparative analysis shows there are some similarities in the overall policy regimes between the two regions, which have often been disregarded in the policy debate. Yet these apparent similarities conceal subtle, yet crucial,

differences in the policy design and implementation context of each of the two regions. It is these differences that have been critical in engendering the differential degree and forms of integration of these economies into the global economy.

Clearly, these critical differences can be revealed only by detailed comparative analyses of historical and institutional conditions prevailing in the economies. These conditions have been too long ignored in the debate about appropriate trade regimes and development strategies for Sub-Saharan Africa. Useful lessons from the Southeast Asian experiences for policy makers in SSA cannot be drawn on the basis of the sharp dichotomy conventionally applied in contrasting the policy regimes. Our policy analysis unequivocally points to the need for differentiating between strategic integration and laissez-faire liberalisation in formulating policies intended for achieving integration into the global economy.

## Notes

1. S. Radelet and J. Sachs, "The East Asian Financial Crisis: Diagnoses, Remedies, Prospects" (Harvard Institute for International Development, Cambridge, Mass., 1998, mimeographed).
2. See Chapter 14 of this volume for Africa's visions and challenges in years to come.
3. Nissanke and Aryeetey use institutional analysis as a framework for such a comparative study. See Machiko Nissanke and Ernest Aryeetey, "Comparative Institutional Analysis: Sub-Saharan Africa and East Asia" (paper presented at the AERC-UNU Conference on Comparative Development Experiences in Africa and Asia, Johannesburg, November 1997), in *Comparative Development Experiences in Africa and Asia*, eds. Machiko Aryeetey and Ernest Nissanke (Aldershot: Ashgate, 2003, forthcoming).
4. World Bank, *The East Asian Miracle: Economic Growth and Public Policy* (New York: Oxford University Press for the World Bank, 1993).
5. Jomo K. S., Chen Yun Chung, Brian C. Folk, Irfan Ul-Haque, Pasuk Phongpaichit, Batara Simatupang, Mayuri Tateishi, *Southeast Asia's Misunderstood Miracle: Industrial Policy and Economic Development in Thailand, Malaysia and Indonesia* (Westview Press: Malaysia, 1997).
6. World Bank, *East Asian Miracle*, 5.
7. Within the region of Southeast Asia, the paper focuses on three second-tier NICs, i.e., Indonesia, Malaysia and Thailand, since Singapore is a special island city-state and the Philippines has not had a high enough growth record to be classified as a high-performing economy.
8. For our analysis of the causes and nature of the Asian crisis and their implications for countries in SSA, see Ernest Aryeetey and Machiko Nissanke, *Comparative Development Experiences in Africa and Asia* (Aldershot: Ashgate, 2003, forthcoming), Chapter 1; and Machiko Nissanke and Howard Stein, "Financial Globalization and Economic Development: Toward an Institutional Foundation," *Eastern Economic Journal* (2003, forthcoming).
9. Issues related to policies towards portfolio flows in the two regions are dealt with in Chapters 10 and 11 of this volume.

10. This subsection draws heavily on Machiko Nissanke, "From Aid Dependence to Self-articulated Aspiration: Comparative Analysis of Sub-Saharan Africa and East Asia," *Cambridge Review of International Affairs* 14, no. 1, Autumn–Winter (2000).
11. For detailed discussion on this question, see Hayami Yujiro and Jean-Philippe Platteau, "Resource Endowments and Agricultural Development: Africa vs. Asia," *CRED, Serie Recherche*, no. 192 (Namur, Belgium: Universitaires Notre-Dame de la Paix, June 1997).
12. Paul Collier and Jan W. Gunning, "Explaining African Economic Performance" (Centre for the Study of African Economies, University of Oxford, Oxford, 1997, mimeographed), 8.
13. Jomo K. S. and Terence Gomez, "Rents and Development in Multi-Ethnic Malaysia," in *The Role of Government in East Asian Economic Development*, eds. M. Aoki, H. Kim, and M. Okuno-Fujiwara (Oxford: Clarendon Press, 1996).
14. Paul Collier and Jan W. Gunning, "Why Has Africa Grown Slowly?" *Journal of Economic Perspectives* 13, no. 3 (September 1999).
15. John Broom and Jefferey Sachs, "Geography, Demography and Economic Growth (paper no. 2, Brookings Papers in Economic Activity, Brookings Institution, Washington, D.C., 1988)," 207–95.
16. J. Sachs and M. Warner, "Sources of Slow Growth in African Economies" (development discussion paper 545, Harvard Institute for International Development, Cambridge, Mass., 1996).
17. Anne Booth, "Initial Conditions and Miraculous Growth: Why is South East Asia Different From Taiwan and South Korea?" *World Development* 27, no. 2 (1999): 301–21.
18. *Ibid.*
19. John Sender, "Africa's Economic Performance: Limitations of the Current Consensus," *Journal of Economic Perspectives* 13, no. 3 (September 1999): 89–114.
20. World Bank, *East Asian Miracle*.
21. David L. Lindauer and Michael Roemer, eds. *Development in Asia and Africa: Legacies and Opportunities* (Cambridge, Mass.: Harvard Institute for International Development, 1993).
22. Chang Ha-Joon, "The Initial Conditions of Economic Development: Comparing the East Asian and the Sub-Saharan Experiences" (paper prepared for UNCTAD, Trade and Development Report, 1998).
23. To illustrate his point, he refers to the fact that Korea in 1945 had an illiteracy ratio of 78%, which was higher than the ratio found in 10 out of 37 SSA countries in 1960.
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## Governments and External Performance in Africa

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Africa's general economic performance since 1960 has been described as tragic<sup>2</sup> especially when compared to the – now battered – star performers in East Asia. While East Asian countries saw more than two decades of high growth based largely on increasing exports, most African countries have hardly seen any export growth at all. On average real merchandise export growth of Sub-Saharan African countries has been 2.6% over the past three decades, while the average for many Southeast Asian countries has been in the region of 10%. However, there were also differences in export performance within Africa. For instance Mauritius saw export growth which rivaled Southeast Asian star performances, but overall there is a stark contrast between the two regions.

There is by now a substantial body of literature which tries to explain why East Asian countries have managed to expand their external sector so rapidly and successfully.<sup>3</sup> The consensus of this literature is that East Asian countries conducted a conscious strategy of export promotion. This export promotion in many cases consisted not only of leveling the playing field for exporters but of tilting it in their favor by employing interventionist policies, which ranged from coordination of investment plans to directed credits and infant-industry protection.<sup>4</sup> Africa, so it has been suggested, could learn from this experience.

The catch is that many of these selective interventions have already been tried in Africa, with very different results than in East Asia. Harold, Jayawickrama, and Bhattasali conducted a detailed study of the

success of the East Asian type of export promotion policies in African countries. Their conclusion is worth quoting:

Export development policies have been a critical part of East Asia's success and merit consideration. These schemes, mainly duty exemption and drawback systems, have failed in Sub-Saharan Africa for reasons of trust and capacity, cumbersome procedures, and because the cost from delays and paperwork outweighs the reductions in duty.<sup>5</sup>

This conclusion reflects the general tone of the study. After a careful comparison of schemes in African and East Asian countries, the authors suggest that industrial and trade policies have not been successful in Africa because of a more general failure of institutions, including bureaucratic failure, mistrust in the relations between governments and the private sector, corruption, and political instability.

The conclusion that institutional failure is an important obstacle to better economic performance in Africa has also been supported by other recent studies.<sup>6</sup> To name just two, Fischer, Hernandez-Cata, and Khan note that African countries need far-reaching improvements in governance;<sup>7</sup> the World Economic Forum, in its *African Competitiveness Report*,<sup>8</sup> shows that one of the greatest concerns of local and foreign businesses were corruption, lack of stability, and lack of transparency. Even though there is wide acceptance of the proposition that poor African institutions are a determinant of external performance, there is, to my knowledge, no cross-country empirical study which tests this. Presumably, the lack of adequate data on institutional performance is a reason for this gap.

This chapter sets out to analyze the relationship between institutions and export performance with special reference to Africa. I proceed in three steps. First, I investigate whether institutional quality can explain differences in export performance across countries, i.e., not only in the direct comparison between East Asia and Sub-Saharan Africa but also in a comparison of a larger set of countries.

Second, I test the same proposition within Sub-Saharan Africa. I use data on institutional quality from various sources; the main one has become available only very recently. I find that a number of indicators of institutional quality are closely associated with export performance in the cross-country regressions. However, they are less powerful in explaining differences within Africa. The most powerful indicators explaining differences within Africa are related to general property rights security.

Given the importance of differences in the security of property rights, the third step is to explore which factors explain these differences. In particular, I explore whether the security of property rights is associated

with the level of ethnic diversity of a country. Easterly and Levine have suggested that ethnic fragmentation helps explain cross-country differences in public policies, political stability, as well as economic performance.<sup>9</sup> They show that, in the case of Sub-Saharan Africa, ethnic fragmentation explains a significant part in policies and economic performance. Collier starts from the observation that this may be an unhelpful line of research, because there is nothing a country can legitimately do about its ethnic composition.<sup>10</sup> He goes on to demonstrate that the effects of diversity are not always detrimental, that the relationship between ethnic diversity and the risk of violent conflict is not monotonic. The aim of the last section is to test whether differences in the security of property rights and rule of law can be explained by ethnic diversity, wars, or the form of the political system. I find only very weak evidence of such an association. This can be interpreted as a hopeful result because it can imply that external performance can be improved through institutional reform.

The chapter is organised as follows. Section 2 discusses the data and the empirical strategy. Section 3 presents the results from regressions on real export growth for a set of 49 developing and developed countries and for a subset of 21 African countries. Section 4 proceeds to explore whether differences in the security of property rights in Sub-Saharan Africa can be explained by political or cultural factors.

## Data and Empirical Strategy

### *Measures of Institutional Quality*

Detailed data on institutional quality for many countries has become available only recently. The problem is that institutional quality is not easy to measure objectively. For instance, there is simply no objective data on the level of corruption or the effective security of property rights enforcement. Data on such issues is typically obtained from surveys of experts or of the private sector. In this chapter I rely on three sources of data on institutional quality. One is derived from an expert survey; the second is based on private sector surveys; and the third is from compilations of data on the form of the political system. Appendix 2 describes the variables and their sources.

The first source of data is the International Country Risk Guide (ICRG), a private firm which produces annual ratings of *bureaucratic quality* and *the rule of law* (variable names in italics) based on experts' surveys.<sup>11</sup> Indicators are rated from 0 (worst option) to 6 (best option). I use the average of the 1982–1995 indicators.

The second source of data is the WDR+ survey collected by the World Bank and the University of Basel in preparation for the World Development Report 1997. This data is based on private sector surveys in 73 countries.<sup>12</sup> I use ten different measures from this survey. The first four are all related to the credibility and accountability of rule making. They are as follows: the degree of *policy surprises*, the *credibility of announcements*, the extent of *information* on new rules, and the degree to which business can *participate* in making new rules. As a variable which measures the predictability of law enforcement, I use the *predictability of judiciary* enforcement (as well as two variables by ICRG, the quality of the *bureaucracy* and the *rule of law*). A third set of variables measures the degree to which property rights are perceived to be secure. They are *theft and crime* and *security of property rights*. The last set of variables from this source consists of corruption variables. They measure the *frequency of corruption*, the *uncertainty of corruption*, and the extent to which *corruption is perceived as an obstacle to business*. All indicators are rated from 1 (worst) to 6 (best).

Finally, I also use three objective variables which measure the form of the political system and political instability. The first variable is one from the Polity III data set presented by Jaggers and Gurr, which rates the degree of *democracy* in the election process.<sup>13</sup> This variable is rated from 0 (not democratic) to 10 (fully democratic) for the year 1990. The second is a dummy variable, *war*, which takes the value 1 if there was a war or a civil war in the country. The last variable, *ethnic*, is an index of ethnolinguistic fractionalisation for 1960. It measures the probability that two randomly selected people from a given country will not belong to the same ethnolinguistic group. Both variables are obtained from Easterly and Levine.<sup>14</sup>

### *Empirical Strategy*

In the empirical section I estimate regressions for the growth in the volume of exports over the period from 1980 to 1995, and I test whether different measures of institutional quality can help explain differences in external performance across countries.<sup>15</sup> The choice of the time period is dictated by the coverage of the variables on institutional quality.

As a minimal specification, I control the initial level of GDP per capita and the average inflation during the period. The level of GDP per capita is a summary measure of the stage of development, which captures a number of factors relevant to trade performance. At higher levels of income, trade tends to become increasingly more specialised, which leads to a faster pace of growth. Higher levels of income go hand in hand with higher levels of education; therefore, income is also a proxy for the level

of human capital.<sup>16</sup> Inflation, the second control variable in the base specification, attempts to measure overall distortions in the economy. In addition to inflation, I also test more direct measures of distortions, such as an index of protectionism, the black market premium, and the levels of export and import duties. I introduce the size of the country as an additional variable. However, the explanatory power of all these additional variables is quite low. For the entire period, the R<sup>2</sup> are in the region of 10–20%. For the period 1980–1990, the explanatory power is higher, especially in the case of the African sample. Here a regression from the base specification obtains an R<sup>2</sup> of 35%.

There is a question of causality in this approach; however, I argue that it is not particularly strong. I postulate that good institutions (a predictable rule-making process, property rights security, a stable political system, etc.) lead to a better export performance by providing enterprise with a fertile business environment. The reverse argument is that higher exports and a larger share of exporting firms create political pressure which leads to better institutions. This argument may, in part, hold for issues, such as the participation between government and business associations, or even for corruption. The argument is much more difficult to make for such fundamental factors as the security of property rights.

## The Empirical Results

This section presents the empirical results for the two sets of countries. The first subsection tests institutional variables in a set of 49 developing and developed countries. The second subsection does the same for the African sample only. The list of countries is shown in Appendix 1.

### *Explaining Differences in Export Performance Across Regions*

Table 4.1 shows the results of multivariate regressions. Every row shows one regression. The dependent variable is always the average growth of export volumes over the period 1980–1995. The independent variables are an institutional variable (INST VAR), the initial GDP per capita, and the average inflation rate for 1980–1992. The first column presents the coefficient of the respective institutional variable. *T*-statistics are in parentheses.

The first set of institutional variables measures the credibility and accountability of the rule-making process. It has been suggested that one of the features of successful export promotion in East Asia was that private enterprise was involved in decision making through business groups and deliberation councils.<sup>17</sup> Therefore, the private exporting sector was not



only informed about changes in rules and regulations but could actively participate in the process. The results were that there were few negative policy surprises and that government announcements were generally credible, allowing the export businesses to plan their investment strategies and expand. In the cross-country regressions, three out of the four variables – *policy surprises*, regression (1), *information*, regression (3), and *participation*, regression (4) – are significantly related to export growth. Out of the significant ones, *information*, regression (3), has the best fit and the highest coefficient.

The second set of variables relates to the predictability of law enforcement. The first, regression (5), the *predictability of the judiciary*, is highly significant in the export regression. *Rule of law* and *bureaucratic efficiency* are two variables from the expert survey. *Rule of law*, regression (6), is clearly significant, whereas *bureaucratic efficiency*, regression (7), is not.

The next set of variables measures the security of property rights. The first variable is based on a question which asked entrepreneurs to rate a list of potential obstacles to their business operations. The measure of *theft and crime as a business obstacle*, regression (8), is highly significant in the export regression. Almost a third of the variation in export performance can be explained by this specification. The same is true for the second variable, the *security of property rights*, regression (9).

The fourth set of variables captures the impact of corruption from different angles. The first variable is the mean of answers to a question in the WDR+ survey which asks for the *frequency of corruption* payments; the second is the standard deviation of responses to the same question. The larger this standard deviation, the higher the *uncertainty of corruption* in the respective country. For instance, a country may, on average, have relatively low corruption; however, there are large and unpredictable differences in the treatment of private firms, and, therefore, the standard deviation of responses to this question is high. It has been argued that *uncertainty of corruption* may be at least as damaging to economic performance as high corruption.<sup>18</sup> If the same argument is applied to external performance, we expect a negative correlation with export growth. The last variable is derived from a question which asks, comparatively, whether *corruption* is considered an important *obstacle for doing business*. The correlation between this variable and the *frequency of corruption* need not be perfect. In other words, even in a high-corruption country, the local business community may be so accustomed to the corruption and there may be such well established channels for bribing that corruption is no longer perceived as a mayor business obstacle. In fact, this last indicator of corruption, regression (12), is the only one which is significant at the conventional level. The other two indicators have the

Table 4.1 Export Performance and Institutional Quality: Results of OLS Regressions with Dependent Variable: Average Annual Growth Rate of Volume of Exports 1980–1995

Independent Variables	INST VAR	Constant	GDP	Inflation	Adj. $R^2$
<b>Credibility and Accountability of Rule-Making Variables</b>					
(1) Policy surprises	6.01 (2.28)	-14.7 (-1.86)	-0.0001 (-0.58)	0.07 (0.038)	0.16
(2) Credibility of announcements	-0.067 (-0.03)	3.57 (0.37)	0.00004 (2.61)	-1.674 (-0.64)	0.05
(3) Information	4.63 (2.84)	-9.24 (-2.06)	-0.0002 (-0.96)	-1.12 (-0.54)	0.25
(4) Participation	3.22 (1.90)	-5.04 (-1.04)	0.0001 (0.88)	-1.27 (-0.57)	0.14
<b>Variables on the Predictability of Law Enforcement</b>					
(5) Predictability of the judiciary	2.03 (2.41)	-2.29 (-1.06)	0.0001 (0.72)	-0.85 (-1.37)	0.14
(6) Rule of law	2.69 (2.14)	-2.73 (-0.87)	-0.0004 (-1.07)	-0.57 (-0.51)	0.18
(7) Bureaucratic efficiency	0.80 (0.99)	1.45 (0.72)	0.0001 (0.52)	-0.88 (-1.05)	0.07
<b>Variables on Property Rights</b>					
(8) Theft and crime as a business obstacle	2.63 (3.49)	-4.00 (-1.73)	0.00003 (0.24)	-1.13 (-1.60)	0.28
(9) Security of property	2.35 (3.75)	-2.07 (-1.23)	0.0001 (0.94)	-0.47 (-0.75)	0.29

**Variables on Corruption**

(10) Frequency of corruption	-0.46 (-0.40)	4.88 (1.18)	0.0004 (1.90)	-1.67 (-0.77)	0.05
(11) Uncertainty of corruption	-2.73 (-0.98)	7.20 (1.82)	0.0003 (1.18)	-1.40 (-1.76)	0.08
(12) Corruption as a business obstacle	1.89 (1.84)	-0.89 (-0.38)	0.00003 (0.12)	-1.16 (-1.54)	0.12

**Political System and Political Instability Variables**

(13) Level of democracy	0.57 (2.44)	2.37 (2.49)	-0.0001 (-0.457)	-2.16 (-2.44)	0.19
(14) War	-0.40 (-0.22)	3.48 (3.13)	0.0003 (2.27)	-1.33 (-1.55)	0.06
(15) Ethnic diversity	-5.48 (-2.56)	6.96 (4.06)	0.0002 (1.17)	-1.01 (-1.47)	0.16

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*T*-statistics in parentheses; standard errors are White-corrected for heteroskedasticity; 49 observations.

expected sign – i.e., regression (10) has the positive sign and regression (11) the negative – but they are not significant, indicating that the relationship between export performance and corruption is complex. This result is consistent with the East Asian story, where high levels of corruption in some countries have not prevented them from increasing exports at a rapid pace.

It should be noted that the variables tested so far are all subjective indicators. In other words, they do not necessarily reflect the "true" scale of theft and crime or of corruption. They reflect the perceived scale of the problem from the point of view of the private sector. Given that these perceptions guide entrepreneurs' decisions, these subjective feelings – rather than objective measures of institutional problems – should ultimately be relevant in determining economic performance. Nevertheless, there are a number of objective variables on political instability which can be thought of as proxies for perceived uncertainties. The last set of institutional variables tests three of these measures, which are commonly used in the empirical growth literature.

This last set of variables includes measures of the form and the stability of the political system. The first variable, regression (13), is a *democracy* variable and is significant in the cross-country export regression. The second, regression (14), is a dummy variable, which takes the value 1 if there was a *war* in the country. The *war* dummy has the expected sign but is not significant. The last variable, regression (15), is a measure of *ethnic* diversity as a proxy for political instability. This variable is certainly a very indirect measure of institutional performance, and, as discussed above, Collier has shown that ethnic diversity is also an imperfect proxy for political stability.<sup>19</sup> Nevertheless, in this analysis, ethnic diversity and export performance are significantly and negatively associated.

To conclude, out of 15 variables tested, 10 were significant and all had the expected sign, indicating that institutional performance and external performance are indeed closely associated. The variables which have the highest power in explaining differences in external performance across countries are the *security of property* rights and *theft and crime*. They are followed by variables which measure the credibility and accountability of rule making and the predictability of law enforcement. Variables on corruption and on political instability have mixed results.

### *Explaining Differences in Export Performance within Africa*

In this subsection I study differences in export performance across African countries. As noted above, export growth has been varied also within African countries (although less varied than in the larger cross-country

comparison), and the question is whether differences in institutional performance can help explain these differences in external performance.

The results of this “within” analysis have to be interpreted with care, however, because they are based on a small set of countries. The WDR+ data set includes 21 African countries (see Appendix 1 for a list of them) and, therefore, the regressions can have only a few degrees of variation.

Table 4.2 shows regression results for export growth for the African countries for which data was available. The results are less clear-cut than in the larger country set. Most of the variables have the expected sign, but only a few are significant.

There is only one set of variables which contributes significantly to explaining differences in export growth across Africa: variables related to the security of property rights. Both variables, *theft and crime as a business obstacle* and *security of property*, are significantly related to differences in external performance. Another variable that has some explanatory power is the *rule of law*, which is also the one most intimately related to the *security of property*. Regression (6) shows that differences in *rule of law* (plus the control variables) explain about 20% of differences in export performance. Regression (9) shows a similar result. The best fit to export performance is regression (8). Countries where *theft and crime* were perceived as a large business obstacle were also the ones that had the lowest export performance. These results are quite robust. I tested a number of other control variables, including other institutional variables. The results continued to hold. Given the strength of these results on property rights, I will explore this issue in more detail in the next section.

## Explaining Security of Property Rights in Africa

Before exploring how one can explain differences in the security of property rights, I present some descriptive statistics on the variable which was most strongly associated with export performance within Africa, as well as in the large country set. Table 4.3 shows the average answer to the question: “How large were theft and crime perceived as obstacles for doing business in the respective country?”

This table presents the country ratings sorted from the highest to the lowest concerning theft and crime as a business obstacle. A rating of 1 means, on average, entrepreneurs in that country responded that theft and crime represented a major obstacle for their business operations. A rating of 6 means that these were not considered a problem at all. In other words, the country where theft and crime are perceived as the largest business obstacle is South Africa, and the one where theft and

Table 4.2 African Export Performance and Institutional Quality: Results of OLS Regressions with Dependent Variable: Average Annual Growth Rate of Volume of Exports 1980–1995

Independent Variables	INST VAR	Constant	GDP	Inflation	Adj. $R^2$
<b>Credibility and Accountability of Rule-Making Variables</b>					
(1) Policy surprises	3.00 (0.91)	-6.23 (-0.66)	-0.0004 (-0.45)	-5.58 (-1.72)	0.10
(2) Credibility of announcements	3.87 (1.90)	-12.42 (-1.56)	-0.0003 (-0.51)	-4.24 (-1.50)	0.23
(3) Information	3.17 (1.33)	5.12 (-0.87)	0.0007 (0.76)	-7.72 (-2.22)	0.16
(4) Participation	0.48 (0.22)	0.76 (0.14)	0.0003 (0.36)	-6.37 (-1.57)	0.04
<b>Variables on the Predictability of Law Enforcement</b>					
(5) Predictability of the judiciary	1.71 (1.27)	-1.57 (-0.57)	-0.00001 (-0.13)	-8.66 (-1.82)	0.10
(6) Rule of law	2.03 (2.10)	-3.54 (-1.07)	-0.0006 (-0.95)	-6.31 (-2.19)	0.20
(7) Bureaucratic efficiency	0.11 (0.11)	2.04 (1.43)	-0.0003 (-0.19)	-6.03 (-1.40)	0.00
<b>Variables on Property Rights</b>					
(8) Theft and crime as a business obstacle	2.14 (2.74)	-4.29 (-1.46)	0.0004 (1.05)	-5.04 (-1.44)	0.26
(9) Security of property	1.68 (1.87)	-1.98 (-0.76)	0.0003 (0.81)	-4.60 (-1.35)	0.17

**Variables on Corruption**

(10) Frequency of corruption	-1.64 (-1.92)	6.99 (2.42)	0.0001 (1.78)	-5.91 (-1.71)	0.14
(11) Uncertainty of corruption	-2.30 (-0.61)	5.11 (0.96)	0.0002 (0.30)	-6.03 (-1.59)	0.06
(12) Corruption as a business obstacle	-0.05 (-0.02)	1.94 (0.32)	0.0004 (0.71)	-6.29 (-1.52)	0.04

**Political System and Political Instability Variables**

(13) Level of democracy	0.37 (0.83)	2.48 (1.89)	-0.0005 (-0.38)	-6.24 (-1.58)	0.03
(14) War	-1.41 (-0.77)	1.90 (1.84)	0.0005 (1.21)	-5.06 (-1.14)	0.07
(15) Ethnic diversity	3.70 (1.51)	-0.54 (-0.30)	0.0002 (0.29)	-4.86 (-1.77)	0.00

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*T*-statistics in parentheses; standard errors are White-corrected for heteroskedasticity; 21 observations.

Table 4.3 Country Distribution Ratings on “Theft and Crime as a Business Obstacle”

1–2	2–2.5	2.5–3	3–4	4
South Africa	Malawi	Uganda	Congo	Ghana
Mozambique	Zambia	Guinea	Togo	Mauritius
Kenya	Cameroon	Tanzania	Chad	
	Nigeria	Zimbabwe	Mali	
	Ivory Coast	Benin	Senegal	
	Guinea-Bissau			
	Madagascar			

Source: WDR + dataset.

crime are perceived as the smallest obstacle is Mauritius. As noted above, this conclusion does not mean that the absolute level of theft and crime is highest in South Africa. But it indicates that the local private sector perceives it as being very high and, indeed, a serious obstacle to its business operations. In the case of South Africa, it is worth mentioning what will not come as a surprise – that the perceived security of property has significantly deteriorated over the past ten years. But, even so, entrepreneurs seemed to have taken into consideration potential future conflicts, since their rating from ten years earlier is 3.6.

The next step is to ask, “What explains differences in security of property rights across African countries?” This line of inquiry is relevant because the security of property rights might be mainly determined by factors which are outside the possibilities of reform. They might be determined by cultural or social factors which cannot be changed easily. For instance, a high level of ethnic division might lead to conflicts, or even war, which would lower the security of property rights.

Table 4.4 presents three regressions with three variables on property rights security as dependent variables. The independent variables are given in the rows. The first regression tries to explain the perceived security of property rights with three variables: war, ethnic diversity, and democracy. None of the variables are significantly associated with perceived property rights security. The second regression uses the variable “theft and crime as a business obstacle” as a dependent variable and the same right-hand variables. And it obtains the same result: War, ethnic diversity, and the form of the political system (i.e., “democracy” or otherwise) cannot explain differences in how large theft and crime are perceived as obstacles to doing business. The last regression does the same thing for the variable “rule of law,” the third variable which was signifi-



Table 4.4 Explaining Security of Property Rights in Africa

Dependent Variables	Security of Property Rights	Theft and Crime as a Business Obstacle	Rule of Law
Constant	2.17 (3.03)	3.03 (4.27)	2.34 (3.64)
War	-0.34 (-0.91)	-0.14 (-0.38)	0.27 (0.61)
Ethnic diversity	0.14 (0.15)	-0.40 (-0.42)	0.67 (0.77)
Democracy	0.07 (0.99)	0.05 (0.81)	0.19 (2.98)
Observations	21	20	28
Adj. $R^2$	-0.01	-0.11	0.20

*T*-statistics in parentheses.

cant in the African export regressions. Here the result is somewhat different. War and ethnic diversity are, again, not significant (war does not even have the expected sign), but democracy is. This indicates that in more democratic countries the rule of law tends to be better respected. However, this relationship does not hold up well to changes in measurement, as was shown by the previous two regressions.

It seems, then, that security of property rights in Africa is not systematically related to social, political, or cultural factors, such as the propensity for political instability or ethnic diversity. This could be interpreted as good news, because it would imply that property rights security may be improved with institutional reform, which is much more under the control of governments than, for instance, the ethnic composition of a society.

## Conclusions

This chapter has shown that the quality of institutions may help explain differences in external performance across countries. Reliable institutions, efficient bureaucracies, and secure property rights protection are associated with better export performance. This result is in line with the literature that has suggested that such qualities of government institutions did contribute to the good external performance in some East Asian countries.

The differences in the quality of government institutions can even help

explain differences in external performance within a set of African countries. Furthermore, the quality of these institutions does not seem to be predetermined by “exogenous” factors, such as the level of ethnic fragmentation. Therefore, the evidence presented in this chapter suggests that institutional reforms would be a good strategy for promoting external performance in Sub-Saharan Africa. They should be directed primarily at improving the rule of law and property rights security.

## Appendix 1: Country List

### *Sub-Saharan Africa*

Benin  
Cameroon  
Chad  
Congo  
Côte d’Ivoire  
Ghana  
Guinea  
Guinea-Bissau  
Kenya  
Madagascar  
Malawi  
Mali  
Mauritius  
Mozambique  
Nigeria  
Senegal  
South Africa  
Tanzania  
Togo  
Uganda  
Zambia  
Zimbabwe

### *Southeast Asia*

Hong Kong  
Malaysia  
Singapore  
South Korea  
Thailand

### *Other Countries*

Austria  
Canada  
Fiji  
France  
Germany  
India  
Ireland  
Italy  
Jordan  
Morocco  
Portugal  
Spain  
Switzerland  
Turkey  
United Kingdom  
United States

### *Latin America and Caribbean*

*(LAC)*  
Bolivia  
Colombia  
Costa Rica  
Ecuador  
Jamaica  
Mexico  
Venezuela

## Appendix 2

Name of Variable	Description of Variable	Period	Source
Export growth	Average annual growth of real export volumes	1980–1995	World Development Indicators 1997
GDP	Real GDP per capita in base year	1980	Penn World Tables 5.6
Sec	Secondary school enrollment in base year	1980	Penn World Tables 5.6
Policy surprises	Private sector survey Rated 1 (worst) to 6 (best)	1986–1996*	WDR+ survey
Credibility of announcements	Private sector survey Rated 1 (worst) to 6 (best)	1986–1996*	WDR+ survey
Information	Private sector survey Rated 1 (worst) to 6 (best)	1986–1996*	WDR+ survey
Participation	Private sector survey Rated 1 (worst) to 6 (best)	1986–1996*	WDR+ survey
Predictability of judiciary	Private sector survey Rated 1 (worst) to 6 (best)	1986–1996*	WDR+ survey
Rule of law	Based on expert survey Rated 1 (worst) to 6 (best)	1982–1995	ICRG
Bureaucratic efficiency	Based on expert survey Rated 0 (worst) to 6 (best)	1982–1995	ICRG
Theft and crime as a business obstacle	Private sector survey Rated 1 (worst) to 6 (best)	1986–1996	WDR+ survey
Security of property	Private sector survey Rated 1 (worst) to 6 (best)	1986–1996*	WDR+ survey
Frequency of corruption	Private sector survey Rated 1 (worst) to 6 (best)	1986–1996*	WDR+ survey
Uncertainty of corruption	Private sector survey Standard deviation of “Frequency of corruption”	1986–1996*	WDR+ survey
Corruption as a business obstacle	Private sector survey Rated 1 (worst) to 6 (best)	1986–1996*	WDR+ survey

Name of Variable	Description of Variable	Period	Source
Democracy	Political rights Rated 1 (worst) to 7 (best)	1974–1989	Freedom House
War	Dummy of war period	1980–1989	Easterly and Levine (1997)
Ethnic diversity	Probability that randomly selected people belong to the same ethnolinguistic group	1960	Easterly and Levine (1997)

\*The time average is constructed from the survey.

The data of the WDR+ survey are available from [www.unibas.ch/wwz/wifor/survey/](http://www.unibas.ch/wwz/wifor/survey/)

## Notes

1. For valuable comments I would like to thank Ernest Aryeetey, Machiko Nissanke, Robert Bates, Julius Court, Rolf Weder, as well as the participants of a conference of the United Nations University on “Asia and Africa in the Global Economy,” in Tokyo.
2. See William Easterly and Ross Levine, “Africa’s Growth Tragedy: Policies and Ethnic Divisions,” *Quarterly Journal of Economics* 112 (November 1997): 1203–50.
3. The most prominent of these studies is certainly the “East Asian Miracle” by the World Bank. See World Bank, *The East Asian Miracle: Economic Growth and Public Policy* (New York: Oxford University Press, 1993), 157–89.
4. The Asian financial crisis has tilted the balance in favor of those who were always skeptical of the effectiveness of interventionist policies even in East Asian countries. Now many commentators blame East Asian governments for causing the crisis by misallocating resources and fueling corruption. However, this claim is exaggerated, as was later shown by, e.g., Jason Furman and Joseph Stiglitz, “Economic Crisis: Evidence and Insights from East Asia” (paper, Brookings papers in Economic Activity, Brookings Institution, Washington, D.C., 1999) and by Beatrice Weder, *Model, Myth or Miracle? Reassessing the Role of Governments in the East Asian Experience* (Tokyo: United Nations University Press, 1999).
5. Peter Harrold, Malathi Jayawickrama, and Deepak Bhattasali, “Practical Lessons for Africa from East Asia in Industrial and Trade Policies” (discussion paper no. 310, Africa Technical Department Series, World Bank, Washington, D.C., 1996), 80.
6. There is a growing more general literature which shows that dysfunctional institutions reduced growth. See, for example, Stephen Knack and Philip Keefer, “Institutions and Economic Performance: Cross-Country Tests Using Alternative Institutional Measures,” *Economics and Politics* 7 (1995): 207–27; Paolo Mauro, “Corruption and Growth,” *Quarterly Journal of Economics* 110 (1995): 681–712; or Aymo Brunetti, Gregory Kisunko, and Beatrice Weder, “Credibility of Rules and Economic Growth: Evidence from a Worldwide Survey of the Private Sector,” *World Bank Economic Review* 12, no. 3 (1998): 353–84.
7. Fischer Stanley, Ernesto Hernandez-Cata, and Mohsin Kahn, “Africa: Is this the Turning Point?” (paper on policy analysis and assessment, no. 98/6, IMF, Washington D.C., 1998).

8. World Economic Forum, "Africa Competitiveness Report" (1998), available at <[www.weforum.org](http://www.weforum.org)>.
9. Easterly and Levine, "Africa's Growth Tragedy."
10. Paul Collier, "The Political Economy of Ethnicity" (paper presented at the Annual World Bank Conference on Development Economics, Washington, D.C., 20–21 April 1998).
11. See Keefer and Knack, "Institutions and Economic Performance."
12. For a detailed description of the survey and the variables see Brunetti, Kisunko, and Weder, "Credibility of Rules and Economic Growth." The data can be obtained at <[www.unibas.ch/wwz/wifor/survey/](http://www.unibas.ch/wwz/wifor/survey/)>.
13. Keith Jagers and Ted Robert Gurr, "Tracking Democracy's Third Wave with the Polity III Data," *Journal of Peace Research* 32, no. 4 (1995): 469–82.
14. Easterly and Levine, "Africa's Growth Tragedy."
15. Another approach is to estimate predicted trade shares based on a trade model and then compare these to the actual trade shares, as for instance in Adrian Wood and Jörg Mayer, "Africa's Export Structure in Comparative Perspective" (1997, mimeographed). However, their interest is to explain the structure of African trade rather than the overall export performance.
16. I tested specifications which include the level of secondary school enrollment instead of the level of income, and this did not alter the results.
17. See, for example, The World Bank, *The East Asian Miracle*.
18. See, for example, Shang-Jin Wei, "Why is Corruption So Much More Taxing Than Tax? Arbitrariness Kills," working paper 6255, NBER, Cambridge, Mass., 1997; or The World Bank, *The State in a Changing World*, World Development Report 1997 (Washington D.C.: Oxford University Press, 1997).
19. Collier, "The Political Economy of Ethnicity."

## Local Entrepreneurship in Southeast Asia and Sub-Saharan Africa: Networks and Linkages to the Global Economy

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*Deborah Bräutigam*

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For much of the past two decades, the world has applauded the striking development performance of Indonesia, Malaysia, and Thailand. Despite the 1997 Asian financial crisis, these three countries still managed an average annual export growth of 10.5% between 1990 and 2000, while exports from Africa grew by only 3.9% per annum in the same period.<sup>1</sup> The rapid structural transformation and improvement in the standard of living in these three countries remain a powerful testament to the benefits of a strategy emphasising industrial exports. Most African countries have remained dependent on commodity exports, which makes them subject to the instability inherent in those markets. While Africa remained largely untouched by the “Asian flu,” the continent also missed out on the benefits of Asian-style engagement with the global market.

Why has Southeast Asia developed such a dynamic industrial export sector, while Sub-Saharan Africa has not? Until the recent financial crisis, most analyses argued that Southeast Asia had “developmental states,” while Sub-Saharan Africa largely did not. These developmental states were credited for putting in place the fundamentals of macroeconomic stability and investment in education, and orienting policy to favor exports or at least to create a level playing field between exports and imports. They were said to have engaged their private sectors in high-level “deliberative councils,” designing and implementing policies that encouraged productivity and efficiency. However, the financial crisis has put this interpretation into question. In the aftermath of the crisis, the Southeast

Asian states are now being castigated for their high levels of patronage, corruption, and business-state collusion.

It remains a little too soon to put nails in the coffin of the Southeast Asian developmental state. However, the Asian miracle always had a societal side, one that a state-centric focus largely missed. Many who wish to compare Southeast Asia and Sub-Saharan Africa point to the structural similarities between the two regions: similar commodity export histories, similar GNP per capita in the 1960s, etc. Yet the differences between the two regions are significant, and particularly so in their experience of entrepreneurial development. This chapter suggests that Southeast Asia's lead over Sub-Saharan Africa is not simply a response to good policies undertaken in the past two decades, but rather also reflects the different ways in which each area first engaged with the capitalist world. This engagement shaped the paths indigenous and nonindigenous entrepreneurs were allowed to take and the experiences they were allowed to accumulate during the colonial period and after, as well as the subsequent depth and breadth of the business networks and global linkages that characterised the entrepreneurs of each region.

When seen historically, three striking differences emerge between Sub-Saharan Africa and Southeast Asia. First, Southeast Asia was well integrated into Asian and European maritime trading networks several centuries before maritime trade reached most of Sub-Saharan Africa. The lower cost and greater ease of maritime trade meant that traders in Southeast Asia could develop business skills, be exposed to outside innovations, and accumulate significant capital much earlier than was possible for many in Africa. As part of this maritime mobility, waves of Chinese immigrants settled in Southeast Asia and were to become significant elements in the area's economic development. In contrast, much of Africa was first exposed to maritime commerce through the slave trade, and this also affected the continent's later trajectory. Second, significant import substitution industrialisation began in Southeast Asia in the late nineteenth century, three or more decades before any significant modern industrial development occurred in Africa, giving Asian entrepreneurs and workers a longer history of experience with industrialisation. Third, proximity to Japan served as a powerful catalyst for entrepreneurial development in Southeast Asia. Japanese firms appear to be much more likely to enter into joint ventures in manufacturing with domestic firms, and at a lower level of technology, than western firms. African entrepreneurs had no similar "appropriate" catalyst. Direct foreign investments in Africa are still much more likely to be in mining, petroleum, and other primary commodity extraction ventures.

This chapter reviews the state of knowledge about local entrepreneurship in Southeast Asia and Sub-Saharan Africa. It then provides a short

social history of entrepreneurial development in both regions. The third section reviews the enabling conditions and constraints facing local entrepreneurs in both regions, while the conclusion suggests some policy recommendations and areas for further research.

## Capitalism and Entrepreneurship in Southeast Asia and Sub-Saharan Africa in Comparative Historical Perspective, A.D. 600 to the 1970s

Southeast Asia and Sub-Saharan Africa differ sharply in the extent of time each has been exposed to the stimulus, learning, and accumulation opportunities inherent in international trade networks. Southeast Asia is strategically located along the great ocean trade routes between India and China. The spices of Southeast Asia brought Arab, Indian, and Chinese traders to the region by the sixth century A.D. International trade had grown substantially by the second millennium. Chinese and Indian traders visited and later settled in trading ports from Malacca to Kerala. Between the 1300s and 1600s, indigenous entrepreneurs also played a major role in Southeast Asian trade: Malays, Sulus, Javanese, and others contributed the bulk of the goods, ships, and finance for trade during this period.<sup>2</sup>

During this period, parts of Sub-Saharan Africa were also linked to international trading circuits. By the ninth and tenth centuries A.D., Arab traders, sailing small dhows along the coast, had established significant trading ports from Zanzibar to Mozambique, exporting ivory, gold, and slaves, which were transported overland by local traders. Gujarati traders followed the dhow routes from Muscat and Aden to Mombassa, Lamu, and Zanzibar, as early as the thirteenth century, bringing Indian textiles and buying ivory and gold, but they did not settle in the area at that time.<sup>3</sup> Camel caravans moved across the Sahara into the Sahel and Savannah regions, and large canoes made their way up and down the navigable African rivers. Yet the very different geography made transport much more difficult and impeded trade links. Furthermore, the western coast and the interior were almost completely cut off from significant outside contacts. As Oliver and Atmore's history of the African Middle Ages notes, in 1400, "[T]here was no maritime traffic anywhere between southern Morocco and the Limpopo, and for those living between these points the ocean marked the end of the world."<sup>4</sup> It was not until the arrival of Europeans and the marked acceleration of the slave trade that Africa's many small, regional trading networks were finally linked into a regular, continent-wide system in the late eighteenth century. Yet for another hundred years, until the demand for Africa's



industrial raw materials rose in the mid-nineteenth century, neither production nor trade grew in a sustained manner.<sup>5</sup>

Colonialism brought intense competition and often brutal suppression for indigenous traders in both regions. In the seventeenth century, Portuguese and Dutch trading groups in Southeast Asia fragmented the “vibrant indigenous trading circuits” which “failed to survive into the colonial era.”<sup>6</sup> The Chinese and Indian immigrants, on the other hand, were able to draw on the resources of ethnic networks and, as outsiders, to make themselves useful to the colonial powers. Their investments and trading networks rivaled those of the Europeans. Serving as middlemen between European traders and the indigenous residents, the Chinese continued to accumulate wealth. Some were able to establish themselves as informal bankers to European merchants.

In Sub-Saharan Africa, Portuguese efforts to capture the gold and ivory trade greatly reduced the activities of the Arabs who had traded along the east coast and also kept local groups from taking their place. As colonial trading enterprises penetrated further into the interior of Africa, they used their exclusive charters, greater access to capital, and the protection of colonial authorities to force African competition out of business. In Nigeria in the 1880s, for example, Ja Ja of Opobo, a successful indigenous trader, with some several thousand employees, was moving into direct export of palm oil to Europe when he was “deposed” by the British.<sup>7</sup> Likewise, in Southern Africa, the colonial powers protected European traders by tightly controlling the entry of Africans.<sup>8</sup> In the early colonial period, these moves kept most indigenous African entrepreneurs from accumulating capital on any significant scale.

By the late nineteenth century, both regions were on different paths. Southeast Asia moved into modern manufacturing well before Africa, with almost exclusively foreign and Chinese or Indian investment. The first phase of industrial development in Southeast Asia – cement production, food canning, beer, soap, and biscuit manufacture, rubber processing, and other basic industries – began between 1870 and 1914. Factories producing chemicals, refined sugar, light machinery, cycles, paper, textiles, and other goods were well in place by 1930.<sup>9</sup> Dunlop invested in rubber plantations in Malaya in the early 1910s, Goodyear in Sumatra. Thailand (which was never a colony) imposed trade barriers as early as the 1930s to stimulate domestic industry. The colonial authorities in Indonesia also introduced quotas on textiles in the 1930s to stimulate textile production. As intended, this pushed domestic capital (mainly Chinese) and foreign capital into manufacturing. As Yoshihara recounts, “Some traders went into manufacturing because the goods they were importing could no longer be imported. For them, entry into manufacturing was a strategy for survival. Others went in seeing a great opportunity to make

profits under the protection and incentives offered by the government.”<sup>10</sup> The colonial authorities in Malaysia, on the other hand, maintained essentially laissez-faire policies until a 1955 World Bank report urged Malaysia to raise tariffs on manufactured goods to stimulate import substitution industrialisation.<sup>11</sup>

By 1941, although Southeast Asian industrialisation could still be described as “patchy,” it was well underway, led by Chinese, Indian, European, and Japanese entrepreneurs, and already involving production for export: “Entrepreneurs had identified potential areas of investment and used their trading base to take the opportunities for specific industrial initiatives. They initially targeted the domestic market and later, through cartels, attempted to secure a market share in Asia.”<sup>12</sup> Even at this early point, the economies of Southeast Asia had already become well integrated with extensive intraregional trade and investment.

In contrast, the initial development of manufacturing in Sub-Saharan Africa lagged Southeast Asia’s by some thirty to forty years, and no region of the continent is anywhere near being well integrated. The first modern factories were established in Kenya and other places in the first two decades of the twentieth century. Nigeria appears to have established its first modern factories only in the 1920s.<sup>13</sup> In one of the more advanced regions, Côte d’Ivoire, John Rapley notes that industrial development was almost nonexistent “until after the Second World War, and even then it was limited until the postcolonial period.”<sup>14</sup> Entrepreneurs in Côte d’Ivoire tended to focus on plantation agriculture and diversify into services (transport, money lending) and real estate. After World War II, as African countries moved closer to independence, some colonial authorities began to implement import substitution policies. For example, in the 1950s, Nigerian authorities raised tariff levels on some classes of imports. But, in general, policies to stimulate domestic industry waited until after independence.

Industrial development has an ethnic dimension in each region. Both Southeast Asia and Sub-Saharan Africa have found their indigenous entrepreneurs getting a later start than the Chinese, Indian, and other foreign entrepreneurs who entered as long-term residents. The Chinese and Indians have been a presence in Southeast Asia for more than a thousand years. In 1981, about 33% of Malaysians, 13% of Thais, and about 3% of Indonesians were of Chinese descent.<sup>15</sup> Local rulers used the resident Indian and Chinese merchants as *syahbandar*, or port masters, responsible for fee collection and harbor management. “Tax farms” were also established, which essentially privatised revenue collection by contracting out monopolies to Chinese syndicates (*kongsi*), enabling them to raise revenues without the risk of accruing obligations (and demands for power sharing) from their indigenous noble families.<sup>16</sup> Tax

farming worked synergistically: the Chinese identified a sector or product that could be monopolised, obtained an agreement to control its production or distribution, and paid a fixed rent to the ruler, while keeping the surplus.<sup>17</sup> This became a lucrative source of capital accumulation for Chinese business families, while also establishing the Chinese as a useful “comprador” for royal interests.

By the start of the twentieth century, Southeast Asia had many very large Chinese family firms already diversified into a number of activities. The Khaw family, for example, began their accumulation in the nineteenth century as tax farmers in Southeast Asia and Hong Kong and moved in the early twentieth century into shipping, insurance, and tin mining and smelting in Siam (Thailand), Burma, and the Malay States. Their investments included several joint ventures with Australian companies, Chettiar groups, and other Chinese.<sup>18</sup> Chinese firms in Southeast Asia dominated small-scale industry in the 1930s and 1940s and moved increasingly into larger-scale manufacturing in the 1950s, although they tended still at that time to concentrate in sectors with simpler technology: garments, molded plastics, wood products, and paper, leaving the more complex sectors to foreign investment. The entire first wave of business activity in Southeast Asia depended heavily on foreign and Chinese investment. By the late 1930s, the Chinese controlled half of the investment in Thailand, nearly a third in Malaya-Singapore, and 10% in Indonesia.<sup>19</sup>

Chinese, Indians, and Lebanese immigrants first settled in Africa much later than in Southeast Asia. The earliest may have been the Chinese in Mauritius, who by the mid-1780s already numbered several thousand. By the mid-1840s, the Port Louis market in Mauritius was “dominated” by Chinese traders, and two decades later, one visitor reported, “[I]n every out-of-the-way nook and corner of the island’ you found ‘a Chinaman’s shop.’”<sup>20</sup> However, with the exception of Mauritius (where the Chinese population is currently about 30,000), Madagascar (10,000), and South Africa (10,000), Chinese immigration was not significant in any African country.<sup>21</sup> Indian immigrants began to arrive in significant numbers in Mauritius in 1834, as labourers in the sugar plantations, and came to the rest of Africa as traders throughout the nineteenth century, settling primarily in southern and East Africa.<sup>22</sup> By the 1930s, some Indian firms like Chellarams, a Sindhi Indian trading company, with branches in Southeast Asia, the UK, the Middle East, the West Indies, and West Africa, and the Chandaria Group, with subsidiaries in Kenya, Nigeria, and elsewhere, had become true multinationals. Syrians and Lebanese came predominantly to West Africa, arriving in Nigeria in the mid-1890s, where they became traders and transporters.

As the colonial period came to a close, indigenous African entrepreneurs remained concentrated in the service sector: trade, transport,

real estate, and construction, where some amassed considerable investment. Others set up mills, bakeries, and other light industries, but very rarely on any significant scale. For indigenous entrepreneurs in Southeast Asia, the situation was not very different. Even in the most advanced country, Malaysia, indigenous firms remained “feeble” and concentrated in batik printing, rattan products, and other handicrafts.<sup>23</sup> One handicap indigenous entrepreneurs had was their inability to, as one study reported, “develop business networks.”<sup>24</sup>

In both regions, it was nonindigenous entrepreneurs who had accumulated the networks, capital, and business skills, and who had the global linkages necessary to begin the transition from commerce to modern manufacturing. European capital in Nigeria first began to shift into larger-scale, import substitution manufacturing after 1957 as a defensive reaction to new tariffs on imports.<sup>25</sup> Kenyan Indians (“Asians”), who had started out in commerce and banking in the late nineteenth century, slowly moved into manufacturing in the 1920s. By the 1950s, they were producing on a large and diversified scale, and by the mid-1980s, one study concluded that the “Kenyan manufacturing industry is almost exclusively owned by multinational corporations, Kenyan Asians, or government parastatals; Africans own very few medium or large-sized manufacturing firms.”<sup>26</sup>

Ethnicity became an important political issue in both regions, as colonial governments reconsidered economic development strategies in the post-World War II period. After independence, pressure grew for the new leadership to intervene to create opportunities for indigenous capital. A number of African countries, such as Kenya and Nigeria, attempted to promote indigenous African business by new licensing requirements and regulations that pressured Lebanese and Indian entrepreneurs to vacate trading and small-scale services (leaving these for African entrepreneurs) and move their capital into more sophisticated manufacturing. Some, like Uganda, expelled their Asian population.

Malaysia’s New Economic Policy (NEP), put in place in 1971, was the most explicit effort to boost business opportunities for indigenous capital. The government pledged that by 1990 Malays and Malay interests would own at least 30% of the corporate capital in the country. Dozens of programmes were put in place to promote Malay entrepreneurship. One effect of the NEP was that the proportion of Chinese investment in manufacturing fell by about 50%, as concern rose about the security of Chinese property rights.<sup>27</sup> Much of the difference was made up through state corporations, often in joint ventures with foreign firms. Up until the mid-1960s, Indonesian policies did little to support entrepreneurship for any ethnic group. As development economist Benjamin Higgins charged in 1963, “[T]he story of Java seems to be one of repeated nipping off of a

budding entrepreneurial upsurge by a political elite essentially hostile to it.”<sup>28</sup> After the 1965 coup, policy became more nurturing, targeting in particular the *pribumi*, or indigenous Indonesians. Yet, at present, Chinese Indonesians contribute some 70% of domestic investment, and they also continue to bear the wrath of the indigenous people whenever the economy slumps.<sup>29</sup> Several thousand Chinese were killed in the riots that accompanied the price hikes introduced by the government to address the economic crisis of the late 1990s. Thailand actually moved in a different direction by dropping its official policies of ethnic discrimination in the late 1950s. Consequently, “there has been virtually no significant indigenous business class in Thailand in competition with the Chinese.”<sup>30</sup>

By the end of the twentieth century, the structural transformation and industrial advance of Southeast Asia was still substantially better than most of Africa. Manufacturing output first exceeded agricultural output in Thailand in 1981, in Malaysia in 1984, and in Indonesia in 1991. In 1995, only five Sub-Saharan countries – Zambia, Zimbabwe, Lesotho, South Africa, and Mauritius – had reached that level of structural transformation. Government policies were critical in creating, or not creating, an “enabling environment” for entrepreneurs in both regions, but, as the discussion above points out, for various reasons, history has presented different paths to different groups of entrepreneurs in each region. Some have thus been more able than others to draw on networks and other informal institutions for support, accumulate substantial capital, and be exposed to models of capitalist rationality and external catalysts who can provide the ideas and the strategy for an initial industrial investment.

## Local Entrepreneurship and Global Linkages: Enabling Conditions and Constraints

What do entrepreneurs need in order to invest successfully in manufacturing? At a basic level, particularly if they are traders thinking about moving their capital into a fixed investment, they need a political and economic environment with a certain degree of stability and predictability and some incentives, or at least the absence of strong disincentives for investment. They also need good infrastructure: roads, ports, a constant supply of electricity and water, and reliable telecommunications. On an institutional level, they need contract enforcement and security of property. These can be supplied by the state, or by informal systems based on reputation or sanctions of exclusion. Finally, entrepreneurs are tasked with gathering the “inputs” to the production process: ideas and information about opportunities and markets, investment finance and working capital, sources for technology and inputs, and skilled personnel. In this

section we consider the enabling conditions and constraints faced by local entrepreneurs in both regions. The section begins with a review of networks and clusters as institutions that strengthen entrepreneurs individually and collectively, continues with a discussion of relationships between entrepreneurs and the state, and concludes with a review of foreign investment links. We argue that different local groups have developed different histories of linkage to the global economy, to ideas and resources outside their locality, and to the state, and that this explains an important part of the ability of some groups to embark on dynamic industrialisation.

### *Networks and Global Linkages*

An entrepreneur seeking to enter industry faces high transaction and learning costs. Networks are one way in which entrepreneurs reduce search costs while also lowering the risks of embarking on a new venture. Industrial districts, or clusters of contiguous and often related enterprises, are one way in which networks form. However, today, in an increasingly competitive world, networks need to be global. Global linkages are critical for passing on information and ideas, providing catalysts and capital, and for gaining experience via learning from others. Vertical linkages among firms are formed through subcontracting: larger firms (often international) subcontract parts and processes to smaller (often domestic) firms. Horizontal linkages are those between more or less equal firms and are formed either through geographical proximity (clusters) or networks. Global linkages occur most frequently through trade.

Trading networks have always existed outside of the artificial boundaries established by states, and both Southeast Asia and Sub-Saharan Africa today have impressive trading groups with extensive global contacts. Although many hope that small-scale artisans will make the transition to modern manufacturing, local entrepreneurs who start manufacturing ventures in less developed countries seem more likely to begin as traders. Trade provides a vehicle for capital accumulation and an intimate knowledge of markets and distribution. Travel provides exposure to new ideas and sources of information. Furthermore, traders that are part of an ethnic network have other advantages. As Weidenbaum and Hughes point out, “[I]n a region [East Asia] where capital markets are rudimentary, financial disclosure is limited, and contract law very weak, interpersonal networks are critical to moving economic resources across political boundaries.”<sup>31</sup> These conditions apply even more in Sub-Saharan Africa.

Both regions have different experiences of entrepreneurial accumulation, network formation, and global linkages. The Chinese and, less so, the Indian networks of Asia are legendary.<sup>32</sup> Based originally on ties of

kinship and of dialect, these networks provided credit, preferential distribution agreements, advice, information, and contacts for their members. Extended family and locality-of-origin connections enabled Chinese networks of the eighteenth and nineteenth centuries to expand easily beyond national boundaries, reduce search costs, and resolve problems of trust. As the first generations of trading families reproduced, the following generations had those networks to draw on and expand. The challenges of entering manufacturing from a family with its roots in agriculture, artisanry, or even government service, are much steeper.

African traders and other entrepreneurs also have extensive networks. Indeed, Hausa and Igbo trading networks are also “legendary” in West Africa. Ghana has its famous microenterprise cluster, the Suame Magazine in Kumasi. Much less research has been done on the nature of these clusters and networks as they facilitate modern industrial development. An exception is the Igbo town of Nnewi in eastern Nigeria, where several researchers have studied the development of a cluster that began with trade but evolved into the manufacture of automobile spare parts.<sup>33</sup>

The Igbo of eastern Nigeria live in one of the more densely populated areas of Africa, which may explain why their people became traders, settling in other regions of Nigeria and of West Africa, but always maintaining their connections to eastern Nigeria. With the arrival of a market for exports of oil palm at the end of the nineteenth century, Nnewi entrepreneurs began to collect and (later) transport the valuable oil. During the colonial period, several businessmen, including Philip Ojukwu, amassed considerable wealth through their transport businesses, one of the few areas that were open to indigenous entrepreneurs.<sup>34</sup> With transport becoming an important activity, a market for spare parts soon grew in the centre of Nnewi town. By the 1930s, Nnewi people were at the centre of an international trading network that dominated the supply of motor spare parts. Like the Chinese, Nnewi traders used family networks, clustering close relatives at the centre of each web of distribution and nonrelatives (but generally coethnics) at the outer edges.

Europe supplied the first spare parts, but quite soon Asian entrepreneurs discovered the Nnewi market and began arrangements to manufacture the European parts in their own factories, at considerably less cost. Japanese traders arrived first, but they were soon replaced by Chinese traders, primarily from Taiwan, whose counterfeit “reproductions” of European brand name parts were popular in markets across Nigeria.<sup>35</sup> Over time, ambitious Nigerian traders began to establish their own brand name products, which they commissioned from the Taiwanese traders. The great majority of industrialists in the cluster of spare parts factories in Nnewi are also traders. Most of these are producing one or more of the products they specialise in as traders (usually motor vehicle

parts), and most distribute their products through their preexisting trading networks.

With experience, Nnewi traders began to make direct contacts with their Taiwanese counterparts in Taiwan itself, visiting the factories that manufactured the parts. "For eight years I imported these things and saw how simple they were to make," as one entrepreneur noted, "so I decided to start manufacturing them."<sup>36</sup> International networks gave Nnewi entrepreneurs access to information that simply did not exist inside Nigeria. They were then positioned to move into medium-scale production technologies that Asian firms were beginning to outgrow. At the same time, they kept their networks updated by continuing to import other items that were difficult to make locally.

Another case of Africa-Asia networks can be found in Mauritius. Soon after independence, Mauritius became the first African country to establish Export-Processing Zones (EPZs). Chinese networks were also important in this case. Professor E. Lim Fat, whose family was originally from the Canton area, was instrumental in developing the EPZs, which he had learned about while visiting his wife's family in Taiwan. Taiwan offered technical assistance for establishing the zones (which the Mauritians apparently did not take up formally, although through study tours they learned much from Taiwan). Sino-Mauritians advertised the opportunities through their contacts in Asia and invested in the zones themselves. Between 1971 and 1975, EPZ exports grew at 31% per annum. Although expansion in the zones then went through a slower period, foreign investment from Hong Kong and Taiwan surged in the mid- and late 1980s, becoming the nucleus of a thriving knitwear and garment export industry. By the late 1980s, Mauritius was the third largest exporter of woolen knitwear in the world.

Although Mauritius relied initially on foreign investment and its production and marketing knowledge, entrepreneurs in Mauritius were also quick to take advantage of the business opportunities presented by knitwear, garments, and other products. Franco-Mauritians, who had amassed capital in the sugar industry, and Sino-Mauritians, who had become wealthy through trade, were eager to establish links to the new foreign firms, who acted as catalysts for local investment. The ability of Mauritian firms to attract workers who had been trained in foreign firms and who brought useful skills into local firms spread capacity throughout the industry. At present, Mauritian owners account for about 60% of the capital invested in export production in Mauritius.

Finally, Africa-Asia linkages are also present in Lesotho, where many Hong Kong and Taiwanese investors have recently set up garment factories, and in Kenya, where Kenyan Asian (Indian) entrepreneurs have recently established Export Processing Zones on their own. Chinese in-



vestors have been exploring possibilities in Namibia and Mozambique, while Malaysians were among South Africa's largest investors in the late 1990s.

Industrial clusters that start with trade like that in Nnewi or with artisanship, like the Suame Magazine in Kumasi, Ghana, are historically determined and may build slowly. In Indonesia, where these clusters are common, regression analysis suggests that agglomeration economies go far toward explaining regional enterprise concentration. Yet, as van Dierman notes, "[T]he mere occurrence of clusters does not guarantee that productive networks will develop and agglomeration economies will accrue to individual enterprises within the clusters."<sup>37</sup> Sometimes, the characteristics of an industry will lend themselves to the development of collaboration and horizontal relations. Garment manufacture is one good example of this, where a process that could be vertically integrated is often disaggregated and parts are given to subcontractors. As Pederson notes, this may be rare in Africa:

Many of the small industrial clusters found in Africa appear to have developed out of market towns rather than out of vertical sectoral disaggregation. They are often characterized by very limited vertical specialization and diversification and may develop into clusters of petty commodity producers rather than full-blown industrial clusters. This may be one reason for the limited success of many African enterprise clusters.<sup>38</sup>

Research conducted by McCormick in Kenya reinforces this conclusion. At the low-skill end of the garment market, she found "very limited contracting of specialized services,"<sup>39</sup> and a sharp ethnic division of labour: mass producers of garments were 100% Asian, while the custom tailors were 95% African.

Recent work by economists has begun to quantify the advantages networks may (or may not) provide to entrepreneurs in Asia and in Africa. Economist Marcel Fafchamps has established that personal networks do give entrepreneurs in Kenya and Zimbabwe significant, preferential access to supplier credit.<sup>40</sup> The kinds of networks that could benefit from this access generally were limited to nonindigenous groups who could easily identify each other: Europeans and "Asians," who had access to information about the reliability of others in their network but not of those outside. Research by Oxford economist Abigail Barr suggests that network diversity among Ghanaian manufacturers is significant in explaining productivity differences between enterprises. Barr demonstrates that networking helps Ghanaian entrepreneurs achieve increasing returns to scale, facilitating enterprise expansion.<sup>41</sup> Her work suggests as well that networks can be divided into two ideal types: "solidarity" and "in-

novation” networks.<sup>42</sup> While solidarity networks serve more to reduce uncertainty for entrepreneurs in marginal and traditional industries, innovation networks provide relatively larger, more modern enterprises with the information they require about technologies, markets, and the external world. Van Dierman also notes in his study of Jakarta’s low-technology garment and wood furniture entrepreneurs that “dense networks of inter-firm linkages were not significant” in their growth.<sup>43</sup> But Richard Doner’s research in Thailand suggests that Chinese informal credit networks and trading company links are still very important, especially during periods of economic downturn and “for those firms just moving into manufacture for export.”<sup>44</sup>

Government policies can promote subcontracting and other kinds of linkages, although it is not clear that Southeast Asian or African countries have been effective in these efforts. Indonesia, for example, began in the late 1980s to actively promote linkages between foreign and domestic firms with a well-enforced local content scheme and linkages between large and smaller firms with the *Bapak-Angkat* (“foster-father”) scheme. When these programmes are evaluated, we may learn more about their usefulness.

### *Entrepreneurs and the State*

Entrepreneurs require an “enabling state” to provide the policy framework, supportive services, and the public goods of a social and physical infrastructure. Government officials are more likely to support their entrepreneurs if they can identify private sector industrialisation as being in their interest. Both Southeast Asia and Sub-Saharan Africa have had challenges in this area. For example, James Jesudason notes that in Malaysia “the lack of co-operation between the state and Chinese capital has compromised the nation’s ability to enhance its technological capabilities and develop a strong manufacturing sector.”<sup>45</sup> Likewise, Coughlin comments that in Kenya “Africans own very few medium or large-sized manufacturing firms. This has seriously impeded an identification of interests between local industrialists and the political circles. As a result, the government’s economic policies and bureaucratic decisions are frequently detrimental to the nation’s long-term industrialization.”<sup>46</sup>

The World Bank’s study on the East Asian “miracle” gave some of the credit for East Asia’s success to the relationship between entrepreneurs and the state. In particular, states were said to have engaged in productive discussions with their entrepreneurs, receiving and giving guidance on industrialisation. While this does seem to characterise the northern tier of Asian countries, with Japan as the foremost example, this kind of consultation has been nascent at best in Southeast Asia. Yet the countries

there have made some efforts to institute consultative mechanisms.<sup>47</sup> Malaysia is probably the furthest along in this regard, and its major formal consultations only began in 1991. As of 1993, Indonesia had no formal government-business links for policy coordination, and, although Thailand did establish such links, there is considerable debate over whether or not they have been effective.

States also have the option of direct intervention to promote entrepreneurship. Again, both regions have attempted to “indigenize” their productive base. The Southeast Asian countries seem to have been more serious about using government to provide a boost to indigenous entrepreneurs. For example, Indonesia promoted indigenous investment in oil sector support services by closing certain services to foreign investment and allowing only indigenous firms to bid. The government also promulgated “buy Indonesian” procurement regulations for all government agencies in 1980.<sup>48</sup> In Malaysia, where the state was “relatively autonomous from the dominant foreign and Chinese business groups,” its desire both to promote Malay interests and larger-scale projects led to joint ventures between state enterprises (with shares held in trust for Malays) and foreigners.<sup>49</sup> While the government could have promoted subcontracting to build up the capacity of the small- and medium-size entrepreneurs in Malaysia, most of these entrepreneurs were Chinese, and thus the state chose the option of creating a new business class among the Malays. Indonesia did institute a programme to support small- and medium-size enterprises, but the low level of state capacity hindered the outcome of the programme.<sup>50</sup>

Recent work on industrial clusters, districts, and regions, such as Baden Württemberg in Germany, Sakaki Township in Japan, and Emilia Romagna in Italy, point to the important influence of regional and municipal governments, in addition to, or instead of, national governments, in providing an enabling environment, establishing supportive institutions and public goods, and encouraging industrialisation.<sup>51</sup> There is, however, little evidence that regional and municipal governments have had this kind of nurturing role in either Southeast Asia or Sub-Saharan Africa.

### *Foreign Joint Ventures in Southeast Asia and the Role of Japan*

It is next to impossible to discuss the dynamism of local entrepreneurship in Southeast Asia without discussing its relationship with foreign capital. Foreign joint ventures have been the major form of international linkage in Southeast Asia, transferring technology and skills to local investors. This kind of foreign investment has been much less common in Africa. In Southeast Asia, foreign firms acted as catalysts, and their role has dimin-

ished over time as local firms have gained access to the same international networks, skilled personnel, equipment, and information. Critical to this process has been the role of Japanese and other Asian investors, who tend to behave quite differently from European and U.S. investors.

The story of foreign investment in Southeast Asia has been one of continual change. For example, in 1974 in Malaysia, foreign firms produced nearly 50% of manufacturing output and made up 11% of firms. Ten years later, these statistics dropped to 35% of output and 7.6% of firms.<sup>52</sup> In part, this was a response to the NEP, which led many British firms to withdraw from Malaysia. But the same phenomenon has also been observed in Thailand. In the mid-1960s, Japanese companies owned most of the textile industry in Thailand, but by the 1980s, most factories were owned by Thai firms.<sup>53</sup> However, the World Bank's 1993 study on East Asia stated that most of Thailand's manufactured exports "are produced by foreign investors or joint ventures," implying that the foreign role is still quite large, at least in the export sectors.<sup>54</sup>

Foreign investors need incentives to source their component supplies locally, and Southeast Asian governments have been actively promoting joint ventures as a mechanism for the transfer of skills. For garments, the skills are relatively easy to transfer. Skill requirements are higher in electronics, but many Malaysian firms are now exporting indirectly through supplying components to foreign assemblers. In Indonesia, domestic entrepreneurs "thrived" by entering joint ventures with foreign firms in "textiles, electronics, glass manufacture, pharmaceuticals, and finance."<sup>55</sup> Ownership data do not always reflect local-foreign linkages. For example, economist Hal Hill notes that, in Indonesia, "most firms in the manufacturing sector have some kind of commercial involvement with foreign parties," either through subcontracting or marketing arrangements.<sup>56</sup>

More than others, Japanese firms are likely to be the partners in these foreign linkages, and Japanese firms are not only more likely to enter into joint ventures; they are more likely to be using technology that is transferable to partners at the skill levels present in Southeast Asia. Japan has a long presence in Southeast Asia (and a brief presence in Africa). Trading firms such as Mitsubishi had already established outposts in Southeast Asia by 1917. Because Japan has been such an active trading partner in Southeast Asia, when local traders decided to move into industry, they frequently did so with assistance from their Japanese distributors, much as Nnewi traders in Nigeria did later with their Taiwanese distributors. For example, Thai trading groups in the 1950s and 1960s moved into manufacturing under ISI policies, producing the same products they had formerly been importing. About a third of the

211 industrial firms owned by the major trading groups were joint ventures with foreign firms; of these, 80% were with Japanese firms.<sup>57</sup>

Japanese firms often entered into joint ventures as minority partners, often with Chinese businessmen who “provided important distribution networks which were vital for the Japanese because they were newcomers and specialized in consumer goods.”<sup>58</sup> Yet government actions to promote indigenous interests in Malaysia led to a drop in Chinese participation in these joint ventures. Between 1970 and 1975, 40% of Japanese investment was in joint ventures with Chinese firms, and 18% with state enterprises or Malay firms. By 1976–1980, with more emphasis by the government on Malay participation, joint ventures with Chinese firms dropped to 29%, and ventures with Malay interests (including the state) rose to 54%.<sup>59</sup>

Japanese investment tends to come in waves, whenever the yen is highly valued, making exports from Japan itself uncompetitive. The economic slump Japan experienced throughout the 1990s led to a falling off in new joint-venture investment in Southeast Asia. Although Japanese firms had started to invest in Sub-Saharan Africa, their moves were tentative. For example, not one of the auto assembly firm joint ventures in Nigeria were with Japanese firms, whereas Japanese firms dominate auto assembly in Southeast Asia. Africa has been far more likely to receive investment from Europe and the U.S., and firms from these countries, the U.S. in particular, seem far more likely to remain wholly owned and to invest only in high-capital, extractive ventures.

## Policy Recommendations and Conclusions

To function effectively in a global economy, the entrepreneurs of Southeast Asia and Sub-Saharan Africa will not be able to avoid the kinds of evolution that modern businesses around the world experience. Entrepreneurs in Southeast Asia got an early start in part due to the strength of the Chinese clan and exclusive dialect networks. But some evidence suggests that entrepreneurs move away from reliance on these networks as other institutions develop to take their place: formal banking systems, trade fairs, and trade promotion efforts, etc. Furthermore, as Ruth McVey points out, “[T]he need to act in an increasingly internationalized business world imposes forms and behavior which erode Chinese exclusivity.”<sup>60</sup> Entrepreneurs will move toward public listing of their stocks, greater specialisation and capital mobility, and modern management techniques.

Already this transformation is happening, particularly in Southeast

Asia. By the mid-nineteenth century, for example, more “modern” forms, “such as business partnerships, alliances and trade associations were replacing the guild-like dialect organizations that organized commerce among the Chinese.”<sup>61</sup> Sieh suggests that the new economic groups in Malaysia are different from older groups.<sup>62</sup> They are more diversified, rely more on professional management, tend to grow more through acquisition than through greenfield investment, make more use of external finance (stock issues, bank borrowing), and are less risk-averse. Malay entrepreneurs also appear to be moving away from patronage relations and reliance on state protections, particularly as they grow more experienced and confident.<sup>63</sup> Business groups in Thailand have been slower to grow away from family connections toward the ideal-type modern corporation, with its impersonal character, but Mackie argues that the trend in this direction is quite visible.<sup>64</sup> Mackie also notes that the Chinese in Indonesia are making less use of political connections as their businesses become competitive internationally.<sup>65</sup>

This kind of evolution is assisted by the establishment of institutions such as stock markets, a more efficient means of raising capital through reputation without relying on networks. Indeed, this process has probably gone furthest in Malaysia, where the Kuala Lumpur Stock Exchange was established in 1973. The stock market “made it much easier for larger Chinese companies to advance beyond the single-family firm toward more complex patterns of interlocking share ownership and control, bringing very large sums of capital within the grasp of a single group through takeovers, capital issues, and share swaps.”<sup>66</sup> Conversely, although Thailand has had a stock exchange since 1975, it did not apparently play a significant role in capital mobilisation until the late 1980s. Indonesia was slower in establishing a stock exchange, but its market, too, only began to take off in the late 1980s.<sup>67</sup>

Governments in Southeast Asia also made good use of import substitution (ISI) policies to push their traders into manufacturing. Increasing import duties on consumer goods like textiles and simple electronics has long been a stimulus to move accumulated capital into production. Since traders have the contacts with foreign distributors and networks of information that can make this process easier, they are the logical group to push. African countries had a later start at ISI than Southeast Asia, and they had probably not made full use of this role of ISI in getting local production of consumer goods started before they were swept into the river of liberalisation in Structural Adjustment Programmes in the 1980s. For example, the Nnewi traders in Nigeria were stimulated to shift to manufacturing only by new restrictions imposed in the early 1980s on the goods they were importing. Nigeria liberalised trade considerably under

a Structural Adjustment Programme adopted in 1986, exposing these new manufacturers to the international market. It is important when liberalising trade not to “throw the baby out with the bath water.” Infant industry protection has a rationale in both theory and practice, and many economists have argued that countries should *first* promote exports and only later open up to imports.<sup>68</sup>

When considering what kinds of policies might best boost local entrepreneurship in Africa, this review clearly points in the direction of enabling linkages and networks. Entrepreneurs in Southeast Asia had the advantage of a history of global economic activity and a modern history of linkages with a regional powerhouse, Japan. While the recent economic crisis shows that such informal regional integration can have severe costs, the alternative is not autarchy but rather more careful crafting of regulations and institutions that promote regional investment, joint ventures, etc. The only likely neighbourly powerhouse in Sub-Saharan Africa is South Africa, although Mauritius has begun to export capital to neighbouring countries.<sup>69</sup> Informal institutions in the private sector, particularly private sector linkages and networks that can help overcome information scarcities and reduce transaction and search costs, were critical in Southeast Asia. It is possible that developed countries can help form linkages by providing forums for information exchange and networking to take place or assisting in certification programmes that can help substitute for long years of face-to-face contacts in building confidence among network partners.

Further research is needed on local entrepreneurship in both areas, particularly in Sub-Saharan Africa. We do not know much about the positive role of foreign investment and linkages there, since most of the research on foreign investment in Africa has been conducted from a critical viewpoint. More studies like David Himbara’s of the Kenyan Indian capitalists<sup>70</sup> would also be very useful for a better understanding of the opportunities available to Sub-Saharan countries who have rich entrepreneurial cultures available in their non-African populations. Mauritius may provide guidance here. It is also likely that firms embedded in business networks that span national borders will have different attitudes toward liberalisation: they are likely to be more “outward oriented” than those with only local networks, and this eventually will help promote trade in both regions.<sup>71</sup>

The road out of poverty for Southeast Asia and Africa will likely be built on the dynamism of the entrepreneurs in each region but only to the extent that their governments can provide political and economic stability and the basic public goods of education and infrastructure. There is much that remains in the realm of myth and “stylised facts” about

Southeast Asian and African entrepreneurs: Stories about ethnic exclusion, cronyism, and rent seeking are contradicted by other stories about dynamism, productivity, and global competitiveness. The relations between entrepreneurs and the state have been uneven in both regions, with ethnicity providing a common thread underlying government policy choices. The challenge for governments concerned with ethnic equity is to promote growth while at the same time promoting greater inclusion in the rewards of growth. Much room remains in Sub-Saharan Africa, and in Southeast Asia, for learning from the most successful of each region's entrepreneurs. For many years, entrepreneurs in both regions have been building globalized networks that take advantage of markets but, in some senses, substitute for them as well. Understanding more about the function of networks and entrepreneurial linkages in developing countries may help in fine-tuning programmes and policies to enable more African and Southeast Asian entrepreneurs to compete in an increasingly globalized economy.

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## Resource Exports and Resource Processing for Export in Southeast Asia

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The second-tier or second-generation Southeast Asian high-performing Asia economies (HPAEs) of Malaysia, Thailand, and Indonesia have been distinguished from the first-tier East Asian newly industrialising economies (NIEs) of Korea, Taiwan, Hong Kong, and Singapore, as well as Japan, on a number of grounds, including the resource wealth of the former tier in contrast to the resource poverty of the latter. Southeast Asian resource wealth, it has been argued, made possible rapid economic growth on the basis of primary production and thus weakened the imperative to industrialise. Since much of this primary production was for export, such resource wealth also weakened the imperative to manufacture for export. Thus, resource wealth is seen by some as a “resource curse,” weakening the imperative to industrialise, especially for export. This argument is invoked to explain these second-tier Southeast Asian newly industrialising countries’ (NICs’) later and slower industrialisation (compared to that of Japan and the first-tier NIEs), as well as the allegedly lower emphasis on exports.

Thus, many observers – e.g., Jeffrey Sachs and his colleagues in the *Emerging Asia* study published by the Asian Development Bank (ADB 1997) – suggest that being a natural-resource-rich country is bad for growth. Curiously, the ADB study defines natural-resource abundance in terms of the ratio of net primary-product exports to GDP in 1971 without distinguishing extractive natural resources (especially minerals) from agricultural products. So-called Dutch Disease mainly involves the former,

which tend to be very capital intensive and only involve a small proportion of the population in the extraction of the resource. Consequently, the added income accrues to a few, while the appreciation of the country's currency affects the entire population.

Agricultural exports generally involve much more of the population, and increased income usually accrues to all producers, diffusing the adverse consequences of currency appreciation. The Southeast Asian high-performing economies have been major agricultural exporters, thus offsetting the problems associated with the mineral exports of Malaysia and Indonesia, in sharp contrast to, say, Nigeria. Generally good macro-economic management has also helped, especially to offset the tendency to indulge in expenditure on the nontradable.

Citing Lindauer and Valenchik,<sup>1</sup> Intal has argued that the marginal labour productivity – and hence the opportunity cost of farm labour for manufacturing – is higher in land-abundant African economies, compared to land-scarce Asian economies, even though average labour productivity is usually higher in the latter.<sup>2</sup> Hence, it is unlikely that the former will be able to compete with the latter in labour-intensive manufactures. The Malaysian experience suggests that such labour-scarce, land-abundant economies can only be competitive in skill-intensive rather than unskilled labour-intensive manufactures, requiring considerable investments in human resource development.

Comparing wage rates to labour productivity in manufacturing for 1992, Intal (Table 4) shows the high proportion of wages and salaries to value addition per worker in economies such as Hong Kong (0.51), India (0.39), and Singapore (0.34), compared to Malaysia (0.28), South Korea (0.26), Philippines (0.23), Sri Lanka (0.19), Thailand (0.15 in 1990), and Indonesia (0.14). This suggests that the low wages received by Indian workers, for instance, do not automatically translate into labour cost competitiveness. The situation in much of Africa suggests that, not unlike Indian labour, African labour may also not be competitive in wage/productivity terms.

The “tropical-curse” thesis has also been resurrected by the Asian Development Bank.<sup>3</sup> Surprisingly, the study seems to be oblivious to W. A. Lewis’<sup>4</sup> pioneering work on the economic condition of the tropics. Lewis showed that tropical exports grew faster than temperate zone exports during the last period of global liberalisation from the end of the last century.<sup>5</sup> While the tropics generally had more modest export bases than the temperate zone, their faster growth implies that the tropics were able to respond to export demand despite the disadvantages they faced. Lewis emphasised, however, that not all tropical countries were able to seize the opportunities from increased export demand. He suggests that the exports in greater demand were largely water intensive; hence, only

those areas with enough water to substantially increase their exports were able to take advantage of the new opportunities. The more arid tropical grassland areas thus could not benefit from the increased demand for tropical products. Most important, Lewis observed that the terms of trade for tropical exports had deteriorated badly against those of temperate exports. His observation suggests that productivity gains in the tropics were largely lost to the worsening terms of trade and that the situation would have been even worse where few productivity gains were made.

Since the Southeast Asian newly industrialising countries and some other tropical countries have grown rapidly since the sixties, it is necessary to explain why countries in the tropics have fared so badly in the last few decades. It is not enough to simply attribute the tropical growth shortfall to “pests, diseases, typhoons and other natural calamities,” as the ADB study does, though such factors may not have been unimportant.

Against this background, this chapter will show how the second-tier NICs successfully diversified the range of their primary exports and also developed processing capacities to increase retained added value. As we will show, such diversification and development of resource-based industrialisation did not always come easily, usually requiring government intervention to facilitate the process. Such a discussion implies that the Southeast Asian NICs went beyond static comparative advantages derived from natural resource endowments to develop new capabilities through learning, productivity growth, externalities, and scale economies. Some Southeast Asian governments have captured and deployed resource rents to support policies enhancing new productive capabilities and capacities, as well as international competitiveness, while some firms have invested their resource wealth to develop new internationally competitive capacities.

The story in Southeast Asia is quite varied, emphasising the importance of careful and judicious targeting and organisation to ensure the efficacy of public policy as well as private initiatives. Hence, we provide some detailed description of policy initiatives – including firm and industry level measures – used to encourage primary product diversification and processing. These include “functional” interventions, such as training and physical and social infrastructure support including research and development (R&D), as well as policies aimed at boosting private domestic investment, including foreign direct investment (FDI), fiscal measures, subsidies, preferential credit, procurement policies, etc. We shall also show how export promotion and other policies were used to diversify exports, i.e., to promote nontraditional exports. Finally, some attention will be given to the role of primary-sector institutional reform, particularly in designing, implementing, and monitoring policies.

This chapter proceeds in two stages. Because conventional wisdom exerts substantial influence on the way economic policy making is viewed, our discussion departs from the conventional interpretation by offering an industrial policy interpretation of the three Southeast Asian governments' economic diversification policies. The focus here is on demonstrating how deliberate government intervention was used to diversify the economies away from their previous dependence on a limited range of primary products they had long been producing for export. Such diversification included both broadening the range of primary products being produced as well as industrialisation, including primary product processing – or resource-based industrialisation – for export. The contention of this chapter is that, if these Southeast Asian governments had not intervened selectively and effectively to diversify, they were less likely to have become high-performing economies or second-tier NICs.

## Malaysia

The colonial Malayan economy grew rapidly from the late nineteenth century to become the single most profitable British colony. Access to agricultural land as well as to forest, mineral and, other natural resources increasingly came under the control of the state during and since the colonial period. Peasant agricultural settlement from neighbouring islands was encouraged by the government's offering easy access to cultivable agricultural land. The colonial authorities generally allocated land and other natural resources to favour British investors, ostensibly because they were better financed. Favouring big British capital could have been efficient in so far as there may have been significant scale economies. However, this was certainly not the case in the tin industry during the nineteenth and early twentieth centuries before the advent of the dredge or of the rubber economy during the colonial era.<sup>6</sup>

Infrastructural development – in the form of roads, ports, railways, telecommunications, electricity and water supply – favored British interests. Colonial Malaya's economic infrastructure (e.g., railways, roads, ports, utilities, etc.) was crucial for profitable private investment and generally more developed than in most other British colonies. Ethnic Malays remained largely marginal to the growing capitalist sector, with the elite integrated into the colonial state apparatus and the masses remaining in the countryside as peasants. Instead, emerging business opportunities were mainly taken by some of the more urbanised and commercially better-connected Chinese. However, local businesses often found it more profitable to engage in production for export, commerce, and usury.

The tin boom after the decline of Cornwall in the second half of the

nineteenth century and then the decisive dominance of British dredging, as well as the rubber boom – with the growth of the motor car industry from early in the twentieth century – secured Malaya's high position. In the half-decade after the end of the Second World War, colonial Malaya contributed more export earnings to the British Empire than any other part of the empire, including Britain itself. However, after independence, tin mining, rubber plantations, and international trade continued to be dominated by British-owned agencies in London, until they were bought back, mainly by Malaysian state-owned enterprises, between the mid-seventies and the mid-eighties. Some enterprises have since diversified considerably, at home and abroad, into real property development, financial services, and resource-based as well as import-substituting manufacturing.

Although the Malaysian economy has changed significantly since independence, the many existing differences reflecting uneven development can be traced to the crucial formative decades under colonial rule that shaped Malaysia's economic structure. Helped by favorable commodity prices and some early success in import-substituting industrialisation, the Malaysian economy sustained a high growth rate with low inflation until the early seventies. Malaysia's export-led growth record in the last century has been quite impressive. During colonial times, Malaya was, by far, Britain's most profitable colony, credited with providing much of the export earnings that financed British postwar reconstruction. Only a few industries were allowed to develop by the colonial authorities, who generally considered the colonies as suppliers of raw materials and importers of manufactured goods. Most industries, such as factories for refining tin ore and bottling imported drinks, were then set up to reduce transport costs of exported or imported goods. Local industries developed most when economic relations with the colonial powers were weak, e.g., during the Great Depression and the Japanese Occupation.

Tables 6.1 and 6.2 illustrate some macroeconomic trends in the Malaysian economy in the postcolonial period, showing rapid growth as well as structural change (Table 6.1) and the rapidly changing composition of exports (Table 6.2). After independence in 1957, and especially during the sixties, the Malaysian economy diversified from the twin pillars of the colonial economy, i.e., rubber and tin. The Malaysian economy continued to experience rapid economic growth after independence. The average annual growth rate of the Gross Domestic Product (GDP) in peninsular Malaysia was 5.8% during 1957–1970.<sup>7</sup> Later, the GDP for the whole of Malaysia rose by an average of 6.9% per year between 1971 and 1990<sup>8</sup> and by over 8% percent annually from 1988 until 1996, i.e., before the regional financial crisis of mid-1997. Malaysia's considerable export earnings ensured that it did not suffer from shortages of either



Table 6.1 Malaysia: Gross Domestic Product by Sector, 1960–1995 (%)

	1960 <sup>a</sup>	1970	1980	1990	1995
Agriculture	40	31	23	18	14
Mining	6	6	10	10	7
Manufacturing	9	13	20	26	33
Others	45	50	47	46	46
Total	100	100	100	100	100

Note: *a.* Peninsular Malaysia only.

Sources: R. Alavi, "The Phases of Industrialization in Malaysia, 1957–1980s" (M. A. diss., School of Development Studies, University of East Anglia, Norwich, 1987); Ministry of Finance, Malaysia, *Economic Report*, various issues.

Table 6.2 Malaysia: Export Structure, 1960–1994 (%)

	1960	1965	1970	1975	1980	1985	1990	1994
<i>Agriculture</i>	66.1	54.5	59.5	52.8	43.6	32.7	22.3	14.2
Rubber	55.1	38.6	33.4	21.9	16.4	7.6	3.8	1.9
Timber	5.3	9.6	16.5	12.0	14.1	10.3	8.9	4.5
Palm Oil	2.0	3.1	5.3	15.4	10.3	11.8	6.2	5.8
Others	3.7	3.3	4.0	3.5	2.8	3.0	3.4	2.0
<i>Mining</i>	22.0	30.0	25.9	22.6	33.8	34.0	17.8	6.4
Tin	14.0	23.1	19.6	13.1	8.9	4.3	1.1	0.4
Petroleum	4.0	2.3	3.9	9.3	23.8	22.9	13.4	4.2
LNG	–	–	–	–	–	6.0	2.8	1.6
Others	4.2	4.6	2.4	0.2	1.1	0.8	0.5	0.3
<i>Manufactures</i>	8.5	12.2	11.9	21.4	21.6	32.1	59.3	78.2
<i>Other Exports</i>	3.2	3.3	3.0	3.2	1.0	1.2	0.6	1.2
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Bank Negara Malaysia, *Annual Report*, Kuala Lumpur: BNM, various issues.

savings or foreign exchange, thereby contributing to investments, growth, and structural change.

Primary commodity production continued to dominate the economy in the early years after independence. However, in view of colonial Malaya's heavy dependence on rubber and tin export earnings, following sharp rubber price fluctuations during the 1950s and declining rubber prices in the 1960s and in anticipation of the inevitable exhaustion of tin deposits, diversification of the economy after independence seemed imperative. However, economic diversification remained limited before the 1970s. Thus, despite the promotion of import-substituting industrialisation and the uncertainties that overdependence on tin and rubber production and exports posed for the economy, these commodities remained

the mainstays of the country's economy at the end of the 1960s. From 1951 to 1969, in spite of declining rubber exports due to falling prices, among other reasons, rubber and tin still accounted for almost 80% of Malaysia's gross export earnings.<sup>9</sup> However, continued dominance by foreign capital meant that the surplus generated was often channeled overseas.

In 1957, the primary sector (agriculture and mining) accounted for 45% of the GDP, the tertiary sector (services) for 44%, and the secondary sector (manufacturing and construction) for only 11%. By the late 1960s, there had been little structural change in the economy, both in terms of relative production shares as well as employment. Efforts were stepped up to diversify agricultural exports in the early 1970s. Oil palm and cocoa production, for example, were encouraged with crop-specific incentives, with Malaysia going on to become the world's largest exporter of both agricultural products. Thus, Malaysia extended its colonial global preeminence from rubber, tin, and pepper, to palm oil, tropical hardwoods, and cocoa, i.e., through diversification of primary-sector production. In the mid-seventies, petroleum production – off the east coast of peninsular Malaysia – began providentially, as oil prices soared, beginning in 1973. Since the early eighties, petroleum gas production – almost exclusively for export to Japan – has come on stream, offering yet another primary-commodity engine for the future growth of the Malaysian economy. Petroleum exports thus grew from the mid-seventies, while petroleum gas as well as cocoa production became increasingly significant from the early eighties. The openness of the Malaysian economy has also been sustained by Malaysia's new industries since the late sixties, which have been largely export oriented.

While biased and conservative, postcolonial rural development efforts contrasted with British colonial neglect, especially in the prewar period. Initially, such government efforts were aimed at consolidating a politically loyal Malay yeoman peasantry for counterinsurgency purposes in the late colonial period and to capture the rural Malay vote after independence. Neither the colonial nor postcolonial Malayan governments introduced reforms similar to the far-reaching redistributive land reforms which occurred in China, Vietnam, and North Korea after communist-led revolutions, or the Cold War-inspired system-preserving redistributive land reforms of the late forties and early fifties in Japan, South Korea, and Taiwan. Yet, in the face of a communist-led insurgency from the late forties, the colonial government initiated many reform measures in the early- and mid-fifties, which were subsequently consolidated and elaborated upon by the postcolonial regime to consolidate its rural electoral base.

In 1951, the colonial government established the Rural Industrial De-

velopment Authority (RIDA) under the leadership of Onn Jaffar, the founding president of the United Malays National Organization (UMNO). Onn had left the party to form the multiethnic Independence of Malaya Party (IMP), apparently in response to a British condition for achieving independence. Later, various reforms were introduced to promote rural cooperatives and to limit rents charged for rice land tenancy as well as interest charged on credit loans. In the prewar period, the government had restricted Malay land sales to non-Malays. It had also initiated research by the Rubber Research Institute (RRI) to enhance the agronomic, technical, and other aspects of rubber production and use.

In 1952, the government established the Rubber Replanting Fund, financed by a tax imposed on rubber exports. This facility was introduced in response to a recognition of widespread reluctance to replant less productive rubber trees, owing to the tree removal and replanting costs involved, as well as the opportunity costs due to the temporary loss of income. By providing replanting grants according to the area being replanted, the fund facilitated and encouraged replanting, thus also arresting declining productivity in rubber production. However, plantations and large small-holdings (defined as being less than a hundred acres in area) were better able to utilise the facility, since they could better afford to allow particular areas to be replanted while working the rest of the planted area. For smaller small-holdings that did not have other land to continue working on, the opportunity costs seemed greater, resulting in much less replanting by such small-holders. In response, the government set up the Rubber Industry Smallholders Development Authority (RISDA), which has provided larger replanting grants to small-holders and facilitated replanting in other ways. The more recent demand for rubber wood as commercial timber has also encouraged replanting. However, many rubber small-holdings and other farms have been left idle since the eighties as the small-holders age and their children have secured employment outside the farm sector. As a consequence, productivity on small-holdings is now significantly lower than on plantations.

In 1956, the Federal Land Development Authority (Felda) was established to open up new agricultural land for cultivation by landless settlers. Over the next three decades, Felda was to open up millions of acres of land in peninsular Malaysia, planted with rubber, oil palm, and other crops. The management of these Felda land development schemes has changed considerably over time, involving various experiments, ranging from simple supervision of small-holding operations to virtual plantation style management of workers who are also settler-shareholders. Despite such variation in crop type, management, and other conditions, as well as various controversies, Felda has successfully used public resources (land, capital) to significantly expand agricultural production to the advantage

of the settlers and with some degree of public accountability. While the former might have been achieved through private investments alone, the consequences are likely to have been more inequitable and hence more likely to have been politically destabilising.

The roots of peasant agricultural and rural development efforts and institutional innovation can be traced to the late colonial period, especially the early- and mid-fifties, which were characterised by social-reform policy initiatives as part of British counterinsurgency efforts. These efforts increased after independence in 1957, as the Malay yeoman peasantry was seen as the main rural “vote bank” for the ruling UMNO and its Alliance coalition. The early postindependence period also saw the proliferation of rural development efforts, thanks to the intense political rivalry between the Agriculture Minister and the Rural Development Minister, until the former’s ouster in the early 1960s. The sixties saw the development of extensive irrigation systems to facilitate the Green Revolution in rice farming, especially in the northern parts of the peninsula. The government undertook various initiatives to provide alternative rural and agricultural marketing options (e.g., by establishing FAMA, the Federal Agricultural Marketing Authority), ostensibly to undermine the role of the supposedly ubiquitous Chinese middlemen. While not especially successful, such alternatives, as well as the improvement of rural communications and transport infrastructure, probably undermined their market power. Parallel credit schemes probably had similar effects. Meanwhile, the scope of Felcra and other land development initiatives increased greatly, while small-holder rubber replanting was encouraged by the establishment of RISDA.

The ethnic riots of May 1969 and the enhanced position of UMNO in the expanded National Front ruling coalition afterward were reflected in the New Economic Policy (NEP). The NEP was committed to “eradicating poverty,” initially seen in terms of efforts to raise agricultural productivity and prices. This new commitment saw a further increase in agricultural- and rural-development efforts, mainly involving the expansion of earlier efforts. For example, besides Felcra’s large land schemes, Felcra, the Federal Land Consolidation and Rehabilitation Authority, pursued similar efforts on a more modest scale in situ. Although it now appears that much of the reduction of poverty in the 1970s and thereafter was due to young people leaving the peasant agriculture of their parents for urban factory and service jobs, as well as the increased significance of off-farm rural incomes, the tremendous investments of this period were certainly not without effect.

Since the early eighties, however, more emphasis has been given to the development of commercial agriculture – involving larger farms using more profitable, productivity-raising, and cost-saving modern manage-

ment methods – for export markets. While there has not been any spectacular increase in agricultural production in recent years, except for that due to technical advancements, there has been a significant relative, as well as absolute, decline in the agricultural labour force, although official statistics underestimate the presence of foreign labour, especially of undocumented workers.

Rents in Malaysia have been created and allocated in ways so as to encourage investments in new productive activities, which have accelerated the diversification of the economy from its colonial inheritance. Much of this reform has emphasised economic diversification, especially industrialisation, initially on the basis of import substitution, then export promotion and heavy industrialisation as well. Another important goal of rent creation and deployment in Malaysia has been redistribution, especially along interethnic lines, though the economic effects of redistributive state interventions have generally been quite different from those intended to enhance structural change and economic diversification. But they have also been more varied.

The availability of natural resource rents – most notably from petroleum, natural (petroleum) gas, tin, timber and agricultural products – has been very significant for growth, exports, savings, investment, government revenue, and fiscal capacity, allowing the government greater latitude and capacity than most other governments in the world. It is important to consider the nature and fate of different types of resource rents by comparing the nature and fate of rents to those of petroleum and logging.

The Petroleum Development Act of 1974 has enabled the federal government to successfully capture much of the resource rents from petroleum and natural gas resources, providing a modest proportion to the governments of the states where the deposits are located. The PDA gave the federal authorities jurisdiction over petroleum resources, unlike other natural resources – including land, water, forests and minerals – which have been state government prerogatives under the postcolonial federal constitution. In the mid-seventies, petroleum production off the east coast of peninsular Malaysia began providentially, as oil prices soared after 1973. Although petroleum had long been extracted off Sarawak by Shell, Malaysia only became a net oil exporter from the mid-seventies. Since the early eighties, petroleum gas production – almost exclusively for export to Japan – has come on stream. While petroleum royalties are shared with the state government concerned, the federal government controls the revenues of Petronas, as well as other petroleum revenues. Petronas is widely considered to be a well-run company, with a good international credit rating.

Petronas resources have been abused for various purposes, including, on two occasions, saving the state-owned Bank Bumiputera from “going

under,” and buying into major real-property construction projects of dubious commercial feasibility. These abuses have done little to enhance productivity but have instead served to prop up problematic government projects and to “save” protected and nontradable economic activities or international competitiveness. However, these abuses of Petronas resources have only been possible because the company has been able to capture and retain petroleum rents reasonably well, in sharp contrast to the situation with logging.<sup>10</sup>

In the case of timber, by contrast, almost nothing has been captured by the federal government and relatively little by the state governments, which have controlled all land and natural resources other than petroleum and natural gas since the PDA. Timber rents have mainly been captured by powerful politicians, royalty, and others who secure logging concessions, as well as by their mainly ethnic Chinese logging operator partners and, frequently, Japanese *sogosha* financiers. It should not be forgotten that rent seeking occurs in essentially oligopolistic environments, ensuring that rents are not all dissipated in the process due to political “entry barriers” and that net gains are handsome enough to be very attractive. Such rents have not been restructured to reward productive and productivity-enhancing investments until recently, when bans on log exports have encouraged investments in wood processing, with generally inefficient outcomes owing to the manner in which the incentives have been structured.<sup>11</sup>

The state government authorities do not tax either the timber concessionaires or the logging companies – invariably connected to powerful state government politicians – very much, certainly not even enough to cover the real costs of reforestation and of strict enforcement of logging and other related regulations. Timber companies hardly pay income tax, while the state governments collect a small royalty on the logs extracted, amounting to barely one percent of the timber price. Loggers minimise their tax liabilities by undervaluing both the type, nature, and quality of the timber extracted, and the quantity, volumes, or weights. Under-declaration of wood extracted and exported is common, while accounts are “fiddled” or officials bribed to reduce tax and royalty liabilities and to maximise retained earnings. As the federal government and the state governments realise that timber revenues have been well below what they should be, tax rates have been raised, but the raises often only lead to further tax evasion.

With few taxes to pay, and poor enforcement by the authorities, the loggers seek to maximise short-term rather than long-term returns, especially with the political uncertainties which threaten policy change and the security of their concessions. Having no stake in the forest’s regeneration, owing to the generally short-term nature of the logging concessions

and the subcontracting arrangements to the loggers by the concessionaires, the logging industry has been short-termist and largely oblivious of the requirements of sustainable forestry practices. Much illegal logging – that done outside concession areas, logging of immature trees, etc. – occurs, while logging companies often disregard restrictions for selective felling in order to maximise profits in the short term.

Logging's contribution to Malaysian capital accumulation, investment, and growth has been limited in other ways, too. Underdeclaration of timber production and exports has not only facilitated tax evasion but also capital flight. Many of the beneficiaries have not even reinvested within the country, let alone in the areas from which the timber has been extracted. Not surprisingly, then, Malaysian logging companies have been among the most prominent of Malaysian companies investing abroad in the Southwest Pacific, Indochina, West Africa, and northern South America. Thus, logging has exacerbated resource outflows not only for the communities directly affected but also for the national economy. Despite the considerable money made from logging, both state and federal governments get relatively little, while they are obliged to bear some of the environmental and other costs of deforestation.

Despite some dissipation as well as rent capture by dubious rentiers unlikely to make productivity-enhancing investments, such resource wealth and Malaysia's relatively small population enabled the public sector to develop in the 1970s and early 1980s with a "soft budget constraint." This not only allowed, but even encouraged, various extravagances. Such fiscal irresponsibility seemed to increase with greater state intervention and the availability of enhanced oil revenues from the mid-1970s, until the economic and political crises of the mid-1980s brought about greater fiscal discipline and harder public enterprise budget constraints, besides providing a rationale for privatisation.

By East Asian standards, Malaysia has had one of the highest household savings rates, second only to Singapore. The main reason is a similar employees-provident fund institution, requiring all workers and their employers to contribute the equivalent of between 20% to 30% of their wages to a fund, which later becomes available upon retirement or for other designated purposes. This forced savings institution has also been important as an alternative to "pay as you go" pension fund arrangements, which have become very burdensome and almost unsustainable in mature welfare states.

Malaysia's manufacturing growth has been facilitated by both import substitution (IS) and export orientation (EO) industrialisation policies. Both IS and EO industries have gained from protection and subsidies, respectively. For example, EO rents attracted foreign transnationals to invest in the processing of imported inputs for reexport. Various rents –

offered in the form of financial (especially tax) incentives, low wages, good infrastructure, political stability, and government support – have attracted risky lumpy investments in export processing and even in some design activities since the 1980s. Like import substitution, export orientation has also involved distorting relative prices, contrary to the claims that export success has been due to *laissez-faire* market policies.

Though Malaya was, by far, Britain's most profitable colony, only a few industries were allowed to develop by the colonial authorities, who generally considered the colonies as suppliers of raw materials and importers of manufactured goods. During the colonial period, some such industries enjoyed "natural protection" due to the nature of the raw materials produced (e.g., rubber latex requiring immediate processing near the point of extraction). Most industries then were set up to reduce transport costs of exported or imported goods, such as factories for smelting tin ore, processing smoked rubber sheets to reduce rubber's natural liquid content, and bottling imported drinks. Not surprisingly, then, local industries developed most when economic relations with the colonial powers were weak, e.g., during the Great Depression and the Japanese Occupation.

Resource-based industrialisation was the great hope for postcolonial Malaysia, whose growth during the colonial period had been based on primary production. After independence, for example, it was expected that, as the world's largest natural rubber producer, Malaysia would be placed to become a significant producer and exporter of rubber manufactures such as car tyres. Ironically, owing to the low natural rubber content and high synthetic rubber content of most car tyres, as well as the different effectiveness of industrial policies, rather than Malaysia, South Korea (which does not produce any natural rubber or petroleum, from which synthetic rubber is made) emerged in the eighties as a major rubber tyre producer and exporter.

Inexperienced Korean rubber tyre manufacturers were initially protected on condition that they would export within a few years, which they did with great success. Having to export forced the tyre manufacturers to quickly minimise costs, maximise scale economies, and raise quality to international standards. In Malaysia, however, foreign tyre manufacturers were granted protection to induce them to set up a plant to produce for the domestic market. While the government hoped that they would eventually export, it did nothing to require them to do so, although it offered attractive incentives and support facilities in the hope that they would do so. These transnational tyre manufacturers eventually began exporting, but their achievement has been modest given the amount of protection they have enjoyed in terms of both the duration as well as the effective rate of protection. Exports were initially of tyres with



a high natural rubber content (e.g., aircraft tyres) and have grown most since the ringgit depreciation in the second half of the eighties. The differences in the performances of the rubber tyre industries in South Korea and Malaysia clearly reflect the consequences of appropriate and effective industrial policy measures.

As noted earlier, as part of its measures of agricultural diversification, postcolonial Malaysia promoted increased palm oil production from the sixties, especially in the face of lower, often depressed rubber prices. The nature of the crop and transport cost considerations required the domestic extraction of crude palm oil from the palm fruit before export. However, palm oil producers and other investors were unwilling to invest in palm oil refining capacity before the mid-seventies. Returns to such investments were not expected to be high enough to warrant them. Also, many importing countries imposed higher import duties on refined oil to protect their own refining capacities, effectively discouraging investments in such capacity abroad, including Malaysia.

However, a higher export duty on crude palm oil exports introduced in Malaysia in the mid-seventies attracted massive investments in processing capacity, which led to very intense competition among refiners. This forced refiners to enhance their industrial and technological capabilities rapidly, enabling Malaysia to reach and then even define the world technological frontier in palm oil refining within a decade. The rapid development of such capabilities was facilitated by the achievement of new economies of scale and scope (e.g., specialised palm oil rather than generic vegetable oil processing). In the face of new protectionist barriers erected by traditional European and other importers who wished to promote the consumption of their own vegetable oils or protect their existing refining capacity, the Malaysian government also did a great deal to promote palm oil exports to large new markets, such as the Soviet Union, India, Pakistan, and China. In some instances, the Malaysian authorities have even encouraged potential importers to develop palm oil refining capacities in the importing countries, effectively committing them to future imports of the oil, presumably from Malaysia.

This story provides a splendid illustration of how government intervention – involving a temporary welfare loss for crude palm oil producers (due to the export duty equivalent which accrued to investing refiners instead) – led to considerable net welfare gains for all major segments of the palm oil industry and significant gains in value addition for the national economy. It also underscores the importance of a dynamic perspective on comparative advantage, instead of the static view associated with neoclassical international trade theory.

However, efforts to increase manufacturing value addition in Malaysia have not always been well considered. For example, bans on log exports

Table 6.3 Malaysia: Leading Manufactured Exports, 1970–1993\*

Exports	SITC (Rev. 3)	% of Exports			
		1970	1980	1986	1993
Integrated circuits	773 + 775 + 776	0.1	8.4*	16.6*	18.7*
Telecommunication and sound equipment	76	0.1	0.8	3.8*	16.7*
Petroleum and natural gas	33 & 341	7.3*	24.7*	22.9*	7.0*
Office machines and parts	75	0.0	0.0	0.1	9.7*
Wood, rough and shaped	24	16.5*	14.1*	11.7*	3.7*
Animal, vegetable oils	4	6.0*	11.1*	10.1*	6.8*
Clothing	84	0.3	1.2	3.0*	3.1*
Wood manufactures	63	1.7*	1.7*	1.5*	2.6*
Switch-gear	7720.1	0.7	1.1	1.6*	
General industrial machinery	74	0.3	0.5	1.0	2.2*
Aircraft/parts	7920.1	0.7	0.4	1.7*	
Natural rubber	23233.4*	16.4*	8.9*	2.2*	
Tin	68719.5*	8.9*	1.8*	0.3	
Metal-ferrous ores	28	3.0*	1.1	0.8	0.2
Subtotal, leading exports*	–	87.4*	85.3*	80.3*	76.2*
Subtotal, top 6 exports	–	85.7	83.6	74.0	62.7
Total exports (US\$ 1,000)	–	1,686,632	12,939,233	13,830,248	73,778,170

Note: \* Leading exports: export share greater than 1.5%.

Sources: Nola Reinhardt, “Back to Basics: The Role of Resource-based Industries in Malaysian and Thai Export Growth” (*World Development*, 1999); calculated from UN Commodity Trade Statistics Database (COMTRADE); *Yearbook of International Trade Statistics*, United Nations, various years.

have been progressively extended at various times from peninsular Malaysia in the early eighties to Sabah in the early nineties and Sarawak in the late nineties, with the ostensible intention of promoting wood-based manufacturing activities in Malaysia. While wood-processing activities have certainly grown, much of the existing capacity is quite unsophisticated and inefficient and would not survive without the log export ban. More importantly, there is little evidence that most of these industries are ever going to become internationally competitive, meaning that they constitute a welfare loss, particularly for the timber producers who receive lower prices for their timber due to the market constraints imposed by the log export ban.

There has, consequently, been some upgrading of Malaysia's wood exports since 1986. Rough and shaped wood products (SITC 24), which comprise the lower end of this sector, have decreased sharply as a share of total exports, while the share of shaped wood products within this category has increased relatively. The more sophisticated category of simple wood manufactures (SITC 63) has grown in recent years. Upgrading to higher added-value products has also occurred. There has also been very rapid export growth of manufactured wood furniture from the mid-1980s, although 80% of wood furniture exports are made from rubber wood and the rapid growth was mainly due to Taiwanese investors seeking lower labour costs.<sup>12</sup> Technological development has been slowed by the shortage of skilled personnel.

The government has become more selectively interventionist since the mid-eighties, even withdrawing earlier protectionism in some areas, in line with its commitment to economic liberalisation, giving the overall impression of incoherent industrial policy. The period since the mid-1980s has also seen new efforts by the government to encourage technological deepening by foreign capital. Rents have been increasingly tied to the development of domestic production capabilities, rather than simply to investment and employment generation, as was the situation before the mid-1980s. Human resources, research and development, linkages, exports, and technologically strategic manufactures all enjoy additional tax incentives.

For Malaysia, then, palm oil has remained an important export, although the nation's share of all exports has dropped significantly since the mid-1980s. The U.S. labeling of palm oil as a saturated fat has certainly hurt exports, as have rising costs. Petrochemicals, especially organic building blocks and intermediates (SITC 512) and plastics (SITC 58), were another resource-based subsector with strong potential, based on the availability of petroleum and natural gas reserves. These products also exhibited very strong export growth of over 30% after 1986.

The rubber industry, too, has important potential. Malaysia has been

Table 6.4 Malaysia: Export Growth of Selected Resource-Based Manufactures, 1986–1995

Product	SITC	Average Annual Growth Rate (1986–93)	Percentage of 1995 Exports
Soaps	554	33.7	0.2
Petrochemicals	51 + 58	31.2	1.4
Rubber clothing	8482	38.8	1.3
Rubber manufactures	62	26.5	0.5
Footwear	851	26.6	0.2
Furniture	821	64.1	1.2
<i>Manufacturing total</i>	–	30.4	89.5

Sources: Nola Reinhardt, “Back to Basics: The Role of Resource-based Industries in Malaysian and Thai Export Growth” (*World Development*, 1999); calculated from UN Commodity Trade Statistics Database (COMTRADE); *Yearbook of International Trade Statistics*, United Nations, various years; *Annual Statistics of External Trade*, Department of Statistics, Malaysia, 1996.

able to significantly expand exports from this sector, mainly at the lower end of the industry, with dipped latex goods such as rubber gloves and swimming caps. Exports of rubber clothing have grown rapidly by almost 40% per annum since the mid-1980s. These are the most raw-material-intensive of rubber products benefiting most from the country’s cost advantages. However, exports of higher added-value rubber products, such as tyres, have been modest. Instead, multinational and joint venture firms dominate the protected domestic market. Rubber footwear exports have also been disappointing. The first Industrial Master Plan (1986–1995) argued that Malaysia’s natural rubber cost advantage was offset by the higher costs of other inputs, by uneconomic plant size, and by low labour productivity, affecting the industry’s international competitiveness.

## Thailand

Between 1955 and 1988, per capita economic growth in Thailand averaged 3.9% per annum.<sup>13</sup> Only four countries – Brazil, Malaysia, Taiwan, China, and South Korea – grew faster. High economic growth was accompanied by a rapid decline in the incidence of poverty, mild but rising income inequality, and substantial exports of both manufactures and primary commodities, including processed agricultural commodities.<sup>14</sup> By 1985, the value of manufactured exports exceeded agricultural exports for the first time.<sup>15</sup> Textile exports increased fourfold between 1983 and 1989; integrated circuits (ICs) exports doubled between 1985 and 1987,

Table 6.5 Thailand: Changes in Production Structure, 1960–1993 (GDP share in percentages, selected years)

	1961	1970	1980	1990	1993
Agriculture	39.8	27.0	20.0	13.6	11.8
Industry	18.7	24.4	30.1	37.8	40.8
Services	41.5	48.0	49.9	48.6	47.4
Manufacturing	12.6	16.0	21.7	27.8	31.1
Total	100.0	100.0	100.0	100.0	100.0

Sources: National Economic and Social Development Board; Bank of Thailand.

while exports of plastics and shoes more than doubled in 1988 alone. This export boom (largely based on foreign investment) contributed to an acceleration of growth to 6.4% per capita per annum between 1989 and 1992.<sup>16</sup> This long-term development performance (Tables 6.5 and 6.6) made Thailand one of the development success stories since 1960.

Throughout the nineteenth century, Thailand was a self-sufficient, semifeudal economy.<sup>17</sup> With the imposition of the Bowring Treaty in 1855, the country began a century-long process of integration with the West. The political crisis that accompanied the forced opening of the economy led the monarchy to turn to administrative reform and political change to preserve Thai independence. For the most part, reforms reinforced traditional institutions – the monarchy and Buddhism – and fostered the development of a centralised state, weak interest groups, and nondemocratic politics.<sup>18</sup>

By 1927, the outlines of the modern Thai political economy were set. The centre (Bangkok) had molded a loosely integrated collection of semiautonomous provinces into a nation state by a triad of forces consisting of a highly centralised bureaucracy that invested in national defense and the transport system, a freed peasantry that expanded the area under cultivation, and Chinese traders and European exporters who facilitated the rice trade.<sup>19</sup> Political legitimacy for this particular political economy rested on an aura of sacredness surrounding the monarchy, an elitist, hierarchical social structure in which superiors and subordinates were interlinked in a set of reciprocal but unequal relations, and the pervasive influence of Buddhism.<sup>20</sup> Subsequent political developments – the formal establishment of parliamentary democracy in 1932, accommodation with Chinese “pariah” entrepreneurs in the 1950s, and ceding of substantial control over economic policy to western-trained technocrats in the 1960s – reinforced the traditional pillars of political legitimacy and the tendency toward a centralised state, a weak political-party system, and unstable democratic political institutions.<sup>21</sup>

Industrial policy making in Thailand has been spread across a wide

Table 6.6 Thailand: Structure of Exports, 1981–1993 (percentage of total exports)

	1981	1985	1988	1990	1993	1981–93*
<i>Agriculture</i>						
Rice	17	12	9	5	4	0.8
Tapioca	11	9	5	4	2	-1.06
Total	48	38	26	17	12	1.4
<i>Labour-intensive manufactures<sup>a</sup></i>						
Textiles and garments	10	14	16	16	14	43.0
Jewelry	3	4	6	6	4	40.9
Footwear	0	1	2	3	3	98.5
Total	15	21	29	31	27	57.9
<i>Medium-high technology manufactures</i>						
Machinery and appliances <sup>b</sup>	0	1	4	8	10	346.3
Electrical	0	1	2	6	7	240.1
Electrical circuitry <sup>c</sup>	4	4	7	6	8	65.2
Vehicles and parts	0	0	1	1	2	23.7
Total	5	7	15	22	30	73.3
<i>Manufactures as percentage of total exports</i>	36	49	16	75	80	
<i>Total exports</i>	100	100	100	100	100	

Notes: \* Average annual growth rate of exports (% per annum)

a. All "other" categories (other agriculture, other labour-intensive, etc.) have been omitted.

b. Mainly computers and parts.

c. Mainly integrated circuits.

Sources: Thailand Development Research Institute, 1994; Bank of Thailand.

array of agencies with limited technical capacity. At least seven agencies were responsible for industrial policy. Neoliberals viewed these agencies as either deficient or irrelevant.<sup>22</sup> The lead agency, the Board of Investment (BOI), offered lucrative fiscal incentives to promote investment. But, neoliberals argued, it was understaffed, lacked clear promotion guidelines, and failed to hold promoted firms accountable for their performances. More often than not, promotions were granted on an ad hoc basis and given with little understanding of their macroeconomic effects or of project viability. As noted above, the Ministry of Finance set tariffs and tax rates but lacked the capacity to assess the impacts of changes in tariffs on industrial structure. The Ministry of Commerce (MOC) controlled the import and export of certain goods, including the ability to ban imports and exports of those goods, and operated an export services centre. The Ministry of Industry (MOI) issued licenses to build factories, regulated business conduct, and enforced zoning laws. Neither of these

ministries had much technical strength. The Industrial Finance Corporation of Thailand (IFCT), a private development bank, lent long term to medium- and large-scale enterprises. Its lending was small and irrelevant. Thailand's national planning agency, the National Economic and Social Development Board (NESDB), set the broad direction for the economy, but its role was only advisory and its technical capacity was limited. The Bank of Thailand determined credit policy. Although it was a key macroplayer, it had limited influence over sectoral policy.<sup>23</sup>

Inadequate coordination among these agencies and overlapping jurisdiction contributed to the lack of coherent industrial policies. At least four agencies – the Board of Investment, the Ministry of Finance, the Ministry of Commerce, and the Ministry of Industry – controlled trade policy. Until 1990, attempts by the core macroeconomic ministries to rationalise trade policy along neoliberal lines failed.<sup>24</sup> No less than five departments in three ministries controlled access to numerous permits and licenses. Sometimes multiple offices were involved in obtaining a single permit. Efforts by BOI to facilitate the permit acquisition process through its Investment Services Center (ISC) were routinely blocked by departments or ministries who refused to relinquish control over their prerogatives. As a result, BOI's Investment Services Center was unable to serve as a one-stop shop, and much of its work was limited to handling minor visa problems. Overlapping jurisdiction also meant that industries banned from expansion due to excess capacity by the Ministry of Industry had either been aggressively promoted by the Board of Investment (BOI) or had grown due to the high tariffs under control of the Ministry of Finance.<sup>25</sup> And firms provided privileges by BOI often found those privileges undermined by the actions of other ministries.<sup>26</sup> Neoliberals argued that the fragmentation of industrial policy and its separation from macroeconomic policy making served an important political function.<sup>27</sup> It provided rich opportunities for the “big men” in the bureaucratic polity to use sectoral policies to satisfy the demands of their supporters.

The standard interpretation of the Thai state seems to offer an internally consistent and powerful explanation of the irrelevance of Thai industrial policy. The focus on rent-seeking “feudalisation” of government administration leads many observers to overlook important contrary evidence of highly effective, long-standing and significant selective distortions in agricultural markets. This interpretation causes them to miss equally important examples of successful selective interventions during first-stage import substitution industrialisation (ISI) in the 1960s, as well as during second stage ISI in the 1970s. It also contributes to a critical oversight of the systematic turning of the entire industrial policy machinery to promote nontraditional manufacturing exports and non-traditional agroindustrial exports during the 1980s.

An important part of the neoliberal interpretation of Thai industrial policy rests on an assertion of low price distortions. While the exchange rate, the interest rate, and the price of capital were kept close to their scarcity values, this was not true for agricultural prices, particularly rice prices and, by implication, the price of labour.<sup>28</sup> These distortions were systematic, sustained over time, and large. What was the purpose of the government's rice price policy and how did it intervene in rice markets?<sup>29</sup> Except for occasional rent seeking, government intervention in rice markets was aimed at stabilising rice prices at a low level.<sup>30</sup> This was achieved through a variety of taxes, including a variable export tax on rice. This policy had two important consequences. It facilitated substantial crop diversification.<sup>31</sup> As shown below, it also contributed to the emergence of a large export-oriented agroprocessing industry once the government began offering promotional privileges to large export-oriented agroprocessors. This policy also enabled the government to take advantage of a large land frontier to manipulate the industrious but politically docile peasantry by giving peasants access to land while taxing them heavily.<sup>32</sup> As a result of the government's systematic use of a variable export tax on rice for over thirty years, it was possible to extract resources from agriculture without impoverishing the peasantry and to build an indigenously owned commercial banking system and an import substitution industrial base in Bangkok behind protective barriers.<sup>33</sup>

In 1986, the government began promoting export-oriented agroindustries.<sup>34</sup> These industries were chosen for promotion because all of their output was exportable; most of their raw materials were produced locally; they were labour intensive; and they increased farmer incomes.<sup>35</sup> Since then, promotional privileges for export-oriented agroprocessing industries have included import duty reduction on machinery imports; three-year income tax exemptions extendible to seven years; exemption of import duties on raw- or essential-materials imports; exemptions of export taxes; exemptions of added-value taxes on exports and on local goods used to produce exports; and reduced electricity charges, domestic air cargo charges by Thai International, and rail charges if the industries were located in industrial estates in selective provinces.<sup>36</sup> Agroprocessing industries have also benefited from the extension of subsidised credit to farmers who participate in contract farming and out-growing schemes;<sup>37</sup> from promotional privileges extended to general trading companies; from bilateral intergovernmental negotiations with importing countries, which have resulted in lower tariffs on imports; and from a government programme designed to enhance the quality of agroexports.

Although there are no definitive studies of the impact of promotional privileges on agroprocessing industries and their exports, available evidence suggests that these programmes probably did make a significant



difference. For one, processed agricultural exports grew at an annual average rate of 33.75% between 1986 and 1993 (Table 6.6). Moreover, by the late 1980s, 15 of the largest 26 nonfinancial domestic business groups were exporting processed agricultural commodities.<sup>38</sup> For prepared meat exports, primarily chicken meat exports, growth was even more dramatic. Prepared meat exports were practically nonexistent prior to 1976; by 1980, they equaled US\$ 32.7 million; by 1985, they equaled US\$ 63.5 million. Following heavy promotion by the government, prepared meat exports increased eightfold to US\$ 434 million in 1993 (Table 6.6).

The experience of the Charoen Pokpahan (CP) Group is typical of the expansion experienced by Thailand's agroindustries.<sup>39</sup> The CP group got its start in 1921 as a trading company importing seeds and vegetables and exporting pigs and eggs. The company registered with the Thai government in 1951 and opened a feed mill in 1954. With this mill the company took the first steps toward vertical integration, as the group not only sold seeds to farmers but also bought and processed farmers' crops. In 1976, CP moved into poultry farming, following an announcement by the Board of Investment that promotional privileges were available for this activity. Because of difficulties breeding local chicken, CP entered a joint venture with an American company, Arbor Acres. Arbor Acres provided and continues to provide CP with chicks. CP also established joint ventures with Japanese firms to market frozen chicken meat in Japan.<sup>40</sup> And it pioneered contract farming in Thailand, including guaranteeing loans to farmers from the commercial banks and from the Bank of Agriculture and Agricultural Cooperatives.<sup>41</sup> By 1979, CP controlled 90% of poultry exports and 40% of the domestic animal feeds business. CP also used Board of Investment (BOI) privileges to establish its own trading company, CP Intertrade, and to establish plantations for growing mung beans and maize.<sup>42</sup>

Institutional changes within the government and between the government and the private sector provided a unique opportunity to reform industrial policy along neoliberal lines.<sup>43</sup> But efforts to do so were blocked by old patron-client ties between industrialists in the private sector and cabinet ministers in sectoral (line) ministries.<sup>44</sup> In fact, the trade regime became more protectionist.<sup>45</sup> Following this failure, the government turned its newly found power to neostatist micro- (selective) interventions. Board of Investment (BOI) promotional privileges, including exemptions and/or reductions in import duties and business taxes on imported inputs, machinery, and equipment, and exemptions from corporate income taxes, were extended to export projects, including those of direct foreign investors.<sup>46</sup> This shift required changing the criteria for offering promotional privileges to foreign firms. The new criteria permitted majority foreign ownership for export-oriented firms and 100% for-

eign ownership for plants that exported all of their output. Foreign firms responded well to the BOI-sponsored “contest,” as the average export propensity of foreign firms increased from 33% in 1984 to 50% by 1988.<sup>47</sup> This increase was followed in 1985 by Japanese financing of a long-term Export Industry Modernization Program (EIMP) through the International Finance Corporation of Thailand (IFCT) at highly subsidised interest rates.<sup>48</sup> Starting in 1986, the Bank of Thailand’s (BOT’s) long-standing programme of subsidies for working-capital needs of agricultural exporters was reoriented to meet the needs of exporters of manufactures. By 1988, exporters of manufactures were receiving more than one half (53%) of the BOT’s subsidised loans.<sup>49</sup> The combination of rising effective rates of protection and countervailing export subsidies suggests that Thai trade policy during this period was closer to Korea’s during its early export expansion (1965–68) than it was to neoliberal prescriptions.

If industrial policy was effective, Thailand’s industrial structure should differ significantly from expected international norms. One crude measure of this difference is the ratio of actual value added as a percent of GDP of a sector to predicted value added of that sector.<sup>50</sup> If the ratio of actual value added to predicted value added equals one, industrial structure mirrors international norms. If it is greater or less than one, a sector deviates from international norms. By inference, deviations from international norms reflect, among other things, differences in factor endowments and the influence of industrial policy.

Given Thailand’s rich natural resource base and overwhelming comparative advantage in agriculture, one would expect the share of additional value in agricultural-processing industries to be significantly greater than one and to deviate most from international norms. Yet the actual share of additional value in food, beverage, and tobacco in Thailand in 1986 was only 34% of its expected share.<sup>51</sup> And this was the case despite the substantial success experienced by Thailand’s large-scale agroprocessing industries. Moreover, Thailand’s overall manufacturing share of additional value in GDP exhibits far greater deviation from international norms than that for any other HPAE, including Korea.<sup>52</sup> In three of nine subsectors – textiles (3.33), wood and wood products (1.85), and metal products and machinery (1.82) – actual additional value was between two and three times that predicted by international norms. Taken together, these outcomes suggest that Thai industrial policy almost certainly exerted significant influence on industrial structure.

Conservative macroeconomic policies, consistent selective interventions in agricultural markets (including markets for agroindustrial exports), successful industry and firm specific interventions during first-stage and second-stage import substitution industrialisation, and the systematic

turning of the industrial policy machinery to promote nontraditional manufacturing exports during the 1980s suggest that industrial policy in Thailand has been more coherent than neoliberals admit.

The Thai government identified agroprocessing, including forestry and fishing, as having export potential. Investment privileges have been provided by the BOI, even before the BOI designated agroprocessing as a high-priority sector from the early 1980s. With strong domestic linkages, agroprocessing has been important for the Thai government's export-oriented industrial strategy.<sup>53</sup> Agroprocessing has been developed by Thai industrialists, who have often created large, vertically integrated agrobusiness conglomerates. Multinationals have provided technology and marketing support, sometimes through joint ventures. While Thailand's resource-based manufactured exports have been growing for many decades, other manufactured exports have grown much faster.

Thailand has established itself as a world leader in fresh and canned seafood exports. However, fish exports are dependent on natural resources, cost advantages, and cheap labour. Overfishing, limited fishing zones, as well as environmental problems, have raised costs. While fresh-fish exports have been growing rapidly, higher added-value tinned-seafood exports have grown more slowly.

Fruit and vegetable processing has also been fairly dynamic, with particularly rapid growth in tapioca and pineapple products. Nevertheless, overall growth of processed fruit and vegetable exports has been more modest since 1986. However, prospects for further growth of semi-manufactured food exports to Japan have been reduced by Japanese trade barriers and the Japanese economic slowdown. Continued competitiveness depends heavily on low agricultural prices, but Thai agricultural productivity remains low. Improvements in agricultural productivity and product quality will be crucial for maintaining competitiveness. Meanwhile, the Thai rice export share has been declining in the face of lower Chinese and Vietnamese labour costs and by the higher quality and lower cost of U.S. rice.

Thai forestry has also experienced rising costs due to environmental constraints. Agricultural expansion and extensive logging had led to rapid deforestation by the early 1980s, leading the government to ban logging in many areas and unprocessed wood exports, as well as to impose a 1% export tariff on wood exports.<sup>54</sup>

Furniture emerged as a leading sector in the 1980s. The Thai wood- and paper products and furniture industries have continued to grow, although the industry is increasingly reliant on imported raw materials. Thailand remains quite competitive in furniture production, with its natural resources, cheap labour, and, especially, design and quality factors.

Exports of Thai rubber products (SITC 62) have also grown rapidly

Table 6.7 Thailand: Leading Manufactured Exports, 1970–1995\*

Export	SITC (Rev. 3)	% of Exports			
		1970	1980	1986	1995
Clothing	84	0.1	4.2*	9.4*	8.9*
Office machines and parts	75	0.0	0.0	0.7*	10.1*
Integrated circuits	773 + 775 + 776	0.0	0.2	1.7*	5.2*
Fresh & frozen fish	034 + 036	2.3*	3.4*	5.5*	5.0*
Telecommunications and sound equipment	76	0.0	0.1	0.1	5.4*
Textiles	65	1.2	5.2*	5.9*	3.5*
Milled rice	0422	17.7*	14.8*	8.7*	3.4*
General industrial machinery	74	0.0	0.3	1.1	3.0*
Plastic manufactures	893	0.1	0.5	0.6	2.8*
Tinned prepared fish	037	0.0	1.4	5.1*	2.8*
Natural rubber	232	15.8*	9.5*	6.5*	4.4*
Footwear	85	0.0	0.3	1.3	3.7*
Vegetables, fresh and preserved	054/056	12.2*	12.8*	9.4*	1.4*
Gems	667	1.0	2.5*	3.6*	2.1*
Switch-gear	772	0.0	4.8*	6.0*	1.7*
Jewellery	897	0.1	0.5	2.3*	1.6*
Toys, etc.	894	0.0	0.0	0.3	1.3*
Furniture	821	0.0	0.5	0.8	1.3*
Fruit, dried and preserved	058	0.5	1.4	1.9*	1.0*
Sugar, unrefined	0611	0.6	2.3*	2.6*	1.5
Maize	044	13.0*	5.5*	4.0*	0.0
Textile fibres	26	6.1*	0.7	0.1	0.4
Tin	687	11.4*	8.7*	1.3	0.0
Subtotal, leading exports*	–	78.5*	73.7*	72.6*	71.3*
Subtotal, top 6 exports	–	76.2	56.5	45.9	41.0
Total exports (US\$ 1,000)		685,157	6,369,129	8,786,472	56,647,835

Note: \* Leading exports: export share greater than 1.5%.

Sources: Nola Reinhardt, "Back to Basics: The Role of Resource-based Industries in Malaysian and Thai Export Growth" (*World Development*, 1999); calculated from UN Commodity Trade Statistics Database (COMTRADE); *Yearbook of International Trade Statistics*, United Nations, various years.

Table 6.8 Thailand: Export Growth of Selected Resource-Based Manufactures, 1986–1995

Product	SITC	Average Annual Growth Rate (1986–93)	Percentage of 1995 Exports
Rubber clothing	8482	52.6	1.1
Rubber manufactures	62	25.9	0.8
Rubber footwear	85101	31.1	2.4
Leather footwear	85102	38.9	1.3
Leather manufactures	612	19.0	0.4
Furniture	82	35.1	1.3
Jewellery	897	21.4	1.6
<i>Manufacturing total</i>	–	33.2	86.0

Source: Nola Reinhardt, “Back to Basics: The Role of Resource-based Industries in Malaysian and Thai Export Growth” (*World Development*, 1999); calculated from UN Commodity Trade Statistics Database (COMTRADE); *Yearbook of International Trade Statistics*, United Nations, various years.

since the 1980s. Most Thai rubber product output has been for domestic consumption, with the main exports being low added-value latex products such as rubber bands and examination gloves. Rubber clothing exports also grew very rapidly. Thailand has had some success with rubber and plastic footwear, but Thai rubber exports face difficulties with product quality, as international quality standards have risen. The main obstacle to upgrading rubber products has also been the skills shortage and the low technological level of the industry.

Leather products also grew in the first half of the 1990s, but this sector has been hurt by rising labour costs, with export growth for leather manufactures slowing and footwear growth actually declining in the mid-1990s. While gems and jewellery emerged as important exported items in the early 1980s, they have encountered difficulties.<sup>55</sup>

While there are numerous possibilities for expansion of semiprocessed and manufactured exports based on rich natural resource endowments, the potential is still largely untapped. Upgrading resource-based exports faces higher import tariffs with greater added-value or resource processing.<sup>56</sup> However, the raw-materials cost advantage can and, indeed, often has helped. Rising costs of raw materials and labour, as well as shortages of skilled personnel and technological capabilities, limit progress to higher added-value products. As added value increases, inefficiencies relating to small plant size, inadequate quality control, and obsolete technology have become more significant for achieving competitiveness than the cost of materials. Competition for labour, financial, technological, and public resources has limited resource-based industrialisation. In

Table 6.9 Indonesia: Gross Domestic Product by Sector, 1965–1990

	1965	1970	1980	1990
Agriculture	55.0	47.5	24.3	19.4
Manufacturing	8.5	10.9	13.4	19.4
Other Industry	6.5	8.9	29.7	22.1
Services, etc.	30.0	32.7	32.1	39.1

Sources: Central Bureau of Statistics (BPS); World Bank staff estimates, reproduced in Bhattacharya and Pangestu (1993).

Southeast Asia, government policies have favoured foreign direct investment, e.g., in the electronics industry.

Long-run prospects for resource-based manufacturing export growth depend on the dynamic development of competitive capabilities. Hence, as the domestic costs of natural resources and unskilled labour increase, each country will need to shift to exports in which these inputs are less important. Given their lower share of imported inputs, resource-based exports are likely to benefit more from recent currency devaluations. The governments have had some success in developing resource-based manufacturing, often drawing on local expertise developed over years of experience.

## Indonesia

Between 1965 and 1990, growth in income per capita in Indonesia averaged 4.5% per annum.<sup>57</sup> Only seven developing countries – China, Lesotho, Paraguay, Botswana, Korea, Singapore, and Hong Kong – grew faster. High economic growth was accompanied by a rapid decline in the incidence of poverty and low-income inequality.<sup>58</sup> In addition to equitable and poverty-reducing growth, Indonesia achieved food self-sufficiency (in rice by 1985), a rapid decline in the rate of population growth, and an equally impressive spread of basic education and literacy.<sup>59</sup>

These developments were accompanied by substantial industrialisation and structural change. Agriculture's share in GDP declined from 51% to 22%, while the share of manufactures in GDP rose from 8% to 20%.<sup>60</sup> Because overall growth was so rapid and growth in manufactures even more rapid (manufacturing output grew by more than 12% per year between 1965 and 1990), the manufacturing sector in 1990 was almost 45 times larger than it was in 1965.<sup>61</sup> Although much of manufacturing was fostered under policies of import substitution, Indonesia also experienced

Table 6.10 Indonesia: Major Manufactured Exports, 1980–1993 (US\$ million)

	1980	1985	1990	1993
<i>Labour-intensive</i>				
Total	287	785	4,634	11,344
Major items				
Clothing	98	339	1,646	3,502
Woven fabrics	43	227	1,132	2,247
Footwear	1	8	570	1,661
Electronics	94	77	204	1,382
Percentage of all manufactures	57	38	51	58
<i>Resource-intensive</i>				
Total	119	992	3,324	5,364
Major items				
Plywood	68	941	2,791	4,586
Percentage of all manufactures	24	49	37	28
<i>Capital-intensive</i>				
Total	97	266	1,083	2,729
Percentage of all manufactures	19	13	12	14
Total, all manufactures	501	2,044	9,041	19,437
Three largest as percentage of total	52	74	61	53
Manufactures as percentage of total exports	2	11	35	53

Source: BPS, *Ekspor* (Exports), Jakarta, various issues.

substantial success in exporting manufactures. By 1993, manufactured exports reached US\$ 21 billion and accounted for 53% of total exports.<sup>62</sup> Because of this, Indonesia has gone a long way toward diversifying its economy, including exports, away from oil and other primary products.<sup>63</sup>

This long-term development performance has attracted considerable attention.<sup>64</sup> Broad similarities across the developing world with Indonesia's factor endowments (natural resources, physical capital, and human capital) and with the character of its state (its state is neither "strong" nor "hard" in the Northeast Asian sense and is characterised by corruption, rent seeking, and patrimonial distribution networks) suggest that other economies in similar circumstances might have much to learn from Indonesia.<sup>65</sup> The government's relatively effective husbanding of the country's natural resource riches to promote broad-based growth and economic diversification is also of interest. As experience elsewhere shows, this policy has not proved easy, since, all too often, natural resource riches may be a "curse" rather than a boon to development.<sup>66</sup>

From the nineteenth century until independence in 1949, the Dutch colonial government systematically turned Indonesia into an export-oriented plantation enclave economy. Extraction of an agricultural surplus

in estate crops for export was dependent on a triad of forces. Armed force and legal changes were used to coerce villagers to grow commercial crops and to allocate labour to state plantations.<sup>67</sup> Indonesian Chinese merchants, who served as tax farmers and operators of state trading monopolies, facilitated extraction and transshipment of the agricultural surplus produced in the countryside. Over time, these merchants monopolised trade and petty commodity production. They also became a scorned ethnic minority. Export of primary estate crop commodities was handled by a small number of large European trading houses. By the early part of the twentieth century, transformation of the Indonesian economy was complete. Much of Java had been turned into a virtual sugar plantation, and the export-oriented plantation economy was extended to other crops (coffee, tin, rubber, and petroleum). The same transformation occurred in other islands, most notably Sumatra.<sup>68</sup>

Several crucial elements of Indonesia's postindependence political economy – heavy, continuing, and abiding government intervention in the microeconomy, the emergence and consolidation of patrimonial distributional networks between high-ranking government officials and Sino-Indonesian businessmen, and the long-term shift toward and consolidation of authoritarian politics – owe much of their legacy to elite reactions to the colonial period and the *ekonomi kolonial*. The fourth element, a long-standing commitment to macroeconomic stability, owes more to the failures of Sukarno's "Guided Economy" and to the small group of technocrats who have been advising the New Order government since 1966. More will be said about this later. Taken together, these four elements circumscribe the political economy of economic policy making in the New Order and provide the basis for the neoliberal contention that the New Order state lacks the capacity to successfully implement selective development policies.

There is little doubt that the colonial experience bred a deep-seated mistrust of market forces, foreign investment, and the Sino-Indonesian business community.<sup>69</sup> Because of the mistrust and because of the weakness of the indigenous Indonesian business community, political elites believed there was no alternative to the government's playing a large role in the economy. Initially, state intervention took a variety of forms. In banking, the Dutch Bank was turned into a central bank that provided subsidised credit to a small number of state-owned development banks.<sup>70</sup> One of these channeled subsidised credit to industry. Another provided subsidised and administratively allocated credit to indigenous traders engaged in import and export. A third provided cheap credit to small and medium enterprises. Because of a perceived shortage in indigenous entrepreneurs, state banks also promoted state-owned enterprises in a wide range of industries – cement, textiles, glass, and automobile assembly.



And the state administratively allocated highly lucrative import and commodity distribution licenses to indigenous entrepreneurs and regulated domestic and foreign investment.

Virtually all of these interventions transcended the Sukarno era and became more or less lasting characteristics of the New Order's economic policies. State control of banks and the banking system, including administrative allocation of highly subsidised credit, lasted into the 1980s.<sup>71</sup> State-owned industries in petrochemicals and steel were hallmarks of the New Order's industrial deepening policies of the 1970s and of the high-technology policies that continue to this day.<sup>72</sup> State allocation of lucrative import and commodity distribution licenses were and are a hallmark of the New Order's relationship with the Sino-Indonesian business community.<sup>73</sup> And extensive regulation of both domestic and foreign investment lasted into the 1990s.<sup>74</sup> Because of this combination, the micro-economic policies of the New Order have been very dirigiste and, until recently, attempts to liberalise a highly regulated microeconomy along neoliberal lines have not met with much success.<sup>75</sup>

The expansion and consolidation of patrimonial distributional networks between state actors and the Sino-Indonesian business community is another legacy of the colonial experience. This, too, was carried over from Sukarno's Guided Democracy into Suharto's New Order. These networks have their origin in the independence struggles of the 1940s, when regional military commanders, who found their commands underfunded, developed close relationships with ethnic Chinese *cukong* entrepreneurs<sup>76</sup> – Chinese businessmen who traded a share of their profits for political protection. By this mechanism, high-ranking military and political elites were able to provision their commands and enrich themselves and those in their political entourage.

The activities of Liem Sioe Liong, the head of Indonesia's largest conglomerate, offers a prime example of how this system got started, subsequently expanded after independence, and was consolidated during the New Order. Liem provisioned the army during the struggle for independence.<sup>77</sup> After independence, he consolidated relationships with the military by becoming a reliable supplier of goods to the army to then Lieutenant Colonel Suharto in the Diponegoro Division in Central Java. Later, he parlayed his relationship with Suharto and the army into monopoly licenses for the import of cloves and for milling flour.<sup>78</sup> Large monopoly trading profits earned from these licenses were subsequently invested in manufacturing, banking, cement, and substantial diversification.

The conventional interpretation of Indonesian economic development appears to offer an internally consistent and powerful explanation of the irrelevance of selective (micro-) policies. But the focus on rent-seeking

government at the micro- (sectoral) level leads such interpreters to overstate the technocrats' commitment to neoclassical liberalism and the bifurcation between macro- and micropolicy. This interpretation contributes to an underestimation of the government's commitment and ability, including that of the technocrats, to use income from natural resource riches, including oil, to diversify the economy by financing "full-set industrialization."<sup>79</sup> Because of this, neoliberals miss substantial evidence that reveals rejection by the technocrats of a development strategy based on static comparative advantage in primary products, including oil. They also overlook important contrary evidence of the role of the technocrats in highly effective, long-standing, large, and selective interventions in agricultural markets, particularly for rice. And they miss industry-specific examples of successful selective interventions during first- and second-stage import substitution industrialisation in the 1970s and of export promotion in the 1980s, including the establishment of resource-based industries.

The intellectual predisposition of the technocrats may have been toward neoclassical microeconomic policies.<sup>80</sup> Ideological hostility among political and intellectual elites to markets ("free-fight liberalism"), to foreign investment, and to the Sino-Indonesian business community puts technocrats proposing neoclassical solutions at a substantial disadvantage. Because of this hostility, their proposals to liberalise the Indonesian microeconomy along neoclassical lines have been subject to substantial criticism.<sup>81</sup> In addition, many of the microagencies – most particularly, the Ministry of Industry, the Board of Investment (BKPM), Pertamina (the state-owned oil company), Bulog (the state food procurement agency), and the Ministry of Research and Technology – are in the hands of a group of so-called economic nationalists, who favour state-led industrial development.<sup>82</sup> Some in this group have been influenced by the industrial development experiences of Japan, South Korea, and Singapore, and favour using protection and financial subsidies to build indigenous industrial capabilities in targeted industries such as steel, fertilizers, petrochemicals, and aircraft. This group has had substantial support from Suharto, who sees them as an "embodiment of his dream for more rapid progress toward an industrialized and more powerful Indonesia."<sup>83</sup> Because of this, he favors them when resources permit.

Finally, it must be recognised that the combination of orthodox macropolicies and interventionist micropolicies serves an important political function. Macroeconomic stability facilitates overall economic growth and growth of the Sino-Indonesian business conglomerates that have come to dominate the landscape of the Indonesian economy.<sup>84</sup> Because of *cukongism*, growth of the conglomerates provides the resources Suharto needs to maintain political support among key elites. It also

provides ample opportunities for intraelite rent seeking. As Liddle states, Suharto and the military seem to have realised that “the golden eggs provided by [macrostability] can be distributed to patrimonial clients without starving the goose.”<sup>85</sup> Or, said another way, this particular configuration – separation of macropolicy from micropolicy making, control of microagencies by those favoring explicit and selective industrial policies, and use of selective policies for patrimonial ends – reflects then President Suharto’s political calculus in which “the economists [are] the producers of wealth, the patrimonialists the distributors of it, and the nationalists the embodiment of [his] dream for more rapid progress toward an industrialized and more powerful Indonesia.”<sup>86</sup> Because of this, he favors them when resources permit.

What evidence is there that the desire to create a strong, integrated, diversified, industrialised, and outward-oriented *ekonomi nasional* actually affected the use of selective micropolicies and industrial and export outcomes? Several important micropolicies are consistent with this interpretation. To begin with, technocratic intervention in agricultural markets, particularly the market for rice, has been significant, long-standing, and highly effective.<sup>87</sup> It required substantial coordination with sectoral agencies, particularly the Ministry of Agriculture and Bulog, the food logistics agency. And it facilitated the building of a significant industrial base that ultimately became export oriented.

Because the history of government policies toward rice is well known, only the outlines will be provided here.<sup>88</sup> Government interest in rice, most particularly in achieving self-sufficiency, is the consequence of a complex set of factors: President Suharto’s rural roots; recognition that increasing rural well-being is an effective antidote to agrarian radicalism; the macroeconomic consequences of importing large quantities of rice; the politically stabilising effects of low and stable rice prices for urban consumers (particularly civil servants and the military); and for the pace of industrialisation. For all these reasons, the government committed itself to achieving self-sufficiency in rice.<sup>89</sup> By 1985, this was achieved and it has been more or less sustained.

How was this done? The simple answer is substantial intervention in markets: in markets for inputs (fertilizer, pesticides, and seeds); in credit markets; and in output markets. In each instance, the government and the technocrats in macroagencies deliberately distorted market prices. The objective of intervention in output markets was to stabilise the domestic price of rice to reflect the world price.<sup>90</sup> In fact, domestic rice prices were kept roughly 15% below world prices.<sup>91</sup> What this meant in actual practice was stabilising rice prices amidst a declining real-world price of rice. Achieving this required substantial coordination across several macro- and microagencies, including Bulog, the food logistics

agency; BAPPENAS, the planning agency; the Ministry of Finance; the Ministry of Agriculture; the President's Office; and EKUIN, the Coordinating Ministry for Economics, Finance, and Industry.<sup>92</sup> As Timmer states, the Ministry of Finance was the key organiser of an analytical process that resulted in the government's setting floor and ceiling prices and controlling imports.<sup>93</sup> This gave one of the key macroagencies substantial influence over one of the key sectoral, or micro-, agencies, Bulog. This effort has been highly successful.<sup>94</sup> Because of it, stable price signals were communicated to farmers, encouraging them (and others) to invest in marketed crops and agricultural marketing. Stable price signals also provided stability of real wages (rice is the primary wage good) and contributed to urban political stability (by provisioning cities with low and stable prices for rice). Both wage and political stability induced investment growth in industry.<sup>95</sup>

But this was not the only intervention in rice markets. Because farmers had limited experience with commercial fertilizers and with high-yielding seeds, the government subsidised both and subsidised credit to farmers so they could purchase these new inputs.<sup>96</sup> These subsidies were used to overcome failures in information markets (farmers did not fully understand the impact of new seeds and fertilizer on yields) by significantly improving output-to-fertilizer price ratios.<sup>97</sup> Information failures were also addressed by an aggressive and publicly funded agricultural extension programme.<sup>98</sup> Much of this was funded out of the revenue windfall that accompanied the oil price shocks of the 1970s.<sup>99</sup> The government's highly successful selective intervention in rice agriculture made it possible to finance an indigenously owned import substitution industrial base behind protective barriers.<sup>100</sup>

How has the government policy bias favoring a small number of firms bound together in large family-owned conglomerates affected the international competitiveness of Indonesian manufacturers? As experience elsewhere shows, large business groups can help developing countries acquire industrial competence, internalise external economies, overcome shortages of entrepreneurial talent, and increase exports of manufactures, but they can also lead to substantial economic inefficiency.<sup>101</sup> While research in this area in Indonesia is sketchy, the experience of Indonesia's most influential entrepreneur and his business group appears to be typical.<sup>102</sup> Liem Sioe Liong, founder of the Salim Group, began as an import/export merchant. As is well known, he has benefited greatly from close personal ties with the political elite, particularly the president.

The Salim Group's early profits came from an import monopoly on cloves and preferential access to export quotas for coffee, rubber, cocoa, and other primary products.<sup>103</sup> The group's growth strategy has been largely dependent on government policies. When the government began

promoting import-substitution industrialisation (ISI), it, too, moved into IS industries. During first-stage import substitution, Salim got into cotton spinning and weaving and flour milling; during second-stage import substitution, it diversified into cement and steel.<sup>104</sup>

As government policy shifted in the 1980s to promote exports, the Salim group responded. The Salim Group's response to the new export-incentive system was impressive. Salim reduced investments in cement, liquidated investments in steel, and moved into export manufacture (sport shoes, toys, garments, and leather goods) and export-oriented agribusiness (pig and shrimp farming, fish and poultry farming, orchards, fresh fruit and vegetable cultivation, and oil palm and sugarcane plantations).<sup>105</sup> Salim also moved overseas. The new industries in the Salim Group are notably distinct from past investments. Most importantly, they revolve around vertical integration from raw material production through processing to final product distribution and sales.<sup>106</sup> Because of this, "the Salim Group is in the process of transforming itself from being Indonesia's largest conglomerate to being a conglomerate that is making Indonesia the largest base of raw material production and processing, and whose business operations are now taking place across the broad expanses of Asia."

But these are not the only examples of effective selective intervention. Other examples – the development of resource-based industries, particularly plywood manufacturing and liquefied natural gas (LNG), and of aircraft manufacture – also deserve mention.

The Indonesian government banned log exports from the mid-eighties in order to support the nascent plywood industry. By 1992, APKINDO, the Association of Indonesian Plywood Manufacturers, controlled by Suharto confidante Bob Hassan, had succeeded in raising the quality of Indonesian plywood exports sufficiently in order to get into the heavily protected Japanese plywood market. Despite this achievement, there have been two major criticisms against the Indonesian government interventions in this regard. First, the ban on exports has forced loggers to accept lower prices for their logs from the plywood manufacturers. This represented a welfare loss for the loggers, ostensibly in favour of the plywood manufacturers. However, the latter's inefficiency meant a corresponding welfare loss for Indonesia, involving an instance of value-enhancing but welfare-reducing rent seeking. Second, Bob Hassan's self-serving control of APKINDO is also said to have caused the monopolist to become moribund, inhibiting the rapid development of industrial and marketing capabilities which could ensure greater value enhancement with minimal welfare loss through the development of a more dynamic and efficient plywood-manufacturing industry in Indonesia.

Promotion of LNG followed on the heels of the government's expect-

tation that windfall oil revenues could be used to accelerate the rate of growth of the nonoil economy. Because Indonesia's supply of oil was limited and dwindling, government efforts focused on, among other industries, the development and export of liquefied natural gas (LNG). Development of this industry was based on negotiating long-term production and revenue-sharing contracts with multinational producers and equally long-run sales contracts with buyers, primarily in Japan.<sup>107</sup> To this end, the Indonesian government invested billions through Pertamina, the state-owned oil company, in LNG production.<sup>108</sup> Little is known about the acquisition of technical competence by Indonesians in this industry. But, based on performance to date, these investments have been little short of astonishing. LNG plants have run somewhere between 120% and 145% of capacity and earned healthy profits.<sup>109</sup> And LNG exports rose from virtually nothing in 1978 to over US\$ 4 billion in 1993 (Table 6.6). Because of this performance, it appears that Indonesia's investments in resource-based industries, particularly in LNG, were low risk and relatively efficient.<sup>110</sup>

If industrial policy in Indonesia was effective, each of these – the composition of output, the structure of manufacturing, the composition of exports, and the concentration of exports by commodity group – should deviate from international norms. Productivity growth in industry should also be high, as Indonesian firms grow by learning technological innovation or by catching up with international best practices.<sup>111</sup> Rock has found that the manufacturing sector's share of Indonesian GDP is almost 20% larger than expected;<sup>112</sup> the share of manufactures in exports is almost 60% larger than expected; and the export concentration index is only about 60% of that expected for a country with Indonesia's size, income per capita, resource endowment, and trade orientation. Varying the methodology and measures a little, Rock found the manufacturing share of GDP to be significantly larger (1.28 times larger) than expected, as with the shares of several manufacturing subsectors. These include wood products (the actual share is 5.22 times larger than predicted) as well as petroleum refining and petroleum and coal products (the actual share is 2.86 times larger than expected).

The most dramatic transformation in the economy occurred in exports. In 1970, 93% of Indonesia's exports consisted of unprocessed raw commodities; 5% were processed commodities, and the rest were manufactures. By 1993, the share of raw commodities in exports declined to 31%; processed commodities contributed 17% and manufactures 51%. Except for Thailand and Russia, where average incomes were three times Indonesia's, this transformation made Indonesia the largest exporter of manufactures among lower-middle-income countries.<sup>113</sup> Given Indonesia's low income and its natural resource riches, it is hard to see

Table 6.11 Southeast Asian HPAEs: Different Types of Diversification

		Market Orientation	
		Domestic	External
Nature of New Output	Primary Production Manufacturing	Food Production, etc. ISI	Cash Crop or Natural Resource EOI

how this transformation in exports could have occurred without substantial government intervention.

## Concluding Remarks

Economic diversification has been considered an important component of the national economic development effort in Southeast Asia, at least since the 1950s. This has involved diversification in the range of primary commodities produced, as well as industrialisation, including the processing of raw materials. Such diversification initiatives have often involved going beyond considerations of static comparative advantage. International specialisation, determined by such static comparative-advantage considerations, developed without any government interference, even during the colonial era. Most colonial authorities did not insist on a division of labour not justified by such considerations. Thus, for example, much raw material processing emerged under “natural protection” because of transport costs or physical characteristics during the colonial period. However, new productive capabilities, in which the economy concerned already enjoyed comparative advantage, could not develop in such circumstances. Only government intervention through industrial policy measures could create the necessary windows of opportunity for new capabilities to be developed, thus transforming an economy’s comparative advantage.

Although the colonial division of labour or specialisation under imperial authority largely determined the composition of output and exports before independence in Indonesia and Malaysia, postcolonial governments deemed diversification necessary to reduce their dependence upon and vulnerability to external markets for their generally limited range of primary commodity exports. Hence, diversification involved either greater domestic or external/foreign orientation. Diversification could thus entail more diversified raw-material production or more industrial production.

As the above table suggests, output diversification may involve various

combinations. New production, especially for export, has often been encouraged by new discoveries (of minerals, deposits, or crop suitability), market conditions (e.g., for timber, petroleum), technologies (e.g., new logging or mining technologies), and lower transportation costs (e.g., air freight of electronic components). Nevertheless, while diversification may well have been facilitated by such new circumstances, most diversification would not have taken place without relevant government initiatives and encouragement. For example, government-sponsored research and extension has usually been crucial for crop diversification, while government geological or mineral surveys and exploration have often led to new mining activity. Similarly, government subsidies, protection, incentives, and other support have encouraged agricultural diversification and both import-substituting as well as export-oriented industrialisation.

### *Policy Lessons*

The diverse experiences of the second-generation, or second-tier, Southeast Asian HPAEs include some instances of failure, where government interventions have probably involved continuing net welfare losses in the long run, with little likelihood of the emergence of internationally competitive industries or firms. However, this chapter has focused on how government initiatives to diversify national economies have led to virtuous outcomes involving eventual net welfare gains or other national developmental goals (e.g., greater food security).

Government-promoted new agricultural development enabled the Malaysian economy to be less vulnerable to the vicissitudes of the external markets for the export pillars of the colonial economy, namely tin and rubber. By the eighties, Malaysia had become the world's largest producer of palm oil, cocoa, and pepper, as it lost its leading positions in tin and then rubber. Also, by the eighties, export earnings from both petroleum and timber exceeded all other export items, including manufactures. The chapter also shows that the Malaysian government has more effectively captured resource rents from petroleum and natural gas compared to those from timber.

Government intervention in Thailand supported the rice industry, but also stabilised rice prices at a low level, keeping wage costs low for the economy as a whole, generating a surplus for the government, as well as for private capital accumulation and investments, and encouraging crop diversification. The government encouraged and supported investments in industries, including agroprocessing, which have generally turned out to be internationally competitive quite soon, perhaps due to the relatively modest levels of protection and the greater degree of private-sector influence and consultation. Nevertheless, government interventions have



ensured that manufacturing growth has been greatly in excess of the level to be expected without such encouragement.

At least some of the resource rents from petroleum and LNG captured by the Indonesian government have been deployed to promote rice agriculture. By the mid-1990s, Indonesia had even become a net rice exporter, thus not only achieving rice self-sufficiency and greater food security, but also contributing to economic development more generally, as in the Thai economy, by keeping wage costs down and expanding the domestic market for import-substituting industrialisation.

One important difference in East Asia has been the significant contribution of corporate or firm savings, mainly due to (family) corporate control characteristics, various tax features encouraging reinvestment, rather than disbursement of dividends, and the high profitability of investments, due to government support, incentives, protection, and regulation. The continued availability of such investment opportunities contributes to a virtuous cycle of accumulation and growth. However, unlike Northeast Asian (Japanese, South Korean, and Taiwanese) companies, Southeast Asian firms' industrial, technological, and marketing capabilities have not enabled them to produce for export on their own. Instead, Southeast Asian manufactured exports have primarily come from subsidiaries or companies vertically linked to foreign transnationals that have relocated in the region to lower production costs or to overcome import restrictions. Hence, foreign direct investment has been far more important in Southeast Asia than in Northeast Asia, where the governments have been very selective to the point of being restrictive. Whereas much export-oriented manufacturing in Northeast Asia developed from import-substituting industries, such firms in Southeast Asia have been much less linked to the rest of the host economies, creating the impression of new manufacturing export enclaves, not unlike the primary producing export enclaves from the colonial era.

The banking system and other lending institutions have also been less supportive of manufacturing, especially for export. In recent years, the Bretton Woods institutions have successfully promoted the expansion of stock markets in the region. For example, by mid-1997, the total market capitalisation of stocks listed in the Kuala Lumpur Stock Exchange (KLSE) was more than four times the annual national income. Yet less than 30% of financing of new investments came through the stock market, while only slightly more than 20% came from bank lending and almost half came from the firms' own resources, underscoring the significance of corporate savings for corporate investments and growth.<sup>114</sup>

Perhaps given the colonial and subsequent experience with export-oriented, primary-producing enclaves, Southeast Asia's export-oriented industrialisation strategy, besides those industries involving domestic

primary products (i.e., resource-based industries) has also been primarily of an enclave nature. But Southeast Asian governments have not just let static comparative advantage considerations and natural protection determine the nature of resource-based industrialisation. They have gone well beyond that strategy by actively developing new capabilities through various industrial policy initiatives.

They have provided an array of supportive policies and institutions to support such development. Many of the new institutions have successfully addressed collective action and information problems, e.g., in the areas of research and development, education, training, and marketing. Some of the new institutions have involved civil society, which has ensured policy and institutional responsiveness as well as greater transparency and accountability, thereby reducing the scope for abuse and waste. Although the regimes have often been quite authoritarian in style and method, they have also enjoyed considerable legitimacy by ensuring participation in shared growth, thus also enhancing the credibility of development initiatives, policy, and institutions. For example, the export booms from the late eighties have been associated with greater concessions to and consultation with investors in the real economy.

Through agricultural and rural development ministries and other agencies, the governments have successfully introduced and promoted new crops, new crop varieties (e.g., new rice varieties as part of the Green Revolutions which have achieved rice self-sufficiency), new agricultural inputs (e.g., fertilizers, pesticides) and new techniques and practices which have enhanced productivity, yields, and incomes. Government construction and provision of supporting infrastructure (e.g., irrigation, transport, and communications infrastructure), as well as information (e.g., through agricultural extension, radio-broadcast agronomic advice, weather information, and export crop prices) have also been important. Strong research and extension services have been important in promoting best agricultural practices. Adaptive research and development have been crucial for the successful promotion of the Green Revolution in rice farming, for example.

Intal has suggested that Sub-Saharan Africa has lagged behind in terms of agricultural development since the sixties due to inadequacies in agricultural R&D and infrastructure, crop and agronomic considerations, and macroeconomic conditions.<sup>115</sup> He argues that higher temperate agricultural productivity has partly been due to long, sustained, and larger investments in agricultural R&D, which temperate LDCs (e.g., Chile, Korea, and Taiwan) have been better able to take advantage of. The tropical Green Revolution in rice farming since the sixties has mainly benefited irrigated farms in Southeast and South Asia, while drier agricultural practices in Africa have generally been left out.

However, the Malaysian, Indonesian, and Thai success with tree crop agriculture offers some hope. The Malaysian experience, in particular, suggests that significant investments in tree crop agricultural R&D (e.g., in rubber, oil palm, and cocoa), as well as rural infrastructure, have made possible productivity gains in tree crop agriculture as well. The geographic specificities of agriculture imply that, for imported agricultural varieties and technologies to be successfully adopted, there is a great need for effective adaptive investments in R&D and extension. Unfortunately, in their desire to industrialise, some governments have neglected agriculture, or worse still, subjected it to considerable negative policy bias.

Government-provided and regulated credit facilities have also been very important for encouraging productive investments in new agricultural production as well as in manufacturing. Finance ministries and central banks have stipulated minimal lending requirements to banks and other lending institutions, e.g., for manufacturing, small businesses, or agriculture. Financial institutions have been encouraged through incentives, credit guarantees, and even subsidies to lend to small businesses or farmers to whom they might otherwise not lend. In some instances, the government has intervened directly (through government agencies) or indirectly (via ostensibly private and nongovernmental institutions) to provide credit to “deserving” activities deprived of adequate credit facilities.

In the area of trade policy, the governments have introduced various incentives to increase additional value to exports of traditional primary products, as well as disincentives to discourage primary-product exports and to encourage investments to increase additional value. Market-based incentives have allowed more flexible implementation, besides ensuring greater market responsiveness. Through government-sponsored or organised trade fairs, export promotion missions, and bilateral government-to-government as well as private sector arrangements sponsored by governments, Southeast Asian governments have created new markets. These policies have been important, particularly in the face of exports facing new trade restrictions in traditional markets as well as potential trade barriers in new markets.

Where the quality of government performance has been high, as in Singapore, direct government intervention has generally been very effective and successful. This has been reflected in the effects of specific government regulations and their implementation and enforcement, as well as by the impressive performance of state-owned enterprises in the island republic. Where the likelihood of “state failure” is higher, market forces, as well as greater consultation with and accountability to civil society, have served to discipline the state and to improve the quality and out-

comes of government interventions. However, it is crucial to identify the sources and nature of state failures in determining whether market solutions are necessarily superior; the converse is also true. Other experiences, including those of Southeast Asia, offer important insights into what has happened in particular conditions, and, considered correctly, can be useful guides in contemplating available options, but they should not be treated as inflexible determinants of what should be done in Africa or elsewhere.

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11. Jeffrey Vincent and Yusof Hadi, "Agricultural Expansion and Deforestation in Peninsular Malaysia" (discussion paper, Harvard Institute of International Development, Cambridge, Mass., 1992).
12. United Nations Industrial Development Organization, *Industry and Development: Global Report 1992/93* (UNIDO: Vienna, 1992), 6.
13. Scott Christensen, David Dollar, Ammar Siamwalla, and Pakorn Vichyanond, *Lessons of East Asia: Thailand, the Institutional and Political Underpinnings of Growth* (Washington, D.C.: World Bank, 1993), 2.
14. The incidence of poverty declined by 56% between 1962 and 1986. See World Bank, *World Development Report, 1990* (New York: Oxford University Press, 1990), 41. The Gini coefficient rose from 0.41 in 1962–63 to 0.47 in 1981. See Gary Fields, "Growth and Income Distribution," in *Essays on Poverty, Equity and Growth*, ed. George Psacharopoulos (New York: Pergamon Press, 1991), 21.
15. This observation and those following on manufacturing exports are drawn from Danny Unger, "Politics of the Rising Tide: Riding the Wave of East Asian Capital in

- Thailand,” (paper presented at a meeting of the Association of Asian Studies, New Orleans, 11–14 April 1991), 8.
16. Between 1986 and 1989, annual foreign direct investment flows and exports more than doubled. See International Monetary Fund, *International Financial Statistics Yearbook, 1991* (Washington, D.C.: International Monetary Fund, 1991), 715.
  17. Peter Bell, “The Historical Determinants of Underdevelopment in Thailand” (discussion paper no. 8, Economic Growth Center, Yale University, New Haven, Conn., February 1970).
  18. M. T. Rock, “Transitional Democracies and the Shift to Export-led Industrialization: Lessons from Thailand,” *Studies in Comparative International Development*, 29, no. 1 (Spring 1994): 18–37.
  19. According to Chai-anan, expenditures for defense and the Ministry of Interior increased from 4% of the budget in 1892 to 48% by 1930. See Samudavanija Chai-anan, “The Politics and Administration of the Thai Budgetary Process” (Ph.D. diss., University of Wisconsin, 1971). The government also invested heavily in rail development. See David Feeny, *The Political Economy of Productivity: Thai Agricultural Development 1880–1975* (Vancouver: University of British Columbia Press, 1982), 80–81.
  20. During this time, the king was the formal head of state, a revered symbol of national unity and defender of the Buddhist religion. For a discussion of traditional Thai political culture, including the central role of the king and the extension of that political culture into the modern period, see John Girdling, *Thailand: Society and Politics* (Ithaca: Cornell University Press, 1981), 18–45.
  21. Between 1932 and 1982, Thailand had 13 constitutions, 14 elections, 14 coups, and 42 cabinets. The fundamental weaknesses of legislatures, political parties, and modern political institutions ultimately developed into a vicious cycle in Thai politics. Successful coups have been predictably followed by new constitutions, the emergence of new political parties, elections, a honeymoon period, and the return of “crisis,” which precipitated yet another coup; see Samudavanija Chai-anan, *The Thai Young Turks* (Singapore: Institute of Southeast Asian Studies, 1982), 1–2. The vicious cycle of Thai politics reemerged in the military coup of 24 February 1991, the seventeenth coup attempt in fifty-nine years. Despite the formal establishment of parliamentary democracy in 1932, real political power rested with the bureaucracy and the armed forces. Modern political institutions remained weak and unstable. Legislatures rarely acted as real brakes on executive actions. Political parties were impermanent and subject to constant fragmentation; all too frequently, they were little more than loose alliances of businessmen, bankers, retired military men, and former civil servants who clustered around a “big man.” Few parties operated nationwide, had grassroots bases, or represented consistent philosophical ideas. More often than not, they were part and parcel of Thailand’s traditional patron-client system. For a discussion of patron-client politics in Thailand, see Girdling, *Thailand: Society and Politics*, 119–23.
  22. Critiques of the industrial policy agencies can be found in William Brown, “The Private Sector Institutional and Cultural Environment in Thailand and Suggestions for Facilitating the Private Sector’s Role in Development” (project no. 493–0329, *Thailand: Private Sector in Development Project*, Annex 5, Bangkok, USAID/Thailand, April 1983), 63–64; World Bank, “Industrial Policy and Its Administration” (background paper concerning the report, *Industrial Development Strategy in Thailand*, Washington, D.C., August 1980); and Christensen et al., *Lessons of East Asia*, 7–17.
  23. Unlike elsewhere in East Asia, neither the central bank nor commercial banks administratively allocated subsidised credit to particular industries. See Richard Doner and Danny Unger, “The Politics of Finance in Thai Economic Development,” in *The Politics*

- of Finance in Developing Countries*, eds. Stephan Haggard, Chung H. Lee, and Sylvia Maxfield (Ithaca: Cornell University Press, 1993), 93–122.
24. In fact, average import duties rose from 31.5% in 1981 to 39.4% in 1989, and effective rates of protection rose, widening incentive differences between export industrialisation and import substitution industrialisation. See “A Shift to the City,” *FEER (Far Eastern Economic Review)* (24 July 1986): 56; Akrasanee Narongchai, David Dapice, and Frank Flatters, “Thailand’s Export-Led Growth: Retrospect and Prospects” (policy study no. 3, Thailand Development Research Institute, Bangkok, 1991), 15–17.
  25. World Bank, “Industrial Policy and Its Administration.”
  26. In the early 1980s, the BOI provided a “no competition” guarantee to one firm to make compressors for refrigeration units. Despite this guarantee, one of the rejected firms persuaded the Ministry of Industry to give it a license to operate. See Brown, “The Private Sector Institutional and Cultural Environment in Thailand.”
  27. Christensen et al., *Lessons of East Asia*, 21–24.
  28. Because rice has been the primary wage good, government rice price policies have exerted substantial influence on the price of labour. See Trent Bertrand, “Thailand: Case Study of Agricultural Input and Output Pricing,” working paper no. 385, World Bank staff, World Bank, Washington, D.C., 1980, 45; 79.
  29. For a discussion of Thai rice price policy, see Ammar Siamwalla, “A History of Rice Policies in Thailand,” *Food Research Institute Studies* 14 (1975): 233–49.
  30. Between 1962 and 1980, the wholesale price of nonglutinous rice in Bangkok averaged about 75% of the export price. See World Bank, “Thailand: Pricing and Marketing Policy for Intensification of Rice Agriculture,” statistical annex 2 (1983): 97. But this price varied considerably from year to year, depending on the harvest and world markets. When world rice prices rose, signaling greater profits in exports, the Thai government intervened with a variable export tax to keep the price of rice in Bangkok stable. When export prices fell, the export tax on rice was lowered.
  31. T. Panayotou, “Thailand: The Experience of a Food Exporter,” in *Food Price Policy in Asia*, ed. T. Sicular (Ithaca: Cornell University Press, 1989), 96–97.
  32. On the industriousness of the peasantry, see Charles F. Keyes, “Economic Action and Buddhist Morality in a Thai Village,” *Journal of Asian Studies* 52 (August 1983), 851–68. Piker discusses the role of the land frontier in rural social organisation; see Steven Piker, “The Closing of the Frontier: Land Pressures and Thai Implications for Rural Social Organization in the Thai Central Plain,” *Contributions to Asian Studies* 9 (1976): 7–26. Wong estimated that approximately 7.8% of national income was transferred out of agriculture annually by export taxes on rice through the 1960s; see Chung Ming Wong, “A Model for Evaluating the Effects of Thai Government Taxation of Rice Exports on Trade and Welfare,” *American Journal of Agricultural Economics* 60 (February 1987): 72. Bertrand concluded that between 1955 and 1966, taxes on rice were about 40–45% of the export price and 80–85% of farm gate prices; see Bertrand, “Thailand: Case Study of Agricultural Input and Output Pricing,” 45; 79.
  33. On the development of the banking system, see Akira Suehiro, “Capitalist Development in Postwar Thailand: Commercial Bankers, Industrial Elite, and Agribusiness Groups,” in *Southeast Asian Capitalists*, ed. Ruth McVey (Ithaca: South East Asia Program, Cornell University, 1992), 42–50. On the development of industry, see *Ibid.*, 50–57 and Akrasanee Narongchai, “The Manufacturing Sector in Thailand: A Study of Growth, Import Substitution, and Effective Protection, 1960–1969” (Ph.D. diss., Johns Hopkins University, Baltimore, 1973).
  34. S. Manarungsan and S. Suwanjindar, “Contract Farming and Outgrower Schemes in Thailand,” in *Contract Farming in Southeast Asia*, eds. D. Glover and Lim Teck Ghee (Kuala Lumpur: Institute of Advanced Studies, University of Malaya, 1992), 13.

35. Suehiro, "Capitalist Development in Postwar Thailand, 268.
36. BOI (Board of Investment), "Policies and Criteria for Investment Promotion and List of Activities Eligible for Investment Promotion," Office of the Board of Investment, Bangkok, 1996, 3–4; IEAT (Industrial Estate Authority of Thailand), "Industrial Investment Opportunities," Industrial Estate Authority of Thailand, Bangkok, n.d., 7.
37. Phongpaichit Pasuk and C. Baker, *Thailand: Economy and Politics* (Kuala Lumpur: Oxford University Press, 1995), 60.
38. As a result of these, the government of Japan lowered the tariff rate on chicken broilers by 14% in 1986. See Manarungsan and Suwanjindar, "Contract Farming and Outgrower Schemes in Thailand," 61.
39. Unless otherwise noted, what follows is drawn from K. Hewison, *Bankers and Bureaucrats: Capital and the Role of the State in Thailand* (New Haven: Yale Center for International and Area Studies, 1989), 143–45.
40. Manarungsan and Suwanjindar, "Contract Farming and Outgrower Schemes in Thailand," 17.
41. Pasuk and Baker, *Thailand: Economy and Politics*, 60.
42. Hewison, *Bankers and Bureaucrats*, 145.
43. The JPPCC did simplify export administration. See Laothamatas Anek, *Business Associations and the New Political Economy of Thailand: From Bureaucratic Polity to Liberal Corporatism* (Boulder: Westview Press, 1992), 127.
44. The Minister of Industry blocked neoliberal reform of the trade regime. See Robert Muscat, *The Fifth Tiger: A Study of Thai Development Policy* (Tokyo: United Nations University Press, 1994), 178.
45. By 1985 the effective rate of protection of Thai manufacturing reached 52%, nearly two times that of Korea, Malaysia, and the Philippines. See Christensen, et al., *Lessons of East Asia* 10.
46. By the mid-1980s, over 60% of BOI's promoted projects were export oriented. See Wiboonchutikula Payton et al., "Trade in Manufactured Goods and Minerals" (background paper no. 4, TERI Year-End Conference, Thailand Development Research Institute, Bangkok, 1989), 56.
47. World Bank, *The East Asian Miracle: Economic Growth and Public Policy* (New York: Oxford University Press, 1993), 142.
48. Interest rates for export loans were 3.5% below market rates. See Paitoon et al., "Trade in Manufactured Goods and Minerals," 51.
49. Interest subsidies on export loans ranged from 2.5% to 3%. The volume of subsidised export loans rose from 10.2 billion baht in 1975 to 128.6 billion baht in 1988. *Ibid.*, 52.
50. This test was used by authors of *The East Asian Miracle*, 304–06; 327.
51. Hewison, *Bankers and Bureaucrats*, 306.
52. The actual share of manufacturing in value addition in 1986 was 1.68 times international norms. This compares to 1.26 for Korea and Hong Kong, and 1.38 for Singapore. See World Bank, *The East Asian Miracle*, 327.
53. S. Kunnot and A. Chowdhury, "Export-Oriented Industrialization and Industrial Deepening in Thailand: An Input-Output Perspective," *Economic Bulletin for Asia and the Pacific*, 43, no. 1 (1992): 52–62.
54. Juanjai Ajanant, "Trade and Structural Change in Pacific Asia," in *Trade and Structural Change in Pacific Asia*, eds. Colin I. Bradford and William Branson (Chicago: University of Chicago Press, 1987), 481.
55. Siroros Patcharee and Wannitikul Wilaiwan, "International Competitiveness of Indigenous Firms: Case Studies of the Gems and Jewelry Industry and the Siam Cement Group" (paper presented at Forum for Advanced Studies in International Development, Tokyo, Japan, 1998.)

56. Jomo K. S. and C.B. Edwards, "Malaysian Industrialization in Historical Perspective," in *Industrializing Malaysia: Policy, Performance and Prospects*, ed. Jomo K. S. (London: Routledge, 1993), 36.
57. World Bank, *World Development Report, 1992* (New York: Oxford University Press, 1992), 218.
58. J. E. Campos and H. L. Root, *The Key to the Asian Miracle: Making Shared-Growth Credible* (Washington, D.C.: Brookings Institution, 1996), 9–16.
59. *Ibid.*, 60.
60. World Bank, *World Development Report, 1990* (New York: Oxford University Press, 1990), 222.
61. World Bank, *World Development Report, 1992* (New York: Oxford University Press, 1992), 222.
62. World Bank, *World Development Report, 1996* (New York: Oxford University Press, 1996), 216.
63. Indonesia's export concentration index declined from 0.499 in 1984 to 0.194 in 1992. *Ibid.*, 192.
64. World Bank, *East Asian Miracle*; Campos and Root, *Key to the Asian Miracle*; H. Hill, *The Indonesian Economy Since 1966* (Cambridge: Cambridge University Press, 1996).
65. D. L. Lindauer and M. Roemer, *Development in Asia and Africa: Legacies and Opportunities* (Cambridge, Mass.: Harvard Institute for International Development, 1993).
66. R. M. Auty, *Resource Based Industrialization: Sowing the Oil in Eight Less Developed Countries* (Oxford: Clarendon Press, 1990); R. M. Auty, "Industrial Policy Reform in Six Large Newly Industrializing Countries: The Resource Curse Thesis," *World Development* 22, no.1 (1994): 11–26; A. Gelb and Associates, *Oil Windfalls: Blessing or Curse* (New York: Oxford University Press, 1988).
67. R. Robison, *Indonesia and the Rise of Capital* (Sydney: Allen and Unwin, 1986), 6.
68. *Ibid.*, 9.
69. M. Gillis, "Episodes of Indonesian Economic Growth," in *World Economic Growth*, ed. A. C. Harberger (San Francisco: International Center on Economic Growth, 1984), 231–64; C. P. Timmer, "The Political Economy of Rice in Asia: Indonesia," *Food Research Institute Studies* 14, no. 3 (1975): 197–231; Hill, *The Indonesian Economy Since 1966*.
70. A. MacIntyre, "The Politics of Finance in Indonesia: Command, Confusion, and Competition," in *The Politics of Finance in Developing Countries*, eds. S. Haggard, C. H. Lee, and S. Mayfield (Ithaca: Cornell University Press, 1993), 128.
71. *Ibid.*
72. D. McKendrick, "Obstacles to 'Catch Up': The Case of the Indonesian Aircraft Industry," *Bulletin of Indonesian Economic Studies* 28, no. 1 (1992), 39–66; Auty, *Resource Based Industrialization*.
73. World Bank, *Indonesia: Strategy for Growth and Structural Change* (report no. 7758-IND, Washington, D.C., 1989); R. Robison, "Class, Capital and the State in New Order Indonesia," in *Southeast Asia: Essays in the Political Economy of Structural Change*, eds. R. Higgott and R. Robison (Melbourne: Routledge, Kegan, and Paul, 1985), 302.
74. World Bank, *Indonesia: Strategy for Growth and Structural Change*, 70.
75. Gillis, "Episodes of Indonesian Economic Growth"; World Bank, *Indonesia: Strategy for Growth and Structural Change*.
76. R. W. Liddle, "The Relative Autonomy of the Third World Politician: Suharto and Indonesian Development in Comparative Perspective," *International Studies Quarterly* 35 (1991): 415.
77. Y. Sato, "The Salim Group in Indonesia: The Development and Behavior of the



- Largest Conglomerate in Southeast Asia," *The Developing Economies* 31, no. 4 (1993): 408–41.
78. *Ibid.*
  79. N. Mihira and Y. Sato, *Industrialization in Indonesia: The Full-set Industrialization Strategy* (Tokyo: Institute of Developing Economies, 1992).
  80. This is not to say that neoliberals see the technocrats as unabashed neoclassical economists. Glassburner refers to them as "Indonesian nationalists [with] a strong propensity to control the use of foreign resources [because] they are wary of foreign economic influence." See B. Glassburner, "Indonesia's New Economic Policy and Its Sociopolitical Implications," in *Political Power and Communication in Indonesia*, eds. K. D. Jackson and L. Pye (Berkeley: University of California Press, 1978a), 24. Hill cautions against viewing post-1966 economic policy changes as reflecting a significant break with the past. He also argues that the New Order government's commitment to a liberal economic order has been half-hearted and ambivalent. See Hill, *The Indonesian Economy Since 1966*, 93.
  81. For example, Jusuf Panglaykim, a respected academician and businessman, criticised Bappenas for adopting a fragmented approach to multinationals that guaranteed them too much influence in the Indonesian economy. See Robison, *Indonesia and the Rise of Capital*, 148.
  82. MacIntyre, "The Politics of Finance in Indonesia," 155.
  83. Liddle, "The Relative Autonomy of the Third World Politician," 418.
  84. Their growth and expansion is not unlike that of both South Korea and Thailand.
  85. Liddle, "The Relative Autonomy of the Third World Politician," 407.
  86. *Ibid.*, 419.
  87. Successful intervention in rice markets stands in sharp contrast to what might be called benign neglect of the rest of agriculture, including estate crops. Hill, *The Indonesian Economy Since 1966*, 137–44.
  88. C. P. Timmer, "Agricultural Prices and Stabilization Policy" (development discussion paper no. 290 ASP, Harvard Institute for International Development, Cambridge, Mass., 1989); and C. P. Timmer, "Rural Bias in the East and Southeast Asian Rice Economies," *Journal of Development Studies* (1993), 149–76.
  89. Glassburner, "Indonesia's New Economic Policy and Its Sociopolitical Implications," 143.
  90. Timmer, "Agricultural Prices and Stabilization Policy," 152.
  91. Gelb and Associates, *Oil Windfalls: Blessing or Curse*, 219.
  92. Timmer, "Agricultural Prices and Stabilization Policy," 151.
  93. *Ibid.*, 158.
  94. *Ibid.*
  95. Timmer, "Agricultural Prices and Stabilization Policy."
  96. Between 1968 and 1974, farmers received between 19% and 42% of all central bank credit subsidies. See A. MacIntyre, "Power, Prosperity, and Patrimonialism: Business and Government in Indonesia," in *Business and Government in Industrializing Asia*, ed. A. Macintyre (Ithaca: Cornell University Press, 1994), 244–67; 150.
  97. A. Booth, "Indonesia's Agricultural Development in Comparative Perspective," *World Development* 17, no. 8 (1989): 1243.
  98. Hill, *The Indonesian Economy Since 1966*, 129.
  99. During the first oil price shock, agriculture received 13% of all development spending. Of this, between 4% and 30% was for fertilizer subsidies alone. See B. Glassburner, "Indonesia: Windfalls in a Poor Rural Economy" in *Oil Windfalls: Blessings or Curse?* ed. A. Gel and Associates (New York: Oxford University Press, 1988), 208.
  100. Three aspects of this highly successful rice policy had positive impacts on the indus-

trialisation programme. First, self-sufficiency meant that scarce foreign exchange could be used for importing capital and technology for industrialisation rather than to buy rice. Second, because of the large swings in world rice prices, the thinness of world rice markets, and the large pull on prices exerted by Indonesia when it entered rice markets, large Indonesian imports of rice exerted a destabilising influence on the macro-economy. This undermined investment elsewhere in the economy, including industry. Rice price stabilization helped overcome this problem. Third, stabilization of domestic rice prices around a declining world price of rice buoyed profits as this translated into a tendency for real wages to follow the price of the primary wage good: rice.

101. On the role of business groups in overcoming shortages in entrepreneurial talent and market imperfections; see N.H. Leff, "Entrepreneurship and Development: The Problem Revisited," *Journal of Economic Literature* 17, no. 1 (1979): 46–64. On how business groups can be used to acquire and disseminate industrial competence, see R. Mardon, "The State and Effective Control of Foreign Capital: The Case of South Korea," *World Politics* 43, no. 1 (1990), 111–38.
102. Y. Sato, "The Astra Group: A Pioneer of Modernization in Indonesia," *The Developing Economies* 34, no. 3 (1996): 247–80.
103. The former provided revenues of around US\$ 4.2 million per year between 1971 and 1980. See Sato, "The Salim Group in Indonesia," 411.
104. *Ibid.*, 414; 417–21.
105. *Ibid.*, 423.
106. For example, the Salim Group not only raised chickens, but also transported, butchered, processed, prepared, and sold chickens (in, among other places, Kentucky Fried Chicken franchises that it owned around the world).
107. Auty, "Industrial Policy Reform in Six Large Newly Industrializing Countries," 168–70.
108. *Ibid.*, 171.
109. *Ibid.*, 170.
110. *Ibid.*, 213.
111. Christensen et al., *Lessons of East Asia*, 304.
112. World Bank, *World Development Report 1997: The State in a Changing World* (Oxford University Press, New York, 1997), Appendix Tables 1, 2.
113. World Bank, *World Development Report, 1996*, 216–17.
114. K. F. Chin and Jomo K. S., "Financial Sector Rents in Malaysia" in *Rents, Rent-Seeking and Economic Development: Theory and Evidence in Asia*, eds. M. H. Khan and Jomo K. S. (Cambridge: Cambridge University Press, 2000).
115. Intal, "Comments on Chapter 2 of *The Emerging Asia Study*."

# Primary Exports and Primary Processing for Export in Sub-Saharan Africa

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## Introduction

Primary exports remain the most important link to the global economy for many countries in Sub-Saharan Africa. Arising from the emphasis on manufacturing, the importance of the primary-sector exports has been underplayed. The de-emphasis on the primary-sector exports arises from the efforts of SSA countries to diversify their economies and partly stem the effects of the decline in primary-commodity export prices. When looking for lessons from Southeast Asia for other developing countries, Chibber and Leechor found that one of the key factors to the integration of Southeast Asia was the expansion of primary exports.<sup>1</sup> This led to a surplus that was important not only in its own right but also as a basis for the subsequent upgrading and shift to manufacturing. Manufacturing, whether import substitution or later export orientation, enjoyed considerable subsidies, whether indirectly through the infrastructural support services generated largely through commodity rents or through incentives. It has been argued that foreign investment, either direct investment (which dominated manufacturing operations in Malaysia) or through joint ventures (which dominated manufacturing operations in Indonesia and Thailand), played a major role in export expansion in these economies.<sup>2</sup> Rasiah further argues that political stability, a fairly good infrastructure, and less bureaucratic red tape and rent abuse were instrumental in

making Malaysia and, to a lesser extent, Thailand attractive sites for foreign companies to relocate labour-intensive, low-value-added industries. African economies will have to ensure these characteristics to be able to attract large-scale, foreign, export-oriented operations. Given the lack of domestic capital and huge debt service burden faced by most African economies, FDI can be a useful source of investment and technology, which in turn is essential for the growth of the manufacturing sector.

What chances do African economies have in terms of attracting foreign investment? Unlike the Southeast Asian economies, which are located close to the major production and markets of the Asia Pacific, Africa is located too far away to benefit from regional synergies generated as a consequence of FDI outflows. Hence, the continent is seriously disadvantaged in its capacity to attract low-wage, investment-seeking locations close to the Pacific Rim. Europe is located closest to the SSA countries, but the opening of the eastern-bloc economies is likely to make them more attractive for investment than Africa. It is not our intention in this chapter to pursue this issue any further. Our questions of interest are how have Sub-Saharan African countries performed in both primary-resource exports and manufactured exports over the last thirty years, and what have been the factors that have played a considerable influence on the direction of SSA export performance?

The 1977 report to the UN Secretary General indicates that economic growth in Africa slowed to 3% from 4.4% in 1996. Declines in agricultural production and exports, as well as in oil prices, contributed to slow growth. Given the significance of agriculture, low output adversely affected incomes, consumption, and the growth of the processing sectors. In some countries, political instability or civil strife also negatively affected economic growth in 1997.<sup>3</sup> Growth in Africa could further be affected adversely if expected export growth is held back by the currency crisis and economic slowdown in East Asia, which has become the fastest-growing trading partner for some African countries (for example, South Africa) in recent years.

In addition to the introduction, this chapter is presented in five main sections. While Section 2 presents an account of the export performance in SSA over the last three decades, in Section 3, we present an analysis of the factors that have influenced export performance over the relevant period. Section 3 deals mainly with Sub-Saharan African countries' resource exports (agricultural raw materials, fuel, and minerals), and Section 4 deals with the factors affecting processed exports, mainly manufactured exports. In Section 5 we present a brief account of the institutional framework for export expansion and promotion, while Section 6 presents policy implications and some concluding remarks.

## Export Performance of Sub-Saharan Countries

In recent years, contrary to the period of the mid-1980's, SSA countries' exports have begun to show some signs of recovery. This may be attributed partly to the structural adjustment and trade liberalisation measures adopted since the early 1980s. For example, Africa's exports grew by 12% in value terms in 1995, a considerable improvement compared to the 3% of the previous year and the negative growth in value of the preceding three years. However, Africa's export growth continued to lag behind world trade in both value and volume. Yeats and Ng, in a study of thirty products exported by SSA countries over the period 1962–64 and 1991–93, have shown that, while world trade in all nonfuel goods increased at a compound rate of 11.8%, the corresponding growth rate for the thirty African products was more than six and a half percentage points lower.<sup>4</sup> Based on the available statistics for the year 1995, countries with growth in export exceeding 20% included Angola, Central African Republic, Kenya, Réunion, Tanzania, and Togo.<sup>5</sup>

As can be observed in Appendix Table 7.1, merchandise exports for a number of SSA countries experienced fluctuations over the period from 1984 to 1995. Except for the period between 1991 and 1995, the trend for the majority of SSA countries has generally been upwards.

Notable exceptions are Democratic Republic of Congo (Zaire), where earnings declined from US \$2.46 billion in 1988 to \$1.63 billion in 1995, Nigeria, where earnings dropped from US \$1.63 billion in 1990 to \$1.1 billion in 1995, and South Africa, where earnings declined from US \$2.35 billion in 1990 to \$1.89 billion in 1995.

The countries that experienced the highest increase in export earnings in the late 1980s and early 1990s are those that experienced the worst decline in export earnings in the late 1970s and early 1980s. Such countries include Ghana, where earnings increased from US \$808 million in 1989 to \$1.4 billion in 1995, Madagascar, where earnings increased from US \$318 million in 1990 to \$502 million in 1995, and Tanzania, where earnings increased from US \$290 million in 1986 to \$639 in 1995 (see Figure 7.1).

Agricultural raw-material exports experienced much higher degrees of fluctuations in export earnings than mineral and oil exports. Figure 7.2 shows that, as a proportion of world exports, SSA countries have experienced a general decline in all categories of resource-based exports for the period 1970–1995. As a percentage of total world exports, SSA's share dropped from 0.8% in 1970 to about 0.3% in 1995 (see also Appendix Table 7.2).

Table 7.3 indicates that most SSA countries are essentially primary-

Table 7.1 Merchandise Exports to the World (Millions of US Dollars 1980–95)

Country/Region	1980	1981	1982	1983	1984	1985	1986
<b>Central Africa</b>							
Cameroon	1,418	1,610	1,637	1,317	1,289	1,409	1,603
CAR.	147	NA	NA	NA	85	92	66
Gabon	2,531	NA	NA	NA	2,012	1,952	1,271
Zaire	2,269	1,079	986	956	1,023	1,071	1,399
<b>Eastern Africa</b>							
Ethiopia	459	701	727	798	417	334	464
Kenya	1,363	NA	NA	NA	NA	NA	NA
Mozambique	281	NA	NA	NA	96	77	79
Tanzania	508	NA	NA	NA	NA	359	290
Uganda	319	300	292	275	385	387	436
<b>Southern Africa</b>							
Angola	NA	NA	NA	NA	2,053	2,224	1,319
Botswana	545	NA	NA	NA	674	744	714
Lesotho	58	NA	NA	NA	29	23	26
Malawi	281	NA	NA	NA	309	249	245
Swaziland	368	NA	NA	NA	237	176	267
Zambia	1,457	789	748	498	661	547	704
Zimbabwe	281	NA	NA	NA	1,148	1,109	1,301
<b>Western Africa</b>							
Côte d'Ivoire	3,013	2,266	1,623	1,404	1,309	1,413	1,621
Ghana	1,104	1,189	803	683	558	658	763
Nigeria	25,956	16,758	12,215	7,707	12,020	13,113	5,899
Senegal	422	928	959	24	534	554	620
Island States	NA	NA	NA	NA	NA	NA	NA
Madagascar	437	NA	NA	NA	333	274	304
Mauritius	434	NA	NA	NA	373	435	675
Seychelles	6	NA	NA	NA	NA	NA	NA
<b>Developed Africa</b>							
R.S.A.	25,698	NA	NA	NA	17,163	16,293	18,385

Sources: United Nations, UNCTAD Commodity Yearbook, 1995; World Bank, African Development Indicators, 1997.

commodity exporters, where the share of primary-commodity exports as a proportion of total merchandise exports have remained high, and in most countries, except Mauritius and Zimbabwe, the share has remained above 70%, leaving them vulnerable to changes in demand and prices on world markets and to exogenous factors affecting domestic supply. However, Kenya and Seychelles experienced significant improvements in export diversification, where the share of primary-commodity exports in total merchandise exports declined from 93.8% in 1980 to 70.9% in 1993 for Kenya and from 96.9% to 71.1% for Seychelles.

1987	1988	1989	1990	1991	1992	1993	1994	1995
1,729	1,670	1,837	1,906	2,159	1,937	1,651	1,432	1,662
129	134	148	151	126	116	132	151	173
1,286	1,196	1,629	2,490	2,230	2,257	2,326	2,365	2,643
1,813	2,460	2,417	2,326	1,649	1,246	1,144	1,256	1,632
391	381	444	366	276	154	222	281	454
907	1,014	922	993	1,052	1,008	1,099	1,482	1,875
97	103	105	126	162	139	132	164	174
337	338	423	415	342	416	450	519	639
384	298	282	210	176	172	157	254	595
2,322	2,520	3,014	3,884	3,449	3,833	2,900	3,002	3,519
1,592	1,478	1,820	1,753	1,903	1,725	1,725	1,880	1,848
30	64	66	60	58	105	95	136	168
279	294	269	412	476	397	321	373	410
424	466	494	554	580	608	626	827	781
873	1,155	1,410	1,264	1,085	1,111	949	1,067	1,190
1,455	1,668	1,692	1,726	1,785	1,530	1,610	1,947	2,216
3,091	2,664	2,697	3,003	2,705	2,945	2,519	2,869	3,870
825	881	808	897	998	986	1,064	1,236	1,431
7,383	6,875	9,812	13,670	12,264	12,307	11,297	9,534	10,916
671	679	758	894	803	828	707	794	969
NA	NA	NA	NA	NA	NA	NA	NA	NA
329	280	318	318	334	324	332	447	502
892	1,001	995	1,201	1,213	1,303	1,299	1,344	1,539
8	17	15	28	19	20	22	27	22
21,219	21,871	22,191	23,549	23,306	23,413	24,261	18,296	18,976

Other countries whose share of primary commodities in total exports has remained low include Botswana (13%), Lesotho (14.0%), and Swaziland (43.2%) in 1993. Not only are most SSA countries dependent on primary-commodity exports, but export earnings are also highly concentrated in a few primary products. Table 7.4 shows, for example, that some countries are dependent on three commodities for as much as 90% of their total merchandise exports. For most of the countries, the percentage is above 50. Countries with very high export concentration include Angola, Uganda, Seychelles, Nigeria, Zambia, and Gabon. All except Uganda are mineral and oil exporters. The dependence of SSA countries on exports of a narrow range of largely unprocessed primary

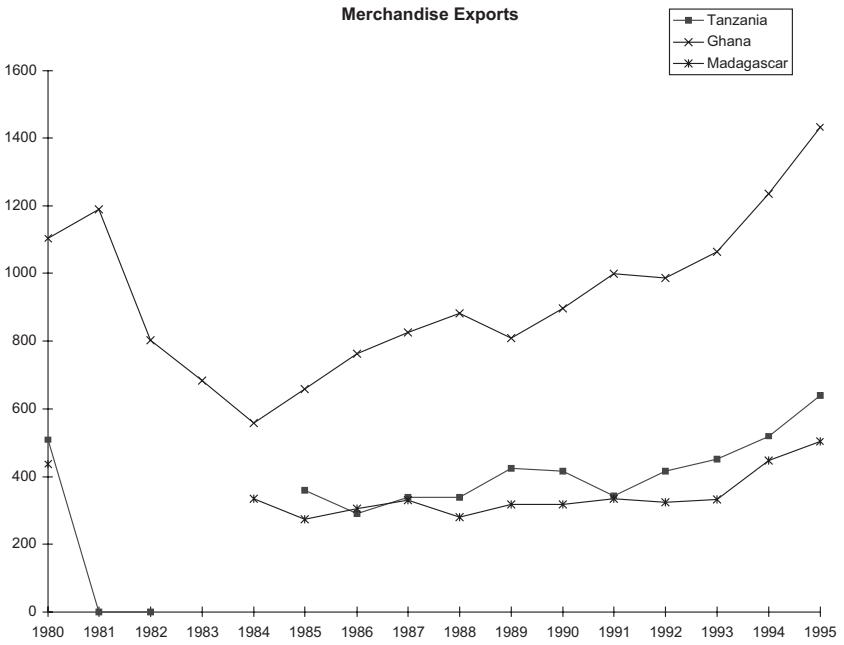
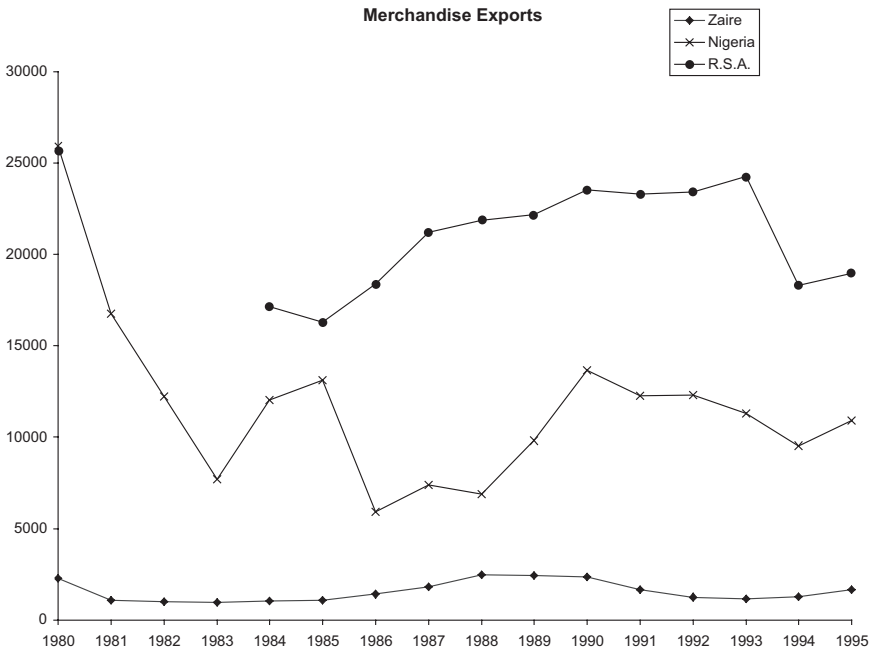


Figure 7.1 Merchandise Exports to the World (Millions of US Dollars 1980–95)



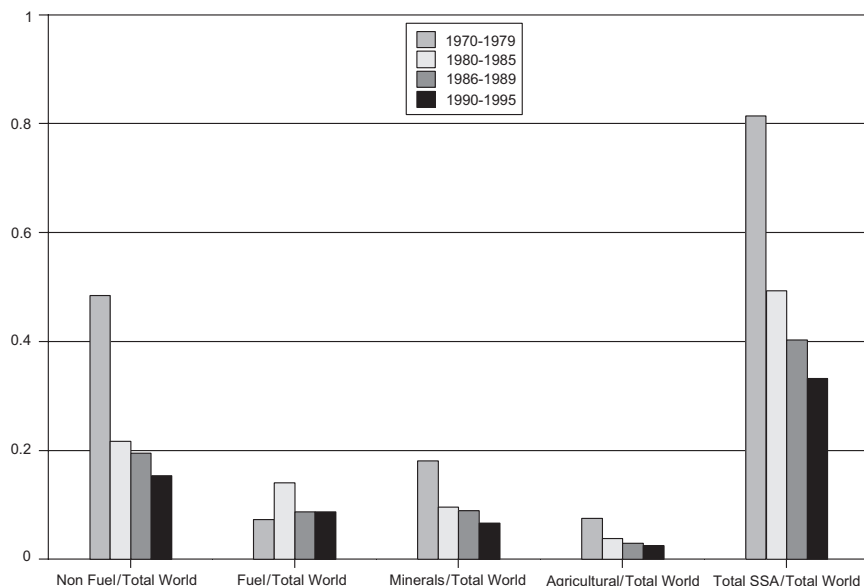


Figure 7.2 Sub-Saharan Africa Resource-Based Exports As a Percentage of World Exports

Appendix Table 7.2 Sub-Saharan African Exports by Category as a Ratio to Total World Exports

	Nonfuel/ Total World (%)	Fuel/Total World (%)	Minerals/ Total World (%)	Agricultural/ Total World (%)	Total SSA/ Total World (%)
1970-1979	0.485	0.073	0.181	0.076	0.814
1980-1985	0.217	0.141	0.096	0.039	0.493
Growth (%)	(123.4)	(48.1)	(87.3)	(94.0)	(65.1)
1986-1989	0.195	0.088	0.090	0.030	0.403
Growth (%)	(11.4)	(60.2)	(7.7)	(28.1)	(22.5)
1990-1995	0.154	0.088	0.067	0.025	0.333
Growth (%)	(26.9)	(0.0)	(34.5)	(23.4)	(21.1)

Source: UNCTAD, 1995.

commodities and raw materials, which are susceptible to price volatility on the world market, whose price and income elasticity of demand is low, and whose growth has been slower than world trade overall, is one of the main factors hindering their export performance. It has also limited severely the stimulus that the export sector can provide to the domestic economy through backward-linkage activities.<sup>6</sup> African countries' exports are also concentrated in a few markets, mainly the European Union,

Table 7.3 Share of Primary Commodities in All Merchandise Trade Values

Region (Country or Area)	Exports of Primary Commodities as a Percent of Total Exports							
	(A) Excluding fuels				(B) Including fuels			
	1975	1980	1990	1993	1975	1980	1990	1993
<b>Central Africa</b>								
Cameroon	89.2	63.3	44.6	44.9	89.5	92.6	95.6	86.1
Cent. African Rep	83.5	84.5	68.2	46.3	83.6	84.5	68.2	46.3
Gabon	15.4	18.9	26.4	24.8	94.9	99.2	99.0	99.0
Zaire	98.0	60.5	83.6	66.5	99.0	72.8	99.0	99.0
<b>Eastern Africa</b>								
Ethiopia	83.6	92.3	85.7	95.6	86.6	99.7	91.7	96.5
Kenya	53.0	58.6	72.9	59.5	69.7	93.8	85.9	70.9
Mozambique	82.2	75.1	84.0	91.8	93.4	80.0	85.1	93.4
Uganda	99.0	98.2	99.0	99.0	99.0	99.0	99.0	99.0
Tanzania	79.4	85.4	73.7	77.4	84.4	90.2	73.9	77.9
<b>Southern Africa</b>								
Angola	31.7	10.0	0.3	0.5	96.0	88.7	92.9	76.2
Botswana	64.0	37.5	14.5	13.1	64.0	37.5	14.5	13.1
Lesotho	77.7	27.5	22.1	14.0	77.7	27.5	22.1	14.0
Malawi	88.2	86.0	91.6	88.1	88.3	86.2	91.6	88.1
Swaziland	80.0	79.0	83.3	43.2	80.0	79.0	83.3	43.2
Zimbabwe	71.7	51.9	57.3	63.3	73.1	53.2	58.0	63.7
<b>Western Africa</b>								
Côte d'Ivoire	82.0	84.1	64.3	76.9	87.6	86.3	78.2	98.1
Ghana	86.0	87.6	93.6	73.6	88.5	87.9	97.7	80.0
Nigeria	6.3	2.0	2.3	2.5	99.0	95.5	95.7	89.3
Senegal	82.7	65.7	68.7	37.3	89.7	84.5	81.7	48.3
<b>Island States</b>								
Madagascar	87.3	91.3	78.1	82.3	95.9	97.1	78.6	82.7
Mauritius	87.6	71.4	33.2	31.4	87.6	71.4	34.6	31.4
Seychelles	33.1	23.9	24.6	32.0	99.0	96.9	68.2	71.1

Source: United Nations, UNCTAD Commodity Yearbook, 1995.

North America, and Japan. This limitation has implications for market access, calling for both product and market diversification.

A question of considerable interest is which countries were primarily responsible for the erosion of Africa's market share. Was the erosion broad-based in terms of the competition, or was one or two groups of countries primarily responsible? Yeats and Ng have shown that the OECD countries themselves made the largest overall displacement of African exports.<sup>7</sup> Specifically, while Africa's trade shares fell by 11.1

percentage points for these products, OECD shares rose by 9.9 percentage points.<sup>8</sup> Market shares for middle-income Asia rose by over 4%, while those for other (non-OECD) countries in Europe and Central Asia increased by almost the same amount. In contrast, Latin America's trade shares dropped by about 4 percentage points, which was about one-third the overall African losses. Perhaps the key point to note is that no other group of countries has experienced any general loss of competitive position which comes close to matching that for Africa. Comparing Asia, Latin America, and Africa, it has been observed that in both Asia and Latin America, nontraditional crops have expanded, while the composition of exports from SSA has remained fairly stagnant.<sup>9</sup> In Latin America, export expansion has included fruits, vegetables, and oilseed production. In Asia, on the other hand, production increases have affected all sectors of agriculture, with the largest gains coming from fruits and vegetables.

Yeats and Ng have further shown that, for a combined total of 30 African export products, over the periods 1962–64 and 1991–93, Africa's market share declined by over 11 percentage points (from 20.8% to 9.7%), a decline which implies annual trade losses for the region of just under \$11 billion, which is equivalent to the total development assistance of \$10.9 billion in 1991.<sup>10</sup>

Over the decade of the 1980s, for example, we witnessed rapid declines in the share of world exports for both Ghana and Zambia. Ghana's merchandise export earnings declined from \$1104 million in 1980 to \$560 million in 1984, recovered to \$890 million by 1990 and have experienced an upward trend since 1990, primarily due to the structural adjustment and trade liberalisation measures undertaken since the early 1980s. Zambia, on the other hand, had its merchandise export earnings drop from \$1460 million in 1980 to \$550 million in 1985, a decline resulting from the very rapid drop in world copper prices (copper is Zambia's main export product). The trend, though fluctuating, has been reversed since 1987. We have also witnessed sharp declines in the rates of growth of GDP and per capita GNP for both countries. Is this purely a case of lack of market access, terms of trade shock, domestic supply constraint, or a combination of the three factors? In Section 3, an attempt will be made to determine the main factors that have influenced SSA countries' export supplies.

Sekkat and Varoudakis<sup>11</sup> and Elbadawi<sup>12</sup> have shown that the evolution of the share of manufacturing in total exports has remained extremely low in most SSA countries, although some of them have made considerable progress in this respect. Most remarkable examples are, in the CFA zone, Côte d'Ivoire, Congo, and Mali and, in the non-CFA zone, Ghana, Madagascar, and Tanzania (during the 1990s), countries which achieved

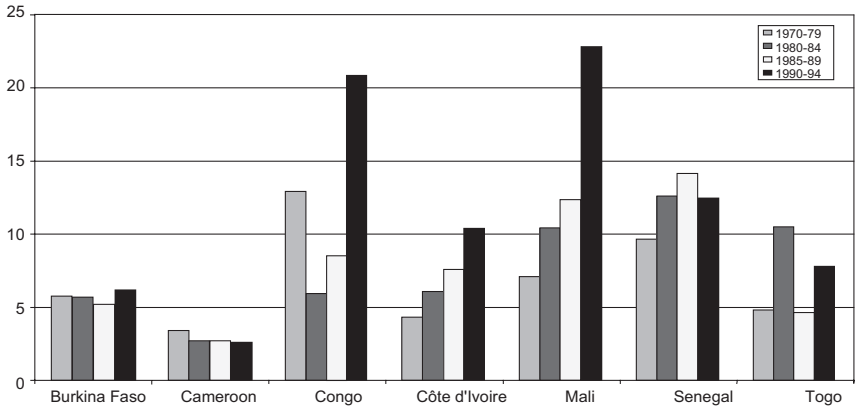
Table 7.4 Share of Three Leading Commodities in Total Exports

	Export Dependence on Three Leading Commodities		Dependence on Three Nonoil Commodities		Three Leading Commodities in 1990-92
	avg 75-77	avg 90-92	avg 75-77	avg 90-92	
<b>Central Africa</b>					
Cameroon	69.1	81.0	69.1	25.8	Fuels-Woods-Coffee
C. African Rep.	69.9	55.7	69.9	55.7	Wood Nonconiferous-Live Animals- Cotton
Gabon	91.0	99.0	15.3	19.2	Fuels-Manganese Ore-Wood
Zaire	83.5	81.5	81.6	59.5	Copper-Fuels-Coffee
<b>Eastern Africa</b>					
Ethiopia	70.5	79.0	70.5	78.0	Coffee-Hides & Skins-Fuels
Kenya	60.5	56.0	44.9	45.6	Tea-Coffee-Fuels
Mozambique	48.0	58.1	46.3	58.1	Fishery Commodities-Nuts-Cotton
Uganda	97.9	81.5	97.9	81.5	Coffee-Cotton-Sesame Seeds
Tanzania	52.5	43.5	52.5	43.5	Cotton-Coffee-Tea
<b>Southern Africa</b>					
Angola	99.0	94.5	24.9	0.3	Fuels-Fishery Commodities-Coffee
Botswana	61.9	10.4	61.9	10.4	Nickel Intermediate Products-Bovine Meat Fresh-Copper Ore
Lesotho	48.3	11.1	48.3	11.1	Wool-Cereals Preparations-Wheat & Wheat Flour
Malawi	78.2	88.8	78.2	88.8	Tobacco-Tea-Sugar
Swaziland	47.2	33.3	47.2	33.3	Sugar-Fuels-Fishery Commodities
Zambia	93.2	99.0	93.2	99.0	Copper Metal-Sugar-Ground Nuts
Zimbabwe	25.2	53.0	25.2	53.0	Tobacco-Nickel Refined-Cotton

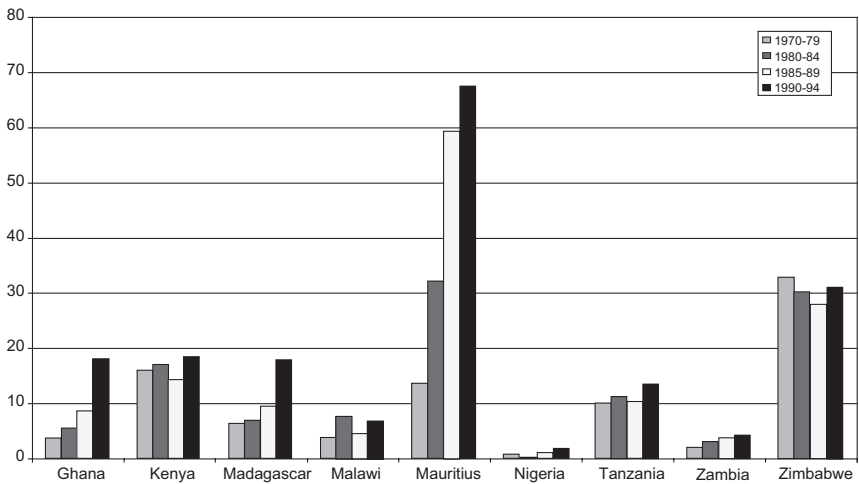
<b>Western Africa</b>					
Côte d'Ivoire	75.7	55.0	75.7	48.1	Cocoa & Products-Fuels-Wood
Ghana	83.0	67.4	83.1	67.4	Cocoa & Products-Aluminum-Wood
Nigeria	97.5	99.0	4.9	1.8	Fuels-Cocoa & Products-Natural Rubber
Senegal	59.5	49.3	59.5	43.8	Fishery Commodities-Fuels-Ground- Nut Oil
<b>Island States</b>					
Madagascar	59.5	43.4	59.5	43.4	Vanilla-Fishery Commodities-Coffee
Mauritius	79.6	32.3	79.6	31.2	Sugar-Fuels-Fishery Commodities
Seychelles	99.0	78.6	30.4	30.6	Fuels-Fishery Commodities-Copra

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Source: United Nations, UNCTAD Commodity Yearbook, 1995.



(a) CFA Countries



(b) Non-CFA Countries

Figure 7.3 Share of Manufacturing Exports In Total Exports

a steady increase in the export share of manufacturing (see Figure 7.3 and Appendix Table 7.5). Manufactured products (mainly textiles and clothing) constitute about 10% of the SSA countries' exports in aggregate, but they are significant for a few of them, notably Mauritius. Mauritius has been particularly successful in promoting manufactured exports, primarily as a result of a policy of Export Processing Zones (EPZs).

Appendix Table 7.5 Average Share of Manufactured Exports in Total Exports

	Country	1970–79	1980–84	1985–89	1990–94
<b>CFA</b>	Burkina Faso	5.81	5.73	5.22	6.22
	Cameroon	3.45	2.75	2.76	2.64
	Congo	12.94	5.97	8.58	20.89
	Côte d'Ivoire	4.35	6.11	7.63	10.43
	Mali	7.14	10.45	12.39	22.84
	Senegal	9.69	12.63	14.19	12.52
	Togo	4.85	10.53	4.67	7.86
<b>Non CFA</b>	Ghana	3.87	5.65	8.77	18.24
	Kenya	16.15	17.17	14.49	18.57
	Madagascar	6.54	7.14	9.62	18.04
	Malawi	4.02	7.98	4.86	7.01
	Mauritius	13.83	32.36	59.46	67.61
	Nigeria	0.92	0.42	1.27	2.00
	Tanzania	10.18	11.39	10.41	13.74
	Zambia	2.16	3.23	3.99	4.47
	Zimbabwe	33.08	30.42	28.19	31.29

Source: K. Sekkat and A. Varoudakis, "Exchange Rate Management and Manufactured Exports in Sub-Saharan Africa" (1998, mimeographed).

Starting in the 1970s, with an export share of manufacturing lower than in Kenya and with a share of MVA in GDP lower than in Senegal, manufactured exports in this country reached more than two-thirds of total exports in the first half of the 1990s.<sup>13</sup> On the side of nontraditional export performance as an indication of export diversification, SSA countries still lag behind the fast-growing economies of East Asia, but they are comparable to countries in Latin America. For SSA, the share of nontraditional exports to GDP in 1994/95 was 3.77% compared to 9.21% for East Asia and 3.62% for Latin America. The best performances have been South Africa, 5.66%, Tanzania, 8.84%, and Zimbabwe, 7.1% (see Table 7.6).

Notwithstanding efficiency consideration, the share of gross investment to GDP is a useful broad indicator of an economy's potential to sustain high rates of export growth (as well as overall economic growth).<sup>14</sup> On this score, Elbadawi has pointed out that most African countries lag behind the fast growing economies.<sup>15</sup> Except for Mauritius and Tanzania – which have investment ratios comparable to those of Chile and Costa Rica, between 26% and 31%, respectively – virtually all the remaining African countries have investment rates lower than 20%. Few other countries, such as South Africa, Mauritius, and, to some extent, Zimbabwe, have shown substantial capacity in these areas.

Table 7.6 Non-Traditional Exports in A Sample of Developing Countries

	Average Exports Current US\$m	Non- traditional Exports Current US\$m	% Share of Total Exports to GDP	% Share of Non- traditional Exports to GDP
Burkina Faso				
1994/95 Average	93.07	4.89	4.45	0.23
Growth rate 84–95 (%)	43.78	331.85	(6.33)	181.34
Côte d'Ivoire				
1994/95 Average	3,209.60	371.49	36.64	4.24
Growth rate 84–95 (%)	24.94	77.54	(1.45)	40.04
Ghana				
1994/95 Average	1,386.51	153.50	21.55	2.39
Growth rate 84–95 (%)	197.28	721.62	105.96	469.23
Kenya				
1994/95 Average	1,305.00	227.64	15.82	2.76
Growth rate 84–95 (%)	44.94	115.05	8.28	60.67
Mauritius				
1994/95 Average	1,447.56	110.02	39.04	2.97
Growth rate 84–95 (%)	2,225.21	343.50	11.35	51.86
South Africa				
1994/95 Average	17,493.31	7,294.59	13.56	5.66
Growth rate 84–95 (%)	76.12	192.28	(12.66)	44.94
Tanzania				
1994/95 Average	547.56	168.85	15.69	8.84
Growth rate 84–95 (%)	37.71	192.03	129.89	387.49
Uganda				
1994/95 Average	513.66	11.54	10.66	0.24
Growth rate 84–95 (%)	27.60	376.56	(5.92)	251.37
Zimbabwe				
1994/95 Average	1,321.11	437.19	21.46	7.10
Growth rate 84–95 (%)	96.60	296.15	53.47	209.25
Chile				
1994/95 Average	14,161.12	3,662.31	23.71	6.13
Growth rate 84–95 (%)	280.26	463.27	13.51	68.13
Costa Rica				
1994/95 Average	3,605.11	873.82	41.08	9.96
Growth rate 84–95 (%)	213.58	243.12	35.50	48.27
Malaysia				
1994/95 Average	73,086.43	19,716.02	93.66	25.27
Growth rate 84–95 (%)	315.14	429.05	73.28	120.83
Thailand				
1994/95 Average	46,180.11	11,128.64	29.78	7.18
Growth rate 84–95 (%)	610.82	585.14	84.98	78.30
Indonesia				
1994/95 Average	42,599.13	18,323.67	22.81	9.81
Growth rate 84–95 (%)	114.52	673.35	0.31	261.62



Table 7.6 (cont.)

	Average Exports Current US\$m	Non- traditional Exports Current US\$m	% Share of Total Exports to GDP	% Share of Non- traditional Exports to GDP
SS Africa				
1994/95 Average	1,976.24	382.52	19.47	3.77
Growth rate 84–95 (%)	28.60	183.89	10.89	144.80
East Asia				
1994/95 Average	88,979.56	23,532.90	34.80	9.21
Growth rate 84–95 (%)	397.73	494.72	78.87	113.72
Latin America				
1994/95 Average	9,830.39	2,462.38	14.44	3.62
Growth rate 84–95 (%)	108.87	164.13	(4.58)	20.66

Note: For various countries, due to the unavailability of data, the nearest approximations have been used.

Source: I. Elbadawi, "Real Exchange Rate Policy and Non-Traditional Exports in Developing Countries" (1998, mimeographed).

## Factors Affecting Primary Export Performance

SSA countries have become increasingly marginalised in the world economy in terms of their share in world trade and output (both agricultural and industrial). Heavy dependence on primary commodities is one important reason for their slow growth of exports and of their economies in general.<sup>16</sup> However, most SSA countries have undertaken trade liberalisation since the early 1980s in efforts to expand and diversify output and exports.

During the last decade, most of the economies in SSA have been liberalised from command economies and a one-party state to macro-economic- and trade liberalisation and contested politics. State trading and marketing boards have been eliminated, and, in a majority of cases, export taxes have either been eliminated or reduced drastically, except in some countries in West Africa. With the changed policy environment, the microlevel sources of export bias have to a large extent been reduced.

The extent of trade liberalisation in SSA appears to have been quite impressive, but has liberalisation improved economic performance? To answer this question, one has to bear in mind what liberalisation was supposed to achieve, namely an expansion of exports through a diversion of resources from the domestic to the export sector. Such export orientation would in turn, if it is maintained, lead to faster growth of GDP.<sup>17</sup>

Moreover, by removing the traditional bias against exports and productions of manufactures, trade liberalisation would lead to diversification of production and exports in favour of manufactures, a policy which has been identified as positively related to economic growth.<sup>18</sup>

Recently completed AERC studies on trade liberalisation in ten countries in SSA have indicated clearly that domestic supply constraints constitute a significant part of the antiexport bias observed over the last three decades.<sup>19</sup>

A measure widely used by the AERC case studies to determine whether trade liberalisation took place is the extent of the reduction of the antiexport bias related to the application of both tariff and nontariff barriers for protective purposes. The results of the cumulative effects of the various liberalisation episodes, as summarised by Oyejide, Ndulu, and Gunning, confirm that antiexport bias has been generally on a downward trend, particularly if one takes into account the steep decline in exchange rate premiums as quantitative restrictions were dismantled and there was a general downward trend of import tariff rates.<sup>20</sup>

Oyejide, Ndulu, and Gunning also point out that changing to the use of exchange rates for clearing disequilibria in the market for foreign exchange has considerably reduced the need for using trade policy instruments for managing balance-of-payments pressures. What has been posed as the critical question is whether this momentum can be sustained in view of the fact that the process of liberalisation, to a dominant extent, has been prompted by external pressure and has been sustained to a significant extent so far by large inflows of external resources to ameliorate adjustment costs along the way. This is an empirical question which we will not attempt to answer in this chapter. Our aim is to present an empirical assessment of the export supply constraints that SSA countries have experienced over the last thirty years and their effect on export performance.

The ability of developing countries to take advantage of the emerging opportunities in world markets depends crucially on the ability to foster the development of internationally competitive industries which can meet strict standards of cost, quality, reliability, and delivery schedules. Supply capabilities can be a major constraint on the ability to exploit the opportunity arising from globalization. It has been observed, for example, that good infrastructure, political stability, trade links to major markets, and a potentially literate labour force helped the East Asian countries become attractive for FDI.<sup>21</sup> Most African countries enjoy static comparative advantages in natural resources but have lacked the political stability, infrastructure, and proximity to major production regions to participate more actively in manufacturing chains.

Among the impacts of trade liberalisation, for example, the most

widely cited one is that liberalisation provides expanded market opportunities, which, when coupled with reduced discrimination against exports, allow exploitation of comparative advantages and permit greater capacity utilisation and exploitation of scale economies. Secondly, liberalisation, through reducing antiexport bias, stimulates export performance, particularly nontraditional exports. Openness to international trade and complementary macroeconomic policies are regarded as the keys to successful export-led industrialisation and rapid growth.

The AERC studies have also shown that trade liberalisation has been associated with increased export orientation and higher trade shares in all countries in the study. Most of the studies, though, identify real depreciation rather than trade policies per se as the key explanatory factor behind the improved export performance. It has, however, been acknowledged that a fundamental problem lies in the attribution of observed postliberalisation changes in economic performance to changes in trade policies. In Southeast Asia, many enterprises expanded exports when supported by export incentives (such as subsidised credit refinancing and export rebates) and corporate tax holidays for exporting firms. Also important were the market access these countries enjoyed through GSP privileges and the Multifibre Agreement (MFA) quotas in North America and Europe.<sup>22</sup>

Using a panel data of 32 SSA countries for the period 1980–1995, we have tried to determine the factors that influence export performance for the categories of agricultural raw materials, fuels, and minerals. The data are further divided into three periods, 1980–1984, 1985–1990, and 1991–1995.

The regression equation is presented as:

$$Y_i = \beta_i X_{it} + \varepsilon_i$$

where  $Y_i$  is a vector of the dependent variable,

$\beta_i$  is a vector of coefficient,

$X_{it}$  represents a block matrix of the explanatory variables,

$\varepsilon_i$  is a vector of the random error terms,

$t = 1980 - 1995$ .

The key variables are the annual rate of change of the real-exchange and consumer price index as measures of macroeconomic stability, gross domestic investment as a proportion of GDP as a measure of the growth of capital stock, and an economy's potential to sustain high rates of export growth and external tariff as a measure of market access. The annual rate of change of the real exchange rate, rather than the level rate, has been

Table 7.7 An Empirical Model of Agricultural Raw Materials: Exports in Sub-Saharan Africa

Dependent Variable Log (XARMY)	Fixed Effects		Random Effects	
	Coefficient	<i>T</i> -Statistic	Coefficient	<i>T</i> -Statistic
Log XARMYL	0.112	0.550	0.821	17.862
Log DRER	0.163	1.129	0.103	1.341
Log DRERL	0.228	1.549	0.152	2.115
Log GDIY	0.412	1.027	0.076	0.317
Log GDIYL	0.396	1.331	0.461	2.039
Log CPI	-0.171	-1.063	0.148	2.443
Log CPIL	-0.423	-2.146	-0.216	-2.970
Log TA	0.000	0.000	-0.106	-1.821
Constant			-1.079	-2.954
<i>R</i> squared		0.981		0.938
Adjusted <i>R</i> squared		0.949		0.836
<i>P</i> value	0.000			
Number of observations	64			
Number of countries	32*			
Periods of estimation	1980–85, 1986–89, 1990–95			

Notes:

XARMY Exports of Agricultural Raw Materials/GDP

DRER Annual Change in Real Exchange Rate, i.e.,  $((RER_X - RER_{(X-1)}) / RER_{(X-1)}) * 100\%$

GDIY Gross Domestic Investment/GDP

CPI Consumer Price Index

TAMT Tariffs Faced by Exports (Agricultural Goods exc. Fish, estimate 2)

*P* Value Probability Value for Hausman Test – Random vs. Fixed Effects

A suffix of *L* denotes a variable lag of one period.

\* Botswana, Burkina Faso, Burundi, Cameroon, Central African Republic, Chad, Congo, Congo (Democratic Republic of), Côte d'Ivoire, Gabon, Gambia, Ghana, Guinea, Kenya, Lesotho, Madagascar, Malawi, Mali, Mauritius, Niger, Nigeria, Rwanda, Seychelles, Sierra Leone, South Africa, Sudan, Swaziland, Tanzania, Togo, Uganda, Zambia, Zimbabwe.

used in order to avoid potential problems of nonstationarity. The selection of the countries is based on availability of data. The consumer price index has been used as a measure of the annual rate of inflation.

The estimation results are reported in Tables 7.7, 7.8, and 7.9. A set of results are reported, containing two regressions of the same equation: one based on a fixed-effects model and the other on a random-effects model. The Hausman test suggests that the random-effects model is uniformly superior to the fixed-effects model. Further analysis will, therefore, be confined to the results of the random-effects model. The results

Table 7.8 An Empirical Model of Fuel Exports in Sub-Saharan Africa

Dependent Variable Log (XFY)	Fixed Effects		Random Effects	
	Coefficient	<i>T</i> -Statistic	Coefficient	<i>T</i> -Statistic
Log XFYL	-0.108	-0.693	0.912	17.031
Log DRER	-0.203	-0.740	0.012	0.075
Log DRERL	-0.125	-0.592	0.150	1.003
Log GDIY	0.341	0.725	-0.406	-0.789
Log GDIYL	-0.494	-0.538	1.104	2.365
Log CPI	-0.234	-0.691	0.229	1.838
Log CPIL	-0.252	-0.934	-0.356	-2.347
Log TPO	0.000	0.000	0.094	0.583
Constant			-1.225	-1.580
<i>R</i> squared		0.976		0.930
Adjusted <i>R</i> squared		0.937		0.815
<i>P</i> value	0.000			
Number of observations	64			
Number of countries	32*			
Periods of estimation	1980–85, 1986–89, 1990–95			

## Notes:

XFY Exports of Fuel Products/GDP

DRER Annual Change in Real Exchange Rate, i.e.,  $((RER_X - RER_{(X-1)}) / RER_{(X-1)}) * 100\%$ 

GDIY Gross Domestic Investment/GDP

CPI Consumer Price Index

TPO Tariffs Faced by Exports (Industrial Goods)

*P* Value Probability Value for Hausman Test – Random vs. Fixed EffectsA suffix of *L* denotes a variable lag of one period.

\* Botswana, Burkina Faso, Burundi, Cameroon, Central African Republic, Chad, Congo, Congo (Democratic Republic of), Côte d'Ivoire, Gabon, Gambia, Ghana, Guinea, Kenya, Lesotho, Madagascar, Malawi, Mali, Mauritius, Niger, Nigeria, Rwanda, Seychelles, Sierra Leone, South Africa, Sudan, Swaziland, Tanzania, Togo, Uganda, Zambia, Zimbabwe.

show that, while the combined effect (goodness of fit) of all the factors is about 84% in the case of agricultural raw materials and about 93% in the case of minerals, ores, and metal exports, its effect on fuel exports is about 82%. The annual change in the real exchange rate is significant in the case of minerals, ores, and metal, but insignificant in the cases of agricultural raw materials and fuels. Elbadawi has pointed out that the absolute level of the RER (or its equilibrium level) is irrelevant to export performance.<sup>23</sup> This observation arises from his econometric results, which show that the levels of RER were not significantly related to ex-

Table 7.9 An Empirical Model of Minerals, Ores, and Metals Exports in Sub-Saharan Africa

Dependent Variable Log (XMOMY)	Fixed Effects		Random Effects	
	Coefficient	<i>T</i> -Statistic	Coefficient	<i>T</i> -Statistic
Log XMOMYL	0.322	1.587	1.011	25.273
Log DRER	-0.031	-0.173	0.265	2.809
Log DRERL	-0.164	-1.213	0.000	0.004
Log GDIY	-0.477	-1.131	-0.395	-1.266
Log GDIYL	0.338	0.582	0.701	2.542
Log CPI	0.229	1.693	0.381	5.092
Log CPIL	-0.284	-1.448	-0.501	-5.250
Log TMOM	0.000	0.000	0.019	0.457
Constant			-0.497	-1.131
<i>R</i> squared		0.990		0.973
Adjusted <i>R</i> squared		0.973		0.929
<i>P</i> value	0.006			
Number of observations	60			
Number of countries	30*			
Periods of estimation	1980–85, 1986–89, 1990–95			

Notes:

XMOMY Exports of Minerals, Ores & Metals/GDP

DRER Annual Change in Real Exchange Rate, i.e.,  $((RER_X - RER_{(X-1)}) / RER_{(X-1)}) * 100\%$

GDIY Gross Domestic Investment/GDP

CPI Consumer Price Index

TAMT Tariffs Faced by Exports (Metals)

*P* Value Probability Value for Hausman Test – Random vs. Fixed Effects

A suffix of *L* denotes a variable lag of one period.

\* Botswana, Burkina Faso, Burundi, Cameroon, Central African Republic, Chad, Congo (Democratic Republic of), Côte d'Ivoire, Gabon, Ghana, Guinea, Kenya, Madagascar, Malawi, Mali, Mauritius, Niger, Nigeria, Rwanda, Seychelles, Sierra Leone, South Africa, Sudan, Swaziland, Tanzania, Togo, Uganda, Zambia, Zimbabwe.

ports. However, the variable consumer price index as a measure of inflation and, hence, macroeconomic stability is significant in the three cases. This significance is an indication that primary-export supply can be influenced by macroeconomic stability/instability. The variable gross domestic investment is not significant in all the three cases of agricultural raw materials, fuels and minerals, ores and metals. The lag of the change in real exchange rate is significant in the case of agricultural raw materials but not in the other cases. The lag of gross domestic investment is significant in the case of agricultural raw materials, fuels and metals, ores and min-

erals. This significance is consistent with the postulation that gross domestic investment represents infrastructural development, which is very essential for sustained export growth, particularly in the movement and storage of agricultural exports in SSA. We have observed in some countries, for example, that, during periods of significant output increases, some of the them were wasted as a result of poor transport and storage facilities. External tariffs were significant in the case of agricultural raw materials, but not in the case of fuel and mineral exports. It should be noted, for example, that products of the ACP countries (the majority are in Sub-Saharan Africa), which entered the EU market free of customs duties, accounted for 99.3% of total EU imports from the ACP in 1996. Exceptions cover products under the Common Agricultural Policy. It should also be noted that the ACPs' share in extra-EU imports of agricultural products was 14% compared to a mere 3% in the case of industrial products in 1996. This percentage difference not only shows the significant role of agricultural exports in total exports but that very few of such products face entry barriers. Although for many products the level of duties faced by SSA countries' exports is small and is unlikely to affect market access, products they export, which continue to face relatively high applied tariffs (over 5%) in developed-country markets, are, significantly, beef, asparagus, and processed wood.<sup>24</sup> The regression results are presented in tables 7.7, 7.8, and 7.9.

## Factors Affecting Process Exports

Export diversification, through the promotion of manufactured exports, has generally been viewed as an important factor in sustained economic growth. SSA countries have over the years relied on primary-commodity exports to spur economic growth. However, Fosu, using pooled data for 77 developing countries for the period from 1967 to 1980, has shown that countries with a larger composition of primary exports tend to experience lower GDP growth.<sup>25</sup> Wood and Berge have shown that East Asia's "miraculous" development success (in terms of equity as well as growth) has been intimately associated with the export of manufactures.<sup>26</sup> By contrast, countries whose exports still consist largely of primary products – most notably in Africa – have done far less well. This broad correlation between export composition and development performance raises some controversial questions in the development literature, both about the causes of economic progress and about the best policies for achieving it. The question that arises from this analysis is whether African countries can emulate the development experience of the East Asian countries.

Recent research raises serious doubts, however, about the scope of

other developing countries that would allow them to follow East Asia down the road of export-oriented industrialisation.<sup>27</sup> The problem is that many of these countries, particularly those in Africa and, to some extent, in Latin America, do not have a comparative advantage in manufacturing, because they have the wrong resource endowments. More specifically, they have too low a ratio of human resources to natural resources, or, in other words, of skill to land, which causes their comparative advantage to lie, instead, in primary exports. In a cross-sectional study of 64 developing countries over the period 1960–1980, using Ordinary Least Squares, Fosu found that the previously reported positive influence of export on economic growth in developing countries may be attributed almost entirely to the manufacturing content of exports.<sup>28</sup>

This question overlaps with another one, long discussed in the literature, and it concerns the benefits to developing countries of further processing their primary exports. Notable contributions to this debate on resource-based industrialisation, which includes many case studies of particular products and countries, are those of Roemer, Singer, Wall, Yeats, and Londero and Teitel.<sup>29</sup>

Wood and Berge point to a minor distinction between primary processing and narrow manufacturing – as regards the importance of transport costs and of the volatility of primary commodity prices, for example.<sup>30</sup> In general, however, most authors conclude that the similarities between these two sorts of manufacturing outweigh the differences. Primary processing, like narrow manufacturing, provides opportunities to acquire new technologies and learn new skills and can be an important new source of export revenue. Growth of primary processing is constrained, like growth of narrow manufacturing, by protectionist policies in developed countries and by shortages of skills and infrastructure in developing countries. Whether significant gains can be reaped from further processing of local raw materials thus varies, depending on the product and on the circumstances of the developing country concerned.

For Southeast Asia, the pattern of change in the structure of manufactured exports was enhanced by considerable state involvement in attracting, supporting, and promoting export-oriented enterprise. It has been observed, for example, that financial incentives – based on employment, investment, export, and, in Malaysia, on technological criteria since the late 1980s – were instrumental, at least in the initial years, in attracting FDI, which has been the backbone of manufactured exports.<sup>31</sup> Unlike import-substituting firms, export-oriented ones faced fewer problems of government failure as they enjoyed sophisticated capabilities and competed in external markets. Sub-Saharan African countries, on the other hand, are faced with numerous supply constraints problems, particularly those related to processing and manufacturing for export.



In SSA countries, some of the infrastructure-related supply constraints include the following: frequent power cuts and water shortages, which greatly affect industrial production; poor road networks and, in particular, the lack of all-weather roads and feeder roads necessary for the transportation of agricultural produce from villages to major centres; insufficient rolling stock; and lack of refrigerated trucks and cold storage facilities necessary for the export of perishables. Some of the services necessary to support production, such as the provision of adequate finance or marketing services, may be lacking or often inaccessible. Given the high risks associated with relocating business in Africa, it might be useful for SSA governments to offer financial rents in the form of reduced taxes in the initial years so that the payback discounts (taking into account the risks) exceed interest rates.

It has been argued by Yeats, Amjadi, Reincke, and Ng that many African countries adopted anticompetitive cargo reservation policies to foster the development of material fleets and to conserve foreign exchange, but without any success.<sup>32</sup> They cite that, for example, in 1990/91 Sub-Saharan Africa's net freight and insurance payments were about \$3.9 billion, or roughly 15% of the value of the region's exports, compared with 11% in 1970. For a third of the countries, the payments amounted to more than 25% of the value of their exports; for Somalia and Uganda the payments exceeded 70% of their export values .

Yeats et al. have also shown that Africa is at a transport cost disadvantage relative to its competitors.<sup>33</sup> For example, half the minimal vessel freight rates for middle-income West Africa are about 2 percentage points higher than those paid by other exporters of the same goods.

The cost of doing business in Africa relative to other parts of the world is further complicated by the very low level of access to information systems. While everybody else is moving towards the information superhighway, most African countries still control the airwaves, which makes it extremely expensive to get direct satellite connection since the controlling agencies extract monopoly rents that they are not readily willing to let go.

Africa's transport and telecommunication policies and international freight costs have a major negative impact on the promotion and diversification of exports. To build export supply capabilities and encourage product diversification, specific measures and incentives are necessary with regard to investment (including foreign direct investment), technology acquisition, and human resources development, as well as direct fiscal and financial export incentives. While appropriate exchange rate policy is central to a successful export promotion strategy, an export-promoting exchange rate policy cannot be sustained unless monetary and fiscal policies are fully consistent with it. In many developing countries, misman-

agement of macroeconomic and trade policies have led to real exchange rate misalignment – that is, to a substantially overvalued RER with respect to its market-clearing level. Real exchange rate misalignment is damaging to economic performance – and especially to manufactured exports, since it decreases the profitability of production of tradables. All successful East and Southeast Asian countries have kept the RER close to its market-clearing level, while Sub-Saharan Africa and Latin America countries experienced serious RER overvaluation.<sup>34</sup>

Moreover, inconsistent macroeconomic, trade, and exchange rate policies increase the variability of the real exchange rate. In turn, higher RER volatility sends conflicting signals to economic agents and increases the uncertainty of long-term investments as well as of the profitability of producing tradable goods. The negative influence of RER variability on economic performance of SSA countries has been demonstrated by Ghura and Grennes.<sup>35</sup> Its negative impact on manufactured exports has also been established by Grobar on a panel of ten developing countries, excluding Sub-Saharan Africa.<sup>36</sup>

Using panel data representing 17 countries (based on availability of data) over the period from 1980 to 1995, we estimated a manufactured export supply (i.e., processed exports) equation using, as explanatory variables, the annual change in the real exchange rate, gross domestic investment as a proportion of GDP, consumer price index as a measure of inflation, and external tariffs as barriers to market access. The regression equation is the same as the one specified earlier in the case of primary exports. The annual rate of change of the real exchange rate and the consumer price index as a measure of inflation are used as proxies for macroeconomic stability, which is conducive to manufactured export expansion. Gross domestic investment as a proportion of GDP is used as a measure of the change in capital stock and of infrastructural development necessary to sustain export development and promotion. It has been argued that the development of the primary sectors and infrastructure development and maintenance stimulated the growth of small-scale manufacturing activities in Malaysia.<sup>37</sup> It has been argued that Sub-Saharan African exports face disproportionately higher transport costs when compared to exports from other parts of the world, specifically the EU, the U.S., and Japan.<sup>38</sup> In addition, manufactured exports from SSA countries face both tariff and nontariff barriers in these markets. We have used average levels of and changes in tariffs faced by manufactured exports as a measure of the barriers to entry. However, our approach may not be a good indicator, since tariffs on manufactures vary from one product to another and from one country to another. For example, Mauritius, which has a highly developed textile sector, faces higher tariffs on its textiles to the U.S. than, say, Tanzania.

Table 7.10 An Empirical Model of Manufactured Exports in Sub-Saharan Africa

Dependent Variable Log (XTXTY)	Fixed Effects		Random Effects	
	Coefficient	<i>T</i> -Statistic	Coefficient	<i>T</i> -Statistic
Log XTXTYL	-0.383	-2.384	0.759	8.664
Log RER	-0.288	-0.793	-0.099	-0.611
Log RERL	0.042	0.157	0.201	1.467
Log GDIY	-0.204	-0.287	0.382	1.103
Log GDIYL	-0.394	-1.371	0.030	0.077
Log CPI	-0.173	-0.997	0.236	2.220
Log CPIL	-0.229	-1.964	-0.276	-2.562
Log TMFX	0.000	0.000	0.159	0.619
Constant			-1.235	-2.259
<i>R</i> squared		0.985		0.928
Adjusted <i>R</i> squared		0.946		0.739
<i>P</i> value	0.000			
Number of observations	34			
Number of countries	17*			
Periods of estimation	1980–85, 1986–89, 1990–95			

## Notes:

XTXTY Exports of Textile Produce/GDP

DRER Annual Change in Real Exchange Rate, i.e.,  $((RER_X - RER_{(X-1)}) / RER_{(X-1)}) * 100\%$ 

GDIY Gross Domestic Investment/GDP

CPI Consumer Price Index

TMFX Tariffs faced by Textiles

*P* Value Probability Value for Hausman Test – Random vs. Fixed EffectsA suffix of *L* denotes a variable lag of one period.

\* Burkina Faso, Burundi, Cameroon, Central African Republic, Chad, Côte d'Ivoire, Kenya, Lesotho, Madagascar, Malawi, Mali, Niger, Swaziland, Tanzania, Togo, Uganda, Zimbabwe.

The regression results are presented in Table 7.10. In interpreting the results, one should note that the period of estimation, 1980–1995, represents two very distinct periods as far as export development and promotion are concerned. The 1980s represents an environment of extreme macroeconomic instability, followed by the relatively stable macroeconomic environment of the late 1980s and early 1990s. It should also be noted that the sample of countries in SSA represent both CFA and non-CFA countries with differing macroeconomic environments during the relevant periods. Hence, the results show that annual changes in real exchange rate are not significantly related to exports supply. However, the results also show that the consumer price index is important and sig-

nificantly related to exports supply. Investment, including investment in human capital, has been credited for the tremendous export-led growth of most of the Southeast Asian economies. However, in our model, gross domestic investment as a proportion of GDP does not significantly influence exports of manufactured products. While the precision of fit is about 74%, this statistic has been explained primarily by the variables of the consumer price index and the lagged value of exports of manufactures. It has been observed that, in both developed and developing country markets, tariffs tend to be higher on processed than on primary commodities, resulting in tariff escalation; this observation has, however, not been confirmed by the results of our model. However, tariffs are of particular relevance as obstacles to efforts by developing countries to diversify their exports into higher value-added products and to engage in sustained export-led growth.

## The Institutional Framework for Export Expansion

Getting prices right, though necessary, is not a sufficient condition to trigger the requisite supply response. Institutions do matter. In this section we will examine the institutional framework that is conducive for efficient market operations and enhanced exports. Drawing on the experience of the Southeast Asian economies, it has been observed that export orientation in Indonesia, Malaysia, and Thailand involved heavy state promotion and subsidies. In the case of Korea and Taiwan, extensive credit financing through government-regulated and subsidised loans, which squeezed out speculation and targeted investment in productive activities, characterised the development of export-oriented manufacturing. Government interventions were targeted at addressing issues of market imperfections. Laws on labour and industrial relations were tightened to restrict workers' wages, working conditions, and mobility. The state pursued interventionist labour policies to promote export growth, curtailing the movement of the relative costs of labour in the allocation of resources. Countries with abundant labour supply and low wages proved attractive for the relocation of labour-intensive and low-technical contents of production, particularly textiles, garments, and wood-based products.<sup>39</sup>

Aron explains the failure (after getting the prices right) of supply response in Africa on the basis of cumulative institutional impoverishment.<sup>40</sup> Getting the prices right may be useless in the absence of getting the institutions and the rules right. She argues that macroeconomic performance is positively related to the extent of development of the institutional framework and that rules and contentions incorporated in the

institutional fabric of the society and the economy narrow the feasible policy space and reduce the scope for discretionary action by decision makers. Consistent adherence to a set of macroeconomics rules plays a crucial role in providing a stable, predictable, and credible macroeconomics environment and encourages a process of institutional change favourable to growth and to poverty alleviation.

She argues further that a written constitution, if it is to be meaningful, must reflect the underlying values of the population. In turn the existence of a working constitution acts as both a guide to and a restraint on the actions of the state. It commits the government to following certain objectives and principles and helps provide a sense of continuity, consistency, and credibility to its actions.

The experience of the North Asian and Southeast Asian economies may shed some further light on the role of institutions. It has been demonstrated that, while many nationalist regimes of the postcolonial era in Africa and Latin America promoted industrialisation directly through state enterprises, some regimes in North Asia used protection and support for import-substituting industries to make them produce for export, thus raising the quality and efficiency necessary to achieve international competitiveness. Government administrative competence has been cited as the single most important explanatory variable determining differing economic performances.<sup>41</sup>

It has further been observed that structural transformation towards higher productivity sectors required complementary developments in human resource capabilities. Given infrastructure associated with labour markets, especially training/education involving long gestation periods, and information asymmetries that typify underdeveloped countries, there is need to stimulate state-business collaboration in creating and coordinating institutions to generate manpower for technological upgrading.<sup>42</sup> However, in most SSA countries, institution building to facilitate locally effective technology absorption and development has been lacking.

The remedy for the slow development of institutional facilities to support technological upgrading and effective coordination does not suggest unfettered liberalisation as the solution. Instead it calls for a review and enhancement of industrial policy so that its focus is widened to include institutional support facilities and greater coordination with enterprises. Liberalisation is inevitable; however, specific industrial policy initiatives will continue to characterise successful developers.

In the case of the Southeast Asian economies, it has been argued, the rationale behind the pattern of change in the structure of manufactured exports cannot be explained by simple neoclassical free trade or market-friendly arguments.<sup>43</sup> Considerable state involvement was necessary to attract and support enterprise in promoting export-oriented activities.

Financial incentives – based on employment, investment, export, and, in Malaysia, on technological criteria since the late 1980s – were instrumental, at least in the initial years, in attracting FDI, which has been the backbone of manufactured exports.

A successful strategy for export expansion will need to be based on an interactive approach to supply, demand, and export marketing in a framework of close cooperation between the government and the business community. The strategy will need to focus on export product and market diversification in a dynamic search for comparative advantages in product and market niches.

To diversify markets and take full advantage of trading opportunities, attention needs to be given not only to demand conditions and market-access opportunities on major world markets but also to regional markets, including the opportunities for cross-border trade. However, it has been observed that intra-African trade flows have been minimal.<sup>44</sup> The explanation has been found in the structure of production (primary and raw materials), marketing channels (north-south), poor infrastructure, lack of information on markets, and the small size of the African economies.

Export-marketing support and other trade-related services are crucial if small- and medium-sized enterprises (SMEs) are to be able to export to and compete in world markets. Given the relatively small size of developing-country exports, government-backed, trade-related services are essential components of any export expansion strategy. In this regard, key services include export-financing schemes, quality control, marketing and distribution services, and the trade promotion activities of trade promotion organisations (TPOs).

A major concern is how to make TPOs more effective. In the post-Uruguay Round situation of increased global competition, TPOs are necessary because of a greater need for information, especially by SMEs, on market opportunities and trends in diverse markets around the world, as well as because of the need to make known the products of a country in various markets.<sup>45</sup>

## Summary and Policy Implications

In this chapter we have shown that the export performance of SSA over the last three decades has not been encouraging. In fact, SSA has lost its share of world exports by over 250% over the last 30 years. All categories of exports for all subregions in SSA, including South Africa, have faced drastic falls in export earnings. SSA faced serious import compres-

sion particularly during the 1980s, and, since trade is the main vehicle for Africa's participation in the global economy, its participation has declined, and its place has been taken over by the fastest-growing economies of East Asia and Latin America, as well as the OECD countries. While there may be lessons that can be drawn from other developing countries which have emerged from economic and social instability, SSA countries should also strive to regain the developmental momentum which underpinned the social and economic gains of the decade following political independence. Too much emphasis on getting prices right, when some of the more important agents and institutions of a modern market economy are underdeveloped or completely absent, is not likely to trigger the much-needed export growth and the growth of the economy. It has been pointed out in this chapter and in the literature that creating conducive, environments for FDI, i.e., political stability, solid infrastructure, and less bureaucratic red tape, were instrumental in enhancing export expansion in Southeast Asia. African economies might well be advised to adopt the effective policies from East Asia to raise their exports.

Regression estimates for all categories of exports from SSA have shown that inflation as measured by the consumer price index is positively associated with export growth. This association is an indication that macroeconomic stability is essential for export growth. This necessity is consistent with observations in the literature. Appropriate domestic policies are essential in overcoming low productivity and in spurring growth and export diversification to reduce the very heavy dependence on a small number of commodities. The share of gross investment in GDP is a useful indicator of an economy's potential to sustain high rates of export growth. The econometric results presented in Tables 7.7, 7.8, and 7.9 indicate that the lag of gross domestic investment as a proportion of GDP is significant in explaining export supply. However, most African countries lag behind the fast-growing economies. Except for Mauritius and Tanzania – which have investment ratios comparable to those of Chile and Costa Rica, between 26% and 31% – virtually all the remaining African countries have investment rates lower than 20%. External tariffs were found to be negatively associated with export growth in the case of agricultural raw materials but, surprisingly, positively associated with export growth in the case of manufactured exports, where higher levels of processing face higher tariffs in external markets (both developed and developing). It should, however, be pointed out that most SSA countries are at very low stages of development and processed exports also face preferential treatment in advanced-country markets; hence tariffs are not likely to be a binding constraint.

## DATA APPENDIX

### 1. SOURCES

All export data, except for manufactured exports (which were obtained from the WDI CD-ROM), have been obtained from the UNCTAD Commodity Yearbook.

All national accounts data have been obtained from the World Bank CD-ROM database – World Development Indicators, 1997. All tariff data have been obtained from the World Bank statistics on the Uruguay Round.

### 2. DEFINITIONS

#### *Agricultural Raw Materials*

These exclude synthetics and refer to SITC section 2 (less divisions 22, 27, 28, and groups 233, 244, 266, and 267).

#### *Minerals, Ores, and Metals*

These refer to the sum of SITC divisions 27, 28, 68, and item 522.56.

#### *Fuel*

These refer to SITC section 3.

#### *Manufactures*

Exports of manufactures comprise commodities in SITC revision 1, sections 5 through 9 (chemicals and related products, basic manufactures, machinery and transport equipment, and other manufactured articles and goods not elsewhere classified), excluding division 68 (nonferrous metals).

#### *CPI*

Data for the consumer price index are obtained from the International Financial Statistics of the IMF.

#### *Gross Domestic Investment*

Gross domestic investment consists of outlays on additions to the fixed assets of the economy plus net changes in the levels of inventories. Fixed



assets cover land improvements (fences, ditches, drains, and so on); plant, machinery, and equipment purchases; and the construction of roads, railways, and the like, including commercial and industrial buildings, offices, schools, hospitals, and private residential buildings.

### *Real Exchange Rate*

A nominal effective exchange rate represents the ratio of an index of the period's average exchange rate for the currencies of selected partner or competitor countries. A real effective exchange rate is a nominal rate adjusted for relative movements in national price or cost indicators of the home country and its partner countries.

### *Tariffs*

Average levels and changes are weighted by values of exports to the world, excluding values of exports from reporter countries that do not participate in a Free Trade Agreement with the country in question. Weighted average tariff reductions were measured by  $dT/(1 + T)$ . Post-Uruguay Round-bound rates of tariffs were used.<sup>46</sup>

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## Export-Oriented Industrialisation and Foreign Direct Investment in the ASEAN Countries

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*Kian Wie Thee*

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This chapter discusses the rapid industrial growth and transformation which four of the five founding-member countries of the Association of Southeast Asian Nations (ASEAN), including Indonesia, Malaysia, Singapore, and Thailand, have experienced during the past three decades, at least until the severe financial and economic crisis hit the five original ASEAN countries in mid-1997.

Although all the five ASEAN countries initially embarked on import-substituting industrialisation, over time one after another of them shifted to export-oriented industrialisation, albeit with varying degrees of success. Starting with Singapore in the late 1960s, and subsequently with Malaysia, the Philippines, and Thailand since the 1970s, and, finally, with Indonesia since the mid-1980s, these countries began to promote export-oriented industrialisation.

In all the five ASEAN countries, foreign direct investment (FDI) has played a significant role in the industrialisation process, during both the import substitution and export promotion phases. This chapter will try to assess to what extent the five ASEAN countries were able to mobilise FDI for the purpose of promoting their manufactured exports and upgrading their industrial structures through the transfer and diffusion of advanced industrial technologies.

This chapter first provides an overview of the industrial development in the five ASEAN countries, with a special focus on the period since the early 1980s, when export promotion was pursued with greater vigour

than in the past. After an assessment of the role which FDI has played in the industrial development of these countries, this chapter will discuss the economic policies, including industrial policies, which these countries were pursuing (at least until they were hit by the Asian economic crisis) to sustain their export-oriented industrialisation, in particular by broadening and upgrading their industrial structure in order to raise their industrial competitiveness.

The remarkable economic development of the ASEAN countries, including their rapid industrial development and transformation, can, to a large extent, be attributed to their increasing globalization, that is, to their increasing integration with the world economy through the steady increase in the role which foreign trade and FDI have played in their economies. However, the serious financial and economic crisis which has hit the ASEAN countries since mid-1997, in particular Indonesia and Thailand, has exposed some basic weaknesses in their economic policies, structures, and institutions which have rendered these countries less resilient to withstanding severe external shocks. Hence, this chapter will also try to identify the basic weaknesses in the industrial policies and structures of these countries which only became evident after the onset of the crisis and which need to be addressed once the financial and economic crisis has been overcome. For this reason the chapter will start with a brief overview of the impact of the severe economic crisis of 1997/1998 on the manufacturing sector in the ASEAN countries, specifically in Indonesia, which has been the hardest hit by the crisis.

## The Impact of the Crisis on the Manufacturing Sector in the ASEAN Countries, Particularly in Indonesia

While all the ASEAN countries have been adversely affected by the financial crisis of 1997 (which hit Thailand first), none of them have been as badly hit as Indonesia. As a result of the gradual widening differential between the inflation rates of the U.S. and the ASEAN countries, the real effective exchange rates of these countries started appreciating since the mid-1990s. In turn, the real appreciation of the currencies of these ASEAN countries resulted in a gradual but steady deterioration in their export competitiveness. This deterioration and the decline in electronics exports of some of the ASEAN countries, because of the weakening of the world market for semiconductors, led to a rapid increase in the current account deficits of these countries, particularly Malaysia and Thailand, and, to a lesser extent, Indonesia.<sup>1</sup>

Because of the burst of the “bubble economy” in the ASEAN countries in mid-1997 (caused by a sudden change in perceptions on the part of foreign and domestic investors about the foreign-exchange risk of their local currency-denominated financial assets), these countries were faced with the serious problems of servicing a huge foreign debt and of the resulting steep depreciation of their currencies. However, none of these countries experienced such a steep depreciation as Indonesia, whose currency depreciated by more than 80% against the U.S. dollar by late January 1998. Subsequently, however, the Indonesian rupiah gradually strengthened to around Rp 7,000 to the U.S. dollar by mid-1999. This appreciation was primarily the result of market forces and not of government intervention in the foreign exchange market.<sup>2</sup> In the ensuing years the rupiah continued to fluctuate. By early 2003, however, the rupiah had stabilised at around Rp 9,000 to the U.S. dollar because of greater political and macroeconomic stability and structural reforms during the past year.

As a result of the steep rupiah depreciation in 1998, almost all the sectors of the Indonesian economy, except for the agricultural and utilities sectors, experienced a substantial decline in their activities in that year. During that year Indonesia’s Gross Domestic Product (GDP) contracted by an unprecedented  $-14.8\%$ , while the manufacturing sector contracted by  $-12.9\%$ .<sup>3</sup> Burdened with foreign debts they could not repay and the higher prices of their imported inputs, as well as with declining revenues because of the reduced purchasing power of consumers, many manufacturing firms had to reduce their output drastically and lay off a large number of their workers. However, in 1999 the Indonesian economy slightly recovered, although it grew only by a miniscule  $0.2\%$ , while the manufacturing sector grew by a slightly higher  $2.2\%$ .<sup>4</sup>

According to a World Bank-sponsored survey on the impact of the crisis on the manufacturing sector, conducted jointly by Indonesia’s National Planning Board (Bappenas) and the Central Agency of Statistics (BPS) in late 1998, large and medium-scale domestic-market-oriented firms in general experienced greater reductions in capacity utilisation rates and employment levels than export-oriented firms and foreign-owned firms. However, even among the domestic-market-oriented firms, responses to the crisis were varied; for instance, firms in the food-processing industry in general experienced smaller reductions in capacity utilisation rates than firms operating in the other industries.<sup>5</sup>

As the two major causes of the decline in their output levels in 1998, the manufacturing firms mentioned the sharp decline in domestic demand and the adverse effect of the sharp rupiah depreciation on the costs of imported inputs. In some cases another cause of the reduction in output was the high cost of capital because of the sharp increase in interest rates.

However, in general the firms did not consider access to credit and the lack of guarantees for letters of credit (LCs) to be major causes of the decline in their output.<sup>6</sup>

The problems faced by many manufacturing companies, including a number of small- and medium-scale enterprises (SMEs), can be attributed to the fact that they are assembling companies highly dependent on imported inputs, including raw materials, parts, and components. Hence, as a result of the steep rupiah depreciation, these foreign inputs became very expensive.

The problems caused by the difficulties in importing expensive inputs were experienced both by export-oriented industries (e.g., the textile, garment, footwear, and consumer electronics industries) and by domestic market-oriented industries (e.g., the steel, automotive, and pharmaceutical industries). The difficulties faced by these assembling industries exposed their vulnerability and the failure of Indonesia's manufacturing sector to develop a broad base of economically viable supporting industries to supply them with the inputs which, until now, still had to be imported.

It should be pointed out, however, that the export-oriented manufacturing firms, including the export-oriented small- and medium-scale enterprises (SMEs), which were using local rather than imported inputs, were able to benefit more from the steep rupiah depreciation than the firms more dependent on imported inputs.

Since 1999 Indonesia's economic growth, driven largely by consumption, has remained relatively modest. Consumption growth, however, has led to greater capacity utilisation and a modest increase in manufacturing output and employment. During 2000, real output of nonoil manufacturing for the first time exceeded the level achieved in 1996, the last year before the Asian crisis. Since early 2002, however, the growth of Indonesia's manufacturing industry has again slowed down because of lower consumption growth and sluggish manufactured exports.

Although the manufacturing sectors in the other ASEAN countries were also adversely affected by the severe economic crisis of 1997/98, they felt its impact less than Indonesia's manufacturing sector. According to a similar World Bank-sponsored comparative study on the impact of the crisis on the manufacturing sectors in the worst-affected ASEAN countries, conducted by the Economic Research Department of the Bank of Thailand, 76.3% of the Indonesian firms surveyed experienced a decline in their output since the onset of the crisis in July 1997. The comparable figures for Malaysia, the Philippines, and Thailand were 69.6%, 68.7%, and 73.1%, respectively.<sup>7</sup> The data on Thailand confirms the fact that, next to Indonesia, Thailand was the worst-affected country among the ASEAN countries.

Similarly, Indonesia's manufacturing sector experienced the largest decline in capacity utilisation levels – from 74.5% in the first half of 1997 to 59.2% in the first half of 1998. For the manufacturing sectors of Malaysia, the Philippines, and Thailand, the comparable figures were 78.5% to 66.3%, 75.1% to 68.8%, and 71.4% to 61.8%, respectively.<sup>8</sup>

The comparative study also found that the reduction in output of the manufacturing firms in the ASEAN countries as a whole was caused by the contraction in domestic demand after the crisis and by inadequate liquidity and credit because of the burden of debt servicing and the shortage of loans for working capital. Like the adverse impact of the contraction in domestic demand, reductions in foreign demand also had an adverse impact on the output of a relatively large proportion of export-oriented firms in Malaysia (30.4%), the Philippines (31.0%), and Thailand (37.7%). Unlike the large proportion of firms in these three ASEAN countries, however, the proportion of Indonesia's export-oriented firms which experienced an adverse impact on their output was much less, only 14.8%.<sup>9</sup> The relatively high percentages among the export-oriented firms of the first three ASEAN countries were most likely due to the fact that intraregional trade, which had rapidly increased since the late 1980s, declined after the ASEAN and East Asian economies were adversely affected by the crisis. The smaller percentages among the Indonesian firms may have been caused by the fact that their products became quite cost-competitive because of the rupiah depreciation, which was much steeper than the currency depreciations in the other ASEAN countries.

## Industrial Development in the ASEAN Countries: From Import Substitution to Export Promotion

Until the financial crisis hit Southeast Asia in mid-1997, industrial growth and transformation in the ASEAN countries, with the exception of the slower growing Philippines, were very rapid during the past three decades and, in fact, were among the fastest growing developing countries. While all five of the ASEAN countries, starting with the Philippines in the early 1950s, initially embarked on an import-substituting pattern of industrialisation, the levels of protection varied widely among the five countries, with Singapore having the lowest level of protection (with nominal rates of protection averaging only 7% in 1967)<sup>10</sup> and the Philippines the highest level, with Indonesia close behind. In pursuing import-substituting industrialisation, the ASEAN countries were simply following a similar path of industrialisation traversed earlier by Latin American and South Asian countries, particularly India.



Singapore was the first ASEAN country which shifted to export-oriented industrialisation, following its separation from the Malaysian Federation in 1965 and the subsequent loss of its expected larger domestic market. However, the need to shift to export promotion became even more imperative in 1967, when the British announced their plans to phase out their military bases by 1971. Since these bases employed nearly 20% of Singapore's labour force and generated nearly 20% of Singapore's GNP,<sup>11</sup> export-oriented industrialisation was seen as the only way to overcome the adverse effects of the liquidation of the British military bases.

To support the shift to export promotion, the Singapore government progressively eliminated tariffs and quotas. By 1973 only 197 manufactured products were subjected to mild tariff protection, while only another three enjoyed quota protection.<sup>12</sup> To support its export drive Singapore turned to the transnational corporations (TNCs) from the advanced countries to set up export-oriented plants. TNCs were attracted to invest in Singapore because of its very liberal policies towards foreign investment, its efficient and supportive bureaucracy, and its excellent physical infrastructure. As a result, TNCs have played a crucial role in Singapore's export-oriented industrialisation, accounting for almost 90% of Singapore's manufactured exports, over 70% of its capital expenditure, and almost 70% of its total manufacturing value added.<sup>13</sup> This great reliance on TNCs continued until the 1990s, as in 1992 TNC subsidiaries still generated 85% of Singapore's manufactured exports.<sup>14</sup>

In the four other ASEAN countries, import-substituting industrialisation lasted longer, since it was less necessary for these countries to promote manufactured exports than it was for Singapore, as these countries had larger domestic markets and could still rely on commodity exports. This was particularly the case with Indonesia, which during the 1970s benefited from the oil boom, as the large volume as well as the high unit price of petroleum exports led to a huge increase in oil export earnings. As a result of this oil boom, Indonesia caught the "Dutch disease," albeit a mild form of it, since the surge in oil export revenues and the subsequent real appreciation of the rupiah made it difficult for the other tradable industries, including the nonoil manufacturing industries, to compete in the export markets.<sup>15</sup> This difficulty was less the case with Malaysia, which became an oil exporter only in 1975.

In the four large ASEAN countries, import-substitution policies were supported by tariff and nontariff (particularly quota) protection, as well as by various import surcharges. Although import protection was often introduced in an ad hoc way and often changed, protection in these countries had, in general, a cascading structure in which finished goods enjoyed the highest protection, while primary products and industrial raw

materials had the lowest protection. As a result, there was a wide difference in the effective rates of protection (ERPs) among the various industries.<sup>16</sup> Moreover, the large-scale, capital-intensive, import-substituting industries producing final consumer goods, including consumer durables, such as the automotive and the consumer electronics industries, often enjoyed the highest ERPs, while labour-intensive industries producing exportable goods often had negative ERPs. Hence, industries producing goods in which these countries had a comparative advantage were often discriminated against, while those industries producing goods in which these countries had a comparative disadvantage were often promoted.<sup>17</sup>

Not surprisingly, therefore, by 1981, some two decades after Malaysia, the Philippines, and Thailand had started developing their manufacturing sector, the bulk of their merchandise exports still consisted of primary commodities, with manufactured exports accounting for only 20% of total exports in Malaysia, 23% in the Philippines, and 25% in Thailand. In that same year Indonesia's manufactured exports accounted for even less, a miniscule 3% of total exports.<sup>18</sup> To some extent, Indonesia's much poorer performance in manufactured exports can be attributed to the fact that it had started developing its modern manufacturing sector about one decade later than its ASEAN neighbours.

Following the example of Singapore, the other four more resource-rich ASEAN countries also began to pursue export-promoting industrial policies, first Malaysia, the Philippines, and Thailand in the early 1970s, and then Indonesia in the mid-1980s. Three reasons have been advanced to account for this shift in policy orientation.<sup>19</sup> First and most important, the import-substituting pattern of industrialisation had, in general, not been able to generate sustained growth in manufacturing output and employment, particularly after the completion of the first, or "easy," phase of import substitution.

Second, the remarkable success of the first-tier East Asian newly industrialising economies (NIEs), including Singapore, in achieving sustained rapid growth in output and employment and an equally rapid reduction in the incidence of absolute poverty had been underpinned by export-oriented industrial development. Third, a number of authoritative studies commissioned by the Organisation of Economic Cooperation and Development (OECD), Paris, and the National Bureau of Economic Research (NBER), New York, had clearly shown the economic drawbacks of inefficient import-substituting industrialisation and the economic advantages of export-oriented strategies. The findings of these studies gradually led to a change in the thinking among international and regional aid organisations, as well as among policy makers in the ASEAN countries: There were limits to import substitution and economic benefits of export-oriented industrialisation.

In view of the traditional relative openness of the Malaysian and Thai economies, even during the import-substitution phase, the shift to an export-oriented pattern of industrialisation proceeded relatively smoothly, even though in these countries the shift did not involve the introduction of a neutral trade regime (i.e., first-best trade reforms). However, even during its import-substituting phase of industrialisation in the 1960s and early 1970s, Malaysia never discriminated strongly against other traded goods, nor did it overvalue its currency, as was the case in other developing countries pursuing import-substitution policies. Though there was a wide divergence in its tariff rates, Malaysia's overall average tariff rate on manufactured goods was relatively low. Malaysia also did not make much use of nontariff barriers (NTBs) to protect its manufacturing sector.<sup>20</sup>

In the early 1970s Malaysia's major device for promoting manufactured exports was the establishment of export-processing zones (EPZs). In these EPZs the exporting companies were allowed to import duty-free raw materials, parts, and components, subject to the requirement that their entire output be exported. Aside from Singapore, which can be considered as one whole export-processing zone, Malaysia has been the most successful among the ASEAN countries in effectively operating its EPZs within the context of a relatively open economy, an able and generally honest bureaucracy, and a location strategy which linked these EPZs in an efficient way to the country's good transport infrastructure.<sup>21</sup> Malaysia also benefited from the fact that it had established its EPZs at a time when the internationally integrated production of electronics goods was growing rapidly. Under this production system, vertically integrated electronics TNCs, particularly from the U.S., relocated the labour-intensive processes in the chain of the whole production process of an electronics product to low-wage production sites in Southeast Asia, particularly Malaysia because of its good physical infrastructure and its liberal foreign investment regime, which allowed foreign investors to establish fully owned subsidiaries.<sup>22</sup>

Malaysia's reliance on EPZs during its early stage of export-oriented industrialisation has been criticised, since they were basically export enclaves, generating little, if any, local linkages. Virtually all the plants in EPZs are highly import-intensive assembling operations, thus generating neither significant domestic value added nor extensive backward linkages with the local economy. On the other hand, EPZs are useful in providing job opportunities for low-skill labour as well as in establishing a country's international reputation as a reliable exporting country by virtue of its reliance on TNCs.<sup>23</sup>

Like Malaysia, Thailand also pursued a relatively mild import substitution policy, although its tariffs were, on the average, higher than those

of Malaysia.<sup>24</sup> On the whole, however, tariff duties in Thailand were not prohibitive and were largely imposed for revenue purposes. But, compared to Malaysia, Thailand also made greater use of nontariff barriers (NTBs). However, once the “easy” phase of import substitution was completed in the early 1970s, it became obvious that sustained industrial growth required a need to shift from import substitution to export promotion. This realisation was reflected in Thailand’s Third Five-Year Development Plan (1972–1976), which stressed the need to reorient the manufacturing sector from import substitution to export promotion.<sup>25</sup>

One factor which may also have accounted for the rapid increase in manufactured exports from Thailand since the early 1960s was the effective cooperation between the government and the private sector, as reflected by the establishment of the Joint Public-Private Consultative Committee (JPPCC) in 1982. One of the important tasks of the JPPCC was to provide the government with information on the various problems which export-oriented Thai companies, including foreign-owned companies, were facing in exporting their products. These problems included long delays in obtaining tax refunds (i.e., duty drawbacks) and cumbersome custom procedures for getting export clearance. To its credit, the Thai government accommodated many of the complaints of the private companies.<sup>26</sup>

In Indonesia and the Philippines, on the other hand, the policy reorientation to export promotion turned out to be much more difficult. Since the Philippines had the longest history of import-substituting industrialisation (dating back to the early 1950s), vested interests in protected industries in that country managed to hamper efforts in export promotion despite the disappointing results of import substitution.<sup>27</sup> Hence, despite half-hearted attempts at export promotion, the Philippines remained stuck in its pattern of import-substituting industrialisation because of continued high import protection. Industrial expansion, however, was hampered by the small domestic market for consumer durables and capital goods and by the increasing scarcity of investable funds. Since manufacturing firms were unable to import intermediate goods and capital equipment, the manufacturing sector was saddled with substantial excess capacity, leading to negative growth of the sector.<sup>28</sup>

It was only under pressure from the World Bank and the IMF that the Philippine government finally started gradually reducing its tariff and nontariff protection in the early 1980s. However, it was only under the Aquino administration (1986–1992) that significant progress was made with trade liberalisation.<sup>29</sup> Under the Ramos administration (1992–1998) further progress was made with trade liberalisation, which, in turn, has led to the steady increase in manufactured exports since the mid-1990s.

In Indonesia the shift to export promotion proved to be the most diffi-

cult, since it had been pursuing the most inward-looking economic policies among the ASEAN countries. Import-substituting industrialisation in Indonesia in the 1970s was buttressed by a wide array of protectionist barriers, including the highest nominal and effective rates of protection for consumer goods among the ASEAN countries and a wide array of nontariff barriers (NTBs).<sup>30</sup> It was only after the steep decline in oil prices in 1982 that Indonesia, forced to develop a more sustainable source of nonoil exports, particularly manufactured exports, was forced to undertake a thorough reappraisal of its industrial strategy. However, in the immediate period following the end of the oil boom, roughly from 1982 through 1985, the policy response did not involve a major shift in the trade regime but only measures to restore macroeconomic stability: financial deregulation allowing state banks to freely set deposit and lending rates and a substantial devaluation in March 1983.<sup>31</sup> In fact, during this period the planned implementation of the ambitious second phase of state-led, import-substituting industrialisation, involving the establishment of large-scale, state-owned, resource-processing heavy industries, was not immediately abandoned, despite the clear evidence of high domestic resource costs (DRCs) associated with the establishment of these industries and the clear need to promote manufactured exports.

It was only with the introduction of a duty drawback and exemption scheme for export-oriented companies in May 1986, after an even steeper decline in the price of oil, that a more decisive step was taken to shift to a more export-oriented industrial strategy. The introduction of the May 1986 deregulation package, which also involved some steps to liberalise the restrictive foreign investment regime, was soon followed by subsequent deregulation packages to encourage the private sector to become more efficient. The deregulation measures also included trade reforms aimed at reducing the "antiexport bias" of the trade regime. In fact, the surge in Indonesia's manufactured exports since 1987 can largely be attributed to the introduction of the duty exemption and drawback scheme which, at least during the first years, was efficiently administered by Bapeksta, an agency under the jurisdiction of the Department of Finance.

Besides the trade reforms, the shift to an export-oriented industrial strategy since 1986 was also supported by a sensible exchange rate policy. Following the devaluation in September 1986 in response to the steep decline in the price of oil in early 1986, the Bank of Indonesia began to pursue a managed float policy, which involved the steady depreciation of the rupiah by 4% to 5% annually to offset the differential between Indonesia's higher inflation rate and the inflation rates of its major trade partners. In this way the Bank of Indonesia largely succeeded in keeping the real effective exchange rate at a competitive level.

The above policy measures turned out to be quite successful in stim-

ulating Indonesia's manufactured exports, particularly labour-intensive products such as garments, footwear, toys, and consumer electronics products. In fact, since 1987, for the first time in Indonesia's modern economic history, manufactured exports and the private sector have become the primary engines of industrial growth. It was during this period that Indonesia began to resemble the other East Asian countries, both in regard to its economic performance as well as in the causes of its rapid growth.<sup>32</sup>

### Rapid Industrial Growth and Transformation in the ASEAN Countries, 1980–1996: The Record

During the period 1980–1990, the ASEAN countries, except for the Philippines, were generally able to sustain their rapid industrial growth, as shown in Table 8.1. This growth was sustained during the first half of the 1990s. Because of the Asian economic crisis, however, average industrial growth of the two worst-affected ASEAN countries, Indonesia and Thailand, declined substantially during the 1990s compared to the 1980s.

During this period Indonesia's manufacturing sector grew the fastest, at double digit rates on the average, both during the 1980s and the first half of the 1990s. During the same period the manufacturing sector of both Malaysia and Thailand also grew at a rapid rate. Since the 1980s these three ASEAN countries, which until the early 1980s were still largely dependent on the exports of primary commodities, also began to record rapid increases in manufactured exports, although not at the high rates achieved during the 1970s and 1980s by the "first-tier" East Asian NIEs, South Korea, Taiwan, Hong Kong, and Singapore.<sup>33</sup> As a result of this surge, the share in manufactured exports of these three ASEAN countries of total world manufactured exports rose from 0.1% in 1965 to 0.4% in 1980 and to 1.5% in 1990.<sup>34</sup>

As a result of the continued surge in manufactured exports from these three ASEAN countries during the early 1990s, their combined share of total world manufactured exports rose to 2.2% in 1992. Of this figure, Indonesia's share was 0.6%, while Malaysia and Thailand each accounted for 0.8%.<sup>35</sup>

While these figures are striking, the figures relating to the rapid rise of their share in total developing-economy manufactured exports are even more impressive, namely 1.1% in 1965, 3.8% in 1980, and 12.0% in 1990.<sup>36</sup>

In both Malaysia and Thailand the surge in manufactured exports started in the early 1980s, while in Indonesia it has started only since

Table 8.1 Industrial Development in the ASEAN Countries 1980–2000

Country	Manufacturing Value Added (MVA) % (Millions of US\$)		MVA per Capita (US\$)		Manufacturing Average Annual Growth Rate (%)		MVA as % of GDP		Manufacturing Exports As % of Total Exports	
	1980	1999	1980	1999	1980–90	1990–2000	1980	2000	1980	2000
Indonesia	10,133	36,626	68.5	176.9	12.8	6.7	18	26	2	57
Malaysia	5,054	23,175	361.0	1,007.6	9.3	9.8	24	33	19	80
Philippines	8,354	16,475	174.0	214.0	0.2	3.0	25	23	37	92
Singapore	3,415	21,017	1,707.5	7,005.7	6.6	7.1	27	26	50	86
Thailand	6,960	37,959	148.1	612.2	9.5	6.4	27	32	28	76

Sources: World Bank, *World Development Indicators 2002* (Washington, D.C.: World Bank, 2002), Tables 4.1; 4.2; 4.3; 4.5, 204–23. For data on population in 1999, see World Bank, *World Development Report 2000/2001*, Table 1, 274–75.

1987. As a result, by 1993, in all these three ASEAN countries, manufactured exports accounted for the bulk of their total exports (Table 8.1). For the above reasons these countries were referred to in the World Bank's "East Asian Miracle" study as the three Asian "newly industrialising economies (NIEs)," following in the footsteps of the Asian "Four Tigers," South Korea, Taiwan, Hong Kong, and Singapore.

As a result of this rapid industrialisation, the economic structure of these three ASEAN countries also underwent a rapid transformation, as the contribution of the manufacturing sector to their Gross Domestic Product (GDP) rose very rapidly. With the manufacturing sector contributing more than 20% to GDP, according to the standards of the United Nations Industrial Development Organization (UNIDO), by the late 1990s Indonesia and the Philippines could be categorised as "semi-industrial economies." On the other hand, Malaysia and Thailand, with their manufacturing sectors contributing more than 30% to GDP, could already each be categorised as an "industrialised economy."

In the Philippines growth of the manufacturing sector has been quite sluggish, during both the 1980s and the 1990s. However, during the 1990s, its industrial growth has been slightly higher than in the 1980s, even though this growth has been much lower than that of the other ASEAN countries.

Compared to that of the first three ASEAN countries, Singapore's industrial growth has also been less impressive, as Singapore has become a "modern services economy." Since the early 1980s, both the Philippines and Singapore have, for different reasons, been experiencing "de-industrialisation," as the share of their manufacturing sector in GDP has declined. In the Philippines this process was caused by protracted industrial stagnation and faster growth of the services sector. In Singapore the process of "de-industrialisation" has been similar to that of Hong Kong, as these two economies have become "postindustrial" or "modern-services economies," with the modern-services sectors (financial services, telecommunications, tourism) becoming the major engines of economic growth. In addition, the relocation of a large number of Singapore's low-skill, labour-intensive industries to Johore, Malaysia, and the offshore islands of Riau province, Indonesia, has also contributed to the "de-industrialisation" of Singapore.

Using manufacturing value added (MVA) per capita as another indicator of industrial development, the data in Table 8.1 show that, among the ASEAN countries, Singapore and Malaysia are industrially the most advanced, while Indonesia and the Philippines are the least advanced. Thailand occupies an intermediate position between these two groups of countries.

Over time structural change has also taken place in the manufacturing



sectors of these ASEAN countries, as the share of “low-technology” industries in the five economies has declined, while the shares of both “medium- and high-technology” industries have increased, albeit at different rates (Table 8.2).

The data in Table 8.2 also show that, during the period 1980–1995, the share of the “low-technology” industries in Indonesia, the Philippines, and Thailand has only declined slightly in total MVA, while in Malaysia and Singapore the share of these industries has declined much more rapidly. To the extent that “low-technology” industries are also low-skill, labour-intensive industries, the modest decline of “low-technology,” labour-intensive industries in Indonesia and the Philippines reflects the fact that these two economies are still labour surplus economies. Consequently, their major comparative advantage still lies in the low-technology, low-skill, labour-intensive industries. For this reason these countries have found it less profitable to invest in more technology-intensive industries.

On the other hand, the much more rapid decline of low-technology, labour-intensive industries in Malaysia and Singapore reflects the fact that the labour markets in these two economies have become increasingly tight, which has led to rapidly rising real wage rates in these countries. As in Japan and the “first-tier” East Asian NIEs, the tight labour markets in Singapore and Malaysia have forced these countries to develop more skill- and technology-intensive industries.

The rapid growth of high-technology industries in Singapore and Malaysia has been supported by a correspondingly high rate of investment in these industries, as shown in Table 8.3.

During the period 1970–1994, the share of investment spending on high-technology industries in Singapore rose from 11.1% in 1970 to 27.6% in 1980 and to around one half of total manufacturing investment by 1994. In Malaysia the share of investment spending on high-technology industries rose from 13.7% of total manufacturing investment in 1970 to 21.2% in 1980 and to slightly more than one third in 1994.<sup>37</sup>

The data on the two other ASEAN countries, Indonesia and the Philippines, contrast quite sharply with those of Singapore and Malaysia. In the two former countries, the bulk of manufacturing investment is still taking place in the low-technology, mostly labour-intensive industries, with relatively little investment in high-technology industries. To a large extent, this investment pattern can be attributed to the prolonged industrial stagnation in the Philippines and the belated shift to export-oriented industrialisation in Indonesia, which was mostly supported by low-technology, labour-intensive industries.

Although Table 8.3 does not contain data on the pattern of manufacturing investment in Thailand, a study by a Thai economist indicates

Table 8.2 Composition of the Manufacturing Industries in the ASEAN Countries by Level of Technology, 1980–1995

ISIC	Indonesia				Malaysia			
	1980		1995		1980		1995	
	MVA (millions of US\$)	%	MVA (millions of US\$)	%	MVA (millions of US\$)	%	MVA (millions of US\$)	%
1. Low-Technology Industries	3,193	75.4	22,656	71.5	2,311	63.8	8,424	38.1
311–312 Food Products	376		2,906		667		1,790	
313 Beverages	51		339		106		206	
314 Tobacco Products	649		3,372		94		217	
321 Textiles	420		4,398		185		774	
322 Wearing Apparel	15		1,251		67		498	
323 Leather	5		96		3		32	
324 Footwear	26		1,245		11		13	
331 Wood & Wood Prod.	239		2,551		388		1,551	
332 Furniture	6		319		34		314	
241 Paper & Paper Prod.	43		1,053		34		401	
342 Printing & Publishing	51		467		145		638	
353 Petroleum Refineries	978		34		115		589	
354 Misc. Petroleum & Coal Prod.	4		12		2		115	
361 Pottery, China, Earthenware	8		322		10		77	
362 Glass & Glass Prod.	36		151		24		180	
369 Other Nonmetal Min. Products	200		797		169		1,120	
371 Iron	107		1,889		79		448	
372 Nonferrous Metals	–		319		39		204	
381 Metal Prod.	1,135		139		976		127	
2. Medium-Technology Industries	792	18.7	7,997	25.2	713	19.7	4,878	22.0
351 Industrial Chemicals	145		1,544		79		1,298	
352 Other Chemical Products	241		1,417		117		525	
355 Rubber Products	164		643		295		977	
356 Plastic Products	25		619		69		922	
384 Transport Equipment	217		3,774		153		1,156	
3. High-Tech. Industries	235	5.6	1,802	5.7	576	15.9	8,618	38.9
382 Nonelectrical Machinery	53		437		117		1,097	
383 Electrical Machinery	180		1,303		434		7,219	
385 Profess. & Scientific Equipment	2		62		25		302	
4. Other Manufac.	13	0.3	242	0.7	23	0.6	211	1.0
390 Other Manufac. Industry	13		242		23		211	
Total	4,233	100	31,697	100	3,623	100	22,131	100

Note: The Classification of Manufacturing Industries according to the Level of Technology is based on UNIDO's Classification, as explained in the Technical Notes to the Statistical Annex of UNIDO's 1997 Global Report 1997, 17.

Source: Calculated from UNIDO, *Industrial Development Global Report 1997: Financing Industrial Development* (Oxford: Oxford University Press, 1997), 176; 194; 209; 218; and 229.

Philippines				Singapore				Thailand			
1980		1995		1980		1995		1980		1995	
MVA (millions of US\$)	%	MVA (millions of US\$)	%	MVA (millions of US\$)	%	MVA (millions of US\$)	%	MVA (millions of US\$)	%	MVA (millions of US\$)	%
3,343	68.8	10,374	65.8	1,761	44.0	6,791	27.3	7,181	79.5	41,420	75.5
964		2,934		121		629		2,039		7,341	
195		1,787		52		230		682		2,504	
309		739		25		168		375		1,603	
395		514		770		74		1,118		6,898	
205		913		127		242		591		6,902	
8		26		7		27		38		577	
13		117		9		12		47		363	
229		180		84		59		244		972	
75		116		40		133		132		1,021	
128		264		45		376		213		251	
89		297		128		1,175		110		440	
328		715		656		1,339		537		3,189	
2		17		30		80		29		27	
33		67		1		7		35		316	
42		138		7		13		64		740	
63		491		82		410		267		4,347	
98		488		62		102		316		2,088	
35		343		9		65		118		432	
228		206		228		1,650		226		1,407	
1,107	22.8	3,428	21.7	823	20.6	4,678	18.8	1,000	11.1	6,437	11.7
296		524		52		877		94		172	
389		1,735		143		1,277		245		1,401	
103		269		44		77		221		1,534	
85		286		84		714		102		417	
234		614		500		1,733		338		2,913	
363	7.4	1,815	11.5	1,349	33.7	13,270	53.4	534	5.9	5,331	9.7
98		153		319		6,805		168		1,792	
260		1,607		950		5,991		340		3,050	
5		56		80		474		26		489	
49	1.0	161	1.0	69	1.7	111	0.5	314		1,679	3.1
49		161						314		1,679	
4,862	100	4,002	100	4,002	100	24,850	100	9,029	100	54,867	100

Table 8.3 Investment Composition in the ASEAN Countries, 1970–1994

Country	Type of Industry	Share of Manufacturing Investment (%)			
		1970	1980	1990	1994
Indonesia	Low technology	77.1	76.5	76.5	67.1
	Medium technology	21.7	18.8	18.2	25.9
	High technology	1.1	4.3	4.6	6.4
Malaysia	Low technology	67.0	60.7	43.6	42.6
	Medium technology	18.1	17.6	17.3	23.2
	High technology	13.7	21.2	38.5	33.8
Philippines	Low technology	87.3	70.0	67.5	66.5
	Medium technology	7.8	22.8	16.7	15.9
	High technology	4.8	6.9	15.4	16.7
Singapore	Low technology	72.6	56.8	35.1	32.8
	Medium technology	14.3	14.2	16.2	17.6
	High technology	11.1	27.6	47.6	48.8

Source: UNIDO, *Industrial Development Global Report 1997: Financing Industrial Development* (Oxford: Oxford University Press, 1997), Table 15, 38.

that the industrial structure of Thailand is still largely dominated by low-technology industries. The study also argues that the shift to more technology-intensive industries was hampered by several constraints to technology development.<sup>38</sup>

The Indonesian data on the pattern of manufacturing investment, however, must be qualified, as they do not include the huge expenditures on the high-technology industries (strategic industries), particularly IPTN (*Industri Pesawat Terbang Nusantara*), Indonesia's state-owned aircraft enterprise, which was initiated in the late 1970s by Dr. B. J. Habibie, the then State Minister for Research and Technology. For instance, much of the investment in the aircraft industry was, at least until the fall of President Suharto in May 1998, financed by off-budget funds, including the Investment Fund and Reforestation Fund, which were not subject to the fiscal discipline normally imposed by the Minister of Finance. Expenditures from these off-budget funds were put under the discretionary authority of the President and, therefore, were largely nontransparent. Adding these off-budget expenditures to the large explicit and implicit subsidies provided to the aircraft industry and the other strategic state-owned industries, including the shipbuilding industry, would obviously raise the figure on Indonesia's manufacturing investment in the "high-technology industries."

However, since the onset of the severe financial and economic crisis since mid-1997, government spending on the ambitious high-tech aircraft

Table 8.4 Merchandise Exports of the ASEAN Countries, 1980–2000

Country	Merchandise Exports		Per Capita Merchandise (US\$)	
	1980	2000	1980	2000
Indonesia	21,900	62,124	149.4	295.8
Malaysia	13,000	98,237	935.3	4,271.2
Philippines	5,740	39,783	117.1	523.5
Singapore <sup>1</sup>	19,400	137,875	8,083.3	34,468.8
Thailand	6,510	69,057	138.5	1,132.1

Note: Includes reexports.

Sources:

1. For export data, see World Bank: *World Development Indicators 2002* (Washington, D.C.: World Bank, 2002), Table 4.5, 220–23.
2. For population data in 1980, see World Bank: *World Development Report 1982* (Washington, D.C.: World Bank, 1982), Table 1, 110–11.
3. For population data in 2000, see World Bank: *World Development Report 2000* (Washington, D.C.: World Bank, 2000), Table 1, 274–75.

industry and the other strategic industries has virtually come to a halt, as the Indonesian government has run out of money. Moreover, under the terms of the second Agreement with the IMF of 15 January 1998, the two large off-budget items, namely the Investment Fund and the Reforestation Fund, were incorporated into the central government budget, beginning with the 1998/1999 fiscal year (i.e., 1 April 1998).<sup>39</sup> As a result, neither IPTN nor any of the other “strategic industries” enjoyed further access to these off-budget funds.

The pattern of manufacturing investment in the ASEAN countries is also reflected in their merchandise exports, as shown in Table 8.4.

The data in Table 8.4 show that Singapore is by far the largest exporter of merchandise products, most of which consist of manufactured exports. However, the Singapore data must be qualified, since they also include the reexports of products previously imported from other countries. Not surprisingly, the protracted sluggish growth of the Philippine economy accounts for the reason why the Philippines’ merchandise exports have by far been the lowest among the ASEAN countries throughout the 1980s and 1990s.

While Indonesia’s exports have almost trebled during this same period, Indonesia’s per capita exports are still the lowest among the ASEAN countries, even lower than the slow-growing Philippines. Aside from Singapore, the growth of Malaysia’s per capita merchandise exports has been the most impressive among the ASEAN countries.

The data in Tables 8.3 and 8.4 underline the need for the large ASEAN countries, particularly Indonesia, the Philippines, and Thailand, to gradually develop more technology- and skill-intensive, higher value-added industries which are internationally competitive in order to sustain their industrial growth, which, in turn, depends on a sustained growth of their manufactured exports. The need to develop these industries has become more evident as the manufactured exports from the larger ASEAN countries, particularly Indonesia, the Philippines, and Thailand, had, even before the economic crisis, been growing at a sluggish rate.

To develop more skill- and technology-intensive industries, the ASEAN countries will need to make a greater effort to invest more in the broadening and deepening of their indigenous technological capabilities and human capital.<sup>40</sup> This need also applies to Malaysia, since the relatively larger presence of high-technology industries in its economy is mainly due to the greater presence of foreign investment projects established by transnational corporations (TNCs) from advanced countries. However, the presence of high-technology industries cannot be said to have led to a substantial improvement in Malaysia's indigenous technological capabilities.

To the extent that the above ASEAN countries will be able to develop internationally competitive, higher value-added industries, their pattern of industrial development will be in accordance with the catching-up product cycle (CPC) model of industrial development, originally developed by Professor Kaname Akamatsu and further extended by other Japanese economists to the historical pattern of industrial development in the East Asian NIEs. This CPC model of industrial development, more popularly known as the "flying wild geese" pattern of industrial development, is based on the empirical observation that late-industrialising economies, such as Japan and subsequently the first-tier East Asian NIEs, generally started with the import of new manufactured products from the advanced industrial countries, which was followed by import-substituting production and then progressed to production for exports.<sup>41</sup>

Whether the industrial development of the ASEAN countries in the coming years will be in accordance with the CPC model will depend on the extent to which these countries will be able to improve the international competitiveness of their industries through sustained productivity improvements, cost reductions, and better innovative capabilities. This improvement, in turn, would require the manufacturing firms in these countries to develop their industrial, technological, and innovative capabilities. Obviously, this goal cannot be achieved if the manufacturing industries in these countries continue to rely on high tariffs, import restrictions, and export subsidies.<sup>42</sup>

## Foreign Direct Investment in ASEAN Manufacturing

Compared to Japan, South Korea, and, to a lesser extent, Taiwan, the ASEAN countries have, in general, been pursuing relatively liberal policies towards foreign direct investment (FDI). However, among the ASEAN countries, foreign investment policies have varied widely, ranging from the very liberal policies being pursued by Singapore to the much more restrictive policies being pursued by Indonesia until the early 1990s. Moreover, some countries, notably Indonesia, have often changed their foreign investment policies in response to domestic or external developments. For instance, during the early years of independence in the 1950s, Indonesia's attitude towards foreign investment was still very much influenced by its bitter colonial experience and was therefore quite hostile. A foreign investment law, which, after many deliberations, was finally enacted in 1958, was repealed in 1959, only one year after its enactment.<sup>43</sup> Not surprisingly, no new foreign investment was flowing into the country during that period, and whatever little prospect remained evaporated after the nationalisation of Dutch enterprises in 1958 and the takeover of British and American enterprises in 1963 and in early 1965, respectively.

However, in 1967, with the advent of a new, more pragmatic government strongly committed to economic development, a new, quite liberal policy towards FDI was introduced, which subsequently led to the first substantial inflows of FDI into Indonesia since independence. The substantial improvement in the investment climate during this period was not only due to the liberal policy towards FDI but also due to the liberalisation of the capital account in 1972.<sup>44</sup>

The liberal policy towards FDI, however, lasted only for a few years, as, beginning in the early 1970s, foreign investment policy again became increasingly restrictive in response to a resurgence of economic nationalism and a tendency towards increased government regulation of the economy, including foreign investment activities, as a result of the greater fiscal capacity of the government associated with the oil boom.

With the sharply reduced fiscal capacity of the Indonesian government after the end of the oil boom in the early 1980s, more liberal foreign investment policies were once again introduced in response to the increased need for more private investment, including FDI, to sustain the high rate of investment needed for rapid economic growth. The thrust towards a more liberal foreign investment policy culminated in the June 1994 foreign investment deregulation package. This package substantially diluted the mandatory divestment rule, which had been a key principle of Indonesia's foreign investment policy since 1974. Under this rule, foreign

investors were required to divest their equity ownership in joint ventures to a minority shareholding of a maximum of 49% within a specified period of time, which initially was set at 10 years after the start of commercial production, but then was extended to 20 years.

After the fall of President Suharto in May 1998, the new Indonesian government, under newly appointed President Habibie, took various steps to further improve the investment climate for foreign investors. Amongst others, the steps included further simplifying the investment licensing procedures and substantially reducing the fields closed to FDI. These steps were taken because new inflows of FDI were badly needed for the economic recovery of Indonesia. In January 1999 the Indonesian government offered a tax holiday of five years for pioneer FDI and domestic investment projects in regions outside of Java and Bali. An additional tax holiday of one year was also offered to investment projects employing more than 2,000 workers; to investment projects, at least 20% of whose equity shares were owned by cooperatives; and to investment projects whose investment, outside the value of land and buildings, was at least U.S. \$200 billion.<sup>45</sup>

However, despite these more FDI-friendly policies, which were continued by the subsequent Abdurrachman Wahid and Megawati administrations, Indonesia has continued to experience net FDI outflows, as shown in Table 8.5. Without the restoration of political stability, greater legal certainty, better industrial relations, improved safety, and greater certainty about the implications of greater regional autonomy, it appears unlikely that Indonesia will be successful in attracting new FDI. Tax incentives, in particular, cannot function as a sole panacea for the shortage of inward FDI, as foreign investors in general are often more interested in nonfinancial matters, including the intangible attitudes of host governments towards FDI and the investment climate of the potential host country, before deciding whether or not to invest in a certain country.<sup>46</sup>

In contrast to Indonesia, Singapore and, to a lesser extent, Malaysia have been pursuing consistently liberal policies towards foreign investment. Singapore's great attractiveness as a favourable location for FDI has not only been due to its liberal policy towards FDI but also to what a Singapore economist has called the Singapore government's total approach to ensuring a business environment characterised by transparent, predictable rules. Under these rules both local and foreign companies can operate efficiently.<sup>47</sup> In addition, the Singapore government has also invested heavily in physical infrastructure and in human capital, particularly in education at all levels, investments which have contributed to overall efficiency, low costs of operation, higher labour productivity, and accumulation of human capital.<sup>48</sup>

While the foreign investment policies of Malaysia and Thailand have



not been as liberal as those of Singapore, they have been far more liberal than those of Indonesia. Although both Malaysia and, to a lesser extent, Thailand have pursued active industrial policies and promoted local enterprises in certain industries, they have pursued relatively liberal, noninterventionist, foreign-investment policies, particularly in the export-oriented industries.<sup>49</sup>

Although the Philippines has, like Indonesia, also pursued a relatively restrictive policy towards FDI, it has also in recent years, like Indonesia, been pursuing an increasingly liberal policy towards FDI. This policy and the improved political and economic stability achieved under the Ramos administration have led to increased inflows of FDI into the country. As the Estrada and, subsequently, the Macapagal-Arroyo administrations have in general continued the sound economic policies of the Ramos administration, including a relatively liberal policy towards FDI, modest amounts of new FDI have continued to flow into the Philippines.

Since the early 1990s, the policies of the four large ASEAN countries towards FDI have become increasingly liberal as a result of the increased competition from the other rapidly growing East Asian economies, particularly China, in attracting more FDI. As a result of the financial and economic crisis of 1997/1998, this competition has become even stronger, as new FDI inflows are now needed more than ever to revitalise the ASEAN economies.

While most of the FDI in the 1990s has gone to advanced countries, particularly in North America and the European Union, the bulk of FDI flowing into the developing countries has, at least until the crisis of 1997/1998, gone to China and the other rapidly growing East Asian countries, including the ASEAN countries. The data in Table 8.5 show that, through 1996, FDI flowing into the ASEAN countries has been growing rapidly, even though in 1997 the increase in FDI inflows slowed as a result of the crisis. In fact, during 1996 the amount of FDI flowing into the ASEAN countries combined was more than double the amount during the early 1990s. Among the developing countries, the amount of FDI flowing into the ASEAN countries combined has only been surpassed by the amount of FDI in China, which since the early 1990s has been one of the top destinations of FDI in the world.

After the onset of the crisis in mid-1997, however, actual FDI inflows into the ASEAN countries in 1998 declined steeply, except for the Philippines and Thailand. In the case of Indonesia, net FDI inflows since 1998 even turned negative in view of the country's severe political instability and its deteriorating safety conditions. This contrasts quite sharply with Thailand which, though, along with Indonesia, was the hardest hit by the economic crisis, nevertheless experienced an increased inflow of FDI in 1998. Compared with Indonesia and Thailand, the Philippines was not

severely affected by the crisis, and, for this reason, it also experienced a slight increase in FDI inflows in 1998.

During the period 1989–1994, on average each year, the five ASEAN countries combined received about 22% of the total FDI inflows into the developing countries. However, by 1999, this average had declined to 6%, largely because of the strong competition with China as the top destination of FDI inflows into the developing countries.<sup>50</sup>

Throughout the early 1990s Malaysia and Singapore ranked as the two top destinations of FDI into the ASEAN countries, but in 1996 Malaysia emerged as the second-ranking destination of FDI, being surpassed only by Singapore. The equally rapid increase of FDI into Indonesia during the first half of the 1990s was the second surge of FDI into Indonesia since the first one in 1988–90, when large amounts of export-oriented FDI from East Asia, particularly from the NIEs, flowed into the textile, garment, and footwear industries.<sup>51</sup> This export-oriented FDI led to the quadrupling of Indonesia's textile and garment exports in the five years leading up to 1992–93, when they were Indonesia's largest manufactured exports.

The surge of FDI into the ASEAN countries since the late 1980s, particularly export-oriented FDI from the East Asian NIEs, was not only caused by “pull” (host country) factors, such as the generally favourable investment climate for foreign investors but also by “push” (home country) factors. In the case of Indonesia, its successive deregulation measures to improve the country's investment climate and the trade reforms to reduce the “antiexport bias” of its protectionist trade regime were important “pull” factors which led to increased export-oriented FDI flowing into the country since the late 1980s, particularly from the East Asian NIEs.<sup>52</sup>

The “push” factors at work in the home countries of export-oriented FDI, specifically in the East Asian NIEs, were the rapidly rising real wages in these countries, caused by the increasingly tight labour markets and the steep appreciation of their currencies, particularly the Korean won and the New Taiwan (NT) dollar. As a result of these developments, the labour-intensive industries in these countries lost their comparative advantage in their home countries, forcing them to relocate themselves to the lower-wage countries in Southeast Asia, particularly Thailand and Indonesia.<sup>53</sup> As a result of the surge of East Asian FDI, including Japanese and East Asian NIEs' FDI, into the ASEAN countries since the late 1980s, intraregional FDI has emerged as the dominant feature of FDI in the ASEAN countries.

The large inflows of FDI into China and the ASEAN countries since the early 1990s were, in part, driven by a worldwide boom in FDI during this period, as shown in Table 8.5. But the surge of FDI into Indonesia

Table 8.5 FDI In- and Outflows by Host Region and Economy, 1989–2000 (millions of US\$)

Region/Economy	1989–94 (annual average)	1995	1996	1997	1998	1999	2000
World	200,145	331,068	384,910	477,918	692,544	1,075,049	1,270,764
Developed countries	137,124	203,462	219,688	271,378	483,165	829,818	1,005,178
Developing countries	59,578	113,338	152,493	187,352	188,371	222,010	240,167
Asia	37,659	75,293	94,351	107,205	95,599	99,728	143,479
China	13,951	35,849	40,180	44,237	43,751	40,319	40,772
<i>ASEAN Countries</i>							
Indonesia	1,524	4,346	6,194	4,677	–356	–2,745	–4,550
Malaysia	3,964	5,816	7,296	6,513	2,700	3,532	5,542
Philippines	879	1,459	1,520	1,249	1,752	737	1,489
Singapore	4,798	8,788	10,372	12,967	6,316	7,197	6,390
Thailand	1,927	2,004	2,271	3,627	5,143	3,562	2,448
Total ASEAN	13,092	22,413	27,653	29,033	15,555	12,283	11,319

Source: United Nations Conference on Trade and Development, *World Investment Report 2001* (United Nations, 2001), Annex Table B.1, 292–94.

Table 8.6 Approved FDI in Indonesia by Sector, 1996–2002 (millions of US\$)

Sector	1996	1997	1998	1999	2000	2001	2002
Agriculture	1,306	437	965	413	390	367	390
Forestry	136	0	0	9	5	20	9
Fishery	80	27	33	70	50	6	3
Mining & quarrying	1,697	2	0	14	1	118	37
Manufacturing	19,884	23,017	8,388	6,335	9,597	5,145	2,880
Construction	297	307	198	153	161	37	60
Hotels & restaurants	1,716	463	451	229	257	6,892	236
Transport & communications	695	5,900	79	103	1,217	374	1,550
Real estate	2,635	1,394	1,271	171	302	178	6
Other services	1,331	1,581	2,171	3,396	3,305	1,908	1,327
Total	29,776	33,127	13,557	10,892	15,284	15,043	6,499

Source: Badan Koordinasi Penanaman Modal (Capital Investment Coordinating Board), Jakarta, various years.

was, to a significant extent, also caused by the liberalisation of foreign investment regulations in June 1994.<sup>54</sup> During this period, the bulk of FDI flowing into the ASEAN countries was being invested in the manufacturing sector. This was also the case in resource-rich Indonesia, as shown in Table 8.6.

It should be pointed out, however, that the data in Table 8.6 do not include the data on FDI in the oil, gas, and financial sectors, which are regulated under different laws. In view of the large importance of FDI in the oil and gas sectors and the increasing importance of FDI in Indonesia's financial sector (e.g., banking, insurance), particularly since the financial deregulation measures of October 1988, the above figures underestimate the actual importance of FDI in the Indonesian economy. In view of the fact that the banking system in Indonesia has virtually collapsed as a result of the recent crisis, the role of FDI in Indonesia's financial sector is likely to rise substantially if foreign banks acquire more of Indonesia's bankrupt banks.

Although the ASEAN countries have in general been pursuing more liberal policies towards FDI than Japan and the large "first-tier" East Asian NIEs, specifically South Korea and Taiwan, during the early phases of their industrialisation, the degree of openness to FDI among the ASEAN countries themselves has, as we have seen, been quite different. The differential impact of the foreign investment policies of these countries on the inflows of FDI and, in particular, on the relative importance of FDI as a source of productive investment, is shown in Table 8.7. The data in this table show the FDI inflows into the East Asian countries

Table 8.7 FDI In- and Outflows as a Percentage of Gross Fixed Capital Formation in East Asia, 1995–1999

Country	FDI Inflows as a Percentage of Gross Fixed Capital Formation in East Asia (%)				
	1995	1996	1997	1998	1999
China	14.7	14.3	14.6	12.9	11.3
<i>ASEAN Countries</i>					
Indonesia	7.6	9.2	7.7	-1.6	-11.0
Malaysia	15.0	17.0	15.1	13.9	20.1
Philippines	8.9	7.8	6.2	12.7	5.1
Singapore	31.2	29.7	35.3	20.6	26.1
Thailand	2.9	3.0	7.2	20.7	13.7
<i>East Asian Tigers</i>					
Taiwan	2.4	3.0	3.4	-	4.4
Korea	1.0	1.2	1.7	5.7	9.3

Source: UNCTAD, *World Investment Report 2001* (United Nations, 2001), Annex Table B.5, 320–21.

in the second half of the 1990s as a percentage of gross domestic and fixed capital formation in these countries.

Table 8.7 shows that the ratio of FDI inflows to gross domestic capital formation in the second half of the 1990s was the largest in China, Singapore, and Malaysia. In the case of Singapore, this ratio ranged between 21% and 35%, while in Malaysia this ratio ranged between 14% and 20%. In the case of the three other ASEAN countries, the figures were less than 10% during the years before the Asian crisis.<sup>55</sup> After the crisis, however, the relative importance of FDI in Thailand increased, while in Indonesia the ratio of FDI to gross fixed capital formation turned negative because of the net FDI outflows.

Table 8.7 also shows that the industrially and technologically more advanced East Asian NIEs, specifically South Korea and Taiwan, have relied much less on FDI as a source of productive investment than the industrially and technologically less advanced ASEAN countries. Among the “first-tier” East Asian NIEs, the only exception has been Singapore, which, because of its small size, limited resources, and limited experience in manufacturing, has had to rely much more on FDI to develop its manufacturing sector than the larger “first-tier” East Asian NIEs.

The relatively much smaller role of FDI in the two large “first-tier” East Asian NIEs, at least before the Asian crisis, was due to their restrictive foreign investment policies. Their restrictive policies towards FDI can be attributed to their strong determination to promote their own domestic enterprises and to develop their own indigenous technological

capabilities. To achieve these goals, selectivity of FDI was one important aspect of their strategies. It thus appeared that the governments of these countries were seeking to exploit causal relationships between the restricted entry of FDI, the development of domestic enterprises, and the development of indigenous innovative capabilities.<sup>56</sup>

While the ASEAN countries were certainly not less nationalistic, they had in general more modest technological ambitions and less desire to promote domestic enterprises.<sup>57</sup> The only exceptions to this tendency were Indonesia, which, at least until the financial crisis of 1997/98, put a halt to its large-scale, capital-intensive projects, sought to develop a range of expensive high-technology industries, particularly its state-owned aircraft industry, and, to a lesser extent, Malaysia with its ambitious plans to develop its own “national car” and its Multi-Media Supercorridor.

## FDI and the Industrial Technological Development in the ASEAN Countries

Experience of some of the rapidly-industrialising ASEAN countries, such as Singapore and Malaysia, has shown that one of the most important determinants of successful industrial and technological upgrading required to achieve a competitive edge in the export markets has been their ability to attract FDI and make effective use of it by promoting supporting industries and building up a pool of highly skilled managers and workers, who later establish their own firms, including supplier firms which supply parts and components to assembling industries.<sup>58</sup> Hence, FDI can be an important channel for the transfer of advanced technologies and the development of indigenous technological capabilities.

Among the ASEAN countries one can distinguish basically two categories of FDI policies, in particular as it has affected the industrial technological development in these countries. The first category of FDI policies was pursued by Singapore, which actively encouraged the TNCs from the advanced industrial countries to undertake export-oriented investments in manufacturing. Singapore’s industrial and investment policies did not involve any deliberate attempt to promote local industrialists, but it did intervene pervasively and selectively to guide and induce foreign investors to upgrade their activities and increase their local technological activities, particularly R&D and design activities.<sup>59</sup>

The second category of FDI policies has been pursued by Malaysia and Thailand since the 1970s, by Indonesia since the late 1980s, and finally by the Philippines since the early 1990s. Although these countries, particularly Indonesia and Malaysia, have been pursuing an industrial policy of some sort, in that they tried by several means (high import protection,

selective fiscal incentives, assured government procurement) to promote certain industries or local enterprises, their industrial policy was never as pervasive and comprehensive as those pursued by Japan, South Korea, and Taiwan. On the other hand, these countries have also been pursuing relatively liberal foreign-investment policies, particularly in regard to export-oriented industries.<sup>60</sup>

Among the ASEAN countries, Singapore has been an outstanding example of how a developing country, by combining a liberal foreign investment policy with carefully calibrated selective interventions, can effectively harness TNCs to its own ends, specifically by encouraging them with various incentives to facilitate the country's industrial and technological upgrading. In fact, Singapore's liberal foreign investment policies paved the way for technology transfer to local managers and workers. This was, amongst others, facilitated by the introduction in the 1980s of an effective workers' training program, the Local Industry Upgrading Program (LIUP), by the Economic Development Board (EDB). Under this Program selected local industries, including the important electronics industry, were attached to groups of TNCs which trained their workers to make the products they needed for technologically advanced processes.<sup>61</sup> In other words, this LIUP was quite successful in raising the technological capabilities of local small- and medium-scale enterprises (SMEs) to serve as efficient supplier firms to the TNCs.

By giving a high priority to promoting the development of small- and medium-scale enterprises (SMEs) since the 1980s, the Singapore government was also quite successful in improving the technological and managerial absorptive capabilities of these SMEs. Singapore has also made good use of policies that promoted clusters of supporting (ancillary) industries. As a result, there has been a growing trend on the part of the TNCs towards the use of local subcontractors.<sup>62</sup> In particular, the TNCs operating in the consumer electronics, computer manufacture, and semiconductor industries have made increasing use of local subcontractors. The subcontracting activities, which have rapidly increased in response to the rising demand for locally made parts and components, include paper packaging, aluminium and plastic name plating, metal stamping, precision engineering, electroplating, and precision tooling.<sup>63</sup>

Studies on the improvement in the technological and managerial capabilities of the Singaporean SMEs have indicated that this has depended less on the direct efforts of the TNCs in transferring their technology (direct know-how transfer effect) than on the feedback provided by the stringent quality/performance assurance control system imposed by the TNCs on the output of the SMEs.<sup>64</sup>

By giving top priority to the expansion and upgrading of technical education at all levels, the Singapore government has made it possible

that the rapidly growing industries, including the important electronics industry which accounted for 43% of Singapore's total manufacturing output, could be assured of a steady supply of the requisite highly trained engineers and technicians.<sup>65</sup> The availability of highly trained local engineers, technicians, and workers also made it possible for the TNC subsidiaries to rapidly upgrade their operations and produce new, highly sophisticated products.

Like Singapore's, Malaysia's manufacturing sector is highly dependent on TNCs, which generate more than three-quarters of Malaysia's manufactured exports, particularly electronics and electrical products (semiconductors, disk drives, calculators, telecommunications apparatus, colour televisions, and audio and video equipment). The only important mostly locally owned export-oriented industry is the garment industry, which generates about 6% of Malaysia's manufactured exports.<sup>66</sup>

Although the bulk of Malaysia's manufactured exports, unlike the composition of manufactured exports of most other developing countries, consists of products which are classified in the high-skill, high-technology category, including electronics exports, the local content of these exports has remained quite low. For instance, it has been estimated that for every ringgit of output of the electronics and electrical industries, about 80 have been spent on imported inputs. Hence, these important industries generate very little local value added.<sup>67</sup>

This low level of local content has been due to the inability or unwillingness of most TNCs to establish backward linkages with the domestic economy. As a result, most industries in Malaysia, including its export-oriented industries, are still largely engaged in relatively simple assembling and finishing activities. Where there has been some increase in local content over time, this has largely been made possible because of FDI in the parts and components subsectors.<sup>68</sup>

However, although Malaysia has been less successful than Singapore in promoting the development of SMEs as efficient subcontractors to the TNCs, since the early 1990s a growing trend towards more vertical inter-firm linkages between the TNCs and the local SMEs operating as their subcontractors can be detected. This has especially been the case with the TNCs operating in the electrical, electronics, telecommunications, furniture, and automotive industries. The subcontractors which have emerged in response to the rising demand of the TNCs are mostly engaged in tool-and die-mould making, metal stamping, plastic injection moulding, engineering plastics, and application software.<sup>69</sup>

Since the early 1990s the Malaysian government has taken several steps to promote the further development of subcontracting by various efforts to raise the absorptive capabilities of the SMEs, for instance, by providing incentives to stimulate training by the private sector, by pro-



viding adequate infrastructure for and stimulating the creation of clusters of SMEs near the large industrial estates, and by stimulating the setting up of funds, financed by the private sector, for the training of SME workers.<sup>70</sup>

Although Malaysia's various schemes to promote SMEs with a view to broaden its industrial base has been less effective and efficient than Singapore's, its efforts to date have been more successful than the SME promotion policies pursued by the three other large ASEAN countries, Indonesia, the Philippines, and Thailand. For instance, Indonesia, in the late 1970s and early 1980s attempted to foster the growth of local supplier firms, including SMEs, to the large, mostly foreign-controlled assembling companies operating in the engineering goods industries by introducing various mandatory "deletion programs" (local content programs). Under these programs, a deletion schedule was drawn up on an item-by-item basis, under which the large assembling firms were required to use progressively more and more locally made parts and components in the assembly of final goods as specified by the deletion schedule for that particular industry.<sup>71</sup> It was hoped that, through these "deletion programs," the large TNC-affiliated assembly firms could transfer the necessary technologies to their subcontractors, most of which were expected to consist of SMEs.

However, in practice, these mandatory "deletion programs" have in general not been able to develop economically viable SMEs which could function as efficient subcontractors to the large assembling firms. In view of the limited technical and managerial abilities of most small- and medium-scale subcontractors, the mandatory "deletion programs" have, in fact, often resulted in either vertical integration, that is, the establishment by the large assembling firm of an affiliated supplier firm, or the establishment of vertical interfirm linkages between the large assembly firms and unaffiliated large supplier firms, most of which, however, were also affiliated with TNCs.<sup>72</sup>

Unlike Indonesia's government, Thailand's government has not introduced mandatory "deletion programs" to promote the development of subcontractors to the large assembling companies but has instead preferred to let market forces stimulate the use of subcontracting and interfirm linkages. This has indeed stimulated subcontracting in the machinery, electrical, electronics, transport equipment, textile, wood, and furniture industries.<sup>73</sup> However, despite the development of these subcontracting networks, the further development of subcontracting is hampered by the limited technological and managerial capabilities of the subcontractors, which consist mostly of SMEs. Hence, increasing the absorptive capabilities of these SMEs is crucial to developing the capabilities required to become viable subcontractors to the large assembling

companies. This, in turn, requires the development of the human resources of the SMEs, which, in turn, requires a significant and continuous reform of Thailand's education system, which at present is still inadequate.<sup>74</sup>

The above overview of the development of subcontracting networks in the ASEAN countries between large TNC-affiliated firms and SMEs has indicated that in general the hoped-for technology transfer from the TNCs to indigenous ASEAN firms, particularly the SMEs, has been hampered by the lack of the absorptive capabilities of most SMEs in the ASEAN countries, which, in turn, has hampered them from raising the technological and managerial capabilities required to become efficient subcontractors to the large assembly firms. Hence, instead of forcing the pace of subcontracting through mandatory "deletion programs," the development of subcontracting might take place through market forces if promotion efforts are focused on enhancing the "supply side" capabilities of the SMEs, including training efforts for the SME workers. These efforts could be jointly sponsored and financed by the public and by the private sectors, as has been the case with Singapore's highly successful LIUP.

Besides implementing the necessary support programs to enhance the "supply side" capabilities of the SMEs, steps should also be taken to create a more enabling policy environment for the SMEs, since in all the ASEAN countries SMEs often do suffer from unintended discriminatory government policies and practices. In fact, particularly in Indonesia, SMEs face a complex and burdensome regulatory and administrative framework, which poses a great burden on their operations.<sup>75</sup> Simplifying the existing complex regulatory framework, for instance by widely disseminating "one-stop services" for these SMEs, would substantially reduce the high costs of complying with these cumbersome and time-consuming regulations and would go a long way towards establishing a more enabling policy environment for the SMEs.

Although in all the ASEAN countries, technology transfer from the TNCs to local employees (including managers, technicians, and plant workers) has undoubtedly taken place and is still taking place, one important lesson to be drawn from the experience of Indonesia and the other ASEAN countries is that FDI does not provide a simple shortcut to the acquisition of indigenous technological capabilities. In fact, Japan's and, later, South Korea's and Taiwan's experiences show that rapid industrial progress and the development of indigenous technological capabilities have generally not been dependent on FDI.<sup>76</sup> Instead, most Japanese, Korean, and Taiwanese firms were able to become internationally competitive through their own technological efforts, that is through their investments in developing their indigenous technological capabilities. However, after the Asian economic crisis, all three large Asian NIEs,

particularly Korea, have welcomed more FDI into their countries. It was realised that only through greater FDI inflows could Korea benefit from the technological spillovers generated by the presence of TNCs from advanced countries.

FDI has without doubt contributed a great deal to the rapid industrialisation of the ASEAN countries. In fact, with some of the ASEAN countries, particularly Indonesia, still struggling to achieve a full economic recovery from the severe economic crisis of 1997/98, new FDI inflows into these countries are needed to revitalise their economies. This need applies particularly to Indonesia, which was the hardest hit by the crisis and which, largely for political reasons, is facing much greater difficulties than the other countries in achieving a speedy economic recovery.

For this reason alone, the ASEAN countries, particularly Indonesia, are at present simply not in a position to pursue the same restrictive policies towards FDI which the first-tier East Asian NIEs pursued in the past. In fact, these first-tier East Asian NIEs have recently also been pursuing more liberal policies towards FDI in order to accelerate their industrial and technological development.

FDI has without doubt contributed to the technological development of the ASEAN countries, in particular through the transfer of the “easier” technological capabilities, specifically the operational (production), adaptive (minor-change), and acquisitive (investment) capabilities. However, it should also be clear that FDI cannot be relied upon to transfer the more difficult innovative (major-change) capabilities to the local firms. To achieve the latter, more demanding technological capability, there is no shortcut to indigenous effort to acquire domestic technological capability.<sup>77</sup>

## Conclusion

At present all the ASEAN countries, particularly Indonesia and Thailand, having been hardest hit by the financial and economic crisis of 1997–1998, are still struggling to overcome the adverse impact of the crisis. Hence, the most urgent short-term problem facing these countries is to maintain macroeconomic stability and revitalise their economies by attracting more FDI into their economies and by other means. This is a tall order, particularly for the worst affected country, Indonesia, which needs to achieve political stability and a restoration of security, to establish legal certainty, and to reduce rampant corruption before it can ever hope to attract new FDI inflows into the country.

Thus far the Indonesian government has not yet formulated a comprehensive plan for the recovery of its manufacturing sector. However, with

technical assistance from the United Nations Industrial Development Organization (UNIDO), the United Nations Development Programme (UNDP), and the United Nations Support Facility for Indonesian Recovery (UNSFIR), the Indonesian government, in particular, the Department of Industry and Trade, is making preparations to design a comprehensive plan for Indonesia's industrial recovery.

Unlike Indonesia's, Thailand's government, as early as 1998, already unveiled a broad Industrial Restructuring Programme (IRP) for the period 1999–2004.<sup>78</sup> This Programme was intended to stem the contraction of its manufacturing sector by achieving a shared vision between the government and the private sector about the measures needed to restructure and revive the manufacturing sector in the face of the various constraints hampering these efforts. Funded by a soft loan of U.S.\$ 1.2 billion from the World Bank and the Asian Development Bank (ADB), the IRP includes various measures for the process and technology upgrading of various manufacturing firms at the plant level, for the training of workers, and for advisory services for these firms. These latter services will be provided by macro- and sectoral experts in close consultation with Thailand's Ministry of Industry and the Federation of Thai industries (FTI); systems and process experts will work at the plant or firm level, and operations experts will give advice on plant level issues.<sup>79</sup>

Although Malaysia was also adversely affected by the economic crisis of 1997–98, it was not as badly affected as Indonesia or Thailand. For this reason, Malaysia has not made major amendments to its Industrial Master Plan (IMP), which had been designed as early as the mid-1980s and which was only slightly amended in the early 1990s.<sup>80</sup> Moreover, since Malaysia, unlike Indonesia and Thailand, has not put itself under the tutelage of the IMF, it has not been obliged to redesign its IMP in the light of various IMF provisions.

Once economic recovery has been achieved by the ASEAN countries, however, these countries will again be facing the same challenge they were facing before the economic meltdown, namely, how to achieve sustained rapid economic growth required to generate new productive and remunerative employment opportunities for their growing labour force, which, in turn, could rapidly reduce the incidence of absolute poverty in their countries. For the four large ASEAN countries, Indonesia, Malaysia, the Philippines, and Thailand, sustained rapid economic growth would greatly depend on the sustained rapid growth of the manufacturing sector. This, in turn, would depend on sustained rapid growth of their manufactured exports. To this end, these large ASEAN countries would, just like the first-tier East Asian NIEs, need to develop a more sustainable source of comparative advantage, namely, the development of industrial technological capabilities (ITCs).

If these countries develop and continuously improve their ITCs, their manufacturing firms, including their SMEs, will be able to improve their international competitiveness. In the case of the city-state of Singapore, however, which has already become a postindustrial-services economy, sustained economic growth would depend much more on the sustained growth of its modern service sectors.

In order to encourage the manufacturing firms in the large ASEAN countries, including the SMEs, to make the required technological efforts to master their ITCs, the governments of these countries have to ensure that certain basic and enabling conditions are being met. International experience, and particularly the experience of the “first-tier” East Asian NIEs, has shown that the basic conditions needed to encourage and enable manufacturing firms, including SMEs, to develop their ITCs are macroeconomic stability, which would be conducive to long-term investment in the development of ITCs; pro-competition economic policies to stimulate firms to invest in technological development; and the development and upgrading of the skills of their human resources.<sup>81</sup>

Besides these basic conditions, there are also a number of enabling conditions which would facilitate the technological development of manufacturing firms.<sup>82</sup> These conditions should involve better access to foreign technologies (as developing countries are, by definition, net technology importers), for instance, through foreign trade, since a lot of useful technological information can be acquired from a firm’s foreign buyers; a more effective use of FDI (as has been done so effectively by Singapore); better access to finance, including venture capital funds; and a more effective provision of the necessary technology support services, including the important MSTQ (metrology, standardisation, testing, and quality assurance) services to the manufacturing firms, including the SMEs, in order to enable them to meet the exacting international standards (including technical, safety, and sanitary standards) required to enter the demanding export markets.

In view of the greater attention being paid to the role of SMEs in the ASEAN countries, and particularly in Indonesia since the collapse of many large conglomerates in the wake of the recent economic crisis, it should be pointed out that technology support services have played an important role in raising the ITCs and competitiveness of Taiwan’s SMEs. Hence, they could play a similar role in enhancing the supply side capabilities of the SMEs in the ASEAN countries. Thus far, however, technology support services in the ASEAN countries have in general, with the exception of Singapore, not been very effective in raising the ITCs and competitiveness of the SMEs in these countries.

To a large extent, the lack of effective technology support services in these countries has been due to the fact that these services have been

provided by public institutions and therefore have been overly bureaucratic in nature. Hence, in order to provide more effective technology support services to the manufacturing firms, including SMEs, in the ASEAN countries, the public institutions should be restructured in order to make their activities more demand-driven (i.e., driven by the demand of the manufacturing firms themselves). Provision of these services by private institutions could go a long way towards a more effective provision of these important technology support services. In addition, private institutions should be given the opportunity to provide effective technology support services where public institutions are found wanting.

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## Export-Oriented Industrialisation and Foreign Direct Investment in Africa

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*Charles Chukwuma Soludo*

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This chapter argues that export-oriented industrialisation provides the best strategy that could potentially reinvigorate Africa's stalled industrialisation process. Despite nearly two decades of trade and structural reforms at the behest of the BWIs, industrialisation buoyed by FDI and export orientation has yet to happen. We explain why such has not happened and argue that, despite concerted efforts at export orientation, FDI is unlikely to become a significant African phenomenon in the near future, unless some fundamental transformation of the socioeconomic, infrastructural, and institutional arrangements takes place.

We note that Africa, specifically Sub-Saharan Africa (SSA), faces atypical and difficult circumstances and that something beyond the lessons from Asia needs to be done principally by Africans and the donor/international community if Africa is to move forward. As the most land-locked region in the world and one where infrastructural and institutional development is the worst, something beyond "getting the fundamentals right" or "state interventions through industrial policy" is required to create the required locational and competitive advantages for industrialisation and FDI to happen. On this score, we observe that references to "Africa" or "SSA" constitute a misleading aggregate. This is because of the varying types of countries that make up such an aggregate: countries with wide differences in terms of initial conditions, locational advantages, state-civil society development, and sociopolitical and governance structures. While some have the basic infrastructure, industrial base, and

human capacity to embark on some ambitious industrialisation schemes, a majority are preeminently at a preindustrial stage and are still waiting to establish the minimum set of conditions for private enterprise to flourish. For these kinds of economies, it is unlikely that FDI will become part of the development story in the foreseeable future, except through forced locational advantages foisted by a successful regional integration scheme.

We argue for a fundamental rethinking of the donor interventions in Africa – certainly not spooning aid as we know it today. The best the donor community, especially the OECD, can do for Africa is to donate massive assistance to “create” and “expand” the domain of the African market and its integration into the global marketplace. Africa is the last frontier of development, and export-oriented industrialisation will not become significant if the market institutions and links among Africa’s tiny markets are not developed. Regional project aid, not the current haphazard and largely ineffective national aid, is the model.

In the context of increasing globalization and WTO rules, mainstream analysis tenders export-oriented industrialisation and promotion of FDI flows as the winning strategy for rapid development. Developing countries, especially under the aegis of the Structural Adjustment Programme (SAP), are locked in intense competition to outdo each other in terms of trade liberalisation, promotion of export orientation, and changes in laws and incentives to attract FDI. In the case of Sub-Saharan African (SSA) economies, which are too small in economic terms to support large-scale investments, massive trade liberalisation and export orientation (deeper integration into the global economy) are thus expected to provide the haven for investments generally and FDI in particular. If the earlier restrictive trade regimes in the context of small economies inhibited FDI from entering SSA, the new orientation was expected to unleash a new wave of flows into the region.

To be sure, the emphasis on export orientation and FDI is not without merit. The experience of the recent “opening up” of China, the massive FDI flows into it, and its unprecedented industrialisation is a bold testimonial. Furthermore, international trade is increasingly carried out on an intrafirm basis rather than through the use of arm’s length export markets. Indeed, “it is estimated that multinationals now account for foreign sales worth U.S. \$5.5 trillion, compared to a value of world exports of goods and nonfactor services of around U.S. \$4 trillion. Of this latter amount, around one third is intrafirm trade between parents and foreign affiliates.”<sup>1</sup> There are other reasons why transnational corporations (TNCs) are needed to reinforce export orientation: they provide powerful mechanisms for transfer of technologies and management skills, provide competitive impulses by challenging domestic firms, have efficient

mechanisms to penetrate foreign markets and thus give late starters the marketing boost, etc.

Unfortunately, despite two decades of aggressive pursuit of “openness,” much of SSA is bypassed by the global trends in trade and FDI flows. Ironically, instead of export diversification into manufactures, SSA’s concentration on primary commodity exports has increased, while the region’s share of world trade has declined to about 2%. While developing countries as a group increased their share of total world FDI from 16% in 1986–90 to 32% in 1991–93, Africa’s share declined from 1.8% to 1.7%, respectively. Africa’s share of the developing countries’ FDI actually fell from 10.8% in 1986–90 to 5.5% in 1991–93 (see Appendix Table). In only a few African countries has export-oriented industrialisation taken hold (essentially in Mauritius and South Africa).<sup>2</sup> The minuscule FDI that flows into the region is concentrated in the extractive oil and mineral sectors, or in domestic food and other processing sectors.

Thus, while research in other developing regions investigates such issues as trends in the performance of upgrading manufactured exports and FDI, the role of FDI in industrialisation and structural upgrading, sources of success or failure, institutional characteristics (capabilities, incentives, and control structures), the problem in Africa is that neither export-oriented industrialisation is taking place nor is FDI flowing in. The research questions for Africa are, thus, fundamentally different. For Africa, the most basic questions lie in understanding why “opening up” and FDI flows have gone in opposite directions in SSA, contrary to the experience of other regions and when and how export-oriented industrialisation buoyed by FDI will take place in SSA. This chapter attempts to provide some answers to these questions and also examines what possible lessons we can learn from Asia in charting the way forward.

The rest of the chapter is organised as follows: in Section 2, we analyze the role of FDI in export-oriented industrialisation. Section 3 examines why Africa has been different, while Section 4 summarises possible lessons from Asia. In Section 5, we articulate the way forward and conclude the chapter.

## FDI and Export Orientation

### *What Determines FDI and Does It Matter?*

Foreign investors, like other investors, are in business principally to make money. Unlike domestic investors, however, foreign investors must face the extra costs and uncertainties of operating in a foreign land where they are not familiar with local markets and institutions. A number of

theoretical and empirical observations abound in explaining why such firms would choose to invest in particular locations.<sup>3</sup> In sum, mainstream explanations pertain to such reasons as the following: locational advantages, such as access to markets, labour costs, proximity to raw materials, and cheap and efficient infrastructural facilities; the ability of transnational corporations (TNCs) to gain from internalising market relationships; firm-specific attributes that underlie the competitive advantages of TNCs; and the specific policies of the host and supplier countries. Other theories, however, explain investment by TNCs in such other terms as the oligopolistic rivalry between firms at the global level, the empire-building motives of managers of large corporations in advanced countries, or strategic entry deterrence, that is, the build-up of overseas capacity in order to stop potential rivals from entering any specific market(s).

Evidently, whether the explanation is of the cost-benefit (locational advantages) vintage or the oligopolistic empire-building aspect, the key issue is the “strategic” location of the host country in terms of potentials for profitable operations. Either in the short- or long-run, the foreign firms must maximise profits. While appropriate policies can stimulate FDI, they are not sufficient to induce large inflows.<sup>4</sup> The South Centre corroborates this assertion by arguing that “there is overwhelming evidence, however, to suggest that incentives are a relatively minor factor in the location decisions of TNCs relative to other locational advantages, such as market size and growth, production costs, skill levels, political and economic stability and the regulatory framework.”<sup>5</sup> A survey of 173 Japanese investors confirmed that (a) FDI policies such as local ownership requirements, restrictions on repatriation of earnings, and requirements for local content were serious disincentives to investment; (b) tax incentives were not important; and (c) trade policies – particularly high tariffs on parts and components – were obstacles, especially for such technology-intensive sectors as general and electric machinery.<sup>6</sup>

In a recent empirical study of the determinants of FDI in Africa, Elbadawi and Mwega experimented with about 18 variables and found the following to be significantly and positively correlated with FDI flows: GDP growth, openness, real exchange rate depreciation, and quality of institutions.<sup>7</sup> On the other hand, debt service ratio and number of revolutions are strongly negatively related to FDI. A regional integration scheme is found to be strongly positively related to FDI only in the case of the South African Development Coordination Conference (SADCC). The regional GDP, the average years of schooling, the terms of trade and their variability, etc., have insignificant impacts on FDI. Though the regression analysis did not account explicitly for some locational variables, such as shipment and transport costs, infrastructural and labour costs, etc., the results are still insightful. The study draws attention to some of

the policy- and country- or region-specific factors that could potentially have an impact on the FDI flows. If anything, the study confirms some of the intuitive assertions in the growing empirical literature that risk and uncertainty are serious impediments to private investment in Africa. There is, however, an important caveat: It must be noted that the validity of the results depends on the combinations of variables in the regressions, since alternative specifications could lead to widely different outcomes – in terms of the sign, size, and significance of coefficients. Common sense economics tells us, however, that factors that guarantee safety and profitability of investments (with great reductions in uncertainties), and more so, that provide for these guarantees better than in other regions known to the investors would likely induce foreigners to invest in particular locations.

The above discussion sounds warning bells in terms of what might be wrong with the African setting that is hostile to FDI, and it points to the enormity of the challenges in the attempt to buoy export-oriented industrialisation through the FDI flows. (We shall return to this point later in the chapter.)

Whatever the determinants of FDI, an important analytical and empirical question is whether it really matters much for industrialisation and growth. There are two sides to this issue. First, it must be noted that FDI is no free lunch: it has important benefits to the host developing country and possibly significant costs. An important question is whether the benefits of FDI significantly outweigh its costs to warrant the emphasis on it. Second, if the net positive effects are compelling, would the FDI likely occur in the quantum and quality needed to make a difference? We address these issues in turn.

One of the most difficult empirical issues is the evaluation of the net impacts of FDI in host countries. Current obsession with FDI stems from some thinking that perhaps its positive effects outweigh the negatives. As noted earlier, most analysts would agree that FDI brings transfer of technology to individual firms and technological spillover to the wider economy; leads to increased productive efficiency due to competition from subsidiaries of TNCs; brings improvement in the quality of the factors of production, including management in other firms and not just the host firm; provides access to foreign markets; brings benefits to the balance of payments through the inflow of investment funds; fills the savings-investment gap; and provides consumers with sometimes cheaper and better-quality products.

On the other hand, critics of FDI point to a number of costs and negative consequences. FDI could, for instance, hurt the balance of payments due to an increase in the import of inputs by subsidiaries and to payments of dividends and royalties abroad. Also, several TNCs are

known to exercise considerable market power, and thus the direct effects of uncompetitive pricing, as well as the inefficiencies induced by such in the allocation of resources, have to be fully evaluated. There is a potential threat to the competitive environment of the host country, given the absolute size of these TNCs. Also, because of the wider technological spillover effects, TNCs could discourage the development of technical know-how by and in local firms and institutions. Some of the other potential negative effects FDI is charged with include exploiting local labour or paying it too much and thus driving up wages; favouring imported sources of components and materials over local ones, thereby perpetuating dependence on foreign sources; using transfer pricing to escape local taxes and to avoid sharing returns with local partners; not caring for environmental consequences of their actions; etc. Indeed, if the TNCs fail to generate adequate linkages with the local economy, they could have fewer beneficial spillover effects and may, on balance, be harmful if one or more of the costs noted above are present.

What is still not known is whether FDI has net negative or positive effects on host countries. The results of several empirical studies of different industries and countries, covering various time periods, have been mixed, even within the same specific area of analysis. "Moreover, the overall assessment tends to differ according to who has carried it out, reflecting the perspectives and intellectual orientation of the authors."<sup>8</sup> Analysts are split in the middle. On the more cautious (negative) sense, Kumar concludes:

Finally, the overall impression emerging from a great variety of experiences across countries in terms of the impact of FDI on different parameters of development is that FDI promises more than it delivers. The diverging experiences of countries with respect to host country gains from MNE (multinational enterprise) entry could probably result from different policy packages adopted by different countries. In that, the determination of an optimal package of FDI, technology imports, trade, competition and related policies that help to maximize the host country gains is itself a fruitful area of research.<sup>9</sup>

Despite the cautions about overselling the FDI as a veritable agent of industrialisation and development, the mainstream view seems that sustainable growth can hardly take place without it. For example, the view of the WTO is instructive. It argues:

Despite the difficulties associated with the measurement of the efficiency-enhancing effects induced by FDI, let alone with the assessment of the specific channels by which a transfer of technology affects local productivity, the empirical literature offers some important conclusions. First, there appears to be a wide

consensus that FDI is an important, perhaps even the most important, channel through which advanced technology is transferred to developing countries. Second, there also seems to be a consensus that FDI leads to higher productivity in locally owned firms, particularly in the manufacturing sector. Third, there is evidence that the amount of technology transferred through FDI is influenced by various host industry and host country characteristics. More competitive conditions, higher levels of local investment in fixed capital and education, and less restrictive conditions imposed on affiliates appear to increase the extent of technology transfer.<sup>10</sup>

The “consensus” summarised above stems from a vintage of empirical studies that have assigned greater weights to the positive effects of FDI. Summarising the evidence in Lall and Streeten,<sup>11</sup> Reuber,<sup>12</sup> and Encarnation and Wells,<sup>13</sup> Wells argues that “although the methodologies differ from study to study, the conclusions are strikingly consistent: on the order of 60 percent to 70 percent of the projects that foreign investors propose are beneficial to the host country. In the remainder of them, the costs exceed the benefits.”<sup>14</sup>

While the above conclusion generously acknowledges the dominance of the benefits over the costs of FDI, it also raises some troubling prospects. For instance, it admits that in about 30%–40% of the cases, the costs dominate the benefits. This reinforces the views of those who emphasise the costs and thus the call by critics for “special” policies and regulations to “guide” and “manage” FDI in developing countries. This call is an old phenomenon and in fact defines much of the attitudes and policies towards the TNCs and technology transfer in the 1960s through the early 1980s in most developing countries. Needless to say, such policies failed in most countries, with some notable exceptions, especially in the case of some Northeast Asian countries (NEA), especially South Korea and Taiwan. A second, and perhaps more critical, policy issue is how a poor African country, with poor administrative and institutional capacity, can decipher, a priori, whether particular FDI inflows belong to the 30%–40% where the costs exceed the benefits. In other words, how is anyone sure that the inflows of FDI to a particular country are not dominated by projects whose costs dominate the benefits?<sup>15</sup>

In the preceding discussions, we have pointed to the lingering doubts pertaining to the positive effects of FDI and the enduring case for its control. The impression is perhaps created that FDI is so important that export-oriented industrialisation in Africa cannot possibly take place without it. But is FDI really that important, and has it always mattered in the history of the more successful economies?

For emphasis, it must be reiterated that huge capital flows (FDI) can significantly alter the fortunes of a country. The key issue is whether



there is basis to expect that there could be any such significant surges in FDI into Africa to make a difference in its industrialisation and export performance. In this instance, the experience of the Asian developing countries might be instructive.

There is no question that FDI and foreign technology have played significant roles in the export of manufactures in most Asian NICs.<sup>16</sup> Foreign firms have not only played active roles in the diversification process into manufactures but have also helped the NICs penetrate the markets of the industrialised countries for exports. The general trend is an upward surge in FDI, with dramatic differences among the countries, ranging from about 35% domestic capital formation in Singapore to 1.6% in Korea during 1986–89. Other Asian countries are scattered in between the two extremes. But even the low percentage for Korea masks the role of FDI in its export-oriented industrialisation. Korean firms actively sought and acquired foreign technology through licensing agreements, and there were several contractual agreements between foreign buyers and domestic firms.

Singapore is the other extreme from Korea. Since Singapore was a particularly small market, the Korean approach was not open to it. Its locational advantages, however, provided an attraction to foreign firms which knew and had access to foreign markets. Singapore provided an important outpost for foreigners to produce cheaply and to market abroad, and it is little surprise that foreign investment accounted for more than 80% of Singapore's exports. Despite its huge domestic market and rich mineral endowments, Indonesia has recently aggressively sought to attract FDI through a model different from that of Korea. According to Wells, the Indonesian government did not have the tools or the bureaucracy to demand exports of domestic firms as did Korea. "A convertible currency, the proximity of Singapore, and the availability of overseas Chinese finance meant that credit allocation (even with state-owned banks) and exchange controls were not useful tools for the Indonesian government to impose its will on local business."<sup>17</sup> Ethnic Chinese owned most of the manufacturing firms, and Indonesia's aggressive export promotion strategies led to a doubling of manufactures export, from \$11.5 billion to \$22.3 billion between 1988 and 1992. Taiwan benefited from an unusually huge supply of entrepreneurs and managers because many had fled from mainland China during the 1940s. With small populations, Malaysia and Thailand (just like Singapore) pursued more open policies. The ethnic diversity of these countries provided an important impetus for outward orientation.

In the early years of the NICs' industrialisation, the major sources of FDI were the U.S. firms and, to a lesser extent, firms in Japan and Europe. Some factors must explain this influx of the U.S. investment.

Two explanations are the Cold War rivalry and the determination of the U.S. to make its allies in the Korean peninsular and neighbouring countries succeed. These (mostly island) economies occupied strategic locations both geopolitically and as satellite centres for penetrating world markets. The U.S. provided the political guarantees and the incentives to encourage its firms to venture into those countries. The above point and the emphasis on FDI are not to de-emphasise the role of domestic capital and investment in the Asian triumph. Most analysis points to the atypically high levels of savings and investment of the Asians as the most important factor driving their accumulation process. It is therefore possible that domestic investment led to foreign investment. In other words, domestic firms showed the way, and, since money follows money, foreigners had to penetrate these economies through established domestic firms.

Though the U.S., Japan, and Europe provided the initial impetus for FDI, the multiethnic nature of these economies – with significant Chinese presence in most of them – provided an important network to encourage significant regional dynamics. The regional dynamics, especially following Akamatsu's "flying geese" hypothesis, is the characteristic of the Asian NICs that is somewhat "unique" and could be difficult to replicate in Africa.<sup>18</sup> As more advanced countries, led by Japan, upgraded technologically, they moved the more labour-intensive production to less developed, low-wage Asian countries. Neighbourhood effects acted to reinforce the process of copying each other's successful policies and technologies. As the World Bank observes, "close ties through trade, culture, and history have helped East Asian countries take advantage of each other's experience in production, marketing, management, and policy-making."<sup>19</sup> It is therefore little surprise that these ties reinforced the "flying geese" model such that, in recent years, a predominant share (70%) of all FDI in East Asia was intraregional, with the combined share of Europe and the U.S. standing at just 20% less than Hong Kong's.<sup>20</sup>

What does the preceding analysis imply for the prospects of FDI and export orientation in SSA? First, SSA is of little strategic importance either politically or economically: It provides neither a gateway to Europe nor to North America or Asia. Besides Asia, Eastern Europe is likely to be a more attractive site for manufactures export than Africa. Also, with the current waves of regionalism, especially the tendency to broaden the membership of the North American Free Trade Area (NAFTA) to include other Latin American countries other than Mexico, Latin America could become important havens for FDI. This transformation would exploit the huge American market. Currently as a result of NAFTA, Mexico is the highest recipient of the U.S. FDI to developing countries. Mexico and the Caribbean countries benefited from their proximity to the U.S. in the attempt to diversify into manufactures exports. Also, the

smaller European countries, such as Ireland, Spain, Portugal, and Greece, reaped the advantages of their location on the edge of Europe. In the light of the increasing globalization and the regional dynamics discussed above, much of SSA would be left behind. In economic terms, the whole of SSA is just the size of Belgium (a tiny European country of 10 million people), and the region is not likely to be a part of any of the three major economic blocks that are emerging.

Indeed, if history and the emerging trends are anything to go by, there is little basis to expect that FDI would play any significant role in Africa's industrialisation in the near future. It seems that the hopes of FDI for Africa's economic revival are rather too high. Paul Krugman agrees. According to him, "The basic question is whether external finance is likely to be a major engine of development in the new world economic order. My answer, depressingly, is no. There is nothing in past historical experience to suggest that developing countries will be the recipients of large capital flow. . . ." <sup>21</sup>

Krugman's argument reflects a wide range of opinion regarding the potential contributions of FDI in developing countries. Wells summarises this trend of opinion by cautioning:

A few warnings are in order: most developing and East European countries that have turned to foreign investment have done so with unrealistically high expectations. Western firms did not flock to Indonesia when it liberalized its investment policies in the late 1960s. . . . There is no large pool of investors waiting for a particular country to institute new policies, as politicians often seem to believe. Countries that have attempted radical reforms, such as Ghana and Nigeria, have not yet seen an upsurge in foreign investment. Foreign investors tend to be fickle. They follow other firms and succumb to fashions in investment locations. The available data for Africa show declining foreign investment over the 1980s. Starting a new trend is difficult, riding an existing trend is easier. . . . Moreover, for few countries has foreign investment served as the major engine of growth. Only in Singapore, Hong Kong, and Malaysia has foreign investment accounted for more than 10 percent of domestic capital formation. <sup>22</sup>

Furthermore, Wells adds "that certain of the successes of Asia cannot be repeated because of changes in the structures of the world industries involved." <sup>23</sup> These observations seem to bear special significance for much of SSA. Given the increasing regional concentration of FDI, it goes without saying that attracting FDI into such a more outlying region as SSA would require the creation of an exceptionally attractive investment climate, perhaps better than the promise elsewhere. The tragedy, however, is that SSA currently offers the worst investment environment in the world. We discuss the features of this environment and other constraints facing SSA in the next section.

## Explaining Africa's Dilemma

Africa is a sharp contrast from the Asian NICs. While Asia has transformed its production structure towards manufacturing, Africa has deepened its specialisation in primary commodities. Industrialisation generally is still at the inchoate stage, and, aside from Mauritius and a few countries in southern Africa, FDI has not been an important phenomenon in the African manufacturing sector. The minuscule FDI in much of Africa has been concentrated in the enclave, extractive sectors – in mostly oil and mineral extraction. A key question is why FDI and export-oriented industrialisation have not happened in Africa despite the massive trade liberalisation and structural reforms to promote them. Put differently, why has Africa not been able to learn from Asia despite the attention to such lessons in the last two decades?

It is important to stress that references to such aggregates as “Africa” or even “SSA” can be somewhat misleading. Africa is a highly differentiated aggregate, and care must be taken to underscore the substantial differences across countries and subregions. For example, many African countries are too small and balkanized to provide substantial economies of the scale to support profitable investment, with only five countries having a population of more than 30 million (eight countries have a population of less than one million and fourteen less than 1–4 million), while fifteen countries are landlocked.<sup>24</sup> In terms of industrial development, we can classify the countries into two types: countries with fairly developed industrial structure (only five in this group, with the manufacturing sector accounting for more than 20% of GDP) and those at the preindustrial stage of development.<sup>25</sup> Clearly, more than 85% of Africa has a rudimentary industrial base (of less than 20% of GDP). This figure masks the fact of the infinitesimal manufactures exports of the region and the fact that these exports are still in the extremely low-technology, mostly semi-processed, light consumer goods. For over 85% of African countries, competitive industrialisation is a process that has yet to begin.

Explaining Africa's failed industrialisation is coterminous with explanations for the observed growth tragedy. We do not rehearse the familiar debate here.<sup>26</sup> The old acrimonious debate has increasingly given way to some convergence of views regarding the importance of the major aspects of both kinds of explanations. Controversies persist, however, about the relative weights to be attached to the factors, and more so, about the sequencing of the necessary reforms. In the particular case of the structural adjustment era, it is often argued that global liberalisation has pointed to even more profitable investment sites and has further exposed Africa's risky and expensive investment environment. Besides, much of the trade liberalisation and macroeconomic reforms are believed

to be incredible and subject to reversals, and thus private investment (including FDI) has generally not responded as it ought. We argue, however, that, while the key elements of a stable macroeconomic environment are necessary, they are by no means sufficient. For effective supply response in terms of rapid and competitive industrialisation, the other supply side context of the macroeconomic environment is critical. We therefore postulate that key explanations for the stalled industrialisation in most of Africa can be located in such factors as the initial conditions, infrastructural capacity, and institutional constraints, as well as other factors (domestic and external) that impinge upon the functioning of the various markets: small-size economies, technological base, export capacity, market access, etc.

An example of the poor initial conditions is the lack of appropriate sociopolitical environment for the flourishing of private enterprise and growth. Collier et al. provide an interesting typology of African countries on the basis of their location within the spectrum of the prerequisites for growth.<sup>27</sup> Focusing on the low-income countries (below \$1,000 per capita), they filter the countries through a series of three conditions considered necessary foundations for growth: a minimal degree of social stability, a minimal degree of macroeconomic stability, and a minimal degree of allocative efficiency. The idea is that these form a hierarchy of pre-conditions for growth. For example, without a minimum of social stability, there is little point in worrying about macroeconomic stability. Also, if adequate social order is guaranteed but there is macroeconomic chaos, there is little point in worrying about allocative efficiency. Consequently, low-income African economies are divided into four categories. The first consists of economies without peace and includes six countries: Angola, Burundi, Liberia, Rwanda, Somalia, and Sudan.<sup>28</sup> National accounts statistics are unreliable or unavailable for most of them. However, these countries account for some 61 million (11%) of the population in SSA. The second category consists of economies without a minimum adequate macroeconomic environment. The following 13 African countries which satisfied the conditions of minimum social order failed to meet the minimum macroeconomic stability: Comoros, Equatorial Guinea, Ghana, Madagascar, Malawi, Mozambique, Niger, Nigeria, Sao Tome and Principe, Tanzania, Togo, Zaire, and Zambia. With 240 million people, these countries comprise some 46% of SSA population. Economic statistics are also unreliable in most of these countries. The third type includes economies without a minimum adequate resource allocation environment. The following countries satisfied the first two conditions but failed the allocative efficiency criterion: Cameroon, Chad, Congo, Eritrea, Guinea, Kenya, Lesotho, and Zimbabwe. This group has a combined population of 69 million people or 12% of SSA population. The last group consists

of countries whose governments were supplying at least modest levels of social order, macroeconomic order, and resource allocation. They include Benin, Burkina Faso, Cape Verde, Côte d'Ivoire, Ethiopia, Gambia, Guinea Bissau, Mali, Mauritania, Senegal, and Uganda. Thus, according to this classification, only about 23% of SSA population live in countries with minimum adequate environment for growth. The emphasis is on the word "minimum," and some of them could not be said to have basic "growth-friendly" policies. For example, as the authors observe, "Ethiopia has yet to get in place even elementary property rights: it is not yet possible to purchase land on which to build a factory, and the financial system is rudimentary, until 1995 there being a monopoly state commercial bank. Indeed, none of the countries actually rates high across the board on macroeconomic and resource allocation policies." On the basis of statistics up to 1996, the following inference is made about the growth performance of the different groups:

Table 9.1 Population of SSA in Five Policy Environments

Environment:	%pop	Per Capita GDP Growth	
Inadequate social order	11%	-4.0%	1990-94
Inadequate macro policies	46%	-1.3%	1992-94
Inadequate resource allocation	12%	-2.8%	1992-94
Minimal adequate environment	23%	+6.2%	1995
Already middle income	8%	n.a.	

Source: P. Collier, P. Guillaumont, S. Guillaumont, and J. W. Gunning, "The Future of Lomé: Europe's Role" *The World Economy* 20 (1997): 285-386.

Evidently, only 23% of Africa's low-income population lives in countries with minimal adequate environment for growth, while more than 85% of the countries have rudimentary industrial infrastructure. In other words, without a "minimal" adequate environment, discussions about industrial restructuring and competitiveness of manufactures become sterile. In such circumstances, it is difficult for private investment or FDI to flourish, or for government attempts at "creating" industrial infrastructure to succeed. Since more than 70% of Africa has existed in environments without such "minimum" conditions, it is little surprise that industrialisation is yet to take root, and FDI in the region has generally declined.

Another aspect of the initial conditions is the fact that the environment in most of Africa has been atypically hostile to private investment. Industrialisation is about investment, and investment is about balancing risk and returns. New investment theories (investment under uncertainties and irreversibility of fixed investment) provide insights why Africans and foreigners choose not to invest in Africa. On a risk-return analysis, Africa

is rated as the worst continent in the world. From the risk-rating index used by institutional investors, Africa is rated as the most risky region in the world, and its position even deteriorated during the 1980s from 31.8 in 1979 to 21.7 in 1995. Risk, in this sense, is related to a gamut of indices ranging from political instability, volatile macroeconomic environment, civil strife and natural disasters, lack of effective mechanisms for enforcement of contracts, etc.<sup>30</sup> For foreign investors, risk is the most important impediment to investment. For example, a survey of 225 investors identified fear of political instability as the most important of ten constraints.<sup>31</sup> The World Bank survey of about 150 firms in East Africa found that several deterrents to investment included political and economic policy uncertainty; the lack of currency convertibility; poor infrastructure and regulation; rudimentary financial and business services; breach of contract and high taxation.<sup>32</sup> The risk of policy reversal was ranked the most important deterrent. Other deterrents cited in empirical literature include endemic corruption; the uncertain reputation of governments due to a finite possibility of policy reversal; and the illiquidity of firms' fixed assets, which is attributed both to the breakdown of the private audit profession in verifying firms' accounts and to the civil legal system in establishing and enforcing legal title. In essence, poor institutions interact with volatile policy and political environments to heighten the risk of African investment climate. It is little wonder then that, relative to other regions, capital flight is very pervasive, thereby denying the region of the scarce investable resources that could potentially make the difference in its quest for industrial diversification.

These basic elements of risk interact with the poor provision of public infrastructure, complex regulatory environment, high taxation on capital, corruption, etc., to make investments in Africa highly unprofitable relative to the rest of the world. Where public infrastructure is scanty, unreliable, and very costly, firms often have to accommodate these negative qualities through private provisions. For example, over 80% of firms in Nigeria have to provide their own electricity generators, dig their own boreholes for water, buy poles and wires to extend telephones to factory sites, and sometimes have to construct access roads to their sites. Investors in most African countries have to go through a hell of complicated procedures and red tape of paper work to register companies. Endemic corruption which requires that investors have to bribe their way through everything, including the installation of electric generators, constitutes a high level of taxation on investment. Just the "hassles" of setting up and running businesses in several African countries are enough to discourage the most ardent investor.

As the new investment theories would predict, private investors have reacted to the hostile and uncertain environment in certain rational ways.

First, the value of waiting increases, and it is little surprise that capital flight is pervasive. Second, agents have structured the composition of their domestic investment to emphasise mostly reversible and safe investments that have self-insurance characters. Agents systematically choose safe and liquid assets over less liquid ones. It is no surprise, therefore, that many African countries have become nations of traders, with the distributive trade sector booming at the expense of the productive (industrial) sector. This environment also has implications for the flow of FDI. When citizens do not have the confidence to invest in their own countries, foreigners have little motivation to be adventurous. This explains why most of the FDI flows into Africa have been concentrated in the mining (extractive) sectors.

Tangential to the above is the nature of defective or missing markets and the implication for adjustment costs and supply response. The free trade argument is predicated on efficiently functioning markets, with very few adjustment costs and free mobility of productive resources. Evidently, environments characterised by structural and price rigidities, factor immobility, wage rigidity, defective money, capital markets, etc., can greatly reduce the speed and nature of supply response.

Interlinked with the poor infrastructural base and defective/missing markets is the atypically poor institutional capacity of the state to manage the economy – including industrialisation. This is compounded by the atypically low levels of educational attainment and skills development, as well as the small but nascent entrepreneurial class with requisite capital. Africa is the most illiterate region and one where the critical technical and managerial skills for the operations of modern industry are in most acute short supply. This is exacerbated by the massive brain drain that is complicated by declining investment in education; by soft infrastructure in terms of institutions – capital and money markets, audit and accounting standards, and facilities; by the lack of enforcement of contracts; by the lack of transparent and efficient bureaucracy that would reduce the cost of doing business; by the lack of institutions for business-government dialogue and understanding; etc. In this environment, it is not conceivable how merely “getting prices right” through some trade reforms or just macroeconomic stability can elicit sustainable and competitive industrialisation.

In addition, export-oriented industrialisation requires the building of export competence. Penetrating and sustaining positions in export markets require a level of productivity and managerial and technical skills that is lacking in most SSA countries. It is therefore conceivable that part of the observed sluggish export response can be attributed to the weak technological capability, lack of export competence, as well as the daunting infrastructural costs of exporting.



A major aspect of the determinants of competitive export-oriented industrialisation that is not seriously incorporated in standard price-and-trade theory pertains to the space-bridging (transport) and transaction costs. These have become inevitable in the light of increasing globalization, which has made productive resources highly mobile – seeking locations with safety and highest returns. According to Kasper, any realistic analysis of the East Asian experience must explicitly include the following roles: (i) space, transport, and communications costs, and international factor mobility, (ii) the information, transaction, and organisation costs of doing business and the role of institutions in economising on these costs, and (iii) oligopolistic competition and competitive evolution.<sup>33</sup> These roles are necessary because, in modern economies with advanced division of labour and trade over vast distances, transport and transaction costs tend to make up at least 40% of producing the national product.<sup>34</sup> Thus, the competitive edge of many firms/businesses often depends on how well they cope with these costs and how well the society in which they operate manages to reduce these costs.

On account of operating costs for businesses, Africa appears to be the most expensive place for firms to operate. It is atypically the most landlocked region in the world, with about 15 countries completely landlocked and without easy or cheap access to sea transport. Even for countries with easy access to seaports, all studies show that Africa faces the highest transport and telecommunication costs in the world. For example, Yeats et al. notes:

[I]n 1990/91 Sub-Saharan Africa's net freight and insurance payments were about \$3.9 billion, or roughly 15 percent of the value of the region's exports, compared with 11 percent in 1970. . . . Individual country statistics, however, show wide variations. Net transport and insurance payments absorbed more than 25 percent of the value of exports for a third of African countries and exceeded 70 percent for Somalia and Uganda. Net payments averaged 42 percentage points for the landlocked African countries – almost 25 percentage points higher than the average for other African countries. The implication is that a large share of Africa's foreign exchange earnings that might otherwise be used for productive capacity-building investments is being used to pay for international transport costs.<sup>35</sup>

Another factor worth highlighting is the nature and development of the private sector in much of Africa. The Asian experience teaches us that the export orientation was propelled by a vibrant and innovative private sector. On the contrary, the private sector in much of Africa is still very fragile.

Gibbon provides a detailed characterisation of the African private sector.<sup>36</sup> The “purely” or “largely” private sector in Africa comprises mainly the tiny “person” or “person and a family member” operations

undertaken mostly for survival purposes. These enterprises face serious structural constraints in attempting to expand their operations. These include their primitive technical level, shortages of skilled labour, difficulty in obtaining credit, and continuous competition for household and enterprise resources with other household members and other income-generating activities. There is also the problem of markets for the private sector. Markets in several areas of operation of these kinds of enterprises comprise small concentrations of poor consumers. Thus, demand is constrained and, given that the populations are highly dispersed in an environment of poor infrastructure, the cost of moving beyond these market constraints is enormous. Beyond these peasant/small scale enterprises, the private sector in Africa consists mainly of enterprises dependent upon different degrees of state connection. Unlike the pervasive illicit kinds of connections, the open connection entails state assistance with regard to subsidies, access to credit, inputs and state contracts, and implicit or explicit protection via tariff barriers, confinement policies, guarantees of market monopoly, etc. There is, however, a thin line dividing the various kinds of enterprises, as one type easily transforms into another, or even straddles between that of a “purely” private nature and that which enjoys illicit state connections.

The dominant group of the private-sector activities is the category with state connections as well as connections with the outposts of major multinational corporations. Evidence from a sample of SSA countries is that many such enterprises have either collapsed or are choking under the yoke of stabilisation and import liberalisation. As Gibbon observes, “[T]he consequence has been that, following trade liberalisation, consumption of locally manufactured clothing has in most places been mainly displaced not by consumption of cheaper (and possibly more efficiently-produced) new imports, but by imported second-hand clothing.”<sup>37</sup> Furthermore, most of the enterprises have proved to be incapable of competing in export markets. In the 1990s, Africa’s share of the global trade in manufactures has not exceeded a pitiable 0.43%. Such is the state and dilemma of private sector and industrial development in Africa.

In Nigeria, for instance, many of the industries established under the import-substituting regime have collapsed, while, in some sectors, some of the surviving ones have experienced improved capacity utilisation. The booming sectors are mostly those that produce food, drinks, beverages, and pharmaceuticals. The critical, but nascent, capital-goods sector is still sprawling, and its performance is far below the level prior to the commencement of SAPs. Many of the private-sector activities have been driven underground into the commercial subsector: informal, petty, and wholesale trading, smuggling, and speculative activities. Furthermore, some analysts have argued that one of the major reasons for the lack-

lustre privatisation programmes in some African countries is the weakness of the entrepreneurial class. These weaknesses of, or even retrogressions in, the private-sector stability can be generalised for many countries in Africa, and they do not bode well for competitive industrialisation and surges in FDI.

Finally, there are a number of other constraints pertaining to both the region's initial conditions and the altered global environment which act to place Africa's industrial development in a precarious dilemma. UNIDO<sup>38</sup> articulates such obstacles as follows:

**Box 1: Obstacles to Successful Industrialization in Low Income Africa**

- \* Their comparative advantage lies chiefly in low labor costs (sometimes also relatively low raw materials and energy costs). These "lower order" comparative advantages are increasingly less important in global competition today;
- \* their main competitive strengths are in precisely those industries where demand growth is slowest and where international competition, especially from low-cost Asian suppliers is increasingly intense;
- \* they are not part of any cluster; there is no Japan, Hong Kong or Singapore to undertake FDI on the scale witnessed in East or Southeast Asia;
- \* they are at a serious disadvantage in respect of infra-structural costs, but especially transport;
- \* they are at the bottom of the global league in terms of industrial sophistication and technology;
- \* the private sector is very weak in Africa, dominated by a relatively small number of major multinationals at one extreme and by a mass of small and micro-enterprises at the other, The "middle" – comprising medium-sized indigenous firms – is missing;
- \* the "technological terms of trade" have moved against late-starters. The "admission fee" for the acquisition of new technology has risen both in money terms and, more importantly, in terms of the skills needed by operators, technicians and managers;
- \* the increasing importance of labor quality in the attraction of FDI counts against Africa when TNCs consider offshore investment in manufacturing; and
- \* the region has become excessively and unsustainably dependent on external support including foreign technology and expatriate skills.

The foregoing analysis not only explains why export-oriented industrialisation has not happened as expected in Africa but, moreover, points to the magnitude of the challenges in designing appropriate strategies for the way forward. Before charting the road ahead, it is important to examine the experience of Asian NICs for potential lessons.

## Key Lessons from Asia

Over the last two decades, no subject has occupied development analysts more than the attempts to explain the “miraculous” triumph of the Northeast and Southeast Asia’s newly industrialised countries (NICs), namely, South Korea, Taiwan, Hong Kong, Singapore, Thailand, Malaysia, and Indonesia. Interest in such understanding is not purely for its heuristic or pedagogical satisfaction but for the lessons that other regions/countries could learn from the experience, particularly in the context of how these economies were transformed from predominantly primary commodity-based, poor economies to industrial powerhouses and major exporters of manufactures. However, the interminable debates and controversies that have shrouded the explanations are enough to confound rather than clarify the lessons. Alternative theories abound (mainly of neoclassical and heterodox vintages), while empirical evidence is highly diverse. The literature is huge and growing, and no single paper can sufficiently summarise the vintages of explanations and evidence.<sup>39</sup> We do not repeat the review here but succinctly summarise some of the emerging consensus, especially that offered by the heterodox analysts about the useful lessons regarding industrialisation and the role of FDI in the process.

At the theoretical level, economists are divided between the accumulationists and assimilationists, and between the free-marketeers and interventionists/institutionalists. One clear emerging lesson is that no one purist explanation can suffice, since there is hardly a unique Asian model. The experiences are variegated, providing somewhat complex lessons. In broad terms, some analysts point to the differences between the northeastern countries of Japan, Hong Kong, South Korea, and Taiwan, on the one hand, and the southeastern countries of Malaysia, Singapore, Thailand, and Indonesia, on the other. The latter group is claimed to have followed a less interventionist policy regime than the former. Such a menu of diverse lessons provides options which other countries could adopt or adapt to, depending on their own sociopolitical, economic, and institutional settings. A quick rundown of some of the issues/lessons of the Asian debate is provided below.

For the accumulation theorists, there is hardly anything spectacular about the Asian successes: the Asian economies grew rich by rapid accumulation of physical and human capital, that is, high levels of investments. The steep rise in the NICs’ manufacturing exports is seen as that which one would expect in economies where the stocks of physical and human capital were rising rapidly and shifting comparative advantages towards the sectors that employed these inputs intensively. If these economies did better than others, their performance was simply evidence

that these economies got prices right and their economic policies let comparative advantages work effectively.

On the other hand, while the assimilation theorists do not deny the role of rapid investments and comparative advantages, they emphasise the active efforts of the government to induce, almost force, firms to try to export, and the entrepreneurship, innovation, and learning the firms had to undergo in order to compete effectively in world markets – with clear government support. From this perspective, exporting itself also stimulated and supported learning in some other ways. For example, being forced to compete in world markets made the managers and engineers in the firms pay keen attention to world standards. In other instances, much of the exporting involved contracting with American or Japanese firms, which demanded high performance and provided assistance to achieve it. Thus, the development of these competencies is certainly different from merely an automatic result of changing factor availabilities. As Nelson and Pack summarise, “[T]he message of the assimilation theorists is that successful industrial development requires innovation and learning to master modern technologies; effective innovation and learning depend on investments, and a market environment that presses for effective allocations, but it involves much more. And, indeed, to a considerable extent, the investments needed are induced by successful entrepreneurship.”<sup>40</sup>

The difference between the two explanations is often exaggerated. In reality, both theories are simply two sides of the same coin. Rapid accumulation and effective learning, innovation, and entrepreneurship took place. The more interesting issue is not just to point out that they did take place, but why they did so in those economies and not in other ones. Implicit in both explanations is the fact that there must have been an enabling environment for rapid accumulation and enterprise to flourish and for entrepreneurial skills and innovation to be fully realised. A key issue, then, pertains to the basic elements of such an enabling environment.

Discussions of lessons from the Asian experience have been beclouded by a fearsome debate between the free-marketeers’ explanations and the “government interventionist” explanations. In other words, there has been sharp disagreement about the role of the market versus that of the state in Asia’s triumph, with the neoclassical economists and the Bretton Woods institutions perched on the overarching role of the market, or what they call “market-conforming interventions,” and the others (the heterodox economists) insisting on the dominance of the interventionist states.<sup>41</sup> We note, however, that this debate pertains mostly to the Northeast Asian countries (NEA), since most analysts agree that the Southeastern countries generally pursued more open policies. Analysts have noted that the NEA countries have generally outperformed the

Southeast Asian countries. From the articulation of the market-friendly approach to development of 1991 to the attempt in the 1993 study to “prove” that the NEA miracle was due to its adherence to such a framework, the World Bank seems to have come full circle to recently admit the overarching role of the state, such that “without it [the state], substantial development, both economic and social, is impossible.”<sup>42</sup> On the other hand, even the heterodox economists do not doubt the important role played by the market in the success of the NEA countries. What has emerged is the consensus that both the market and active state interventions played mutually reinforcing roles, with varying degrees of emphasis across countries.

One common thread in all of the NEA countries (except, perhaps, Hong Kong) is the preeminent emphasis on the ability of the state to consciously articulate the society’s long-term development vision and to use a battery of instruments to mobilise the country’s productive energies to attain such a vision. State intervention in much of Asia derives from a theory (developed in, and popularised by, Japan) which analyses how late industrialists can catch up with earlier industrialists through well-honed national policies which use the existing international relationships. The Asian theory does not assume that pursuit of national interest should necessarily involve protectionism and excessive controls on capital movements and trade. Equally, it does not prescribe a blind adherence to the tenets of free trade and capital movements. Pragmatism is the key word, and its content at a particular time and circumstance is tailored to serve “national interests.”

Intervention in these economies was not, unlike the experiences of many other countries, geared “to constrain the business sector as a whole in the interests of other classes, and still less to replace private enterprise with centralised state control; nor has it been a system for extending favours to certain individual interests.”<sup>43</sup> In these economies, the primary purpose of policy was to promote the interests of the business sector as a whole in a manner consistent with a broader set of national interests. Another major lesson pertains to the role of strong and efficient institutions in the process of industrialisation. As the experiences of the NICs show, these institutions themselves can be consciously “created” to serve the industrialisation needs, but they need to evolve within the context of each country’s sociohistorical and cultural milieu. One other lesson is that the activist policies of the NEA countries were conducted in spite of the constraints of the GATT rules. In other words, these economies exercised much ingenuity in interpreting and circumventing the multilateral rules. The key lesson, therefore, is that creative deployment of interventionist policies can still succeed, despite the constraints of the external environment and the WTO rules.

The broadest agreement between neoclassical and heterodox economists pertains to the role of the state in export-oriented industrialisation. The World Bank contends that the NICs' industrial growth and competitiveness were strongly anchored on an export-push strategy.<sup>44</sup> Such export-push strategy – the winning mix of fundamentals and interventions to encourage rapid export growth – “was the HPAEs' most broad based and successful application of selective interventions,” and this is the strategy that “holds the most promise for other developing economies.”<sup>45</sup> The hallmark of the strategy was diversification into, and promotion of, manufactured exports.

All the NICs (except Hong Kong) have shown that import substitution and export orientation are two mutually reinforcing phases. Many of the NICs' exports that emerged in the 1980s had a long gestation period under state promotion, since exporting did not begin immediately after an industry was established.<sup>46</sup> Indeed, a probable reason why the HPAEs did better than other developing countries in the 1980s was that they had emphasised for a longer time both import substitution and export promotion, rather than just the ISI strategy. In the NICs, industries that benefited from the ISI strategy were also required to meet specified export performance. NICs aggressively promoted exports through strategic pro-export policies that established a free-trade regime for exporters and offered a range of other incentives for exports. This pressure to also export made the critical difference between NICs and other developing countries. As Amsden concludes, “[T]he lesson for other countries from East Asia's trade and industrial policy is not necessarily to abandon subsidised import substitution – otherwise exports may fail to become more diversified and knowledge- and capital-intensive. Instead, the lesson is to subject every import-substitution industry to various forms of discipline, including possibly some export target, however modest.”<sup>47</sup>

The belief and practice that, with the right policies, one could literally “twist” the market to behave as desired have influenced many government policies in many of the NICs. Nowhere are these pervasive interventions more noticeable than in the industrial sector. Akamatsu formalised the industrialisation strategy of Japan and provided the first theorisation of how growth occurred in newly industrialising countries.<sup>48</sup> One of the papers he wrote in English was entitled, “A Theory of Unbalanced Growth in the World Economy.” In it, he related the growth process in emerging countries to an analysis of the trends towards differentiation and uniformity in the international economic structure as such countries developed. According to Akamatsu, domestic production of imported consumer goods is identified as “the take-off stage in the wild-geese-flying pattern.”<sup>49</sup> This would occur through “a struggle of economic nationalism” in which “there should be fostered a domestic con-

sumer goods industry powerful enough to win in the competition with imported consumer goods and to recover the home market from the hands of foreign industries.”<sup>50</sup> The theory shows that national economic policy is important in promoting a domestic consumer goods industry through protectionist measures and in promoting the accumulation of capital and the technological adaptability of the people in the country seeking to industrialise. Then, as these consumer industries grow, they develop into export industries, and, at that point, a further process of import substitution begins with regard to capital goods industries – which, in turn, become export industries. As for the markets, Akamatsu theorises that, for both consumer and capital goods, the less-industrialised countries initially provide important markets, but, as production progresses from crude and simple goods to complex and refined goods, more advanced countries become significant market outlets. Over time, however, exports of simple consumer goods begin to decline, as other developing countries themselves begin to produce these goods and to compete with the early “newly rising countries.”

A major lesson from the experience of the NICs is that “openness,” “outward orientation,” and “international competition” are terms that should be interpreted with caution. Some neoclassical economists have generally equated outward- or export-oriented economies as “based on private enterprise, managed by market forces and operating under a virtual free-trade regime – at least as far as their production was concerned.”<sup>51</sup> It is generally argued that an outward-oriented strategy allows countries to reap the benefits of specialisation according to comparative advantage, permits the realisation of economies of scale, and provides the spur of competition which induces technological change. A common conclusion is that the more open the economy and the closer its integration with the global economy, the faster is its rate of growth. Paradoxically, the NICs are presented by the analysts as examples par excellence of what outward orientation as described above can achieve. Other economists, however, dispute the characterisation of the Asian experience. They argue that, during the NICs’ periods of rapid growth, instead of a deep and unconditional integration with the global economy, their economies sought “strategic” integration: they integrated up to the point where it was as much in their interest to do so as to promote national growth.<sup>52</sup>

## The Question of Replicability

The foregoing presents some key lessons that Africa is often called upon to emulate or adopt. A controversial question is whether these major



lessons are still valid for other developing countries to replicate in the light of a changed and continually changing international environment. Two not always reconcilable views are posed by the mainstream analysis. The first hinges on the universality of economic theory and principles and thus the replicability of any good economic policy everywhere. On that basis, it is argued that, since much of SSA has “initial conditions” identical to those of the East Asians at the beginning of their “miraculous” triumph, then Africa is just ready to “duplicate” the Asian experience. The second view is predicated on the grudging acceptance that some activist interventions by some of the Asian states contributed significantly to their success. On this account, however, mainstream analysis argues that Africa cannot learn from East Asia because the interventions succeeded as a result of some “unique” Asian characteristics and initial conditions that are absent in Africa or are irrepliable elsewhere. Proponents of this argument suggest that Africa should, instead, emulate the less interventionist, more open Southeast Asian countries.

While there could be a legitimate basis to support one model or the other for several African countries, it should be noted that rejecting one model merely on the basis of Africa’s incapacity is naïve. Even the experience of East Asians teaches us that capacity is not destiny – it can be created through conscious efforts. Secondly, it is naïvely assumed that there is any form of policy regime that does not require a capable state. Paradoxically, much of the blame for failure to establish basic elements of macroeconomic stability, competitive exchange rate regimes, trade policy reforms, etc., has been attributed to the same “lack of capacity” of African states. In other words, the capacity of the African states to design and implement economic policies is a recurring theme which needs to be addressed frontally and not to be an excuse for neglecting a potentially useful policy regime. Eventually, the extent of a country’s interventionist activity would be determined by its sociopolitical and economic circumstances. But an enduring lesson of the Asian countries, Northeast or Southeast, is that there is no detour around a capable state.

Another reason for suggesting less-interventionist regimes for Africa is that the international environment has altered. It is argued that the rules of the game have changed, and many of the things that were done by even the most interventionist states, such as South Korea, are no longer permissible under the WTO rules (by which most African countries have agreed to abide). UNCTAD agrees, in part, but argues that “there is considerable scope to maneuver, if countries skillfully use various ‘permissible’ subsidies, balance-of-payments clauses, non-trade-related policy measures, and are more creative in interpreting the new international trading rules.”<sup>53</sup> The key message from the discussion so far is that, even though much of SSA faces somewhat peculiar circumstances as regards

FDI and industrialisation, the lessons of the “how the Asians did it” remain pertinent for a wider industrialisation strategy.

## The Way Forward

One clear message of this chapter so far is that Africa’s minuscule industrial infrastructure and its stagnant FDI flows can be predicted by its socioeconomic environment. Africa is the region most in need of industrialisation, and FDI could give it the greatest impetus for exporting, but ironically Africa is the region which is the least prepared for this to happen. What is the way forward?

The literature is currently replete with all kinds of proposals regarding what is required for Africa’s industrial takeoff. The suggestions fall into three key categories: (i) the need for capable states and effective institutions to articulate long-term industrialisation vision, to maintain law and order, to enforce contracts and good audit standards, to formulate and implement effective policies for industrialisation, etc.; (ii) getting the fundamentals of macroeconomic policies right through price stability, competitive exchange rate regimes, more open trading regimes, fiscal incentives for manufacturing, mobilisation of domestic savings, human capital development, active export promotion, etc.; and (iii) some micro-level interventions to build national competitiveness as well as to assist infant industries through infrastructural development, through appropriate technology policies, through subsidies to particular industries or firms, and through nurturing industrial development so that it can mature from utilising its comparative advantages in light, labour-intensive industries into utilising the advantages of high-tech ones, etc.<sup>54</sup>

UNIDO has articulated a useful template of an appropriate strategy for the least developed countries, of which Africa constitutes the bulk (see Box 2 below).<sup>55</sup>

**Box 2:** Elements of the Emerging Consensus on Strategy for Industrialization in the Least Developed Countries

- (i) Because there is no single East Asian model to emulate and no firm consensus on precisely what form of intervention will optimize growth in developing countries, and especially LDCs, industrial policy is best viewed as a menu of options. The range of choice open to governments is narrowing as globalization takes hold because, although globalization does not eliminate the need for industrial policy, it limits the options.
- (ii) The shift in strategy on the part of the East Asian NIEs themselves, partly in response to the forces of globalization but also reflecting the

- evolution of industrial policy, suggests that developing countries have more to learn from the recent experience of Southeast Asian economies (Indonesia, Malaysia, Thailand) than the four original NIEs.
- (iii) One of the most important lessons of East Asian experience is that intervention worked where it was carried out in close coordination with the private sector. Industrial policy responded to the problems and needs of private enterprise rather than seeking to impose elaborate schemes according to the dictates of grandiose national plans.
  - (iv) Ultimately, competitiveness succeeds or fails at the enterprise rather than the national level. Governments must create an enabling environment for business and investment, but the choices of what to make and sell, and how and where to do it, must be left to entrepreneurs.
  - (v) There is broad agreement on the need for some selective, targeted interventions and the importance of outward-oriented strategies whereby a country's manufacturing sector is driven by the discipline of market competition.
  - (vi) Where selective interventions are used, these must be closely coordinated and integrated. Uncoordinated intervention in factor markets without appropriate measures in product markets will be ineffective or even counterproductive.
  - (vii) Because resources are limited, only a few activities should be supported at any one time. Targeting is crucial.
  - (viii) Incremental measures and modest technological advances are preferable. Learning is cumulative and intervention must support activities that have a base in existing skills.
  - (ix) The more advanced the developing country, the greater the range of choice. LDCs in tiny markets, with weak infrastructures and a poor skills and technology base, have little option but to focus on simple, consumer-based industries, initially at least. Given their small markets, their prospects for attracting major FDI inflows (other than into natural resource industries) are poor. For such states the option of shutting out technology and FDI has no advantage, and they may need to concentrate on fostering labor-intensive operations and in developing an export-platform strategy, as in Mauritius.
  - (x) Technological upgrading and human capital investment are crucial to competitiveness beyond the year 2000. There is a clear role for the State and for UNIDO and other international agencies in both fields.
  - (xi) Domestic rivalry is a prerequisite for competitiveness.
  - (xii) Clusters and industrial districts have an important role in the development of globally competitive SMEs.
  - (xiv) Incentives are more likely to succeed than sanctions. Efforts to constrain FDI or limit technology imports run the risk of deterring investment altogether.
  - (xv) SAPs should include a specific strategy for manufacturing. The expectation that manufacturing will blossom in the absence of a coherent strategy has not been borne out by African experience.

(xvi) Global competitiveness is two-tier in nature, requiring a blend of national (comparative) advantage and enterprise-driven, strategic advantage. Industry-level competitiveness in global markets invariably depends on a combination of the two. Even in globalized industries – and not all industries are global – the home base, and with it national economic policy, is of major importance. Industrial development cannot be imposed from abroad; indigenous industry capability and productive systems are crucial for long-term industrialization. The home base shapes a company's capacity to innovate rapidly in technology and methods and to do so in proper directions. It is the place from which competitive advantage ultimately emanates and from which it must be sustained.

There is no question: Africa's future must lie in the hands of Africans themselves. To make export-oriented industrialisation happen in the majority of SSA countries would require creative adaptations of the above template. Creating the appropriate environment for private enterprise to flourish and to induce the bulk of Africa's flight capital to return home is the fundamental challenge facing the region. Outsiders (FDI) could play important roles, but there is no question that Africans' money must lead the way. We do not rehearse the proposals required to create such a competitive investment climate.<sup>56</sup>

In the remaining part of this section, we concentrate on the aspects of the strategy by which the international donor community can assist Africa in overcoming its atypically poor locational advantages and the constraints of preindustrial states. Essentially the proposals hinge on creating and broadening the domain of the African market through a re-thinking of the lending programmes to emphasise regional infrastructure and on a serious effort to level the playing field to enable Africa to effectively compete.

## Creating Africa's Regional Dynamics

Our starting premise is that, by increasing the regional concentration of FDI and by strengthening regional blocs in Europe, the Americas, and Asia, such a trend would likely intensify. Second, Africa belongs to none of these clusters, and, with its fragmented 45 SSA countries just the size of Belgium in economic terms, national markets are too tiny to hold any promise for FDI activities. Third, even when FDI and industrialisation are outward bound, Africa remains the highest-cost environment in which to operate, not only because of its institutional and administrative inefficiencies, but, more so, because it is the most landlocked region and

has the worst infrastructure – in transportation, ports, postal service, and telecommunications.

Given the above premise, dramatic reforms and huge investments would be required to build Africa as a profitable and competitive investment site – one that would be good enough to attract FDI from their regional clusters or good enough even for domestic firms to effectively compete in the international markets. A first major step in this direction is to integrate the tiny national markets into a regional one through the implementation of the various proposals for regional infrastructural networks. A regional market would circumvent the constraints of narrow national markets and would also make possible (a) for countries to use existing agricultural and industrial capacities more fully in supplying one another's needs; (b) for new investment to take place in industries that would not be viable if they were confined to individual national markets; and (c) for both old and new industries to reduce costs by benefiting from the economies of scale and specialisation. Regionalism, in this case, could serve as an important learning ground where regional firms could compete freely and mature and ultimately become competitive globally.

Furthermore, an integrated regional market provides for larger investment opportunities and could induce Africa's flight capital to come home. This momentum, led by Africans, would help convince the labour-intensive TNCs, which are losing competitiveness in their cluster regions of operations, to venture into Africa. Some regional dynamics, perhaps of the "flying geese" model, could also spring up.

All the above benefits of a regional market can only materialise under two conditions. First is the political will on the part of governments to allow their countries to become investment sites and to coordinate regional policies to guarantee the free flow of goods and services. Second, the above condition would amount to nothing if the regional infrastructure is not developed (i.e., if it continues to be cheaper and faster to transport goods and services from Europe to Africa than between neighbours in Africa). Here is the aspect that demands the greatest input of the bilateral and multilateral donor agencies. The UN Economic Commission for Africa has undertaken various studies and produced blueprints for infrastructural development and networking in the region, but they all have remained on the shelves for lack of financial resources to implement them.

There is a lot of room for creative thinking. We propose that the bilateral and multilateral donor agencies rethink the current programme lending and instead return to project lending, to be executed at the regional level. This would be especially the programme of infrastructural development – networks of roads, developed seaports, efficient telecommunications to link the entire region, and investments to create and

strengthen regional institutions for safeguards and enforcement of contracts. Member countries could be made to pay for the investment either in proportion to their resource base or in proportion to the value of the infrastructure invested in their respective countries. Alternatively, such infrastructural development may not necessarily require new funds. It may need a redirection of existing resource flows. For example, foreign technical assistance costs some \$4 billion annually. This amount could go a long way towards financing the building and retention of critical skills in the continent, as well as providing some basic infrastructure.

## Leveling the Global Trading Field

Our diagnosis of the problem no doubt places the burden of adjustment mainly on the shoulders of individual countries. But there are several constraints which emanate from the distortions in the global trading field and which UNCTAD, UNIDO, and WTO could act to eliminate. In this area of trade, Sachs proposes a simple but effective solution. According to him, “The biggest source of support from donor nations would also be the cheapest. America, Europe and Japan should launch a New Compact for Africa, guaranteeing open markets for African exports and committing themselves to help reintegrate Africa into the world economy. The commitment would help prove to both sides that the long period of economic marginalization is over, and would energize both African nations and the West to overcome the practical obstacles to a new dawn of rapid growth throughout Africa.”<sup>57</sup> Furthermore, Amjadi et al. and Yeats et al. articulate a number of other proposals for actions by the OECD to level the playing field (see Box 3 below).<sup>58</sup>

### **Box 3:** Required OECD Actions to Level Global Trading Field for Africa

- \* Regional arrangements, like the EU or NAFTA, provide industrial countries trade preferences to each other’s markets and discriminate against African and other developing countries. Policy initiatives are needed to, at least, place the latter on an equal basis with OECD members in these arrangements. Some labor-intensive products like textiles, clothing and footwear played a key role in the early stages of the newly industrialized countries’ transformation, and have a similar potential for Africa. Where they are now excluded (as in United States) these goods should be incorporated into existing GSP schemes – particularly so since intra-OECD preferences in regional FTAs may severely disadvantage these exports.

- \* Since African exports are highly concentrated in primary commodities there is a strong interest in utilizing natural resource-based industrialization strategies for their industrialization. Where further processing is suitable for developing countries OECD preferences should be extended to all stages of a processing chain. Also, an accelerated phase-in of OECD Uruguay Round tariff cuts should be adopted on products of export interest to Africa. This could assist Africa in gaining additional experience in potentially important markets (such as those for textiles and clothing) which will come under increased competitive pressure due to the MFA phase-out.
- \* Ceilings and quotas should be eliminated from developed country preference schemes to be made consistent with unrestricted intra-OECD preferences extended under FTAs. Ceilings considerably reduce the potential worth of the GSP to African countries since, aside from their trade effects, they also introduce further uncertainty regarding the operation of the system (i.e., African exporters may not know whether a shipment will qualify for GSP treatment until its arrival in the import market). It is also being alleged that ceilings are sometimes set below minimum efficient plant size. This negates the intended trade and investment-increasing incentives of the preferences.
- \*\* Some OECD policy initiatives are required to alleviate Africa's transport problems:
  - \* Technical assistance: International shipping has undergone a major transformation in which procedures for cargo utilization, port operations, and related logistical functions have evolved into highly complex operations requiring a considerable degree of technical expertise. Since most African countries have limited access to such expertise, technical assistance programs (such as those provided by UNCTAD and the World Bank) should be expanded and also extended to related activities (such as customs clearance procedures) that impinge on the efficiency of international transport operations.
  - \* Finance and development: Due to insufficient attention and funds, many African countries' fleets, ports, and connecting inland transport infrastructure have deteriorated, or have become technologically outmoded. OECD countries should sponsor a comprehensive survey and report on Sub-Saharan Africa's transport problems along with policy proposals for their alleviation. Given the small size of many African countries, and its influence on cargo volumes and the utilization of efficient transport technologies, further attention should be given to the development of regional ports and required inland infrastructure.
  - \* The situation of land-locked African countries needs special attention, given the major problems these countries face in transiting their neighbor's territories. A major effort should attempt to identify the special trade problems of the land-locked African countries and formulate policy suggestions for their reduction.

Recently, a mission of Commonwealth Ministers completed a tour of multilateral institutions, including the World Bank and IMF, to highlight the plight of small states in terms of their vulnerability to a range of economic and environmental factors. The Ministers' concerns about the disadvantaged positions of the least developed countries under the new highly competitive global trading system are genuine. The best the international community can do in the case of Africa is to level the playing field and help develop the African markets. Aid, as in the past, is no panacea.

## Conclusion

In this chapter, we have shown that export-oriented industrialisation and FDI are not yet important phenomena in much of SSA despite the massive trade liberalisation and structural reforms since the early 1980s. We argue that such minuscule activities are what can be predicted by Africa's sociopolitical and risky environment, as well as by its atypically locational and infrastructural disadvantages. In an era where FDI is increasingly regionally concentrated in part because of the increasing waves of regional integration, it is unlikely that Africa will experience FDI surges in the foreseeable future. Rather than economic reforms leading to industrial diversification, upgrading, and exporting, as promised, deindustrialisation has occurred, and FDI has stagnated. This is due mainly to the incredibility of some of the reforms as a result of their defective designs and implementation and to the fact that globalization has pointed to other, more profitable investment sites. Even in countries where reforms are advertised as successful (Uganda, Ghana, etc.), FDI has not happened. The image of Africa as the "dark continent" persists, and there is no pool of funds waiting anywhere to be invested in the liberalising of Africa.

There are, however, some prospects in the medium-to-longer-term as the new sites in Asia today become high cost and upgrade through the technological ladder. Africa will then become the veritable last frontier for the labour-intensive and SME FDI to relocate (according to the "flying geese model"). But these firms must find it profitable and safe to operate in the African environment. How Africa should prepare for such is the challenge for policy – both for Africans themselves and the international donor community. There is a blueprint of considerable ideas and lessons from Asia to learn from in terms of domestic policies. But getting these "fundamentals" are by no means sufficient, only necessary. Unless a concerted effort by all partners in African development is taken to create and deepen the African regional market as a profitable investment site, export orientation buoyed by FDI might remain a distant dream.



Table 9A Foreign Direct Investment (FDI) Inflows: Africa Compared to the Rest of the World (in Billions of US Dollars)

	1983–1988 <sup>1</sup>	1989	1990	1991	1992	1993	1994 <sup>2</sup>
World aggregate FDI	91.554	200.612	211.425	158.428	170.398	208.388	225.692
Developed market economies	71.779	171.722	176.436	115.092	111.223	129.073	134.984
Developing countries	19.757	28.622	34.689	40.889	54.750	73.350	84.441
* Africa (including South Africa)	2.104	4.812	2.207	2.974	3.265	3.000	3.080
Percentage of world aggregate	2.30	2.40	1.04	1.88	1.92	1.44	1.36
Latin America and the Caribbean	7.438	7.488	8.989	15.254	17.672	19.900	20.254
South Asia	0.238	0.485	0.524	0.464	0.723	1.133	1.393
Southeast Asia	5.885	11.013	15.747	15.843	19.514	19.617	23.741
* China	1.823	3.393	3.487	4.366	11.156	27.515	33.800

Source: United Nations Conference on Trade and Development, *World Investment Report, 1995: Transnational Corporations and Competitiveness* (New York and Geneva: UNCTAD, 1995).

1. Annual average flows.
2. Preliminary figures.

## Notes

1. J. Markusen, "Incorporating the Multinational Enterprise into the Theory of International Trade," *Journal of Economic Perspectives* 9 (1995)
2. Many analysts are likely to point to some peculiarities of these economies in terms of location, of European and Asian influences in terms of citizenship, history, and organisation of production and exporting, etc., that provided an impetus for an earlier head start.
3. For an excellent summary, see South Centre, *Foreign Direct Investment, Development and the New Global Economic Order: A Policy Brief for the South* (Geneva: South Centre, 1997), 31–36; C. Pitelis, "Effective Demand, Outward Investment and the (Theory of the) Transnational Corporation: An Empirical Investigation," *Scottish Journal of Political Economy* 43, no. 2 (1996); and World Bank, *East Asia's Trade and Investment: Regional and Global Gains from Liberalization* (Washington, D.C.: World Bank, 1994), 43–44.
4. World Bank, *Global Economic Prospects and the Developing Countries* (Washington, D.C.: World Bank, 1992).
5. South Centre, *Foreign Direct Investment, Development and the New Global Economic Order*, 2.
6. World Bank, *East Asia's Trade and Investment*, 44.
7. I. A. Elbadawi and F. M. Mwega, "Regional Integration, Trade and Foreign Direct Investment in Sub-Saharan Africa" (paper presented at the Joint Seminar of the IMF Institute/AERC, Washington, D.C., 1–3 December 1997).
8. South Centre, *Foreign Direct Investment, Development and the New Global Economic Order*, 41.
9. Nagesh Kumar, "Foreign Direct Investments and Technology Transfers in Development: A Perspective on Recent Literature" (discussion paper no. 9606, UNU/INTECH, Maastricht, 1996), 45.
10. World Trade Organisation, *Annual Report Vol. 1, Trade and Foreign Direct Investment* (Geneva: WTO, 1996).
11. S. Lall and P. Streeten, *Foreign Investment, Transnationals and Developing Countries* (Boulder, Colorado: Westview Press, 1977).
12. G. Reuber, *Private Foreign Investment in Development* (Oxford: Clarendon Press, 1973).
13. D. J. Encarnation and L. T. Wells, Jr., "Evaluating Foreign Investment," in *Investing in Development: New Roles for Private Capital*, ed. T. H. Moran (New Brunswick: Transaction Books, 1986).
14. L. T. Wells, Jr., "Foreign Direct Investment," in *Asia and Africa: Legacies and Opportunities in Development*, eds. D. L. Lindauer and M. Roemer (San Francisco: ICS Press, 1994), 341.
15. This point is about the ability of poor developing African countries, perhaps without any discernible locational advantages, to effectively bargain favourable terms with TNCs. In effect, when a country has few locational advantages and therefore has no exceptional promise for profitability and no safety of investments, it is difficult to see what bargaining power or leverage it can have with the TNCs.
16. For detailed discussion, see Wells, "Foreign Direct Investment," 348–53.
17. *Ibid.*, 350.
18. The few African countries with such international multiethnic diversity (especially Mauritius, South Africa, etc.) are also experiencing significant inflows of capital.
19. World Bank, *East Asia's Trade and Investment*, 28.
20. *Ibid.*, 43.

21. Paul Krugman, "International Finance and Economic Development," in *Finance and Development: Issues and Experience*, ed. A. Giovannini (Cambridge: Cambridge University Press, 1992), 22.
22. Wells, "Foreign Direct Investment," 364.
23. *Ibid.*, 337.
24. Elbadawi and Mwege, "Regional Integration," 16.
25. Of 35 African countries for which data is available in the World Development Indicators (1997), only five countries have a manufacturing share in excess of 20% of GDP (Burkina Faso, with an industry share of 27% and a manufacturing share of 21%; Mauritius, with an industry share of 33% and a manufacturing share of 23%; South Africa, with 31% of GDP for industry and 24% for manufacturing; Zambia, with 40% for industry and 30% for manufacturing; and Zimbabwe, with 36% of GDP for industry and 30% for manufacturing). Out of the remaining 30 African countries, another five could be considered as marginal cases, with a manufacturing share of between 18%–20% of GDP. Three of these five have a share of 18% of GDP for manufacturing (Côte d'Ivoire, Lesotho, and Malawi), while two have a manufacturing share of 19% (Morocco and Tunisia). The share of the industrial sector in these countries varies from a high of 56% for Lesotho to a low of 20% for Côte d'Ivoire. For the remaining 25 countries in the sample, the share of manufacturing varies between a low of only 3% of GDP (Angola, Ethiopia, and Rwanda) to a high of 16% in Chad (with Egypt's manufacturing share being 15% of GDP).
26. According to the neoliberal framework that underpins SAPs, the chief culprit is the poor macroeconomic environment that is hostile to competition and profitable enterprise (macroinstability and inflation; exchange rate overvaluation and volatility; protective trade regimes; etc.). While this school of thought believes other factors could be important, it lays overarching emphasis on "getting prices right." Once the markets are liberalised under a sound macroeconomic environment, competition would be unleashed, and enterprise and industrialisation would boom. On the other hand, the adherents of "industrial policy" point to the plethora of structural, capacity, and institutional constraints that prevent profitable and competitive industrialisation.
27. P. Collier, P. Guillaumont, S. Guillaumont, and J. W. Gunning, "The Future of Lomé: Europe's Role," *The World Economy* 20 (1997): 285-386.
28. This categorisation was done in 1996. With the recent election in Liberia, peace is expected to return to the country. However, some other countries have quickly taken its place – Sierra Leone and Congo.
29. Collier et al., "The Future of Lomé"; P. Collier and J. Gunning, "Explaining African Economic Performance," working paper series WPS/97-2.1, Centre for the Study of African Economies, Oxford, 1997.
30. See M. Nissanke, "Africa: Institutions, Policies and Development" (report submitted to the International Development Centre of Japan, 1997).
31. G. G. Blakey, *Economic Integration in Sub-Saharan Africa: The Implications for Direct Foreign Investment* (Brussels: European Commission, 1994).
32. Economisti Associati, "East Africa Survey of Foreign Investors' Report" (World Bank, Washington, D.C., 1994, mimeographed).
33. W. Kasper, *Global Competition, Institutions, and the East-Asian Ascendancy* (San Francisco: International Center for Economic Growth, ICS Press, 1994).
34. D. C. North, "Transaction Costs, Institutions, and Economic Performance" (occasional paper no. 30, International Center for Economic Growth, San Francisco, 1992).
35. A. J. Yeats, A. Amjadi, U. Reincke, and F. Ng, *Did Domestic Policies Marginalize Africa in International Trade?* (Washington, D.C.: World Bank, 1997), 17.
36. P. Gibbon, "Structural Adjustment and Structural Change in Sub-Saharan Africa: Some

- Provisional Conclusions” (Centre for Development Research, Copenhagen, 1994, mimeographed).
37. *Ibid.*, 23.
  38. UNIDO, *The Globalization of Industry: Implications for Developing Countries Beyond 2000* (Vienna: UNIDO, 1996), 122.
  39. For a detailed review of the alternative explanations and evidence, see C. C. Soludo, “Industrialization and Growth in Sub-Saharan Africa: Is the Asian Experience Useful?” in *African Perspectives on Adjustment: Background Studies*, eds. T. Mkandawire and C. C. Soludo (New Jersey: Africa World Press, Inc., 1996); and C. C. Soludo, “Between Free Trade and Mercantilism: Rethinking Africa’s Trade and Industrial Policies” (1997, mimeographed).
  40. R. R. Nelson and H. Pack, “The Asian Miracle and Modern Growth Theory,” policy research working paper no. 1881, World Bank, Washington, D.C., 1998, 6.
  41. World Bank, *The East Asian Miracle: Economic Growth and Public Policy* (New York: Oxford University Press, 1993); R. Wade, *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization* (Princeton, N. J.: Princeton University Press, 1990); A. Singh, “How Did East Asia Grow So Fast? Slow Progress Towards an Analytical Consensus” (discussion paper no. 97, UNCTAD, 1995); M. Kim, “National System of Industrial Innovation: Dynamics of Capability Building in Korea,” in *National Innovation System: A Competitive Analysis*, ed. R. R. Nelson (Oxford: Oxford University Press, 1993).
  42. World Bank, *The State in a Changing World: World Development Report 1997* (Washington, D.C.: World Bank, 1997).
  43. UNCTAD, “East Asian Development: Lessons for a New Global Environment” (report presented at a conference in Kuala Lumpur, Malaysia, 29 Feb–1 March 1996).
  44. World Bank, *The East Asian Miracle*.
  45. *Ibid.*, 358. HPAE refers to the High Performing Asian Economies, that is, Northeast and Southeast Asian economies with spectacular growth performances, including Japan.
  46. A. H. Amsden, “Structural Macroeconomic Underpinnings of Effective Industrial Policy: Fast Growth in the 1980s in Five Asian Countries” (discussion paper no. 57, UNCTAD, 1993), 4.
  47. *Ibid.*
  48. K. Akamatsu, “A Theory of Unbalanced Growth in the World Economy,” *Weltwirtschaftliches Archiv* no. 86 (1961): 196–215; K. Akamatsu, “A Historical Pattern of Economic Growth in Developing Countries,” *The Developing Economies* 1, no. 1 (1962): 3–25.
  49. Akamatsu, “A Historical Pattern of Economic Growth in Developing Countries,” 209.
  50. Akamatsu, “A Theory of Unbalanced Growth in the World Economy,” 13.
  51. M. S. Alam, *Governments and Markets in Economic Development Strategies: Lessons from Korea, Taiwan, and Japan* (New York: Praeger, 1994), 3.
  52. See, for example, Singh, “How Did East Asia Grow So Fast?”; Amsden, “Structural Macroeconomic Underpinnings of Effective Industrial Policy”; Alam, *Governments and Markets in Economic Development Strategies*; C. Gore, “Methodological Nationalism and the Misunderstanding of East Asian Industrialization” (discussion paper no. 111, UNCTAD, 1996).
  53. UNCTAD, “East Asian Development,” 29.
  54. See C. C. Soludo, “Africa: Industrialization Strategy in the Context of Globalization” (paper presented at the joint AERC/IMF Seminar on Trade Policy Reforms and Regional Integration in Africa, Washington, D.C., 1–3 December 1997); C. C. Soludo, “Trade Policy Reforms and Supply Responses in Africa” (research report submitted to UNCTAD, November 1997); D. Lindauer and M. Roemer, eds., *Asia and Africa: Leg-*

*acies and Opportunities in Development* (San Francisco: ICS Press, 1994); UNIDO, *The Globalization of Industry*; UNCTAD, "East Asian Development"; H. Stein, ed., *Asian Industrialization and Africa: Studies in Policy Alternatives to Structural Adjustment* (London: Macmillan Press Ltd., 1995).

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56. For details of such proposals, see C. C. Soludo, "Africa: Industrialization Strategy in the Context of Globalization"; C. C. Soludo, "Trade Policy Reforms and Supply Responses in Africa."
57. J. Sachs, "Growth In Africa: It Can Be Done," *The Economist*, 29 June 1996, 19–21.
58. A. Amjadi, U. Reincke, and A. J. Yeats, "Did External Barriers Cause the Marginalization of Sub-Saharan Africa in World Trade?" (discussion paper, World Bank, Washington, D.C., 1996); Yeats et al., *Did Domestic Policies Marginalize Africa in International Trade?*

## Management of Financial Flows in Southeast Asia

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*Pakorn Vichyanond*

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International capital flows are highly sensitive not only to interest rates and exchange rates but also to macroeconomic potential and stability, as verified by the surge of capital inflows to emerging markets in the first half of the 1990s. Formats and end uses of these flows are very important because they affect external debt-servicing capacity as well as the vulnerability of recipient countries. What is more threatening is the colossal size of these capital flows as compared to the foreign-exchange reserves and typical economic profiles of small debtor countries. Because of their formats and end uses, once allowed to move freely across borders, foreign-capital inflows can have a dominant impact on recipient economies in various respects, including growth, stability, inflation, and the effectiveness of domestic economic policies.

The miserable financial meltdown in Southeast Asian economies in 1997 is clear-cut evidence of the influences of capital flows. In the mid-1990s, export downturn, the rise in value of the U.S. dollar, and dollar-pegging exchange rates led to ominous current account deficits. Worse, the quality of financial institutions' assets deteriorated markedly as a result of the financial deregulation adopted when both financial institutions and their regulators and supervisors were not ready. All these negative factors weakened the confidence of both lenders and borrowers to a large extent and raised widespread doubts about how the governments could maintain the prevailing exchange rate-pegging policy. The situation was aggravated by speculators. Consequently, a flood of capital outflows

pressured Thailand to float its currency and sparked a financial crisis which was not only severe but also contagious.

An explicit lesson from such painful consequences is that the following issues deserve very strong attention from policymakers: the timing of measures, the formats as well as the end uses of capital flows, and policy consistency or coordination. Moreover, recipient countries have to care very much for investor confidence, since investors' decisions can lead to such a huge volume of capital flows that small developing countries are hardly able to endure.

## Macroeconomic Imbalance

From a macroperspective, the strong momentum of current account deficits or the savings-investment gap in Southeast Asia in the mid-1990s was largely spurred by excessive investment funded by capital inflows. A crucial factor that contributed to the surge in capital inflows to emerging markets in the early- to mid-1990s was the decline in asset yields in industrial countries. Weak economic performances of many industrial countries in that period led to accommodative monetary policies, abundant liquidity, and low interest rates. These consequences, in turn, depressed dividend yields as well as ratios of corporate earnings to equity values. Declines in asset yields in industrial countries made the emerging countries an increasingly attractive investment opportunity. Moreover, the exchange rates of the ASEAN-4, Hong Kong, and Taiwan were closely linked to the U.S. dollar, entailing few exchange risks in investment flows from industrial countries. In addition, international wealth holders were impressed by the strong Asian momentum of economic growth and high interest rates throughout the first half of the 1990s (Table 10.2).

The unusually successful performances of Asian economies attracted rapid growth of net capital inflows to the region during the early- to mid-1990s. At that time, Indonesia, Malaysia, and Thailand experienced average real GDP growth above 7% per annum. The Philippines was the only laggard among the ASEAN-4, yet its GDP gradually rose to above 5% by 1995–96. This rapid Asian growth was heavily fuelled by external trade. Quick and outward-oriented growth was not the only feature that attracted foreign investors. Macroeconomic stability played an important role as well.

By developing country standards, inflation was moderate (i.e., below 10%), except for the Philippines, in 1989–91. And the absence of significant fiscal imbalances in most cases confirmed the discipline of macroeconomic policies. Among the ASEAN-4, only the Philippines incurred persistent general government deficits in the late 1980s and 1990s. Thai-

Table 10.1 Key Macroeconomic Data of Southeast Asian Countries, 1991–96

**Panel A: Per Capita Income and Recent GDP Growth Rates**

	1995 Per Capita (US\$)	GDP Growth Rates (% per year)					
		1991	1992	1993	1994	1995	1996
Indonesia	980	7.6	7.0	4.1	4.0	7.6	6.0
Malaysia	3,890	8.7	8.0	9.0	9.1	10.1	8.8
Philippines	1,050	-0.6	0.3	2.1	4.4	4.4	5.5
Singapore	26,730	7.3	6.2	10.4	10.5	8.8	7.0
Thailand	2,740	8.5	8.1	8.3	8.9	8.7	6.7

**Panel B: Gross National Savings Rates (as % of GNP)**

	1991	1992	1993	1994	1995	1996
Indonesia	30.4	32.3	32.8	31.9	31.4	33.7
Malaysia	29.9	34.1	35.3	35.5	36.4	38.8
Philippines	18.2	19.4	18.1	19.0	19.0	20.5
Singapore	45.8	46.5	45.9	49.2	49.9	49.7
Thailand	35.4	34.5	34.2	35.2	35.0	35.3

**Panel C: Change in Consumer Prices (% per year)**

	1991	1992	1993	1994	1995	1996
Indonesia	9.4	7.6	9.6	8.5	9.4	7.9
Malaysia	4.4	4.7	3.6	3.7	3.4	3.5
Philippines	18.7	8.9	7.6	9.0	8.1	8.4
Singapore	3.4	2.3	2.3	3.1	1.7	1.4
Thailand	5.7	4.1	3.4	5.1	5.8	5.9

**Panel D: Current Account Balances (as % of GNP)**

	1991	1992	1993	1994	1995	1996
Indonesia	-3.5	-2.1	-1.4	-1.6	-3.6	-4.1
Malaysia	-9.2	-3.9	-4.6	-6.0	-9.0	-6.3
Philippines	-2.2	-1.8	-5.5	-4.5	-3.3	-4.1
Singapore	11.1	11.1	7.3	15.9	17.6	15.3
Thailand	-7.8	-5.8	-5.2	-5.8	-8.3	-8.1

**Panel E: Central Government Budget Surpluses (as % of GNP)**

	1991	1992	1993	1994	1995	1996
Indonesia	-0.7	-0.4	-0.4	0.2	-0.2	-
Malaysia	-2.0	-0.8	0.2	2.3	0.9	0.6
Philippines	-2.1	-1.2	-1.5	1.0	0.6	0.3
Singapore	4.7	5.4	4.6	3.4	7.4	5.4
Thailand	4.3	2.6	1.9	2.7	3.0	0.9

Source: Asian Development Bank, *Emerging Asia: Changes and Challenges* (Manila: Asian Development Bank, 1997).



land, in contrast, recorded general government surpluses every year between 1988 and 1996. Given such healthy fiscal positions, the sizable external current account deficits were not due to public dissaving but due to shortfalls of private savings relative to private investment. Moreover, those shortfalls were not associated with low savings but rather with extraordinarily high investment, which was linked to these countries' growth records. In other words, a sizable part of this investment was financed by foreign capital attracted by relatively high returns.

## Capital Formats

Formats of capital inflows posed challenges in terms of their contributions to productivity and repercussions upon recipient countries' macroeconomic policies as well as financial systems. In these respects, foreign direct investment and other long-term flows were superior to short-term flows, especially the ones into banks and other financial institutions. Unlike China and Vietnam (where foreign direct investment dominated net private inflows), the ASEAN-4 and Korea before the crisis chose to rely upon growing shares of short-term debts (Table 10.3), which brought about a large degree of volatility to flows of funds across borders. In Thailand, for example, short-term inflows were abundant, amounting to 7–10% of GDP each year during 1994–96, while foreign direct investment languished at about 1% of GDP.

Remarkable increases of net capital inflows into almost every region (except Africa) in the first half of the 1990s are immediately evident in Table 10.4. Asia kept capturing the largest portion (42%) of developing countries' net private-capital flows. Another distinguished feature of Asia is that its net capital inflows in the form of short-term credits, listed under the category "other net investment," represented the biggest among all continents'. This statistic verifies that Asian countries attracted strong attention from international investors and financial intermediaries in the early 1990s. That is particularly so in the ASEAN-4. Table 10.5 demonstrates that the ASEAN-4 absorbed rising net private-capital flows. Within the ASEAN-4, Thailand was the most reliant (10.2% of GDP in 1989–95), and debt commitments far overwhelmed both foreign direct investment and portfolio investment.

Among the incentives encouraging borrowings from abroad were capital account liberalisation, relatively high domestic interest rates by international standards, and exchange rate policies that appeared to provide assurance that the price of foreign currency would not increase to outweigh interest differentials. Burgeoning capital inflows resulted in growing foreign exchange reserves, increasing commercial banks' liquidity and

Table 10.2 Important Economic Statistics

<b>Economic Growth (%)</b>											
	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
USA	3.4	1.2	-0.9	2.7	2.3	3.5	2.3	3.4	3.9	4.4	4.2
UK	2.1	0.6	-1.5	0.1	2.3	4.4	2.8	2.6	3.5	2.6	2.1
Germany	3.7	5.7	13.2	2.2	-1.2	2.9	1.9	1.3	2.0	2.1	1.6
Japan	4.7	4.8	3.8	1.0	0.3	0.6	1.5	3.9	0.9	-2.5	2
ASEAN-4											
Thailand	12.2	11.2	8.6	8.1	8.7	8.6	8.8	5.5	-0.4	-10.2	4.2
Malaysia	9.2	9.7	8.6	7.8	8.3	9.3	9.4	8.6	7.7	-7.4	5.6
Indonesia	7.5	7.2	7.0	6.5	6.5	7.5	8.2	7.8	4.9	-13	0.3
Philippines	6.2	3.0	-0.6	0.3	2.1	4.4	4.7	5.8	5.2	-0.6	3.3
<b>Inflation (%)</b>											
	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
USA	4.8	5.4	4.2	3.0	3.0	2.6	2.8	2.9	2.3	1.6	2.2
UK	7.8	9.5	5.9	3.7	1.6	2.5	3.4	2.4	3.1	2.7	2.3
Germany	2.8	2.7	1.6	5.1	4.5	2.7	1.8	1.5	1.8	0.6	0.7
Japan	2.3	3.1	3.3	1.7	1.3	0.7	-0.1	0.1	1.7	0.6	-0.3
ASEAN-4											
Thailand	5.4	6.0	5.7	4.1	3.4	5.0	5.8	5.8	5.6	8.1	0.3
Malaysia	2.8	2.6	4.4	4.8	3.5	3.7	5.3	3.5	2.7	5.3	2.8
Indonesia	6.4	7.8	9.4	7.5	9.7	8.5	9.4	8.0	6.7	58	20.8
Philippines	11.4	13.2	18.5	8.6	6.9	8.4	8.0	9.0	5.9	9.7	6.7

**Current Account/GDP (%)**

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
USA	-1.9	-1.6	-0.2	-1.0	-1.5	-2.1	-1.8	-1.9	-2.1	4.5	4.2
UK	-4.3	-3.3	-1.4	-1.7	-1.7	-0.3	-0.5	0.1	0.6	4.7	4.3
Germany	4.7	3.2	-1.0	-1.0	-0.7	-1.0	-1.0	-0.6	-0.3	9.0	8.3
Japan	2.0	1.2	2.0	3.0	3.1	2.8	2.2	1.4	2.2	4.1	4.7
ASEAN-4											
Thailand	-3.5	-8.5	-7.7	-5.7	-5.1	-5.6	-7.9	-7.9	-2.2	12.7	9.1
Malaysia	0.8	-2.0	-8.9	-3.8	-4.8	-7.8	-10.0	-4.9	-4.8	12.9	15.8
Indonesia	-1.2	-2.8	-3.7	-2.2	-1.3	-1.6	-3.3	-3.3	-2.6	4.2	3.7
Philippines	-3.4	-6.1	-2.3	-1.9	-5.5	-4.6	-4.4	-4.7	-5.4	2.4	9.4

**Exchange Rates**

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
UK	1.6397	1.7847	1.7694	1.7655	1.5020	1.5316	1.5785	1.5617	1.6377	1.6564	1.6182
Germany	1.8800	1.6157	1.6595	1.5617	1.6533	1.6228	1.4331	1.5048	1.7341	1.7591	1.8358
Japan	137.96	144.79	134.71	126.65	111.20	102.21	94.06	108.78	120.99	130.91	113.91
ASEAN-4											
Thailand	25.70	25.59	25.52	25.40	25.32	25.15	24.92	25.34	31.36	41.36	37.84
Malaysia	2.7088	2.7049	2.7501	2.5474	2.5741	2.6243	2.5044	2.5159	2.8132	3.9244	3.8000
Indonesia	1770.1	1842.8	1950.3	2029.9	2087.1	2160.8	2248.6	2342.3	2909.4	10013.6	7855.2
Philippines	21.74	24.31	27.48	25.51	27.12	26.42	25.71	26.22	29.47	40.89	39.09

Table 10.2 (cont.)

<b>Interest Rates (%)</b>											
	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
USA	9.1	8.2	5.8	3.7	3.2	4.6	5.9	5.4	5.6	5.5	5.3
UK	11.5	12.5	10.3	7.5	4.0	3.7	4.1	3.1	3.6	4.5	n.a.
Germany	5.5	7.1	7.6	8.0	6.3	4.5	3.9	2.8	2.7	2.9	2.4
Japan	2.0	3.6	4.1	3.4	2.1	1.7	0.9	0.3	0.3	0.3	n.a.
ASEAN-4											
Thailand	9.5	12.3	13.7	8.9	8.6	8.5	11.6	10.3	10.5	10.7	4.7
Malaysia	4.9	5.9	7.2	8.0	7.0	4.9	5.9	7.1	7.8	8.5	n.a.
Indonesia	18.6	17.5	23.3	19.6	14.6	12.5	16.7	17.3	20.0	39.1	n.a.
Philippines	14.1	19.5	18.8	14.3	9.6	10.5	8.4	9.7	10.2	12.1	8.2
<b>Periodical Averages</b>											
	Economic Growth (%)		Current Account/GDP (%)		Inflation (%)						
	1987-89	1990-99	1987-95	1990-99	1987-89	1990-99					
Thailand	11.7	5.3	-2.3	-2.9	3.9	5.0					
Malaysia	7.8	6.8	4.8	-1.8	1.9	3.9					
Indonesia	6.1	4.3	-1.9	-1.3	7.9	14.6					
Philippines	5.8	2.8	-1.9	-2.3	8.3	9.5					

Sources: *International Financial Statistics* (2000); *World Economic Outlook*, September 2000; Bank of Thailand, *Key Economic Indicators*, various issues.

foreign liabilities. Any country's foreign exchange reserves should then be measured not just in terms of import spending but also in terms of foreign liabilities. For instance, Thailand's foreign exchange reserves more than doubled between early 1992 and early 1996 (reaching a peak of U.S. \$38 billion), while during the same period its commercial banks' foreign liabilities grew from U.S. \$5 billion to U.S. \$46 billion, or from 6% to 24% of their total liabilities.

One salient feature of the Thai economy, which is similar to the economies of some of its Asian neighbours, is the prevalence of family businesses. This tightly knit family relationship is applicable to a large number of business segments in Thailand, including local public companies listed in the stock market. Along the growth path, even though these family businesses were considerably dynamic, they always tried their best to retain management authority within their families. As an underlying result, both domestic and foreign debts were hinged upon them to a much larger extent than equity as a source of finance. Even among non-financial firms listed in the equity market, their average debt-to-asset ratios surged from 1.58 in 1994 to 1.98 in 1996. In the meantime, their debt-servicing capacity, as measured by the ratio of before-tax and before-interest revenue to debt outstanding, fell from 14.2% to 10.7%.

Family businesses did not neglect tapping funds from the local stock market. But the funds obtained from such a source were not meant to substitute for debts. Instead, they were intended to serve as a stepping stone for further borrowing via debt instruments.

Two other reasons favour debt financing. First, similar to those in several other countries, Thailand's tax system allows private corporations to deduct interest payments, but not dividends, as expenses before tax computation. Such allowance gives a privilege to debt financing (over equity financing) in lowering the overall cost to borrowing entities. Moreover, this tax distortion is also resorted to as a means to evade tax burden. For instance, instead of directly utilising their own funds as equity, private companies deposited such funds at financial institutions and borrowed the same amount back in order to gain tax deduction. Second, the tedious procedure of raising funds via equity and the absence of bond markets encourage borrowers to count upon debts as a primary source of financing.

Access to offshore funds or BIBF corresponded well to the preference of Thai family businesses, since low foreign interest rates, together with minimal exchange risks (due to a basket-pegged exchange rate policy), helped reduce their operating costs but not their management control. It is thus unsurprising to find that private nonbank entities accounted for most of the colossal increase in the country's external debt outstanding after the authorities liberalised the capital account.

Table 10.3 External Debt Outstanding (Billions of US Dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998
<b>ASEAN-4</b>									
External debt	142.3	165.6	181.7	202.8	242.1	279.0	299.2	316.5	315.9
Short-term debt	25.7	33.8	41.7	52.6	60.6	79.7	88.9	94.4	59.5
(% of total debt)	18.1	20.4	22.9	25.9	25.0	28.6	29.7	29.8	18.8
Long-term debt	116.6	131.8	140.0	150.2	181.5	199.3	210.3	222.1	256.4
(% of total debt)	81.9	79.6	77.1	74.1	75.0	71.4	70.3	70.2	81.2
<b>Indonesia</b>									
External debt	69.3	79.4	88.0	89.2	107.9	124.4	128.9	133.2	141.8
(% of GNP)	63.5	64.8	66.2	58.7	63.4	64.6	58.3	63.6	165.9
Short-term debt	11.1	14.3	18.1	18.0	19.5	26.0	32.2	32.9	20.1
(% of total debt)	16.0	18.0	20.6	20.2	18.1	20.9	25.0	24.7	14.2
Long-term debt	58.2	65.1	69.9	71.2	88.4	98.4	96.7	100.3	121.7
(% of total debt)	84.0	82.0	79.4	79.8	81.9	79.1	75.0	75.3	85.8
Debt-service ratio	33.3	34.3	32.6	33.6	30.7	29.9	36.6	30	33
<b>Malaysia</b>									
External debt	15.3	17.1	20.0	26.2	30.3	34.4	39.7	47.2	44.9
(% of GNP)	37.4	38.4	36.3	43.0	44.0	41.4	42.0	49.8	65.5
Short-term debt	1.9	2.1	3.6	7.0	6.2	7.3	11.1	14.9	8.7
(% of total debt)	12.4	12.3	18.0	26.7	20.5	21.2	28.0	31.6	19.4
Long-term debt	13.4	15.0	16.4	19.2	24.1	27.1	28.6	32.3	36.2
(% of total debt)	87.6	87.7	82.0	73.3	79.5	78.8	72.0	68.4	80.6
Debt-service ratio	12.6	7.4	9.1	8.7	8.9	7.0	9.0	7.5	8.7

**Philippines**

External debt	29.6	31.3	31.9	34.7	38.3	37.1	39.8	44.8	46.3
(% of GNP)	67.1	68.6	59.2	62.7	58.3	48.7	47.2	52.2	67.9
Short-term debt	4.4	4.9	5.3	5.0	5.7	5.3	8.0	11.8	7.2
(% of total debt)	14.9	15.7	16.6	14.4	14.9	14.3	20.1	26.3	15.6
Long-term debt	25.2	26.4	26.6	29.7	32.6	31.8	31.8	33	39.1
(% of total debt)	85.1	84.3	83.4	85.6	85.1	85.7	79.9	73.7	84.4
Debt-service ratio	27.0	23.0	24.4	25.6	18.9	16.1	13.4	9.3	11.8

**Thailand**

External debt	28.1	37.8	41.8	52.7	65.6	83.1	90.8	91.3	82.9
(% of GNP)	33.3	39.1	38.4	42.9	46.4	50.5	51.4	61.2	73.5
Short-term debt	8.3	12.5	14.7	22.6	29.2	41.1	37.6	34.8	23.5
(% of total debt)	29.5	33.1	35.2	42.9	44.5	49.5	41.4	38.1	28.3
Long-term debt	19.8	25.3	27.1	30.1	36.4	42.0	53.2	56.5	59.4
(% of total debt)	70.5	66.9	64.8	57.1	55.5	50.5	58.6	61.9	71.7
Debt-service ratio	16.9	13.0	13.8	13.0	13.4	11.6	12.7	15.5	19.2

Source: *Global Development Finance* (2000).

Table 10.4 Net Capital Flows (Billions of US Dollars)

	1984–89	1990–96	1992	1993	1994	1995	1996	1997	1998	1999
<b>Total</b>										
Net private capital flows	15.2	148.1	124.9	162.4	160.5	192.0	240.8	173.7	122.0	196.4
Net direct investment	12.9	63.1	37.4	56.2	84.3	96.0	114.9	138.2	119.6	119.7
Net portfolio investment	4.7	54.1	58.6	104.6	87.8	23.5	49.7	42.9	18.0	34.4
Other net investment	-2.5	30.9	n.a.	n.a.	-11.7	72.5	76.2	-7.3	-15.6	42.3
Net official flows	23.9	15.3	13.3	21.2	-2.5	34.9	-9.7	29.0	37.0	-8.9
Change in reserves	-13.8	-81.2	-68.0	-74.5	-77.2	-120.5	-115.9	-54.7	-67.1	-91.1
<b>Developing countries</b>										
Net private capital flows	18.2	131.2	119.7	142.0	136.6	156.1	207.9	154.7	99.5	168.6
Net direct investment	12.1	56.8	33.8	49.5	75.4	84.3	105.0	119.4	99.1	99.1
Net portfolio investment	4.2	49.3	51.6	88.9	85.0	20.6	42.9	40.6	19.4	32.2
Other net investment	1.9	25.1	34.3	3.6	-23.8	51.2	60.0	-5.3	-19.0	37.3
Net official flows	25.8	15.6	13.7	20.0	9.1	27.4	-3.4	17.5	28.6	5.7
Change in reserves	5.8	-55.7	-45.9	-40.7	-42.4	-65.6	-103.4	-55.2	-37.3	-80.8
<b>Africa</b>										
Net private capital flows	3.6	4.4	-	2.8	10.6	13.8	4.5	8.9	7.5	11.3
Net direct investment	1.1	2.9	2.0	2.0	3.6	4.2	5.3	7.7	6.0	6.9
Net portfolio investment	-0.8	-0.2	-0.7	0.8	0.5	1.4	-0.3	2.6	1.7	1.8
Other net investment	3.3	1.6	-1.2	-	6.5	8.1	-0.6	-1.3	-0.1	2.6
Net official flows	5.1	7.1	8.6	5.9	8.1	5.2	6.5	8.4	4.4	4.9
Change in reserves	0.2	-1.9	2.0	-	-4.4	-1.4	-6.4	-11.3	-2.2	-3.3
<b>Asia</b>										
Net private capital flows	13.0	55.9	21.0	53.4	63.1	91.8	102.2	38.5	1.5	58.8
Net direct investment	4.5	32.2	17.6	34.1	43.4	49.7	58.5	55.4	40.6	43.7
Net portfolio investment	1.5	6.8	1.0	11.7	11.3	10.8	10.2	-2.2	-7.0	5.3
Other net investment	7.0	16.9	2.4	7.6	8.3	31.3	33.5	-14.7	-32.1	9.8
Net official flows	7.7	8.4	10.5	9.9	6.2	5.1	9.3	17.7	24.7	7.0
Change in reserves	-2.1	-29.0	-14.6	-26.1	-39.7	-29.0	-48.9	-17.2	-24.4	-65.5



**Middle East and Europe**

Net private capital flows	1.7	25.2	42.8	22.6	15.5	14.8	20.7	16.1	18.7	16.4
Net direct investment	1.1	3.0	1.3	1.8	4.2	5.1	4.3	5.1	4.6	5.8
Net portfolio investment	4.4	12.8	21.0	15.3	12.5	8.4	7.9	6.8	5.2	4.7
Other net investment	-3.8	9.4	20.5	5.5	-1.2	1.3	8.6	4.2	9.0	5.9
Net official flows	4.8	-1.8	-3.3	4.3	-1.2	-4.8	-5.8	-1.3	-1.5	-1.4
Change in reserves	7.2	-6.4	-10.8	6.7	-3.1	-9.4	-21.2	-14.3	-2.4	-3.4

**Western hemisphere**

Net private capital flows	-0.2	45.7	55.9	63.3	47.4	35.7	80.5	91.1	71.7	82.0
Net direct investment	5.3	18.7	12.9	11.6	24.3	25.3	36.9	51.2	48.0	42.6
Net portfolio investment	-0.9	29.9	30.4	61.1	60.6	-0.1	25.2	33.5	19.5	20.4
Other net investment	-4.6	-2.8	12.6	-9.4	-37.5	10.5	18.5	6.5	4.2	19.0
Net official flows	8.2	1.8	-2.2	-0.1	-4.0	22.0	-13.4	-7.3	1.0	-4.8
Change in reserves	0.5	-18.4	-22.5	-21.3	4.7	-25.9	-27.0	-12.3	-8.3	-8.6

**Countries in transition**

Net private capital flows	-1.0	12.8	7.7	12.1	18.4	29.8	21.3	34.5	35.4	39.2
Net direct investment	-0.2	6.3	4.2	6.0	5.4	13.2	13.1	18.2	18.5	20.0
Net portfolio investment	-	2.0	-0.8	3.6	4.1	2.9	2.2	7.3	8.8	9.6
Other net investment	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	8.2	9.6
Net official flows	0.2	0.5	-0.1	3.0	-11.0	8.4	-5.5	0.8	3.5	-4.4
Change in reserves	-3.6	-7.8	-6.0	-12.4	-8.5	-35.9	0.4	-6.2	-4.9	-8.6

Source: *World Economic Outlook*, May 1998.

Table 10.5 Net Capital Flows (Percentage of GDP)

	1983–88	1989–95	1991	1992	1993	1994	1995	1996	1997
<b>China</b>									
Net private capital flows	1.2	2.5	1.7	-0.9	4.5	5.6	5.2	4.7	3.7
Net direct investment	0.4	2.9	0.9	1.7	5.3	5.9	4.8	4.6	4.3
Net portfolio investment	0.2	0.2	0.1	-	0.7	0.7	0.1	0.3	0.2
Other net investment	0.5	-0.6	0.7	-2.6	-1.5	-0.9	0.2	-0.3	-0.8
Net official flows	0.3	0.5	0.3	0.8	0.9	0.4	0.3	0.2	-0.1
Change in reserves	-0.4	-2.2	-3.7	0.5	-0.4	-5.6	-3.2	-4.0	-4.5
<b>Indonesia</b>									
Net private capital flows	1.5	4.2	4.6	2.5	3.1	3.9	6.2	6.3	1.6
Net direct investment	0.4	1.3	1.2	1.2	1.2	1.4	2.3	2.8	2.0
Net portfolio investment	0.1	0.4	-	-	1.1	0.6	0.7	0.8	-0.4
Other net investment	1.0	2.6	3.5	1.4	0.7	1.9	3.1	2.7	0.1
Net official flows	2.4	0.8	1.1	1.1	0.9	0.1	-0.2	-0.7	1.0
Change in reserves	-	-1.4	-2.4	-3.0	-1.3	0.4	-0.7	-2.3	1.8
<b>Malaysia</b>									
Net private capital flows	3.1	8.8	11.2	15.1	17.4	1.5	8.8	9.6	4.7
Net direct investment	2.3	6.5	8.3	8.9	7.8	5.7	4.8	5.1	5.3
Net portfolio investment	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Other net investment	0.8	2.3	2.9	6.2	9.7	-4.2	4.1	4.5	-0.6
Net official flows	0.3	-	0.4	-0.1	-0.6	0.2	-0.1	-0.1	-0.1
Change in reserves	-1.8	-4.7	-2.6	-11.3	-17.7	4.3	2.0	-2.5	3.6
<b>Philippines</b>									
Net private capital flows	-2.0	2.7	1.6	2.0	2.6	5.0	4.6	9.8	0.5
Net direct investment	0.7	1.6	1.2	1.3	1.6	2.0	1.8	1.6	1.4
Net portfolio investment	-	0.2	0.3	0.1	-0.1	0.4	0.3	-0.2	-5.3
Other net investment	-2.7	0.9	0.2	0.6	1.1	2.5	2.4	8.5	4.5
Net official flows	2.4	2.0	3.3	1.9	2.3	0.8	1.4	0.2	0.8
Change in reserves	0.5	-1.1	-2.3	-1.5	-1.1	-1.9	-0.9	-4.8	2.1

**Thailand**

Net private capital flows	3.1	10.2	10.7	8.7	8.4	8.6	12.7	9.3	-10.9
Net direct investment	0.8	1.5	1.5	1.4	1.1	0.7	0.7	0.9	1.3
Net portfolio investment	0.7	1.3	-	0.5	3.2	0.9	1.9	0.6	0.4
Other net investment	1.5	7.4	9.2	6.8	4.1	7.0	10.0	7.7	-12.6
Net official flows	0.7	-	1.1	0.1	0.2	0.1	0.7	0.7	4.9
Change in reserves	-1.4	-4.1	-4.3	-2.8	-3.2	-3.0	-4.4	-1.2	9.7

Source: *World Economic Outlook*, December 1997.

## Usage and Impact

Streams of abundant capital inflows accelerated the growth of private-sector credits. In Thailand, for example, the growth of private-sector credits rose from 20% in 1992 to 30% in 1994, or more than twice the growth rate of nominal GDP. Overheating, or excessive credit growth, fuelled demand expansion and raised the momentum of inflation as well as external current account deficits – especially in Malaysia and Thailand. Malaysia's inflation more than doubled from 1.9% per annum in 1987–89 to 4.0% per annum in 1990–95 while its current account moved from an annual surplus of 4.8% of GDP to an annual deficit of 6.2% of GDP during the same interval. Rates of inflation during 1993–96 were, in most cases, higher than the weighted average of Malaysia's trading partners' inflation rates, thus contributing to the erosion of competitiveness. There were also clear signs of asset price inflation, particularly in real estate as well as in equity markets.

The underlying cause of all the problems mentioned above is that foreign capital was misused. Instead of funding export projects or foreign exchange earning/saving activities, a sizable portion of those capital inflows rushed into short-term and speculative sectors, such as real estate and stock markets. That misuse occurred even in foreign direct investment. The data from Thailand reveal that, during the period of capital glut (1993–96), 37%, or roughly a third of net foreign direct investment, clustered in the real estate sector (see Table 10.6).

After 1995 two external factors aggravated the strains on the current accounts of ASEAN-4: the downturn of export markets and the rise of the U.S. dollar exchange rate. The trade-weighted average growth of trading partners' imports weakened from 11–12% in 1994–95 to 8% in 1996. This slackening was attributed to the following: a widespread deceleration of imports by industrial countries stemming from sluggish economic activity in Europe and stagnant inventories, a glut in the global electronics market that resulted in a sharp fall in prices, and a slowdown of growth in much of the Asian region itself – including China, India, Malaysia, and Thailand – partly in response to measures undertaken in some countries to contain the emerging overheating pressures. Regarding exchange rates, after 1995 the U.S. dollar recovered very rapidly (Figure 10.1). For example, it rose from 94.06 yen in 1995 to 108.78 yen in 1996 and 121.06 yen in 1997. Because the ASEAN-4 pegged their exchange rates closely to the U.S. dollar, their substantial currency appreciation meant that the degree of their competitiveness in the international arena dwindled to a large extent.

On top of capital account liberalisation, the financial deregulation undertaken by the ASEAN-4 in accordance with global pressure raised

Table 10.6 Thailand's Net Flows of Foreign Direct Investment Classified by Sectors (Percentage of Shares)

	1993	1994	1995	1996	1997	1998	1999p
1. Industry	26.1	16.0	28.3	31.2	49.6	42.7	35.6
1.1 Food & sugar	2.2	3.5	2.0	2.0	5.9	1.5	2.6
1.2 Textiles	-0.5	2.6	1.9	2.2	1.3	2.3	0.6
1.3 Metal & non-metallic	5.5	3.4	4.6	5.0	5.6	6.7	7.3
1.4 Electrical appliances	8.2	4.5	11.7	10.6	15.7	5.2	12.2
1.5 Machinery & transport equipment	3.6	0.9	7.2	4.8	10.9	12.6	10.9
1.6 Chemicals	11.7	2.5	4.7	8.1	5.1	4.5	0.2
1.7 Petroleum products	-9.4	-8.6	-8.1	-11.0	0.4	6.3	0.2
1.8 Construction materials	0.3	0.4	1.3	0.2	-0.3	0.4	1.1
1.9 Others	4.6	6.8	3.1	9.5	5.0	3.2	0.5
2. Financial institutions	3.7	0.5	1.3	3.2	3.2	16.4	6.9
3. Trade	12.7	25.8	22.3	24.0	28.9	20.3	29.3
4. Construction	8.8	5.3	1.8	3.1	4.9	3.9	-4.3
5. Mining & quarrying	7.2	3.9	2.8	0.9	0.6	0.5	-1.2
6. Agriculture	0.8	-0.5	0.5	0.1	0.0	0.0	0.1
7. Services	1.1	4.2	4.4	5.5	7.7	5.5	13.4
8. Real estate	40.2	33.5	42.6	33.2	2.9	0.5	4.2
9. Others	-0.5	11.2	-4.0	-1.1	2.2	10.2	16.0
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Bank of Thailand (monthly bulletins).

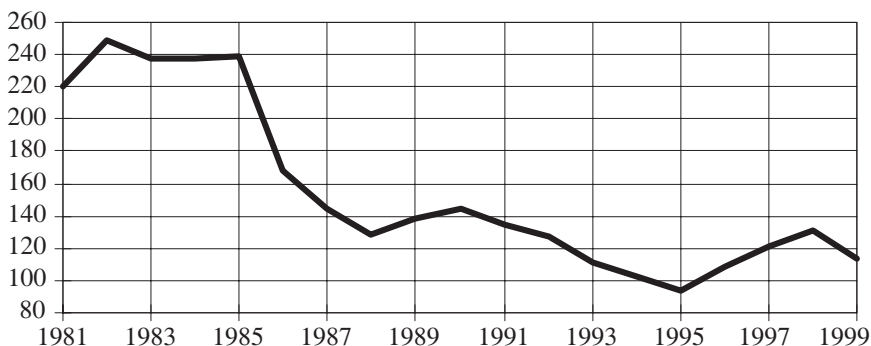


Figure 10.1 Exchange Rate (Yen per US Dollar)

Source: International Monetary Fund, *International Financial Statistics* (2000).

the risks of and the vulnerability to a deterioration of financial institutions' assets quality. Such an adverse impact occurred for three primary reasons. First, amid stronger competition from foreign capital, limited experience among local financial institutions in the pricing and

management of risks in new areas of business practice led to imprudent lending or credit commitments. Second, inadequacies in the regulations and supervision of financial institutions served as loopholes to modern practices in banking and finance. Third, inefficiency on the part of central authorities' regulatory personnel, because of their lack of experience, further worsened the structural weaknesses of the Asian financial sectors. In short, the management, the supervision, and the regulations of financial institutions paid too little attention to prudent analysis and the containment of risks. Consequently, assets quality declined to an alarming degree, while the number of nonperforming loans, as well as bankruptcies, grew without precedent. It should also be noted that the negative effects of initial imprudence were exacerbated by subsequent events, i.e., economic slowdown, tighter financial policies, decline in domestic real estate and equity markets, and eventual currency depreciation that caused difficulty for customers with uncovered foreign currency liabilities. Overall, in addition to threatening deficits on the external account, the weak financial sectors further undermined the confidence of both debtors and investors, leading to the Asian financial crisis.

## Critical Stage

After periodic episodes of speculative attack in 1996, the Thai baht came under downward pressure again in January–February 1997, as currency traders had greater doubts about the sustainability of the U.S. dollar peg in the presence of a large current account deficit and the erosion of external competitiveness because of the dollar's continual rise against the yen and because of growing (i.e., Thai-minus-U.S.) inflation. Though the authorities were at that time able to defend the baht through spot-and-forward intervention and a temporary raising of interest rates, market traders viewed the measures as inadequate, especially when fundamental weaknesses in the financial sector were not remedied and equity prices continued sliding. Meanwhile, there was little market nervousness in the neighbouring ASEAN-4 countries, which were less affected by the export slowdown in 1996 and encountered far smaller current account deficits. However, as the situation in Thailand deteriorated, worries that financial sectors in these countries might also be exposed to property gluts contributed to a downturn in equity prices, particularly in Malaysia and the Philippines.

Severe pressures on the Thai baht reemerged in early May 1997, prompting the central bank to intervene heavily in the spot-and-forward markets, before, on May 15, introducing capital and exchange controls aimed at segmenting the onshore and offshore markets and allowing in-

terest rates to rise. However, these measures failed to restore confidence in the currency, and strong pressures continued in the second half of May and June. On this occasion, the neighbouring ASEAN-4 countries suffered limited spillover effects, but these pressures abated fairly quickly as the authorities intervened in their exchange markets, raised interest rates, and, in Malaysia, introduced limits on swaps by nonresidents not related to commercial transactions.

Underlying these currency attacks was a tightening in global financial conditions resulting from the sudden rise in Japanese bond yields and the sharp rebound of the yen, which reduced the attractiveness of borrowing in Japan to finance investment in high-yielding markets elsewhere, including Thailand, which was heavily reliant on short-term capital inflows. International investors – commercial banks, investment banks, and hedge funds – played a role alongside domestic investors in taking short positions against the baht, which they viewed as providing a one-way bet, given the exchange rate peg, weak fundamentals, and relatively low funding costs.

Large and continual capital outflows made it inevitable for Thailand to abandon its exchange rate peg against the U.S. dollar-dominated basket on July 2 and allow the baht to float. After dropping initially by 10%, the baht continued to falter because of intensified worries about politics, an economic package to support the new exchange regime, and weaknesses in the financial system. The fall of the value of the baht immediately raised doubts about the viability of exchange rate arrangements in neighbouring countries.

The initial victim was the Philippines, where the authorities had also maintained an exchange rate peg to the U.S. dollar. After trying briefly to defend the peg through interest rate hikes and intervention, the authorities floated the peso on July 11 and subsequently imposed restrictions on the sale of nondeliverable forward contracts to nonresidents in an attempt to limit speculation against the peso. Spillover effects spread quickly to Malaysia, where the authorities opted to allow the ringgit to depreciate rather than raise interest rates, and also to Indonesia, where on July 21 the rupiah fell sharply within the official intervention band. Subsequent measures to tighten liquidity conditions in Indonesia failed to stem the growing exchange market pressures, and the authorities allowed the rupiah to float on August 14. At the time of the rupiah's float, the Thai baht weakened by a cumulative 18% against the U.S. dollar, compared with more moderate falls of other ASEAN-4 currencies of around 10%.

The situation, however, worsened markedly in September and October 1997, reflecting concerns about the effects of currency depreciation and higher domestic interest rates on highly leveraged, corporate- and financial-sector balance sheets and about the authorities' commitment to

implement policies needed to restore exchange rate stability. The imposition of controls on capital outflows during the crisis further undermined investor confidence. Although hedge funds played a role in the crisis of the Thai baht, they were not a major driving force behind the downward pressures on ASEAN currencies in the third quarter of 1997. Instead, domestic investors, debtors seeking to hedge their foreign-currency exposures, and international commercial and investment banks played important roles in paring down domestic currencies. By mid-October, the cumulative declines of currency values versus the U.S. dollar exceeded 30% for Indonesia and Thailand and 20% for Malaysia and the Philippines.

As the Southeast Asian crisis deepened, spillover effects began to spread to other countries in Asia, reflecting the same concerns (export competitiveness and the soundness of the financial system). The Singapore dollar and the New Taiwan dollar weakened moderately in July, and the Hong Kong dollar came under temporary attack in early August. A financial crisis in one part of the world can easily occur in other parts of the world for three primary reasons. First, financial markets around the world are linked with each other to a large degree by technological advances. Second, owners of surplus funds ordinarily diversify their investments to different countries or continents in order to maximise returns while limiting risks. Third, a financial crisis in one country or continent typically has an adverse psychological impact upon investor confidence in other countries or continents. Therefore, globalization of financial crises, as a result, for example, of the crisis in Southeast Asia, can occur as no surprise.

Table 10.4 demonstrates that the 1997 reduction in developing countries' net private capital inflows were entirely due to the financial crisis in Asia. Within Asia, Thailand was not the only country which saw a drastic plunge of net capital inflows. The Philippines, Indonesia, and Malaysia were in a similar plight.

## Consequences

Ordinarily, foreign capital serves as a crucial driving force in most developing countries' economic development. The pace of economic growth in the ASEAN-4 therefore slackened to a marked extent in 1997, as displayed in Table 10.2. Industrial countries, on the other hand, were largely unaffected. Given a prolonged recession in Japan since the bubble burst, it remains uncertain how much of its economic slowdown in 1997 can be attributed to the Southeast Asian financial crisis.

The correlation between net capital inflows and economic growth is



reconfirmed by the data in Table 10.5 and Table 10.2. In the 1997 crisis, Thailand suffered the most, as net private-capital outflows reached 10.9% of GDP, the total opposite of what had happened six years earlier (a time which had seen net inflows of 8–12% of GDP per annum). The high percentage of outflows explains why the Thai economy came to a standstill in 1997, while other ASEAN members' economies encountered only minor setbacks. Meanwhile, the momentum of the economic downturn was more than enough to offset the inflationary impact of currency depreciation.

## Lessons

One very important reason why Thailand spearheaded the Asian financial crisis is that not only did a dominant portion of its external debts belong to financial markets which were highly sensitive to up-to-date news (unlike foreign direct investment) but an enormous share of those financial debts were short-term (Table 10.3), making the country's financial status extremely vulnerable to changes in market sentiments. Consequently, a sudden decrease of investor confidence can, and did, spur foreign creditors or investors to immediately retrieve their funds. Simultaneously, once panicked by possible or further currency devaluation and therefore more debt burden, short-term debtors rushed to terminate, instead of rolling over, their external-debt obligations. These pressures generated the primary momentum behind detrimental net capital outflows from Thailand in 1997.

It should be noted that the Southeast Asian crisis differed from many previous crises in that the affected countries had high savings rates and government surpluses. However, their excessive investments, rigid exchange rates, a too-early domestic financial liberalisation, a lack of transparency, and ineffective law enforcement created doubts among traders and speculators about the sustainability of stable exchange rates. The resulting vulnerability to capital outflows was reinforced by heavy reliance upon short-term external debts.

Korea serves as another good example of excessive investment, lax discipline, government intervention, and high vulnerability. Large corporate conglomerates (*chaebols*) opted for heavy dependence on debt instead of equity finance. Corporate entities that encountered financial difficulties were kept alive by debt rollovers that were often demanded by government authorities. The vulnerability of the banking system was increased by large exposures to *chaebols*, compulsory lending to small- and medium-sized enterprises, politically influenced lending, and credit channeling from abroad. Therefore, a large number of Korean firms received

increasing amounts of short-term foreign-currency debts, little of which were hedged.

The management, supervision, and regulations of Korean financial institutions paid too little attention to prudent analysis and containment of risks. According to unofficial estimates, at the end of 1996 the Korean banks' nonperforming loans, their net of reserves, already reached 70% of their equity, indicating very poor assets quality. During 1997, an unprecedented number of *chaebols* declared bankruptcy as a result of several factors, including excessive investment (in such sectors as steel and autos) and cyclical downturn.

Strong government intervention (via directed credits, regulations, and subsidies) heavily influenced Korean industrial structure. Worse, true fiscal positions were not as tight as they appeared to be, because of extra budgetary and quasi-fiscal operations. The resulting lack of market discipline contributed to the unproductive or excessive investment that played an important role in the buildup to the crisis. Fortunately, those substantial short-term external debts of Korea were clustered among few conglomerates, so debt renegotiations were much easier and more successful than renegotiation attempts in Indonesia, where not only were debts widely scattered but political instability debilitated investor confidence.

Singapore, in contrast, was least affected by the recent capital accounts crisis because it had prudent banking regulations and rigorous supervision. Neither cronyism nor nepotism nor corruption distorted the allocation of resources. Public officers acted as referees, not participants, in the market, and good transparency functioned to check abuses of power and privilege.

Even though Singapore faced considerable net outflows of portfolio investment in 1996–97, such events represented temporary market reactions to export downturn (especially in electronics) and to the Asian financial crisis. Given that Singapore has a firm command on economic and institutional fundamentals, those disturbances turned out to be only transitory.

In the countries most affected by the crisis, the key factors that led to the difficulties can be summarised as follows. First, the failure to dampen overheating pressures manifested itself in large external deficits and property and stock market bubbles; second, too long a peg of exchange rates encouraged excessive foreign borrowing without hedging; third, formats of foreign borrowing mattered very much in that short-term debts generated extreme vulnerability while foreign direct investment was much less vulnerable; fourth, lax rules and financial oversight precipitated the deterioration of banks' assets quality; fifth, poor transparency induced speculation; and sixth, political disarray and uncertainties weakened investor confidence.

## Outlook

In 1998 and 1999 the U.S. Federal Reserve is likely to raise its interest rate for the following reasons. Thus far, several economic data demonstrate that the U.S. economy is nearing the peak of its business cycle. For instance, the unemployment rate dipped to the lowest level in two decades. Elevating interest rates will certainly serve as a preemptive measure against inflation. Even though it has been argued that various U.S. industrial sectors have already achieved considerable restructuring, benefiting from advancement in technology, records in the past rarely indicate that incremental worker productivity outstrips inflationary pressure for a long period of time. It is the pace of inflation, instead, that tends to persist, if it is not subdued at its beginning. Once the U.S. starts to hike its interest rate, the Asian financial crisis will deteriorate as the U.S. now serves as a vital export market for most emerging Asian countries. Worse, higher interest rates will accelerate recycling of funds back to the U.S.

What is more threatening is the shifting of capital flows towards Europe, mainly because of currency unification in 1999. Regarding minimal exchange risks and the sustainability of the Euro, under the new tightly linked Euro currency system, European business entities will receive better credit ratings from international capital markets owing to firm currency commitments of credible monetary authorities, such as the Bundesbank and the newly established European Central Bank. Moreover, given that European corporations are inclined to hinge more upon commercial banks' funding than their American rivals, who typically lean towards debentures and securities issuances, international financial institutions will be tempted to feed more funds to European corporations than those elsewhere. Unsurprisingly, the IMF believes that the Middle East and Europe will represent the only region which receives more net private capital inflows in 1998 (Table 10.4).

Asia, in contrast, is suffering the loss of investor confidence after the financial crisis in 1997. Its total net private capital inflows plunged from U.S. \$102.2 billion in 1996 to U.S. \$38.5 billion in 1997 and only U.S. \$1.5 billion in 1998. Such a drop was largely attributed to short-term net outflows, while sizable net portfolio outflows were also distressing. The situation in 1998 would be the reverse of that in 1996 except for foreign direct investment, which remains firm, reflecting promising long-term prospects as viewed by foreign direct investors.

Another factor which may aggravate the Asian balance sheet is that the Euro currency unification requires stringent fiscal and monetary policies on the part of the eleven participating member governments. Therefore, higher interest rates are expected in Europe, attracting or re-

trieving funds from Asia. Meanwhile, in the midst of a bleak status, the suffering Asian economies are not expected to raise their interest rates further, so they can hardly count upon interest rate differentials as a means to capture foreign capital. Instead, they have to upgrade their economic fundamentals to a satisfactory and sustainable level; otherwise foreign investors may shift their funds elsewhere.

One notable feature in 1998 and 1999 is that the east Asian countries which are hard hit by the financial turmoil – Thailand, Indonesia, and Korea – will score current account surpluses as a result of their imports declining more than their exports. What is questionable is whether these surpluses are adequate to compensate for net capital outflows. If not, the consequential balance-of-payments deficits will exacerbate the prevailing financial distress as well as declining investor confidence.

## Thailand

As Thailand's financial crisis triggered a series of economic difficulties in several East Asian countries, it is worth investigating the causes in detail. To be included as well are sociopolitical characteristics and private-public interactions, some of which are common across Asian cultures.

Two central policy issues, the exchange rate and the handling of problems at private financial institutions, deserve strong attention, since not only did they involve various parties and generate widespread repercussions, but they actually spurred critical tension in financial markets and weakened investor confidence to a large degree.

In 1990 Thailand started recognising Article VIII of the IMF, which led to three rounds of foreign-exchange control liberalisation (in May 1990, April 1991, and February 1994). Another pivotal episode was the establishment of the Bangkok International Banking Facilities (BIBF) in March 1993 to serve as a groundwork for international banking services and for mobilising capital across borders to support regional economic growth. According to the Bank of Thailand (BOT), the underlying rationale for establishing the BIBF was more competition and the development of the financial system. An immediate question is whether the BOT was aware that, once the local exchange rate was not market-determined, opening up the country's capital account would totally nullify the effectiveness of monetary policies, since capital inflows (or outflows) induced by higher (or lower) domestic interest rates would cancel the intended tightening (or loosening) of domestic liquidity. Conceptually, the only discretionary instruments that remained effective were the exchange rate and fiscal policy.

Three perplexing points about BOT's actions are as follows. First, ac-

ording to internal reports, before starting BIBF, BOT was well aware that liberal capital transactions would limit the capability of monetary policy if exchange rates continued to be tightly pegged to the basket. Second, the basket-pegged exchange rate policy, which was initiated in 1984, was kept in use by BOT even after the capital account was liberalised and BIBF went into effect. Third, fiscal policy was largely neglected as a means to tone down looming inflation and current account deficits. Instead, the BOT resorted to higher interest rates in order to contain credit expansion and expenditures. Eventually, influx of capital, induced by interest rate differentials and minimal exchange risks, instigated the overheating of the economy.

Given that the authorities knew beforehand that a liberalised capital account could negate monetary policy, their hesitation to float exchange rates must have been an outcome of conservatism and/or business and political influences, particularly those hinging heavily upon external debts. One excuse for restricting exchange rate movement was to avoid bankruptcies of debtors and to uphold the credibility of the nation. However, a vicious circle and greater difficulties occurred, as rigid exchange rates further encouraged foreign borrowings or higher external indebtedness, which magnified the risk of bankruptcies, lower credibility, and other financial disruptions if a floating exchange rate regime was chosen. Therefore, several parties voted for postponing a flexible exchange rate system again. In short, these exchange rate predicaments of Thailand demonstrate two prominent lessons for developing countries. First, a policy should be continually consistent. For example, if foreign exchange funds are allowed to move in and out of the country liberally, their prices or exchange rates ought to be determined by market force or ought to be given a degree of freedom equal to the market. Second, once any policy change is deemed conceptually proper, it should be immediately implemented. Delaying it for whatever reasons tends to complicate an already overheated economy.

Another controversial function of the BOT was to rescue ailing private financial institutions. Despite rapid advancement in banking and financial liberalisation, the BOT maintained its long-held responsibilities not just in monetary policy but also in safeguarding private financial institutions. The latter involves regulations, supervision, and provisions of assistance. In 1985 a special unit called the Financial Institution Development Fund (FIDF) was created and attached to the BOT. Its primary duty was to rehabilitate and develop a financial system in order to attain stability. In principle, FIDF was supposed to offer assistance to ailing banks or finance companies by using various formats, e.g., providing temporary emergency funds, purchasing shares in case of recapitalisation, transferring assets and liabilities, organising mergers and acquisitions, and par-

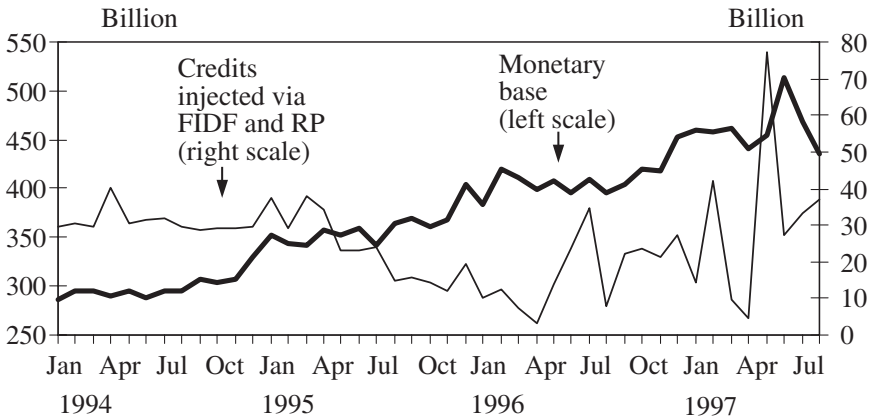


Figure 10.2 Bank of Thailand's Rescue Credits  
Source: Bank of Thailand.

ticipating in management teams. But, in fact, most assistance from FIDF took only two forms, i.e., providing emergency funds and holding stakes in ailing firms or banks. For its funding, FIDF tapped only short-term funds via either repurchasing or entering interbank markets or issuing short-term notes. Whenever FIDF could not obtain enough funds, it often resorted to BOT, as if BOT served as an underwriter.

Various excuses were quoted for FIDF's extension of liquidity aids, e.g., bank runs as a result of political instability, closure of some finance companies, the flotation of the exchange rate. In essence, the BOT offered liquidity funds to problem banks and finance companies in order to avoid panic and maintain confidence as well as stability in the financial system, because in Thailand there was no deposit insurance corporation. Consequently, before the mandate of the IMF, the BOT tried its best to restore ailing private financial institutions.

Even though preserving stability of financial institutions facilitates development of the financial system, the rescue operations undertaken by FIDF as mentioned above should not belong to a central bank's territory, since they could easily interfere with appropriate monetary policy. In Thailand, such interference was immediately evident. Figure 10.2 shows that, before the financial crisis in 1997, when looming current account deficits and inflation needed to be corrected by deceleration of the growth in money supply, credit extension from FIDF did the opposite, for the sake of healing problem banks and finance firms. In other words, amid the dilemma of stability at the micro- or macrolevel, the BOT opted for the former at the expense of the latter. The bank's choice was the second example of BOT's policy inconsistency. Worse, rescuing those

financial patients at their nearly final stages tended to be futile in various respects and subsequently generated numerous adverse repercussions.

Problems of commercial banks and finance companies in 1994–96 stemmed from mismanagement spurred by untimely financial liberalisation. New practices, new units (such as BIBF), and enormous capital inflows gave rise to strong competition. Such pressures, together with domestic financial institutions' inadequate experience, led to excessive and improper credit extension (e.g., in property sectors) without careful screening of a project's viability and its likely risks versus returns. The economy was therefore overheated and, like the Japanese economy, finally reached the bubble status. Overinvestment was fueled by imprudent banks and finance companies, which eventually encountered record high levels of nonperforming loans, 35% of commercial banks' and 60% of finance companies' outstanding credits.

If more efficient and forceful supervision had been done by bank regulators, the crisis may not have occurred, or if it had, it would have been less severe. In the midst of a high-tech financial era, bank examiners and regulators need to thoroughly understand banking and business risks and to move as quickly as possible in dealing with bad loans and financial mismanagement. In Thailand, however, the examiners and supervisors took up to a year to detect and notify the suspected or guilty banks or finance firms. Problems thus became too difficult or too late to solve. In most cases, aids from FIDF did not help rectify the roots of the problems. They only palliated the symptoms at the final stage while exacerbating macroeconomic imbalances. That was why the IMF demanded a termination of continual aids from BOT to ailing financial institutions.

Maturity mismatching by FIDF created strong distortions in local money markets. Since a large portion of assistance from FIDF came in the form of equity holdings in ailing financial institutions, it should have been funded by long-term borrowing, such as government bonds or securities. Instead, FIDF resorted to short-term borrowing, engendering pressure upon domestic liquidity. Such maturity mismatching aggravated the high interest rate environment as prescribed by the IMF.

Given that the policy discretion of FIDF was not transparent, various sources claimed that BOT provided preferential treatments to particular banks and finance companies because of its close connection to or acquaintance with the involved executives. In addition, political influences played some roles in the BOT's determination of which finance firms should or should not be entitled to receive assistance from FIDF. In any case, one distinct defect of rescuing private financial institutions was the moral hazards among executives in the financial circle. Once those executives learned that the central authorities could hardly let any financial institution go under, they were inclined to take more risks and be less

cautious. This generated a vicious circle for the BOT: the more it helped remedy ailing finance companies, the more risks other companies took and, as a result, more firms began to ail.

As formally recommended by a special commission scrutinising the BOT, regulating and supervising private financial institutions should be the responsibility of an organisation separate from the BOT, such as a deposit insurance corporation (like the FDIC in the United States), which acts as a risk evaluator and (partial) guarantor for deposits. Segregating an FDIC from BOT will resolve the policy dilemma at BOT. Meanwhile, the process of supervision at an FDIC should be quick and transparent, which will stimulate the market force to compel problem banks and finance firms to rectify themselves. Otherwise, they will receive lower ratings and fewer guarantees from the FDIC. This process will be unlike those of FIDF and BOT, which revealed nothing but guaranteed everything (including principal plus interest).

## Indonesia

Before encountering the financial crisis in 1997, the suffering Asian countries had to cope with five similar problems: high current account deficits, large short-term external debts, weak financial institutions with high proportions of nonperforming loans, inflexible exchange rates, and political uncertainties. It is therefore tempting to conclude that these problems were the primary causes of the financial debacle. But after detailed scrutiny, one will find that the genuine origin of the crisis lies in the mismanagement of capital flows and the mishandling of financial deregulation. Such errors were outcomes of improper or inconsistent macroeconomic policies (i.e., monetary and fiscal policies as well as those concerning exchange controls and the exchange rate), the immaturity of market participants and regulators, and market distortions instigated by the state. The Indonesian experience substantiates this hypothesis.

Between 1990 and 1996 the widening current account deficits of Indonesia were the result of overinvestment in land-based industries (hotels and tourist resorts, amusement and industrial parks, real estate, commercial buildings and shopping malls), in excessive infrastructure projects, and in other nontradables. Those investments were made possible or largely funded by external private debts which would not have been so attractive if exchange risks had been high or domestic interest rates had been kept low. And pressures on current account balances would have subsided to some degree if fiscal expenditures had been adequately curtailed. Instead, the lack of appropriate policy coordination engendered



excessive spending to such an extent that foreign creditors started to doubt the country's financial credibility and therefore withdrew their invested funds.

Despite the absence of capital controls, the authorities did not float the rupiah exchange rate until August 1997. The rupiah was very much tied to the U.S. dollar via a basket of currencies. On some occasions, it was devalued against the U.S. dollar (by 50% in November 1978, by 40% in June 1983, and by 31% in September 1986). To encourage inflows of foreign investment, between January 1979 and December 1991 Bank Indonesia (BI), the central bank, extended a subsidy on exchange rates to domestic borrowers. Under the so-called exchange rate swap facility, banks, nonbank financial institutions, and customers with foreign exchange borrowing contracts were provided with forward covers.

Ordinarily, BI specified its "intervention band" around the central rate, within which it was ready to intervene in order to support its exchange rate. Between 1992 and 1997, BI widened the intervention band six times as a means to generate some exchange risks and allow more degree of freedom for the monetary authorities to exercise control over monetary aggregates. However, continual encouragement from the state, together with rather rigid exchange rates, led to a surge in private-sector foreign borrowings throughout the 1990s. Indonesia's external debts thus grew rapidly from U.S. \$66.9 billion in 1990 to U.S. \$131.4 billion in 1997, or around twice the size of its exports' value. Of this amount, roughly half was private and short-term, with an average maturity of 1.5 years. Most of the private sector's external borrowings were explicitly or implicitly guaranteed by the state. These included foreign borrowings to finance infrastructure projects largely owned by politically well-connected groups.

Other than capital account liberalisation, financial deregulation was another primary cause of the crisis. Interest rates were liberalised in June 1983, and other restrictions were relaxed since October 1988, e.g., regulations on asset portfolios, reserve requirements, new entrants, privatisation, and greater access to offshore markets. The market environment became more competitive not only because of new entrants but also because of easier credit access for all concerned parties, especially bank clients, since they could tap funds directly from abroad. Unsurprisingly, domestic credits expanded at an excessive pace, i.e., at the rate of 24.3% per annum between 1992 and 1996. That was partly responsible for the growing current account deficits. More worrisome was that banks engaged themselves in riskier activities. And, worse, their inexperienced officers, together with an inadequate capital base, gave rise to high proportions of bad debts and insufficient loan loss provisions or coverage.

One driving force behind such ominous risk taking was that foreign banks and a larger ownership by foreign investors of domestic assets were allowed to penetrate the domestic economy.

Clear-cut examples of the immaturity of Indonesian banks and their customers were mismatches of maturities and currencies. When domestic interest rates were high, there was a strong temptation to borrow in short-term foreign currencies to fund longer-term projects. The risks of maturity mismatching were particularly strong for unlisted banks, which had no access to mobilising long-term funding via shares, bonds, or securities. Given that the rupiah depreciation was historically predictable and rather low, a large portion of the external debts were unhedged. The resulting exchange rate vulnerability, in addition to poor risk management, represented the shortcomings of Indonesian commercial banks. In other words, they were not ready to successfully cope with financial deregulation as well as with an open capital account.

Problems of bad debts were particularly severe at state-owned banks, since they offered subsidised credits to government projects or acquiesced in erratic government policies. As of November 1996, 68% of the banking system's bad debts belonged to state-owned banks. Protected from closure on constitutional grounds and having their losses covered by the public budget, these banks tended to be overstaffed and to have overextended branching networks. Meanwhile, the lack of incentives and lending skills (including risk appraisal) made these state-owned banks' performances far inferior to those of their private counterparts.

More worrisome was the fact that the six state-owned banks controlled a sizable portion (over 30%) of bank assets in Indonesia. Given that these banks were subject to government direction, they extended special credits to particular industries and politically well-connected business groups. Overall, financial deregulation did not end government intervention in lending decisions of state-owned banks and finance companies.

On the part of the regulators, the implemented rules and regulations were very weak, partly because of structural weaknesses in the legal and accounting systems. Besides, bank regulators were both inefficient and prone to frauds as well as collusions or bribes. It was thus easy to find private banks belonging to business conglomerates and offering leniency to affiliated companies.

The absence of a deposit insurance scheme or bailout programme allowed Bank Indonesia (BI) to provide supports to ailing banks on an ad hoc and nontransparent basis (which was similar to the Thai case). These supports included capital injection, liquidity credits, and emergency assistance. It turned out that BI's supports to distressed banks grew rapidly, weakening moral discipline in the financial system while aggravating the

macroeconomic imbalances (inflation and current account deficits) of the country.

Partly responsible for the widening external deficit was fiscal behaviour. Though the government often had budget surpluses, these surpluses were not adequate to counter the rapid expansion of “off-budget expenditures” and government-sponsored projects. There were no data on these “off-budget expenditures,” but the list of involved projects, e.g., in the aircraft and national car industries, showed that they were demanding as well as lengthy. Another strain on the fiscal position arose from revenue losses stemming from the introduction of tax incentives for the national car programme and other pioneering projects. In sum, while exchange rate and monetary policies were misused via several channels, no appropriate fiscal measures were undertaken to counteract the adverse macroeconomic effects.

## Malaysia

Malaysia differed from its Southeast Asian neighbours in that it gave stronger emphasis to foreign direct investment (FDI) than to other formats of capital inflows. The underlying reasons were not only financing and technology transfer but also marketing. Reciprocally, Malaysia’s well-developed infrastructure and administration, together with its well-educated workforce, were attractive to most foreign direct investors seeking locations for their production plants overseas. Therefore, the statistics in Table 10.5 are not surprising. In 1989–95 Malaysia’s FDI/GDP (6.5%) far exceeded those of the Philippines (1.6%), Thailand (1.5%), and Indonesia (1.3%). This larger percentage allowed Malaysia to depend less upon external debt than its ASEAN-4 neighbours, both in absolute terms and in terms relative to GDP (see Table 10.3). In other words, owing to its preference for long-term capital, Malaysia was, among the ASEAN-4, the least vulnerable to volatility in international capital markets. Nevertheless, exchange control liberalisation in December 1994 (allowing residents to hold foreign currency accounts) and the June 1995 measure (which liberalised the capital markets) added more uncertainties to the streams of cross-border transactions.

Although FDI had several benefits as mentioned above, it engendered considerable repatriation of profits (or investment income) as a large debit item on the invisible (or services-plus-transfers) account. Other sizable net payment items on such an account were insurance and freight. Local companies providing transport services, such as the Malaysian International Shipping Company, did not expand as fast as trade. In fact,

these investment income payments because of FDI and shipping were so plentiful that they made deficits on the invisible account larger than Malaysia's trade surpluses in the early 1990s. In other words, Malaysia's current account deficits were then largely attributed to service payments.

After the 1995 liberalisation, private-sector external debts more than tripled commercial banks' foreign liabilities between 1995 and 1997. More worrisome was that only a quarter of the total Malaysian bank lending went to manufacturing, agriculture, mining, and other productive activities. In the stock market, there was no evidence of fund raising for productive investment. In contrast, a considerable portion of corporate foreign borrowings were overinvested in "nontradables," aggravating the prospects of the country's current account.

Almost every party agrees that, other than capital account and financial liberalisation as well as imprudent supervision of banks, the rigid exchange rate or excessive pegging to the U.S. dollar was another significant factor instigating widespread currency speculation and subsequent turmoil. After the Thai baht was floated on July 2, 1997, the Malaysian authorities rushed to defend the nation's ringgit. Such efforts demonstrated the underlying interests of those responsible for substantial increases of unhedged short-term borrowings in U.S. dollars from abroad by politically influential business groups. According to the BIS estimate in 1997, well over half of foreign borrowings in east Asian countries were short-term: in Malaysia, 56%; in Thailand, 66%; in Indonesia 59%; and in South Korea, 68%. These short-term debts raised the degree of the debtor countries' vulnerability to capital flight. It thus came as no surprise that the continual surge in value of the U.S. dollar, to which the ringgit and other Southeast Asian currencies were pegged, sparked a stream of capital withdrawals and financial meltdown in 1997.

The ominous savings-investment gap in 1997 was exacerbated by Malaysian direct investments abroad. Such investments were frequently encouraged by the government and sometimes involved abuse of inter-government relations to favour Malaysian investors, e.g., in logging. There were also strong reactions to the cabinet's decision to rescue selected businessmen by utilising employee-provident funds, because the government failed to ensure clear-cut transparency and accountability in the use of the facility. Various other adverse incidents were quoted as outcomes of nepotism and cronyism.

After the 1997 financial crisis, policy responses on the fiscal front raised some doubts about the government's credibility and suggested that part of the crisis may have been attributed to similar policy errors in the past. In the 1998 budget there was little evidence of belt-tightening as far as government expenditure was concerned. For instance, a lower, instead

of higher, corporate income tax was unlikely to bring about lower consumer prices. (But the government asserted that it would.) Also, trade taxes were increased and nontariff barriers reintroduced. But in view of the much cheaper ringgit and the slowdown in car sales, these measures seemed unnecessary. The higher taxes on imported cars and CKD units mainly favoured Proton and Perodua, the government's national cars, which had not made much progress in overseas sales. The government also did not take an opportunity to cancel most of the postponed megaprojects which were economically indefensible (e.g., the Genting-Cameron's Highland Highway, the Northern Regional International Airport, and the Malacca Straits bridge to Sumatra). Such reluctance by the government did not inspire confidence in official policy responses to the financial crisis. Worse, it has become increasingly evident that the government's fiscal surplus in recent years was not due to either taxes or expenditures but to sales of public assets as part of its privatisation policy. The assets were sold often in dubious circumstances or at heavily discounted prices, with a negative impact on economic and social welfare.

## Philippines

Statistics from the Philippines' national income account as displayed below reveal two outstanding features of the economy. First, in the early 1990s, before the Asian financial crisis, the Philippine economy grew at the slowest rate among the ASEAN-4. That must have been an outcome of various economic prescriptions from the IMF, which offered several rounds of financial assistance during past crises. Unlike its ASEAN neighbours, being able to contain the pace of its economic growth helped the Philippines restrict the extent of its current account deficits and currency speculation. Unsurprisingly, in the second half of 1997, after the devaluation of the Thai baht sparked the devaluation of other currencies in the region, the Philippine peso lost almost the least value (−16%), as compared to the Thai baht (−22%), the Indonesian rupiah (−20%), and the Malaysian ringgit (−10%).

Second, the Philippines' gross national savings relative to its GNP was the lowest in the region – at 18–20% in 1991–96. This peculiar statistic has been largely explained by income, interest rates, bank availability, and the real effective exchange rate. The 1984–85 depression and the 1991–92 recession had strong adverse impacts upon household savings rates, since the 1983 real per capita income did not reemerge even in 1996. Government savings tended to be negatively related to interest rates because high interest payments represented a significant part of

government spending. Though there were a few questions about the positive correlation of bank availability and successful savings mobilisation, bank stability started to matter when competition grew as a result of financial deregulation (1981–83) and foreign-exchange liberalisation (1991–92), especially in the absence of prudent supervision and regulations. The liquidity crisis in 1981 and a severe balance-of-payments crisis in 1983, which resulted in numerous bank failures, shook saver confidence to a large extent. One study<sup>1</sup> finds the real effective exchange rate to be negatively related to the national savings rate. Another explanation for low savings is that in recent years there have been a large number of Filipinos working abroad and the amount of their remittances to be converted into pesos has partly depended on the nominal exchange rate. Meanwhile, domestic inflation has cut the peso's purchasing power and thus the incentive for conversion. Empirical evidence indicates that by 1996 the real peso, as measured by the real effective exchange rate, had appreciated 38.4% higher than it had in 1988, therefore discouraging conversion of workers' earnings from abroad.

To demonstrate the importance of inflows from Filipinos overseas (including contract workers and emigrants), one should compare annual economic growth as measured by GDP and also as measured by GNP (which equals GDP plus net factor income from abroad). While the growth rate according to the first method of measurement stayed at 5.5% in 1996, the rate based on the second surged to 6.9%. In absolute terms, the World Bank estimates funds received from overseas Filipinos at nearly U.S. \$6 billion in 1994, or close to 75% of the trade deficit and equivalent to around 9% of GDP in that year. Another peculiar item in the Philippines' invisible account – inflows through the conversion of foreign currency deposit units (FCDUs) to pesos – plays a significant role. Ever since the foreign exchange liberalisation in 1991–92, exporters of goods and services were given the freedom to place their dollar earnings in this item of the invisible account as they saw fit. Typically, they did so when they expected the peso to depreciate or appreciate in value or when there were attractive peso assets to invest in. The latter response occurred in 1994 and 1995. In 1994 the peso strengthened against the dollar, and 20% of the equity in the state oil refinery became available in the market, as well as some other attractive corporate investment opportunities. Consequently, peso conversion rose by 180% between 1993 and 1995. In 1996, with the peso stable against the dollar, the booming property market acted as a magnet.

Though remittances from Filipinos abroad have been significant in size or have been able to cushion a large portion of trade deficits, they have been highly subject to market sentiments about expected exchange rate movements, foreign-trade status, and politics. For instance, in the first

half of 1997 net factor income registered a year-to-year growth of only 19.1%, down sharply from the 91.5% recorded in the first half of 1996. The slackening was attributed largely to the jitteriness that hit the Philippine equity and foreign exchange markets in the wake of the property and banking crisis in Thailand. FCDUs were caught in a similar dilemma. They complied well with globalization and financial liberalisation. Nevertheless, they added strong momentum to exchange rate speculation and volatility, an extremely formidable problem for any small country's central bank to handle. That is so because the deposits from FCDUs have grown very rapidly in recent years, from U.S. \$2.56 billion in 1990 to U.S. \$14.52 billion in 1996, exceeding the gross international reserves of the Philippines by a wide margin.

One reason why the Philippines did not encounter as severe a foreign exchange crisis in 1997 as Thailand and Indonesia is that, among different formats of foreign capital, it, like Malaysia, resorted mostly to foreign direct investment (FDI). FDI is unquestionably less responsive to shifts in market sentiments and liquidity in the short run than are portfolio investment and foreign loans. In 1991–96 net FDI represented 50% of total net private-capital inflows to the Philippines, a much larger percentage than Indonesia (38%) and Thailand (11%). Malaysia had the highest FDI/GDP ratio, averaging 6.5% in 1989–95. In other words, FDI helped not only in fueling economic growth, financing current account deficits, and transferring technology but also in cushioning turbulent reactions to adverse market conditions.

Another crucial item is interest. Because of the Philippines' substantial and continual foreign borrowing in the past, interest payments constituted a heavy burden in the current account. Fortunately, those interest payments have tended to ease in recent years, in part because of the country's debt rescheduling and restructuring agreements (stretching maturities and counting more on official creditors) since the mid-1980's, culminating in two deals in 1990 and 1991: for debt buyback and for the conversion of some commercial bank debts to long-term bonds.

The heavy influx of foreign funds in 1994–96 provoked an overly rapid loan growth, averaging 30% per annum in 1991–96. This led to the problem of adverse selection. Banking sources indicated an increasing reliance on unaudited financial statements in the granting of new loans and an overexposure to the property sector in 1995–96, as banks became flushed with funds. The overbuilding of the real estate sector and the imminent currency crisis generated more nonperforming loans. Moral hazards, resembling those during the 1980s crisis, reappeared. After the 1997 crisis, the central authorities have been in the midst of revising various facets of financial markets, including information technology, taxation, regulations, supervision, and governance.

## Conclusion

Painful experiences suffered by Southeast Asian countries in the 1997–98 financial crisis clearly indicate that policy consistency or coordination is extremely essential for any country to survive in the current arena of mobile capital. Incidents of policy inconsistency were plentiful, and they were accountable for past crises. For example, even though these nations allowed funds to move across borders without constraints as a result of capital account liberalisation, their prices or exchange rates were kept rigid. When current-account deficits surged frighteningly as a consequence of financial deregulation and more competition, fiscal policy was ignored or not tightened. Instead, the central authorities offered aids to ailing financial institutions for the purpose of averting bankruptcies. Those aids markedly aggravated current-account deficits.

Timing is another vital issue. Before adopting any policy in whichever direction, the government ought to ensure that all pertinent parties are ready. For instance, the Asian financial crisis in 1997–98 was partly due to the fact that the Asian governments opted for financial deregulation when domestic financial institutions were too immature to cope with strong competition from abroad and the central monetary authorities were not adequately experienced in supervision and regulation. Without good timing of policy implementation, a government could easily experience vicious circles. Two of these circles occurred when flotation of the exchange rate was postponed and when ailing financial institutions were rescued.

Business and political influences are also important factors which may lead to some policy inconsistency and/or improper timing. That is understandable as decision makers in macroeconomic issues frequently encounter some trade-off. But the central authorities should constantly bear in mind that errors in macroeconomic policies regarding their consistency and timing are often difficult to rectify and tend to have a series of adverse repercussions.

The formats as well as the end uses of foreign borrowings are very crucial because they have immediate repercussions upon the vulnerability as well as the debt-servicing capacity of debtor countries. The countries which leaned towards foreign direct investment (e.g., Malaysia and the Philippines) were less susceptible than the ones which counted heavily upon short-term loans (e.g., Thailand and Indonesia). The degree of vulnerability is highly meaningful, especially in small developing countries, since capital flows are not only extremely mobile but also huge, relative to those countries' foreign exchange reserves or monetary aggregates.

In short, the financial crises that Southeast Asian countries experi-



enced were the outcomes of the mismanagement of capital flows together with the mishandling of financial deregulation.

## Notes

1. Mario B. Lamberte, Joseph Y. Lim, Rob Vos, Josef T. Yap, Elizabeth Tan, and Socorro Zingapan, *Philippine External Finance, Domestic Resource Mobilization, and Development in the 1970s and 1980s* (Manila: Philippine Institute for Development Studies; The Hague: Institute of Social Studies, 1992).
2. Asian Development Bank, *Emerging Asia: Changes and Challenges* (Manila: Asian Development Bank, 1997).

# Globalization of African Financial Markets<sup>1</sup>

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*Lemma W. Senbet*

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In March 1998, *Time* magazine ran a cover story on Africa entitled “Africa is Rising.” This coincided with positive publicity of President Clinton’s trip to Africa. That the story came out in the wake of the Asian financial crisis and the subsequent global contagion was truly remarkable. But the 1990s was, in fact, a decade of opportunities and challenges for Africa after the region’s dismal performance in the “lost decade” of the 1980s. The positive attention that the region attracted was primarily driven by fundamentals and the increasing empowerment of private initiative. The serious economic and financial reforms that took place, along with extensive privatisation programmes, have begun yielding economic upturns and increasing global attention, including a surge of global investor interest in Africa.

It is tempting to see Africa’s adoption of globalization and openness as not a long-term policy but merely a fad of the day which would now be dropped because of the 1997 East Asian financial crisis and the current crisis in Latin America. This view would be incorrect since Africa faces little choice but to integrate into the global economy. Financial market development is a crucial channel for such integration and for keeping the region at the cutting edge of the best international practices. This paper examines prospects for the globalization of African financial markets, with emphasis on the need to develop and build the capacity of capital markets. Also the paper integrates the East Asian experience into its discussion of the benefits and risks/costs of globalization.

There are serious challenges that Africa faces in its efforts in globalization and the development of capital markets. This paper catalogues some policy measures for dealing with such challenges, including the management of globalization risks and the resolution of financial crises. The paper is organised as follows. Section 1 explores capital market development and globalization by linking them with economic development. This linkage is based on the available evidence about the relationship between capital market development and economic growth. Section 2 discusses the prospects for globalization of African financial markets. It begins by discussing Africa's position in recent capital flows to developing economies. The benefits of globalization are explained, along with Africa's contribution to the global investment portfolio. Section 3 lists the main challenges facing Africa in its globalization efforts. These challenges include the risks and costs of globalization. The section then presents a brief diagnosis of the East Asian crisis, with implications for Africa. Section 4 catalogues mechanisms for meeting the challenges, with particular attention to measures for dealing with globalization risks and financial crises.

## Capital Market Development and Economic Development

As Africa moves toward integration into the global economy, the development of capital market institutions and banking sectors is crucial for accessing the benefits of globalization while controlling globalization risks (and the attendant financial crises). In fact, a strong case can be made for the development of capital markets in Africa. Well-functioning capital markets, along with well-designed institutions and regulatory systems, foster economic development. This linkage between finance and economic development is of particular interest to African economies, since it suggests an indirect linkage between capital market development and poverty alleviation along with an increase in employment opportunities. In fact, there is empirical evidence strongly suggesting that well-functioning capital markets promote long-term economic growth. In particular, studies have found that indicators of stock market development, such as market liquidity, capitalisation, turnover, efficiency of pricing, risk, etc., are positively correlated with current and future economic growth, capital accumulation, and productivity improvements.

What are the channels through which capital markets contribute to economic growth? In order to address this question, we need to have a deeper appreciation of the multiple functions of capital markets. It should be recognised that the broad functions of capital markets extend beyond the mobilisation of domestic financial resources (savings mobilisation). The dominant development view – that the financial sector is a

Table 11.1 Capital Market Development and Economic Growth  
(Stock Market Liquidity Measures: Selected Countries, Annual Averages 1976–1993)

	Turnover Ratio	Value Traded Ratio	Per Capita GDP Growth
<b>Low-Income</b>			
Bangladesh	0.015	0.000	1.89%
Côte d'Ivoire	0.028	0.001	-2.50%
Egypt	0.060	0.030	3.56%
India	0.537	0.036	2.43%
Nigeria	0.006	0.000	-0.11%
Pakistan	0.105	0.008	3.13%
Zimbabwe	0.059	0.010	-0.97%
<b>Lower-Middle-Income</b>			
Colombia	0.087	0.004	1.95%
Costa Rica	0.013	0.001	0.89%
Indonesia	0.193	0.010	4.18%
Jordan	0.154	0.085	3.01%
Philippines	0.250	0.026	0.21%
Thailand	0.739	0.144	5.90%
Turkey	0.207	0.026	2.32%
<b>Upper-Middle-Income</b>			
Argentina	0.266	0.013	0.22%
Brazil	0.355	0.041	0.65%
Chile	0.060	0.021	3.61%
Korea	0.832	0.186	9.67%
Malaysia	0.230	0.243	4.27%
Mauritius	0.059	0.003	1.76%
Mexico	0.498	0.044	0.85%
Portugal	0.108	0.014	2.85%
<b>High-Income</b>			
Australia	0.256	0.124	1.57%
Germany	0.704	0.156	0.95%
Great Britain	0.349	0.253	1.75%
Hong Kong	0.372	0.471	6.20%
Israel	0.669	0.144	1.72%
Italy	0.253	0.028	2.68%
Japan	0.469	0.406	3.42%
Netherlands	0.490	0.123	1.43%
Norway	0.318	0.059	2.48%
Spain	0.216	0.045	1.75%
Switzerland	0.467	0.442	1.16%
United States	0.493	0.299	1.67%

Sources: *International Finance Corporation*, and *Morgan Stanley Capital International*.

Turnover Ratio = value of domestic equities traded on domestic exchanges divided by market capitalization; Value Traded Ratio = value of domestic equities traded on domestic exchanges divided by GDP income classifications from the World Bank's 1995 *World Development Report*.

Low-income economies = average GNP per capita of \$380 in 1993.

Lower-middle-income economies = average GNP per capita of \$1,590 in 1993.

Upper-middle-income economies = average GNP per capita of \$4,370 in 1993.

High-income economies = average GNP per capita of \$23,090 in 1993.

mere conduit for capital mobilisation – has inspired financial liberalisation/reform programmes in developing countries, including Africa, with *undue* emphasis on the development of the banking sector. This perspective, focusing on the savings mobilisation role of the financial system, is short-sighted. In an economic environment characterised by uncertainty, capital markets provide functions beyond capital mobilisation and allow for risk allocation and risk sharing among market participants. For instance, risk sharing allows high-risk, yet high-return, projects to be undertaken; otherwise, such projects would be rationed out of the market, hence destroying, rather than creating, value for the economy.

Moreover, capital markets can provide for efficient contracting among conflicting parties and for the disciplining of corporate insiders. These market functions are vital in an environment with imperfect information and incentive problems, which are likely to prevail among various stakeholders: managers, shareholders, creditors, government officials, etc. (see Figure 11.1). In advanced economies, for instance, capital markets are used

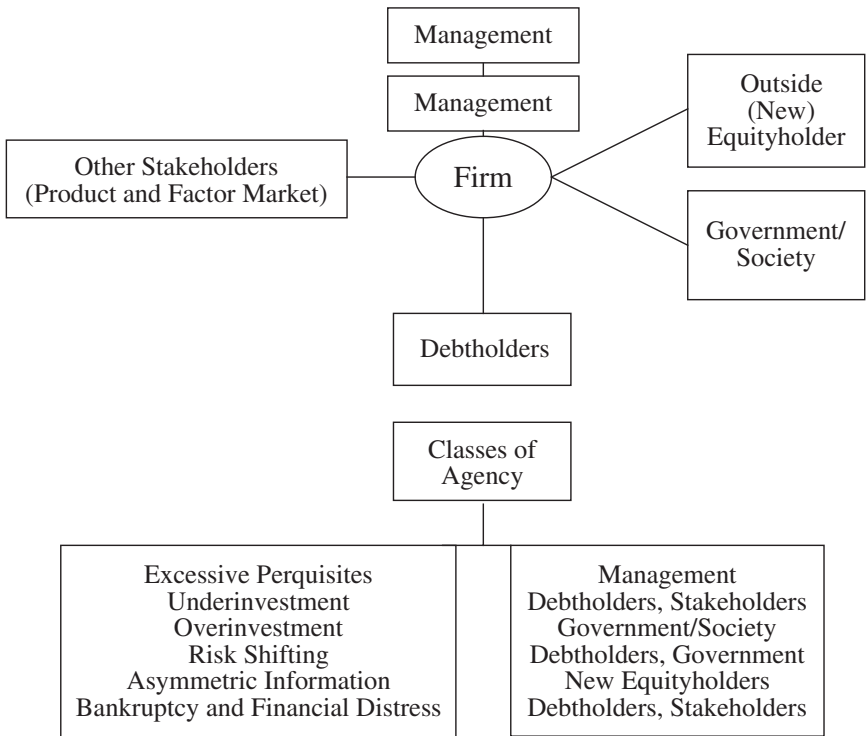


Figure 11.1 The Firm (Corporation): A Network of Contracts  
 Source: John Kose and Lemma W. Senbet, “Corporate Governance and Board Effectiveness,” *Journal of Banking and Finance* 22 (1998): 371–403.

to provide powerful control mechanisms and help correct inefficiencies that arise from distortionary incentive conflicts between decision makers and other stakeholders.

Thus, policy makers need to be aware about multiple functions of capital markets in designing mechanisms for efficient functioning of these markets. The depth of capital market reform and development must be determined by the *efficiency* with which the various *functions* of capital markets are carried out. For instance, the mere establishment of *stock exchanges* is of no consequence if the environment is hostile to opportunities for risk sharing and liquidity provision and transformation. Stock markets are mainly exchange mechanisms for secondary trading in stocks. In a secondary market, liquidity and information production are paramount in enhancing capital market development and a well-functioning financial system. By the same token, the mere existence of banks is of little value if the purpose of their existence is merely to purchase government securities at the expense of commercial lending. In fact, a dearth of commercial lending prevents banks from serving as informed agents or intermediaries on behalf of the society and hence from building vital information capital for efficient allocation of resources. Unfortunately, this pattern of financial *dis-intermediation*, or dysfunctional intermediation, is widely observed in Sub-Saharan Africa.

Consequently, it is imperative to use the multiple functions of capital markets as guiding principles in capacity building and globalization. We categorise the principal functions and discuss them briefly as follows.<sup>2</sup>

### *Capital Mobilisation*

Capital providers may often desire liquidity (ability to exit on short notice) along with attractive returns commensurate with an underlying risk, while entrepreneurs need to commit capital to long-term investments. Capital markets resolve these conflicting needs through risk pooling and through providing alternative instruments to facilitate diversification and allow for maturity transformation.

### *Risk Management and Resource Allocation*

In an environment where uncertainty prevails, a financial system provides risk sharing and insurance. High-return, yet high-risk, investment projects may not be undertaken because they could be too risky for one investor to bear. A well-functioning financial market enables multiple investors to share a project's risk, allowing high-risk, high-return investments to be undertaken. As a result, capital markets help facilitate *allocational efficiency*: in the absence of risk-sharing arrangements, high-risk,

high-return projects may be avoided, resulting in a lowering of the value of firms and the economy.

How do capital markets allocate risk? They do so through various mechanisms on the basis of investor risk preferences. Investors' trade risk is based on their comparative advantage. With an expanded menu of risk-sharing opportunities provided by markets, investors can slice away *unwanted* risks and acquire *wanted* risks. This is not to say that more sophisticated economies need more sophisticated capital markets. Such an interpretation fails to recognise the fact that risk-sharing arrangements are jointly determined by needs, the level of uncertainty, and financial opportunities. In African economies, because of missing markets and institutional failures, the need for enhanced risk-sharing opportunities might be even greater because of the greater uncertainty that agents face in such an environment. These arguments point to a financial sequencing fallacy which implies that African economies should follow the same path as developing markets: from a primitive economy to an advanced one. This fallacy currently directs policy debates toward the more standard financial instruments and away from the nonstandard but potentially vital instruments. Other emerging regions have recognised this fallacy. For instance, there has been a remarkable success in derivative markets – both organised and over-the-counter (OTC) – in such emerging economies as Brazil, Argentina, Mexico, Malaysia, Thailand, Indonesia, etc.

### *Governance and Control*

Capital markets promote efficient governance and control of an organised enterprise. They exert external pressure and discipline on the operation of an enterprise, particularly a corporation whose shares are traded in stock markets. Specifically, capital markets serve as an informational thermometer (signal) for managerial performance and exert discipline on managerial behaviour through monitoring and takeover mechanisms.

#### *Monitoring*

Potential conflicts exist between managers and shareholders (owners of capital), between shareholders and creditors, between private capital contributors and the society at large, and even between political operators and taxpayers (see Figure 11.1). Left alone, each group seeks to maximise its own interests, often to the detriment of the overall economy. Control mechanisms are needed to manage these conflicts in order to achieve allocational efficiency. Capital markets can provide control and monitoring mechanisms for suboptimal behaviour through price discovery, which allows for the transmission of negative information (mon-

itoring) and often puts pressure on management to take corrective action (controlling).

### *Takeover Mechanisms*

A well-functioning economy allows for active contests for corporate control so that resources are controlled by those who create the most value for the stakeholders and, ultimately, for the society at large. Capital markets provide control mechanisms to correct inefficiencies arising from incentive conflicts between decision makers and other stakeholders. They do so through providing price information that uncovers firms that could be targeted for takeover and through enabling active trading for the transfer of control. Inefficient management is typically removed through takeovers which allow raiders to accumulate shares in the open market and thus take control of the corporation. Often, just the threat of a takeover is a powerful mechanism for disciplining management.

### *Promoting Globalization*

Another function of capital markets is to promote the inflow of international capital, or accelerate the process of *globalization*. An efficient financial structure is critical in accessing global markets for capital, thereby lessening reliance on foreign aid. Capital knows no borders. The very ingredients that attract foreign capital are those that retain domestic capital.

The development of capital markets in Africa can provide a country with a competitive position for accessing foreign portfolio flows and for moving away from the already shrinking aid flows. Consequently, the financial-market (capital-market) infrastructure should be conducive to accessing the services of international financial markets as a means of attracting international capital and thus moving beyond the mobilisation of domestic resources.

## Prospects for the Globalization of African Financial Markets

What are the prospects for the globalization of African markets? What are the benefits and risks of globalization? These questions are central to this issue-oriented paper. We begin by positioning Africa in the overall scheme of international capital flows to developing economies.

### *Trends in Capital Flows to Sub-Saharan Africa*

There has been a massive flow of private international capital to developing countries resulting from the opening of the world economy in the



1980s. Interestingly, the fastest growing components of these flows have been equities and bonds (*portfolio flows*), suggesting a radical shift in the pattern of capital flows. Africa was left out of these dynamic portfolio flows. Although development-financing flows have declined over time, Sub-Saharan Africa continues to receive the largest and fastest growing proportion of development finance. On the other hand, *foreign direct investment* has been relatively stable and actually grew throughout the 1980s and 1990s. Overall, however, FDI has been the dominant component of *private* flows to Sub-Saharan Africa. But it is highly concentrated, with the bulk of it being channeled to the four resource-rich countries – South Africa, Nigeria, Angola, and Ghana.

*Portfolio equity* flows to Sub-Saharan Africa were nonexistent prior to 1992. It is encouraging, nevertheless, that they have begun showing up, although they are still small in comparison to other emerging markets. The positive development in portfolio equity opens a *window of opportunity* for the globalization of Africa. For example, global investment funds have begun to target Africa. There are now about twenty Africa-oriented funds trading in Europe and America (e.g., from Morgan Stanley and Citibank).

Thus, with guarded optimism for further development, it is now appropriate to look into the prospects for the globalization of African financial markets.

### *Benefits of and Motives for Globalization*

Why is Africa of potential interest to international investors? It is only rational that international investors take a global view regarding their portfolio investments. Consequently, they evaluate their investment portfolios on the basis of a global risk-reward ratio. The basic questions are: 1) How can Africa improve the *global risk-reward ratio*? 2) What are the benefits of globalization to Africa?

### *Benefits of Global Risk Diversification*

Investors benefit from portfolio diversification across national boundaries, to the extent that there is *diversity* in the economic cycles of countries. Take the case of U.S. investors, for example. They would benefit from diversifying their investment portfolios globally, since the U.S. economy does not move in tandem with the economies of the rest of the world. It is unwise for U.S. investors to put all of their “eggs in the same basket.” The optimal investment strategies are global. There is growing evidence that such global strategies should include investing in emerging markets, and even in *preemerging* markets, such as those in Africa.<sup>3</sup>

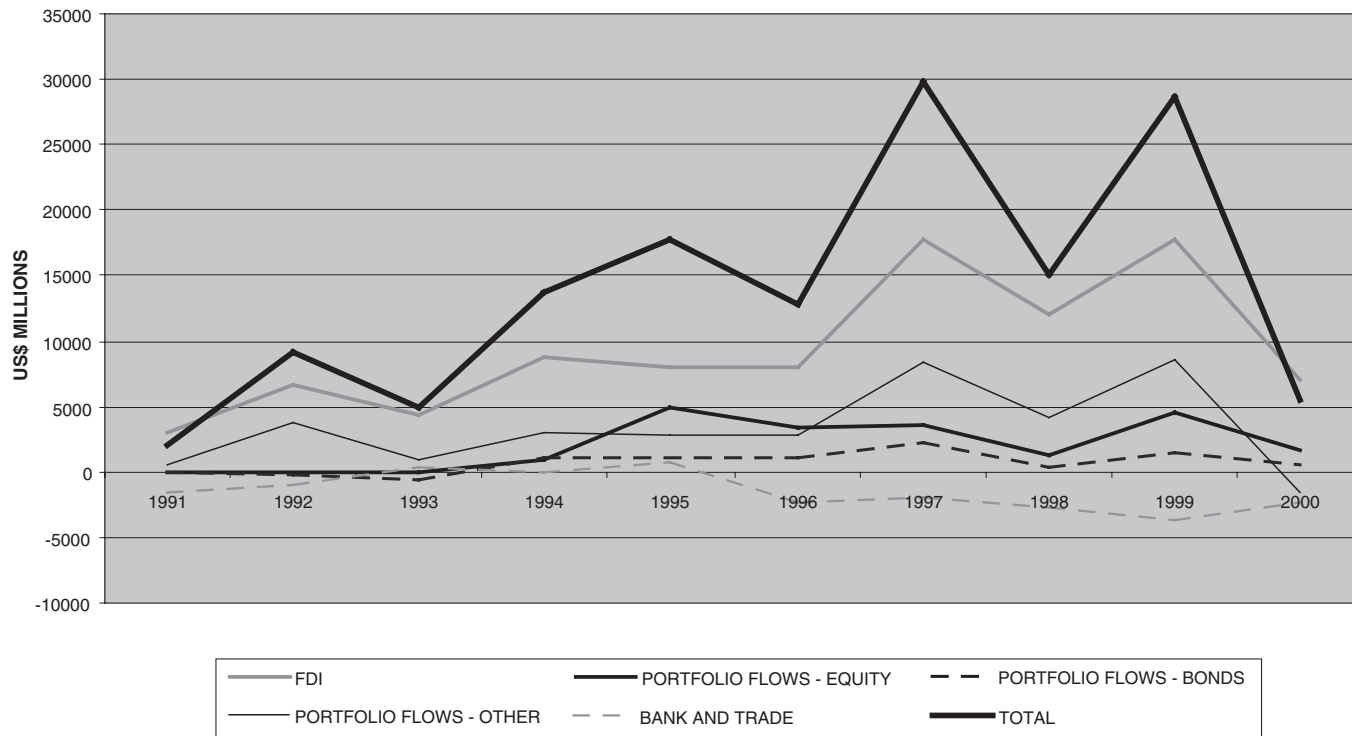


Figure 11.2 Net capital flows to Africa  
 Source: *World Development Indicators*, 2002 (CD-ROM Version).

*Implications for the Globalization of Africa*

Globalization is a two-way street, and there should be mutual gains for countries participating in this process. Consequently, it would be useful to examine the extent to which Africa can contribute to the emerging markets portfolio and, ultimately, to the global portfolio. The preceding illustration demonstrates that globalization is a desirable strategy for U.S. investors in terms of an improved risk-reward ratio. This has important implications for Africa. At a more fundamental level, the benefits from global risk diversification arise from *diversity in* the economic cycles of countries. To the extent that Africa's economies do not move in tandem with advanced economies, there are opportunities for international investors to benefit from including African financial markets in the global portfolio. The diversification benefits of emerging markets and their impact on global risk-sharing have been firmly established by the available evidence, giving rise to opportunities for emerging economies to mobilise capital internationally. Thus, the *competitiveness* of a preemerging region, such as Africa, in attracting international capital depends on its ability to improve the global risk-reward opportunities available to international investors.

The correlation between Africa and the developed countries is apparently low, and therefore it generates a potential for beneficial global diversification (see Table 11.2).<sup>4</sup> Moreover, given the principle of international investment allocation, the potential for growth of capital flows to emerging markets is very high, since the emerging markets portfolio represents only a very small fraction of the global capital. Currently, Africa is grossly underweighted in the perceived optimal portfolios – optimal from the standpoint of industrial investors who are increasingly taking a global perspective. If the global markets were fully integrated, the optimal strategy for investors would be to buy and hold the worldwide market portfolio, which is weighted by the relative capitalisation of individual markets or securities.

The actual portfolio holdings are nowhere near those that would come from the optimal global strategy, a fact suggesting enormous potential for the further globalization of emerging markets as the world becomes more integrated. For instance, in 1996, the total worldwide stock market capitalisation was about \$20 trillion. Emerging markets accounted for only about 10% of the world's capitalization. While emerging markets are *underrepresented* in the global portfolio, Sub-Saharan Africa is underrepresented even in the emerging markets portfolio. In 1996, SSA markets represented only 0.7% of the emerging markets.<sup>5</sup> But, with increasing economic and financial reforms, Africa is poised to be in the next *wave* of emerging securities markets.

Table 11.2 Expected Returns, Volatility, and Correlations for African Countries

Country	Expected Excess Return	Expected Annual Volatility	Expected Correlation With World	IFC Status
Algeria	18.7%	36.6%	-0.01	
Angola	20.0%	39.4%	-0.07	
Botswana	13.3%	24.4%	0.32	Frontier
Burkina Faso	18.1%	35.2%	0.02	
Cameroon	18.4%	35.9%	0.00	
Congo	18.6%	36.3%	0.00	
Côte d'Ivoire	17.6%	33.9%	0.04	Frontier
Egypt	15.2%	28.6%	0.18	New
Ethiopia	17.3%	33.3%	0.06	
Gabon	15.9%	30.3%	0.13	
Gambia	17.8%	34.6%	0.03	
Ghana	15.9%	30.3%	0.13	Frontier
Kenya	15.7%	29.7%	0.15	Frontier
Libya	15.7%	29.7%	0.15	
Malawi	17.4%	33.6%	0.05	
Mali	18.7%	36.6%	-0.01	
Mauritius	18.5%	30.1%	0.16	Frontier
Morocco	15.4%	29.1%	0.17	New
Mozambique	20.6%	40.9%	-0.09	
Namibia	13.6%	24.9%	0.30	
Niger	21.1%	42.1%	-0.11	
Nigeria	19.7%	38.7%	-0.05	Existing
Senegal	17.4%	33.6%	0.05	
Sierra Leone	23.2%	46.7%	-0.18	
Somalia	29.8%	61.9%	-0.35	
South Africa	13.6%	24.9%	0.30	Existing
Sudan	28.2%	58.1%	-0.31	
Tanzania	16.5%	31.5%	0.10	
Togo	19.2%	37.6%	-0.03	
Tunisia	15.0%	28.0%	0.20	Frontier
Uganda	19.2%	37.6%	-0.03	
Zaire	24.6%	50.0%	-0.22	
Zambia	17.0%	32.7%	0.07	
Zimbabwe	17.3%	33.3%	0.06	Existing
<b>Equal Weighted Average Count</b>				
Africa	18.4%	35.6%	0.04	34
IFC Existing	14.5%	27.1%	0.24	28
IFC New	15.5%	29.3%	0.16	3
IFC Frontier	16.9%	29.9%	0.16	14
MSCI Developed	12.0%	21.4%	0.44	21

World-MSCI All Country World Index.

Returns are in U.S.\$ in excess of one year government bond return.

Source: C. Erb, C. Harvey, and T. Viskanta, "The Risk and Expected Returns of African Equity Investment" (paper presented at the Harvard Institute for International Development and The Centre for the Study of African Economies, Cambridge, Mass., September 1996).

Table 11.3 Performance of African Stock Markets (Total Returns in US\$)

	1997	1994–97	1998* (Update)
Egypt	15.7%	284.7%	
Morocco	42.1%	167.5%	6%
Côte d’Ivoire	9.9%	132.3%	
Nigeria	-4.6%	120.4%	-21%
Botswana	93.5%	70.7%	32%
Tunisia	-30.4%	64.3%	6%
Kenya	-12.1%	33.7%	-3.5%
Ghana	10.0%	27.3%	63%
Zimbabwe	-52.0%	13.1%	-55%
Mauritius	-0.7%	2.4%	6%
Namibia	5.0%	-1.9%	-47%
South Africa	-10.5%	-11.4%	-28%
Swaziland		-42.4%	-21.2%
IFC Global	-14.4%	-19.6%	-24.0%

Source: John Niepold, “Africa’s Emerging Markets,” *Africa Business Focus*, The Yearbook of the British African Business Association (1998).

\* Update: *African Development Report* (1998).

The potential benefits of the Africa portfolio go beyond its contribution to global risk diversification. The other dimension of global strategy is an investment reward for an acceptable level of risk. The recent *return performance* of various stock markets in Sub-Saharan Africa shows untapped value potentials for global investors. The Sub-Saharan stock markets have outperformed the emerging indices of the IFC by a considerable margin in 1994–96 and in 1997 and 1998 (see Table 11.3).

Another indicator of the investment potential of African markets is the currently observed low *price-earnings* multiples. For instance, in 1997 shares of some solid companies, such as Zambia Sugar, Standard Chartered Bank (Ghana), and Delta Corporation of Zimbabwe, were trading at  $2\frac{1}{2}$  times their prospective earnings.<sup>6</sup> This reflects a gross *undervaluation* for an acceptable emerging-market risk. By and large, this statistic should reflect an extraordinary level of perceived risk characterising the Sub-Saharan African markets. To put things in proper perspective, the U.S. broad-market index traded at around 28 times the market’s earnings in 1997 – more than 10 times the earnings of African markets! It is important to note, however, that well-meaning financial and regulatory reforms are being put into place in the region: e.g., tax reforms, a reduction in barriers to capital flows, the elimination of rules that discriminate against foreign investors, and the repatriating of capital. These developments are being noticed, as evidenced by a surge of global investor interest in Africa (see Table 11.2 again).

*Benefits to Africa from Integration into the Global Financial Economy*

So far we have explored globalization from the standpoint of its benefits to international investors (or *suppliers* of capital) and of the need for a competitive position of Africa in global markets in response to investors' desires. However, there are considerable benefits to Africa as a recipient of global capital and from its integration into the global economy. These benefits are as follows: (a) an access to more *diversified* sources of external finance, in contrast to a heavy reliance on sovereign debt and its attendant crisis and on the shrinking aid flows; (b) greater *risk sharing* by international investors in the local capital markets, especially through equity investments, in contrast to the syndicated bank lending of the 1970s, and a reduction in the local *cost of capital* since risks of local shares are globally shared; (d) reversal of *flight capital* (often an initial capital inflow and a source of privatisation capital); and (e) the promotion and validation of the *credibility* of capital market institutions (custodial, clearing, settlement, and brokerage services, information and accounting disclosures, etc.) and regulations in response to pressure from international investors.

In more specific terms, greater risk sharing in the local markets by international investors leads to a reduction in the cost of capital for local firms, since risks of local shares are globally shared. This cost reduction leads to an enhanced *liquidity* of the local market and to *capital mobilisation* by firms at more advantageous terms, as the cost of capital diminishes. These results, in turn, lead to improved social welfare in the local economy and enhanced economic performance, since projects, which were previously rationed out because of excessive risk exposure, will now be undertaken.<sup>7</sup> Consequently, the potential benefits of globalization to the recipient countries (e.g., those in Africa) go beyond mere facilitation of international capital flows. In addition, the validation of the credibility of domestic capital market institutions can come about, since foreign investors demand world-class services. The demands of international investors can force governments to strengthen the *rule of law*, *enforce contracts*, and increase the growth of available *information*.

Thus, globalization exposes African stock markets to the best practices and standards and, in turn, puts pressure on African economies for reforming local stock markets. The focus on the banking sector precludes opportunities for building informational technology unique to risk capital and derivative markets (e.g., disclosure and accounting standards). Externally, improvements in making information available exert a positive influence over the entire financial sector, including the banking sector. It is, therefore, important that African countries do not apply counterproductive restrictions, thereby stacking odds against outside investors.

## Challenges to the Globalization of African Financial Markets

The challenges facing Africa in its globalization and development processes are immense. This is true despite the fact that the region has undergone extensive reforms. Interest rates are decontrolled; there are no longer credit ceilings and government-mandated credit allocation; prices and exchange rates are liberalised, as well as capital accounts to a large degree. Yet the financial sector remains malfunctional and this defect is at the heart of challenges facing Africa.

In addition to the multiple *functions* they provide (see above), long-term capital markets are an avenue for fostering competition in the financial sector beyond reliance on banks and their emphasis on short-term lending. This avenue provides an important channel for attracting international capital and globalizing African financial markets. Thus, the development of securities markets, particularly stock (equity) market development, should be on a reform and development agenda. However, the region faces considerable challenges in developing capital markets and in globalization.

### *Thin and Malfunctioning Domestic Capital Markets*

#### *Illiquidity and Thinness*

Despite the positive and encouraging developments in the restructuring of African financial systems, stock markets remain at a very fledgling level. There are close to twenty stock markets in Africa. Except for those in South Africa, the stock markets are by far the smallest of any region, both in the number of listed companies and market capitalisation. They are also characterised by extremely low turnover according to other emerging-market standards.

#### *Weak Disclosure and Enforceability of Rules*

In general, accounting standards are weak and disclosure is poor. More seriously, there is a poor record of enforcing these rules and standards. For example, capital standards for banks and other financial institutions are rarely enforced. Adequate disclosure and sound accounting standards are essential ingredients for stock market development. Financial information disclosure and accounting rules are mandated by law in many African countries. Compliance, in many cases, requires the mere publication of an annual report often containing only summary figures and usually due a year after the report has been made.

## *Risk Factors and the Absence of Risk-Sharing/Allocation Mechanisms*

### *Macroeconomic and Political Risk*

High macroeconomic and political instabilities lead to high volatility in the capital markets. Research has shown that *country risk*, and, by implication, macroeconomic risk, is the predominant cause of variation in stock returns across countries (as opposed to *industry-specific* shocks). Further, international investors are concerned about political risks associated with the odds of adverse changes in government policies. It is often said that the best policy is no change in policy! In addition, policies are as effective as they are *credible*. Unfortunately, Africa is abundantly plagued with abrupt changes in government policies and in political climate. These abrupt changes have adverse consequences in financial markets. An example is the extreme price swing in the Zimbabwe stock market. The Zimbabwe market, which rose phenomenally in 1996 (by 89.5%), dropped by more than 50% during the final quarter of 1997, in the wake of sudden changes in government farm and pension policies.<sup>8</sup>

### *Foreign Exchange Risk*

Hard currencies are readily hedged. High currency exchange volatility is endemic in African economies, creating an impediment to foreign investments. In view of the dearth of hedging mechanisms through derivative markets (futures and options), an indirect approach would be to increase the number of *export-oriented* companies on the stock exchanges. In particular, those with exposure to hard-currency exports should be targeted, in order to provide substantial hedging against local currency devaluation.

### *Risk of Afro-Pessimism*

*Well-functioning* capital markets need to be supported by *well-informed* activities that sustain their *liquidity and depth*. But *preemerging* markets in Africa may be subject to a phenomenon called “Afro-pessimism.” Despite the unprecedented political, economic, and financial reforms that have taken place, Africa still projects images of war, famine, massive corruption, failed projects, grossly undisciplined governance, and gross violations of human rights in international news headlines. These images may lead to *perceptionally* high, even untenable, political and investment risks for potential investors in African markets. Such perceived risks are, in part, reflected by the low ratings for creditworthiness of Sub-Saharan African countries, as compared to other regions which have displayed considerable political and economic improvement in the 1990s.



The risk may be more *perceptual* than *fundamental*. Unfortunately, perception is a reality in an environment characterised by grossly imperfect information, whereby it is difficult to separate out good prospects from bad prospects. The average quality of the Africa “pool” may mask the high quality of genuinely reforming countries because of the monolithic view of Africa as a single, troubled “country” (i.e., *pooling equilibrium*). In truth, Africa is a *continent* of diversities. Since the *perceived* risk in Africa may be generally larger than the *fundamental* risk, the *timeliness* and *reliability* of financial data are crucial in making estimates of investment risks in Africa. Consequently, there is a need for more extensive, detailed, and reliable data reflecting the *diversity* of Africa, along with data reflecting the financial circumstances of private institutions within the formal financial system.

### *Risks of Globalization: Lessons from the Asian Crisis*

The recent Mexican crisis and the ongoing crisis in East Asia suggest broad categories of risks engendered by globalization. In particular, globalization exposes the domestic markets to various classes of risk: (a) *volatility* of the global *financial* markets; (b) large unfavourable *fluctuations* in international *exchange rates* (e.g., speculative attacks on the pegged currencies; testing the resilience of the peg); (c) large unfavourable *swings* in international *interest rates*. Capital flows can easily be reversed if they were originally triggered by favourable external shocks (e.g., low U.S. interest rates). Some believe that historically low U.S. interest rates and the slowdown in the U.S. economy were partially responsible for large inflows into emerging economies.

The bottom line is that the foregoing classes of risk translate into large *unfavourable swings* in international capital flows.<sup>9</sup> These then lead to (a) an unwillingness to supply short-term credit even for a liquidity crisis and (b) default and *contagion* of the type currently being experienced in East Asia (and earlier in Mexico). Therefore, it is crucial that domestic policies be improved to make these flows resilient to adverse changes in the global environment. Indeed, according to the IMF study, emerging markets stabilised after adverse contagion effects associated with the Mexican crisis because of improved policy responses and the more sober attitude of international investors, who began paying more attention to *fundamentals*.<sup>10</sup> In the wake of the Mexican crisis, the emergent consensus seemed that portfolio capital was much more likely to be channeled to those countries best suited to increase productive investments and improve fundamental economic factors and policies. However, the investor sentiment changed drastically in 1997 – this time in another part of the globe. For then came the East Asian crisis.

### *The Drama of the East Asian Crisis and the Contagion*

It has been five years since Thailand devalued the baht in July 1997, which ignited a “financial fire storm” and precipitated a wave of currency crises and financial instability across Southeast Asia and other emerging markets: Korea, Taiwan, Hong Kong, Malaysia, Indonesia, the Philippines, Russia, Brazil, Estonia, Australia, New Zealand, and even South Africa. This global contagion led to the largest bailout scheme in the IMF’s history, making the earlier largest bailout (the Mexican bailout of 1994–95) look small by comparison! However, unlike the Mexican crisis, the *run* on these countries has continued, and no immediate restoration of financial stability is in sight.

The magnitude of the financial crisis is evident in the dramatic declines in assets and *currency values*. For instance, the currency values in Thailand, Korea, Indonesia, and Malaysia declined by at least 50%. So did the *stock market* and property values. The extreme financial instability has been accompanied by poor or declining economic performance. For example, there was a *shrinkage in GDP* for the first quarter of 1998 in Indonesia, Thailand, Korea, Malaysia, Hong Kong, and even Japan. The unfavourable economic performance of the East Asian region has been, in part, attributable to the *negative wealth effect* arising from dramatic declines in currency and asset values. In addition, the IMF austerity measures typically called for budget discipline (i.e., reduction in government spending and in budget deficit) and an increase in interest rates to avert further outflow of capital. The *spillover* effect of the Asian crisis has been worldwide, including the U.S., where the Asia-dependent companies have shown declining profits. The East Asian countries are recovering, and those who genuinely reformed their financial systems in responding to the financial crisis are particularly performing well.<sup>11</sup> Below I provide a brief diagnosis of the East Asian crisis, along with the salient lessons arising from the crisis.

### *Diagnosis of the East Asian Crisis*

Was the East Asian crisis a victory for the Anglo-Saxon economic model over the Asian model? This question was at the centre of the diagnosis of the crisis, but, unfortunately, it distorted the issue. The issue is one of an *effective* economic system and not the Asian versus the Anglo-Saxon model. Features of the economic systems adopted by the Asian countries contributed to the crisis, and these features were not *dissimilar* to those that had contributed to the largest financial disaster in the United States, namely the 1980s savings and loan crisis.

The East Asian economies were built primarily on very favourable *fundamentals*, such as heavy export orientation, high levels of savings,

high levels of education, and work ethic. In fact, prior to July 1997, all the macroeconomic fundamentals appeared sound – low inflation, budget discipline (i.e., balanced budget), high GDP growth, etc. – with no signal of an imminent crisis, if one were to use fundamentals alone to predict a crisis. Thus, we can say, with confidence, that the primary problem was not a *crisis of fundamentals*.

What then went wrong? In answering this question, one should look at the other side of the fundamental economy: *financial* systems. We need to recognise that the problem was primarily a *financial crisis*. This will allow us to focus on the *functionality* of financial systems and the role of government (activist or passivist) in this functionality. Well-functioning systems are devoid of an environment of rent seeking, whereby capital seeks the highest guarantees in lieu of high risk-adjusted returns. Were there features in the Asian economies that pointed to the *dysfunctionality* of their financial systems?

Their exchange rate systems, which were rigidly pegged to the U.S. dollar or Japanese yen, became highly vulnerable to speculative attack, since speculators tested the *resilience* of the peg. The banking and financial systems were largely characterised by close *institutional links*, whereby finance was driven by *relationships* rather than *markets*. These links involved banks and industrial companies, banks and governments, and laxity in banking regulation and supervision. Consequently, there prevailed problems of very poor asset quality. Although we know that governments targeted particular industries and investments and fostered government-directed loans (with the attendant investment excesses), these policies alone could not have precipitated the financial crisis of the magnitude we are observing now. There was massive *private* debt, involving private debtors and creditors, with minimal government intervention. This kind of debt should be contrasted to the 1980s *sovereign debt* crisis of Latin America. In an ill-functioning financial system, debtors have an incentive to undertake excessive risks and to channel capital to inefficient, yet high-risk, investments. The *moral hazard* of debt financing is by now well established in corporate finance and banking paradigms.

The government plays a role in the functioning of the financial system through its action or inaction. It is easier to see the moral hazard problem and the role of the government in the context of a banking system characterised by explicit deposit insurance systems or implicit guarantees (e.g., “too big to fail”). Through its inaction or ineffective (weak) financial regulation, the government creates an incentive for bank owners to expand credit to excessively high-risk borrowers, recognising that the upside is unlimited, if economic conditions are favourable, and the downside is protected by explicit or implicit guarantees. At a global level,

the moral hazard problem is exacerbated by the implicit guarantees associated with IMF-type bailouts, since international lenders to emerging economies, such as in those in East Asia, will become risk aggressive. Thus, the right regulatory regime, or the “right” role of the government, becomes crucial in controlling excessive-risk behaviour and inefficient investments. In this ill-regulated and malfunctioning environment, it is no wonder that the genesis of the crisis was excessive inflow of private capital, seeking and being channeled to high-risk and unproductive investments. This, along with inefficient debt management and unsustainable short-term debt, was bound to erode market confidence and to cause “runs” on the country’s reserves, leading to the contagion that we are observing now.

While attempting to diagnose the East Asian crisis, this section does not grapple with the solution mechanisms. The next section addresses the broad issue of dealing with the risks and costs of globalization and also catalogues various mechanisms for addressing the challenges facing Africa in its effort to be integrated into the global economy. Our focus is on the *long-run* challenges and solutions rather than the short-run resolutions of financial crises, with specific attention to institutional and regulatory designs.<sup>12</sup>

## Meeting Challenges and the Agenda for Globalization

What needs to be in place to encourage private investments, particularly sustainable portfolio flows, into Africa and to globalize the region’s markets?

### *Capacity Building and the Development of Local Capital Markets*

A deep and well-functioning local market is an important facilitator of globalization. Consequently, measures should be taken to develop and build the capacity of local capital markets.

### *Fostering Public confidence and Informational Efficiency*

The government has a vital role in enforcing private contracts and hence appropriate investment returns by ensuring accounting procedures and legal standards and creating an environment of transparency and investor confidence. Corporate accountability is crucial for a sustained stock market development, and this policy is now evident in the more advanced economies in the wake of corporate scandals which have had adverse consequences on the stock market. The mere existence of legislation, which declares and grants inalienable property rights, is insufficient. Indeed, there is no shortage of such legislation in Africa. There ought to be

an independent judiciary, strongly enforcing and protecting these rights. Thus, accounting and legal standards are vital ingredients of capital market development.

### *Designing Efficient Systems for Capital Market Regulation*

Capital markets cannot be expected to develop without credible legal and regulatory schemes that promote, rather than inhibit, private initiative, whereby investors and savers build confidence in the functioning of markets. On the other hand, it is dangerous to *overregulate* capital markets and take a paternalistic view of investors. It is the job of the regulator not to determine what is best for the investor but to create an environment in which the investor makes an informed decision. Thus, the regulatory emphasis should be on *fairness, full disclosure, and transparency*.

At the heart of financial regulation is protection of the investor, particularly of small participants in the market. Small investors need to be properly protected through the strict enforcement of securities laws and regulations. In carrying out this policy, the fledgling African capital markets should capitalise on the best practices by harmonising their laws and regulations with international standards. This protection policy is also a foundation for fostering regional stock markets and attracting international investments, with the ultimate purpose of integrating Africa into the global economy.

Government regulation of securities markets, particularly stock markets, should be more of an *oversight* of self-regulatory agencies, such as the stock exchanges and the brokerage industry. Self-regulatory organisations design rules for business operations and for professional conduct of members who are properly licensed. The oversight function itself is typically done by securities and exchange commissions (SECs), which are organs of the government. *Self-regulation* builds on the capacity and wisdom of men and women inside the member firms that participate in the capital market process directly rather than on government bureaucrats who lack intimate knowledge of the day-to-day functions of markets which are increasingly sophisticated.

### *Building Capacity in Human Resources and Training Programmes*

Well-functioning capital markets are characterised by well-informed participants: investors, investment advisors, government regulators, and self-regulators. In addition, international financial markets have become highly sophisticated in recent years through more advanced information technology. The markets have become increasingly characterised by advanced and exotic securities, including a variety of derivative securities, thus demanding that market participants stay abreast of recent advances. Indeed, derivatives have made their way into Africa. They are useful

mechanisms in terms of risk control and hedging, but, if mismanaged, they lead to financial disasters. Therefore, the training of financial manpower should be at the forefront of financial market development in Africa. This training can be done through improved business school curricula in universities and through training programmes at capital market institutions, including securities and exchange commissions, central banks, stock exchanges, etc.

Moreover, capacity building in risk assessment and control is vital for banks to carry out their functions in building information capital. Banks that fail to develop the capacity of risk assessment and the monitoring of the optimal management of their loan portfolios become uninterested in investing in information capital, which is crucial for the development and functioning of financial systems and the integration of otherwise locally fragmented markets.

#### *Fostering an Environment for Good Corporate Governance*

There are natural conflicts of interests among parties in an organised firm, particularly between management and shareholders (owners of the firm) and even between shareholders and bondholders (see Figure 11.1). There ought to be appropriate mechanisms available to stakeholders of a corporation to exercise control over corporate insiders and management so that stakeholder interests are protected. Corporate governance provides such mechanisms. One familiar element of corporate governance is the board of directors, but more recently its effectiveness has been called into question. The growing consensus is that the board has to be independent of the chief executive officer through appointments of directors who are outsiders with no serious business interests in the firm. In fact, the audit committee of the board should be composed entirely of outside directors. Moreover, it is often suggested the audit committee should take the responsibility of appointing an external auditor.<sup>13</sup> The recent debacles of corporations, such as Enron and WorldCom in the U.S., is, in part, attributable to weak corporate governance, with the board members' and the external auditor's interests being held hostage by these firms. Thus, corporate governance and an appropriately designed bankruptcy code, which provides sufficient rights to creditors and debtors, should be the key ingredients of any agenda for capital market development, an agenda which also becomes a foundation for the globalization of African financial markets.

#### *Linking Privatisation to Capital Market Development*

Privatisation facilitates the development of capital markets. In those countries with stock exchanges, privatisation of state-owned companies enhances the depth of the existing markets through an increased supply

of new listings, while privatisation is being carried out in a *fair* manner. Indeed, capital market development is an important means of *depoliticising* privatisation by making it possible for large-scale privatisation to take place at a fair pricing of the assets to be sold. In addition, local capital markets allow for local investor participation and help alleviate concerns about any foreign grabbing of assets in privatisation. Small investors can participate in large-scale privatisation through institutional funds or unit trusts, if capital markets have developed sufficiently to allow for the establishment of such funds.

Thus, privatisation through stock markets is one way to enhance the *diversity* of ownership of the resources in the economy. This result of privatisation addresses some ill-conceived concerns that stock markets are for the elite. To the contrary, capital market privatisation, as opposed to an outright sale to an individual or a favoured group, promotes distribution of ownership, while simultaneously promoting risk-sharing and governance (and control) functions of financial markets. Apart from enhanced public ownership, privatisation through capital markets increases public awareness about capital markets by creating first-time buyers of market instruments.

### *Designing Efficient Banking Regulation*

Banking regulation takes a form somewhat different from the other elements of financial regulation. Bank deposits are, if not explicitly, implicitly insured in many countries, including those in Africa. This leads to incentive problems among the bank owners, the regulatory agencies, and the taxpayers. In an ill-designed deposit insurance system, public mismanagement of the system and private-incentive incompatibility problems can actually work to increase the *systemic risk* and instability of a financial system. Thus, the moral hazard of deposit insurance is that, although it helps prevent bank runs, it creates incentives for bank owners to take *wild* risks. It is now commonly believed that many Asian banks became overly aggressive with (implicitly/explicitly) guaranteed deposits. Indeed, the Asian experience makes the moral-hazard problem very real.

As yet, no country in the world has come up with an entirely satisfactory banking regulatory scheme. This is exacerbated by the fact that many banks are no longer traditional in the sense of serving as mere conduits for deposit mobilisation and lending activities. Not only do they hold deposits (act as *depositories*) under a government promise to repay depositors if the bank fails, but they also act as *investment managers*. Simultaneously, they extend loans, underwrite shares, sell insurance, arrange corporate mergers, and trade commodities and financial instruments for their own accounts.

Abolishing deposit insurance may be desirable (e.g., New Zealand has already scrapped deposit insurance altogether), but, in countries that lack formal deposit insurance schemes (i.e., most African countries), deposits are implicitly insured even when they are not explicitly insured. At any rate, the purpose of banking regulation is not to eliminate banking failure altogether but to curtail a general, systemic banking crisis. This is done with an appropriate regulatory and supervisory scheme that relies on *capital adequacy* requirements, *surveillance* of asset risk choices, and fast *resolution* of crises.

Capital requirements and restrictions on bank asset portfolios have received increasing attention in bank regulation around the globe. However, there are serious deficiencies in the current regulatory systems. Capital regulation can be beneficial, however, in mitigating the risk incentives of undercapitalised banks, hence moving lending risks toward more socially desirable goals. In addition, bank regulation should pay attention to the incentive features of bank *management compensation* for the simple fact that managerial-*incentive* behaviour directly affects bank investment behaviour. Bank regulation can be more efficient if it takes into account these incentive features of compensation in pricing deposit insurance and disciplining bank risk behaviour.<sup>14</sup>

### *Promoting Regional Cooperation and Developing Regional Markets*

With the development of regional markets and enhanced globalization of emerging markets, the future holds regional cross-listing and cross-border investments. Most premerging economies are, however, just too small to justify the cost involved in setting up well-functioning stock markets. However, these economies can pool resources for regional cooperation in capital market development. This would enhance the mobilisation of both domestic and global financial resources to fund regional companies, while injecting more liquidity into the markets.

The specific mechanisms for regional integration may call for the establishment of regional securities and exchange commissions, regional self-regulatory organisations, regional committees to promote harmonisation of legal and regulatory schemes, and coordinated monetary arrangements (e.g., via currency zones). At a more basic level of integration, it is crucial for member countries to have appropriate securities laws devoid of disincentives for cross-border trading. In particular, the tax treatment of investments must be harmonised, since tax policy is an important incentive or disincentive both for issuers and investors. Ultimately, the regulations, the accounting reporting systems, along with the clearance, settlement, and depository systems, should conform to international standards.



### *Harmonising Rules and Regulations*

Regionalisation requires a strong commitment on the part of African economies to harmonise legal and regulatory schemes, accounting and disclosure rules, tax regulations and incentives, and fiscal and monetary policies. Indeed, cross-border monitoring and the enforcement of laws may enhance competition among the member countries in the region and enhance public confidence in the markets. Thus, as a prerequisite to large-scale cross-border trading, the infrastructure of the domestic capital markets and the regulatory regimes needs to be strengthened. It is encouraging that genuine efforts are already underway to develop mechanisms for regional capital markets, as evidenced by the efforts in the French-speaking African subregions of CEFA and central Africa. It is hoped that these efforts at regional capital market integration will serve as role models for the rest of Africa.

### *Synergising Development Efforts in Human Resources*

Regional cooperation in capital market development calls for a regional approach for skills development, training programmes, and research and information collaboration. Thus, it should be clear that regionalisation, or subregionalisation, is an essential element facing the continent in its effort to develop and build the capacity of capital markets, as well as in integrating into the global economy.

### *Pooling Information and Research*

A genuine effort in developing and building the capacity of capital markets and the regionalisation of these markets in Africa needs a *research and information* arm. Again, this need belongs to an area of synergy and team effort calling for regional cooperation.

A *shorter-term* mechanism would be to *leverage* the activities of some important institutions that are already in place, since they can *anchor* the collaborative effort in setting up the research and information arms of capital market development in Africa. Existing institutions that are candidates for such tasks include the African Economic Research Consortium (AERC), the United Nations Economic Commission for Africa (UNECA), the African Development Bank (AfDB), the International Development Research Centre (IDRC), the International Centre for Economic Growth (ICEG), among other institutions and networks. In addition, there is an ongoing effort to build the capacity of the recently launched African Capital Market Forum.

### *Credit Rating System*

Regional cooperation can go beyond stock markets into the development of debt or bond markets. This would be facilitated greatly by the exis-

tence of a viable and credible credit rating agency at a regional level. Such an agency is nonexistent in Africa. However, again through the pooling of resources, a regional rating agency can be established, which will foster the development of secondary markets in private bonds. While the individual markets themselves may be too small to support a rating agency locally, a sufficient number of debt instruments available in the region may support the establishment of a regional credit rating agency. The added advantage of such an agency is that it will be a catalyst for cross-border trading in debt securities by providing an assessment of sovereign and credit risks for investors with limited knowledge of the debts in other countries within the region.

### *Reducing the Costs and Risks of Globalization: Implications of the Asian Crisis for Africa*

“Fix the roof while the sun shines.” The previous section has catalogued various risks of globalization, leading to large and unpredictable swings in capital flows across borders. These risks manifest themselves in price fluctuations in asset and capital markets, in interest rate fluctuations, and in unfavourable movements in currency values. As we have witnessed from the Asian crisis, the negative-wealth shocks and the global contagion can be enormously costly to the countries affected and potentially destabilising to the entire global economy. Here we outline some mechanisms for dealing with the risks of globalization. If these risks are controlled properly, the benefits of globalization are also enormous, as discussed earlier in the paper (see section 2).

What are the implications of the Asian crisis and of the risks of globalization for Africa? Of course, Africa has been *insulated* from the adverse shocks of the crises in Mexico and East Asia because of its relative absence from the global financial markets. On the *positive* side, it now stands to gain from the more sober behaviour of international investors. Sometimes, there is a “last mover” advantage! The wrong lesson to draw, however, is for Africa to continue being insulated from globalization and its attendant “risks.” One could indeed interpret the virtual absence of Africa’s global participation as a manifestation of *extreme* risk and the resultant “marginalisation” of the region. In other words, one can avoid the risk of globalization altogether (e.g., Africa being left out of massive private flows). However, that avoidance just exposes one to “extreme risk” (marginalisation), with a complete lack of potential benefits coming from globalization, as we amply discussed earlier.

The more appropriate, fundamental questions for Africa are: How can the region manage the risks of globalization (by an efficient management of risk)? How can it resolve crises efficiently (by an efficient resolution of

risk)? In other words, are there efficient mechanisms to manage and control various risks of globalization, and is the region equipped with mechanisms to deal with a crisis if it arises? Even a well-managed financial economy may face a crisis as a result of a *bad draw* when conditions become unfavourable. However, if the crisis is not efficiently resolved, it devolves into a crisis of confidence and the associated negative externality or contagion of the type witnessed in East Asia.

#### *Elements of the Efficient Management of Globalization Risk*

The elements of the *efficient management of risk* are associated with factors that build confidence in the financial and currency systems: (a) sound and disciplined domestic policies; (b) timeliness and accuracy of disclosure of information; (c) sound domestic banking systems; (d) the capacity/efficiency of domestic capital markets; (e) the capacity of risk management (i.e., fostering modern credit evaluation and risk management techniques within banks and other financial institutions); (f) corporate and public governance compatible with a modern market economy, with honest and strict enforcement and contracts and laws. Thus, the regime of efficient risk management is targeted toward reducing the scope for *unpleasant* surprises.

#### *Elements of the Efficient Management of a Financial Globalization Crisis*

Now let us mention briefly the elements of the *efficient resolution of a crisis* – the other dimension of dealing with financial globalization. Crisis resolution calls for speedy measures along the following principal lines: (a) the restructuring of the financial sector or banking system (e.g., the speedy closure of failed banks or the restructuring of their balance sheets), (b) the restructuring of the corporate (real) sector (e.g., resolving the financial distress of a failing firm and improving institutional and resolution schemes). The resolution of a crisis should be *long-run oriented*, even at a cost of *short-term* dislocations and costs. Otherwise, the *long-run* costs may turn out to be even greater if long-term challenges are not addressed. These long-run challenges may call for changes in the institutional environment in order to enhance risk management and control as the economy moves out of its crisis.

#### *On the Role of the Government and the IMF*

It is useful to recognise that there are appropriate roles for the government and international agencies (e.g., the IMF) in dealing with globalization risks or fostering the elements for the efficient management of risk and the efficient resolution of crisis. For instance, the role of the government is not to *overregulate* or *underregulate* but to design an *optimal* regulatory regime (e.g., banking regulatory and supervisory schemes). In

general, the role of the government should be *market-augmenting*, one of fostering and enhancing financial markets and market institutions.<sup>15</sup> In addition, the government should provide a safety net by investing in health and education so that the costs of dislocation associated with a crisis are not imposed on low-income groups (and the poor) disproportionately. Reforms, which are disproportionately burdensome, may not be sustainable. For the IMF, it seems that one of its functions should be to foster an efficient management of risk through surveillance mechanisms, rather than just responding to crisis. Once panic sets in, it is hard to come up with reforms that restore confidence quickly. An additional role of the IMF should be to enhance efficiency in the resolution of crisis through internationally coordinated schemes in order to avert global contagion.

In sum, the wrong lesson for Africa is to avoid globalization in pursuit of avoidance of globalization risks. That is tantamount to a continued “marginalisation,” with no opportunity to access the potential benefits of globalization. Globalization is here to stay. Thus, the fundamental lessons to be drawn as Africa ventures into the global economy revolve around its capacities for the efficient management of “risk” and for the efficient resolution of crisis. With the efficient management of risk, even under *normal* circumstances (i.e., when the sun is still *shining*), and with the efficient resolution of “crisis,” under *difficult* circumstances, public confidence in global parties can be maintained, enhanced, and restored. Without efficiency, the discipline coming from the global markets can be sudden and ruthless, as witnessed in the wake of the Mexican crisis and the crises in East Asia. In panicky moments, capital can flow out with the same speed and ease as it flew in!

## Notes

1. I wish to thank Laurence Harris and the other participants at the Tokyo Conference for helpful comments. This paper has benefited from Lemma Senbet, “Global Financial Crisis: Implications for Africa,” *Journal of African Economies*, AERC Supplement 10 (2001).
2. Nadeem Haque, Robert Hauswald, and Lemma W. Senbet, “Financial Market Development in Emerging Economies: A Functional Approach” (International Monetary Fund and the University of Maryland, 1997, mimeographed).
3. Ishac Diwan, Vihang R. Errunza, and Lemma W. Senbet, “Diversification Benefits of Country Funds,” in *Investing in Emerging Markets*, ed. M. J. Howell (Washington D.C.: Euromoney Books, World Bank, 1995).
4. Table 2 is from C. Erb, C. Harvey, and T. Viskanta, “The Risk and Expected Returns of African Equity Investment” (paper presented at the Harvard Institute for International Development and The Center for the Study of African Economies, Cambridge, Mass., September 1996), and it is calculated according to country credit risk ratings and not

according to the stock markets themselves. In fact, many of these African countries do not have stock markets. It is possible to use stock markets of other economies and their relationships with their credit ratings and project those onto other countries which do not have stock markets. Thus, the expected returns, volatilities, and correlations for African markets are calculated by using the relationships between credit ratings and stock markets and projecting them onto the observed credit ratings of the African countries.

5. John Niepold, "Africa's Emerging Markets," *Africa Business Focus*, The Yearbook of the British African Business Association (1998): 29–32.
6. Deepak Gopinath, "Taking the Road Less Traveled," *Institutional Investor* (March 1998): 173–74.
7. Vihang Errunza, Lemma W. Senbet, and Ked Hogan, "The Pricing of Country Funds from Emerging Markets: Theory and Evidence," *International Journal of Theoretical and Applied Finance* 1, no. 1 (1998): 111–43.
8. The two policy changes are: (a) land reform to take over 1500 commercial farms mostly white, and (b) a decision to pay \$240 million in pensions to disgruntled veterans of the Zimbabwe independence war. See Gopinath, "Taking the Road Less Traveled."
9. Private net inflows to the East Asian countries that were most affected by the crisis – Indonesia, Korea, Malaysia, Thailand, the Philippines – expanded from \$40.5 billion in 1994 to \$92.8 billion in 1996. In 1997, there was a sudden reversal of net flows (–\$12.1 billion), and hence with an unexpected capital flow swing of \$105 billion! See Steven Radelete and Jeffrey Sachs, "The East Asian Financial Crisis: Diagnosis, Remedies, and Prospects" (Harvard Institute for International Development, Cambridge, Mass., 1998, mimeographed).
10. International Monetary Fund, *International Capital Markets: Prospects and Key Policy Issues* (Washington D.C.: IMF, 1996).
11. The Economist, "The Lost (Half) Decade," *The Economist*, 4 July 2002.
12. For the role of distorted incentives in making emerging economies more vulnerable to financial crisis and the proposed mechanisms to prevent financial crisis, see Amar Gande, John Kose, and Lemma W. Senbet, "The Role of Incentives in the Prevention of Financial Crisis in Emerging Economies," working paper, New York University, New York, July 2002.
13. For the specific elements of board effectiveness, see Gande and Senbet, "The Role of Incentives in the Prevention of Financial Crisis in Emerging Economies."
14. John Kose, Anthony Saunders, and Lemma W. Senbet, "A Theory of Bank Regulation and Management Compensation," working paper 98-043, Finance Department, New York University, New York, 1998.
15. Government intervention in financial markets is typically counterproductive, particularly when it is designed to reduce market liquidity. The temptation here is to make the markets illiquid so as to make them "safe and secure" or avert short-run capital flows. This policy is ill-founded. To see this, one needs to take note that the prominently illiquid markets, particularly in real estate, are often prone to booms and busts.

## Aid and Development: What Can Africa Learn from the Macroeconomics of Foreign Aid in Some Southeast Asian Economies?

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The purpose of this chapter is to examine the macroeconomic impact of foreign aid on three Southeast Asian countries. This examination will be done not just for the sake of understanding the connection between foreign aid and economic development in Southeast Asia but, more important, for the goal of learning something about the donor policies, the allocation of aid by the recipient governments, and some of the institutional factors related to the macroeconomics of aid so that African countries can benefit from the experience of the Southeast Asian economies. The three Southeast Asian economies chosen for this examination are Malaysia, Indonesia, and Thailand (the MIT economies from here on). The MIT economies have been among the most rapidly growing parts of what a widely cited World Bank study has called “the East Asian Miracle.” Until the financial crisis of 1997, these economies were very much the vanguard of Asia’s economic march to prosperity.

A combination of factors are often cited for explaining the dramatic transformation of the “miracle” economies of Asia. These factors include openness to foreign trade, high savings rates, stable macroeconomic policies, high literacy rates, and favourable demographic characteristics. One might also wish to include an institutional structure – certainly far from perfect as the financial crises in these countries have shown – which was flexible enough to mobilise domestic resources and to utilise available foreign resources, including development assistance for promoting economic growth.

While some of the factors cited above may be region- or even country-specific, other factors are amenable to attainment through policy changes. The key question is: Should the African countries make certain changes in their macroeconomic policies in light of the Southeast Asian experience? One needs to be cautious in answering this question. The history and institutional complexities of Africa are in many respects different from those in the MIT economies. Furthermore, the initial conditions in Africa today are, in some respects, worse than the initial conditions faced by the MIT economies – with the possible exception of Indonesia – in the late 1960s. In some respects Africa needs to engage in institution building on a much more massive scale than the gradual progress made by the MIT economies over several decades. Keeping such caveats in mind helps us not to overdraw the relevance of the Southeast Asian experience to the African economies. At the same time, I show that there are some lessons to be learned in the areas of aid allocation and macroeconomic policies that can be useful for the African economies in the future. However, given the serious problems Africa faces, the institutional aspects of both the giving and spending of aid money need to be appropriately designed. Only aid that can reach large numbers of genuinely needy people will work in Africa.

I proceed by first sketching an analytical framework for the study. I then outline the aid scenario for the MIT economies in the 1970s and 1980s. I show the linkages between foreign aid and other macroeconomic variables such as savings, investments, and the government budget in these countries. Next, I examine some institutional aspects of aid allocation and its macroeconomic impact. It is not possible to give an exhaustive account of these institutional linkages without expanding this chapter into a book. Therefore, it is necessary to be selective. However, I hope this brief examination reveals some linkages between aid and various growth-inducing factors which help define some policy alternatives for Africa in this area. The concluding section summarises these lessons. One crucial finding is that there are domestic factors that are complementary to foreign financing (called Foreign Aid Complementarity Elements, or FACE in an abbreviated form), such as complementary private investment, human capital, and governance structures, etc. Thus the basic message of this chapter can be summed up as follows: In order to be genuinely effective, foreign aid must have the right FACE. As the concluding part of the chapter emphasises, these complementarities are institutioned in the sense that they are characteristics of state administration, politics and, civil society. They also can derive from policies such as export promotion or the promotion of FDI.

## Some Analytics of the Macroeconomics of Foreign Aid

In this section I discuss the analytical approach followed here in assessing the effectiveness of foreign aid from a macroeconomic perspective.<sup>2</sup> There exists in the literature on foreign aid something of a paradox. On the microproject level many projects financed by aid are deemed to have been successful; however, on the macrolevel the evidence is much more ambiguous. Here, as Mosley has observed, one can indeed find a micro-macro paradox.<sup>3</sup> Mosley himself has offered three explanations for this seeming paradox. The first explanation has to do with inaccurate measurement in micro- or macrostudies (or both). Second, the fungibility of aid within the public sector may also be invoked to find a diversion of aid from investment to consumption. I have more to say about this later. Finally, backwash effects from aid-financed activities may adversely affect the private sector – for instance, the displacement of foreign borrowing.<sup>4</sup>

According to the approach taken here, the complexity of the macroeconomics of aid arises from the opportunities and constraints that a typical LDC faces. For example, on the opportunities side, there is the possibility of increasing investment and consumption in the public sector; there is also the “opportunity” for reducing domestic revenue-raising efforts. These are only some of the possibilities. On the constraints side, the aid-giving mechanism may institute tied-aid disbursements, making aid much less fungible. It is difficult to predict a priori the macroeconomic impact of aid, since many of the opportunities and constraints may work at cross-purposes. Ultimately, it is really an empirical issue, where studies of individual countries are the main sources of our knowledge. At the same time some theoretical structure is necessary in order to prevent a completely ad hoc procedure.

What follows from the above considerations is a blend of two complementary frameworks. In the first place, the three-gap modification by Bacha of the earlier two gap models pioneered by Chenery and Bruno and by Chenery and Strout is the starting point for analysing the need for understanding the impact of foreign aid in a general way.<sup>5</sup> As a second complementary step, the approach developed by Heller and Gang and Khan and later applied by Khan to the MIT economies is also adopted in order to examine the macroeconomic impact of aid on the investment, consumption, and revenues of the recipient governments.<sup>6</sup> The second class of models, especially that developed by Khan, is sensitive to the specific institutional configurations of the recipient of aid. Here I can only offer a brief sketch of both these approaches and explain why these are complementary. The interested reader can consult the references cited here. Also, at the end of this essay, the possible welfare impacts of aid to



Africa are evaluated by using the social-capability approach developed by Sen, Nussbaum, and others.<sup>7</sup>

In the original Chenery-Strout model, the savings gap is initially the binding one and therefore determines the foreign exchange requirements. Once the investment constraint (and hence the savings gap) is no longer binding, the targeted growth rate can be achieved by foreign aid that can finance extra capital goods import. Within the dual gap formulation, it is also usually the case that aid is more productive when the foreign exchange constraint rather than the savings gap is binding. With the help of these models, aid requirements can also be calculated.

As Lance Taylor<sup>8</sup> has pointed out, Bacha<sup>9</sup> was the first to see that the two gaps really correspond to internal and external balances of open-economy macroeconomics. Taylor also underlines the human dimension with respect to foreign aid flows and the fulfillment of basic needs in development thinking during the initial phase of the development of the “gap models.”

For most countries in Southeast Asia, fiscal, foreign-exchange, and financial constraints have become even more stringent after the recent Asian financial crisis. In this context the proper utilisation of excess capacity may require increased public borrowing precisely when, under the standard “Washington Consensus” Structural Adjustment Programmes (SAPs), fiscal contraction is the norm. It may help to point out explicitly the link between public-sector borrowing requirements (PSBR) – that is, the funds that the government must raise in domestic financial markets in order to pay for its net expenditures and other revenues – and capacity utilisation plus further investment. A general expression for computing PSBR is given by the following:

$$\begin{aligned} \text{PSBR} = & \text{Government's current spending} - \text{local revenues} \\ & + \text{public investment} + \text{foreign interest payments} \\ & - \text{net transfers from abroad.} \end{aligned}$$

The approach that results from this consideration focuses on the creation of aggregate demand for increased capacity utilisation. Also, an important feature is the complementarity of public and private investment.<sup>10</sup> Thus public spending on infrastructure and utilities is positively related to private investment. Even public financing of manufacturing can, under some circumstances, lead to complementary private investment.

This “crowding” in of private investment through an increase in appropriate types of public investment leads one naturally to a search for models where the relationship between foreign aid and public investment (and, more generally, development expenditures) can be explored. This search, in our case, ends up in the utilisation of a class of models

pioneered in the development literature by Heller.<sup>11</sup> In the following exposition, Khan's model is used, which takes into account explicitly institutional variations and the bounded rationality of policy makers in recipient countries.<sup>12</sup>

In this model, it is possible to examine the relationship between bilateral and multilateral aid, on the one hand, and development and non-development expenditures, on the other. An important component of development expenditures is public investment.

Existing work on the impact of aid on the recipient countries under the two different aid regimes is also not conclusive. Heller<sup>13</sup> and Khan and Hoshino<sup>14</sup> find no difference between the two sources as far as impacts on the recipient nations are concerned. The pooled time-series, cross-section data used in these studies may partly account for this finding. Gang and Khan,<sup>15</sup> using time-series data for India, find statistically significant differences between the two sources of aid. However, the model used there is limited by insufficient asymmetries in the loss function. In order to capture the asymmetries of policy makers' evaluation function (e.g., if consumption exceeds a preset level, the loss may not be the same as when it falls short by the same level), an explicitly asymmetric loss function is required.

An equally important aspect of policy making in the real world is the endemic uncertainty about and institutional bounds to rational behaviour. Departures from strict neoclassical utility maximisation lead us to a bounded rationality framework. In this framework, development and fiscal targets may not be known with certainty and are the outcomes of a complex negotiation process.

Consider the decision-making process of boundedly rational policy makers who consider, *ex ante* in their budgetary planning, certain indicators of the "proper" level of (planned) expenditures and revenues. Although these levels are treated as targets *ex ante*, the assumption of an asymmetric loss function implies that these are not the utility-maximising values. In fact, the policy makers possess a loss function, in which they try to minimise upward and downward deviations which are weighted differently. The indicator levels from which such deviations are measured can be thought of as outcomes of bureaucratic negotiations within the state and between the recipient and the donors.

It is important to use an explicitly asymmetric loss function because policy makers may weigh the overshooting and the undershooting of these indicator levels differently. For some policy makers the underachievement of some indicators may be more significant than overshooting. For others the opposite may be the case.

By this theoretical and modeling strategy, it is possible to estimate the marginal impact of aid on budgetary expenditure and revenue categories.

Earlier works, such as those by Heller, Mosley, Hudson and Horrell; Gang and Khan; and Khan and Hoshino, employed linear-quadratic or quadratic representations of the objective function.<sup>16</sup> But recent work uses an objective function with higher degrees of both nonlinearity and asymmetry.<sup>17</sup>

A version of the model describes how foreign aid influences the recipient's expenditure and revenue-raising behaviour. In meeting preassigned values of indicator levels of expenditures and receipts, the decision makers respond in a predictable manner to any flows of aid from abroad.

The model takes into account the potential affect of aid on development and nondevelopment expenditures. The former type of expenditures includes the public sector's contribution to capital formation. Human and nonhuman capital are included. A third component of development expenditures is the government's contribution to social and economic services, e.g., expenditure on health and general welfare. Non-development expenditures are the expenditures on state administration. These two types of government expenditures are financed by internal and external means. Domestic revenues include taxes, public enterprise surpluses, and borrowing. External assistance comes in the form of bilateral and multilateral aid.

Much of the literature on the macroeconomic effects of foreign assistance focuses on aid's effect on economic growth. Our modeling approach is to analyze the impact of aid on public sector variables. Since aid funds pass through a policy maker's hand prior to reaching their destination, understanding where these funds are allocated by policy makers is a prerequisite to understanding the long-term effects of aid. The distinction made here is between current development and current nondevelopment expenditures. As a rule, the former will contribute to the long-run health of the economy, while the latter will not.<sup>18</sup> The full model is described in Appendix 1. Structural equations derived from policy makers' alternative preferences are also given in the Appendix.

The purpose of this model is to determine (a) what effect aid has on the development efforts and fiscal behaviour of the recipient and (b) to what extent the type of donor makes a difference. In determining the effect of aid ([a] above), the type of policy maker in the recipient country turns out to be crucial. I now turn to a discussion of these issues with reference to the MIT economies.

## Foreign Aid and the MIT Economies

What role did aid play in the economic development of the three South-east Asian countries? Of the three countries, Indonesia has received

more aid in absolute terms. However, what is similar in all three cases is the increase in nonaid foreign capital flow in the late 1980s and early 1990s. This kind of capital flow is a luxury that African countries did not have and probably will not have in the near future, in spite of their desperate attempts to attract foreign private capital. Thus, the first observation, in a comparative sense, is that aid will be more important for the African countries than it has been for the MIT economies. The proper use of this aid, as I will argue, can make the difference in the coming years between growth and stagnation.

But how important has aid been to these Asian economies? A study of Indonesia which is oil-rich – and generally rich in natural resources – is instructive. In spite of earning revenues from oil, which increased in price during the 1970s and early 1980s, Indonesia was running a current account deficit. Evidence shows that foreign aid made up a slightly increasing portion of the shortfall in budget from domestic revenues alone from 1969/70 to 1983/84. Later, we discuss whether or not the aid flow dampened the revenue-raising efforts of the Indonesian government. For the moment, however, the main point to note is that the volume of aid did enable the government to relax the constraints that are part of the two (or three) gap models.

One important consequence of the steady flow of aid was that it ensured macroeconomic stability without major pressure on foreign exchange reserves. However, it also ensured dependence on aid. As a specialist on the Indonesian economy puts it:

First, macroeconomic stability. Here the record is an unambiguous success. Fiscal policy has lacked flexibility owing both to the rigidities inherent in the balance budget rule, and to the absence of a well-developed government bonds market. In periods of boom, such as the mid-1970s, late 1970s and late 1980s, inflation has emerged as a serious problem. Nevertheless, the fiscal regime has contributed to impressive outcomes in terms of macroeconomic stability. Each time inflationary pressures have developed, there has been a firm response. The record was especially exemplary during the 1980s, when a series of austere budgets was introduced in response to declining oil prices. Few countries can match Indonesia in its stabilization policies, as emphasized in the large comparative World Bank research project on the subject. The government's second objective, that of reducing its dependence on foreign aid, remains as elusive as ever. During the oil boom period the relative importance of aid flows fell sharply, but in the mid-1980s they rose again, to a level approaching that of the early 1970s. The mid-1980s witnessed the first serious attempt to tackle the regime's poor record of (non-oil) tax collection. There have been notable achievements in the past decade, particularly in the case of the VAT and, more recently, income tax. But the agenda of unfinished business is a lengthy one. The tax structure is at best only weakly progressive. Tax evasion and straight-out corruption are still formidable

problems. Regional finance arrangements are in need of major reform. Perhaps most serious of all is the huge under collection of rents in the timber industry.<sup>19</sup>

From the raw data, it is also not clear what precise effect foreign aid per se had on development expenditures. But it is clear that, in some ways, aid did play a key role. During the oil boom period, aid funded a smaller but still significant part of the development budget. However, it was during the time when oil prices were low that the role of aid in the development budget became truly remarkable. By the late 1980s, the part of the development budget financed by aid rose to more than 70%, with the amazing figure of 81.6% in 1988. In the 1990s, aid financed less than 50% of the development budget, following strong growth and relatively successful tax reform; still the significance of aid for development financing is quite readily apparent.

At least as significant during this period was also the flexible manner of delivering the aid. There was, for example, a shift back to programme aid. Some financing of local “rupiah items” was also made possible. Programme aid made up over 50% of the total before the oil boom. The percentage fell to nearly 1% in the early eighties. After the mid-1980s crisis, it rose quickly to 34%. Benedict Anderson has called this aid dependence the annual “IGGI fix.”<sup>20</sup>

The role of aid, it can be stated without going into repetitious details, has been similar for both Malaysia and Thailand. Without the benefit of oil revenues, both countries have made up shortfalls in their development budgets at various times, ranging from 25% to 75%. However, aid dependence has been less in absolute terms for both countries. This was the result of deliberate policy, as well as success in attracting foreign investment. After the recent financial crisis, Thailand, in particular, has been a big recipient of IMF loans (as Indonesia has been). I now turn to the question of the macroeconomic impact of the aid to these three countries on their development expenditures. On the revenue side, the impact of aid on the domestic revenue-raising efforts will also be discussed. As mentioned in the previous section, these computations can be done by estimating, through econometric methods, the model presented before.

It is important to remember that policy makers work with actual budgetary data and not with theoretically defined entities. In the budgets of these countries, however, a distinction is made between development and nondevelopment expenditures. It has been estimated that a large component of the development expenditures is actually noninvestment expenditure. By and large, public administration and defense claim the lion’s share of nondevelopment expenditures. If one includes subsidies for food and other items given to the military, the figure may indeed be even higher.

Development budget includes expenditures on education, health, housing, and social welfare. These expenditures are counted here as genuine development expenditures, since they are directly or indirectly related to the well-being of the people and human capital formation. Needless to say, public investment is counted as an important component of development expenditures.

As mentioned in the previous section, the “boundedly rational” nature of the policy makers means that the chosen indicator levels of budgetary targets are not exact but only roughly accurate. Since there is very little empirical evidence of the policy makers’ actual chosen indicator levels for these targets, it becomes necessary to estimate these. The planning documents are not adequate, since they are drawn up at infrequent intervals and represent longer-term targets. The categorisations are also different from those required by the approach adopted here. Therefore I try to approximate the chosen indicator levels by regressing the actual *ex post* values on a series of instrumental variables and then by forecasting the indicator values. (See Appendix 2 for the exact procedure). As Sargent has recently pointed out in the context of rational expectations, the economist or the econometrician actually works in a bounded rationality sense when predicting these values from models such as the ones I have used.<sup>21</sup>

The econometrics and other technical details related to the estimation of aid impacts on the MIT economies have been described elsewhere.<sup>22</sup> Here the empirical results are summarised for Indonesia and, where relevant, for Malaysia and Thailand.<sup>23</sup> Appendix 2 presents the data set.

### *How Has Foreign Aid Influenced the Fiscal Behaviour of the Indonesian Policy Makers?*

The results of the empirical exercise for Indonesia are given in Table 12.1. The structural equations presented in Appendix 1 contain parameters  $\rho_R$ ,  $\rho_B$ , and  $\rho_M$  by way of constraints (3) and (4). These three parameters show the nondevelopment expenditure responses to an increase in domestic revenues, bilateral aid, and multilateral aid, respectively. In the table, estimates for these three parameters, together with some others, are shown for the eight different models describing eight different policy maker types, ranging from fiscally liberal to fiscally conservative, from statist to nonstatist, and from developmentalist to nondevelopmentalist, as shown in Table 12.2. After some general observations, I discuss two cases in detail for illustrative purposes. Other cases can be interpreted by following a similar approach.

Looking across the rows in Table 12.1, it is striking that for both developmentalist and nondevelopmentalist types of policy makers both

Table 12.1 The Impact of Foreign Aid to Indonesia, 1970–1996  
 Nonlinear SURE Parameter Estimates (Standard Errors in Parentheses)

Model	$\rho_R$	$\rho_B$	$\rho_M$	$\alpha_D/\alpha_R$	$\alpha_N/\alpha_R$	AIC
Type I	.7895 (.2312)	.6955 (.3121)	.8219 (.2311)	-.4131 (.0108)	-.6111 (.0310)	61.812
Type II	.7821 (.1235)	.6586 (.3121)	.6454 (.0501)	.1864 (.2312)	.7121 (.0152)	62.963
Type III	.8221 (.0821)	.7393 (.0333)	.8918 (.0582)	.5312 (.0211)	.4916 (.0982)	61.321
Type IV	.7235 (.1091)	.6123 (.0212)	.7215 (.0012)	.6972 (.0731)	.1693 (.0112)	60.132
Type V	.6291 (.0210)	.4681 (.0510)	.5284 (.0922)	-.0801 (.2310)	-.0428 (.5212)	59.123
Type VI	.4781 (.0191)	.4183 (.0214)	.7235 (.0809)	-.0213 (.0721)	-.0235 (.0412)	58.924
Type VII	.5031 (.0212)	.3283 (.0262)	.4581 (.0319)	.0312 (.0329)	.1912 (.0108)	57.234
Type VIII	.6582 (.0909)	.3581 (.0351)	.5281 (.0828)	.7214 (.0082)	.5821 (.5921)	59.151

Note: AIC = Akaike Information Criterion.

Source: Author's own calculations.

types of aid matter; however, bilateral aid seems to have had a greater impact than multilateral aid in almost every case of development expenditures.

According to the classification adopted here, types I–IV are the non-developmental policy makers and types V–VIII are the developmental ones. It is interesting to see the difference between the two types. The coefficient (with varying degrees of significance)  $\rho_B$  varies between .6123 and .7393 for models I–IV. That means that in the presence of bilateral aid approximately 26% to 39% of this aid goes to development expenditure on the margin, if the policy maker is nondevelopmental. On the other hand, from models V–VIII, the corresponding percentage of aid going to development expenditures lies between 67% and 53%. For models I to IV,  $\rho_M$  varies between .6454 and .8219. For models V to VIII, the range lies between .4581 and .7235. Thus, in terms of influencing development expenditures in Indonesia, rupiah for rupiah, bilateral aid has been more successful than multilateral aid. In addition to revealing the influence of bilateral aid, the above coefficients also indicate that the type of policy maker can really make a difference. This is also true in terms of financing development expenditures from domestic revenue. For a non-developmental policy maker,  $\rho_R$  varies between .7235 and .8221. Rather dismally, this implies that between 72% and 82% of domestic revenues may go to nondevelopment expenditures in the presence of aid.

Table 12.2 Policy Makers' Alternative Preferences  
 $\alpha_0 + (\alpha_D/2)(D^*/D)^2 + (\alpha_N/2)(N/N^*)^2 + (\alpha_R/2)(R/R^*)^2$

Type of Policy Maker	Development Expenditure	Nondevelopment Expenditure	Domestic Revenue	Specific Loss Function
Type I: Nondevelopmental, nonstatist, fiscal liberal	Overshooting worse than undershooting	Overshooting worse than undershooting	Overshooting worse than undershooting	$\alpha_0 + (\alpha_D/2)(D/D^*)^2 +$ $(\alpha_N/2)(N/N^*)^2 + (\alpha_R/2)(R/R^*)^2$
Type II: Nondevelopmental, nonstatist, fiscal conservative	Overshooting worse than undershooting	Overshooting worse than undershooting	Undershooting worse than overshooting	$\alpha_0 + (\alpha_D/2)(D/D^*)^2 +$ $(\alpha_N/2)(N/N^*)^2 + (\alpha_R/2)(R^*/R)^2$
Type III: Nondevelopmental, statist, fiscal liberal	Overshooting worse than undershooting	Undershooting worse than overshooting	Overshooting worse than undershooting	$\alpha_0 + (\alpha_D/2)(D/D^*)^2 +$ $(\alpha_N/2)(N^*/N)^2 + (\alpha_R/2)(R/R^*)^2$
Type IV: Nondevelopmental, statist, fiscal conservative	Overshooting worse than undershooting	Undershooting worse than overshooting	Undershooting worse than overshooting	$\alpha_0 + (\alpha_D/2)(D/D^*)^2 +$ $(\alpha_N/2)(N/N^*)^2 + (\alpha_R/2)(R^*/R)^2$
Type V: Developmental, nonstatist, fiscal liberal	Undershooting worse than overshooting	Overshooting worse than undershooting	Overshooting worse than undershooting	$\alpha_0 + (\alpha_D/2)(D^*/D)^2 +$ $(\alpha_N/2)(N/N^*)^2 + (\alpha_R/2)(R/R^*)^2$
Type VI: Developmental, nonstatist, fiscal conservative	Undershooting worse than overshooting	Overshooting worse than undershooting	Undershooting worse than overshooting	$\alpha_0 + (\alpha_D/2)(D^*/D)^2 +$ $(\alpha_N/2)(N/N^*)^2 + (\alpha_R/2)(R^*/R)^2$
Type VII: Developmental, statist, fiscal liberal	Undershooting worse than overshooting	Undershooting worse than overshooting	Overshooting worse than undershooting	$\alpha_0 + (\alpha_D/2)(D^*/D)^2 +$ $(\alpha_N/2)(N^*/N)^2 + (\alpha_R/2)(R/R^*)^2$
Type VIII: Developmental, statist, fiscal conservative	Undershooting worse than overshooting	Undershooting worse than overshooting	Undershooting worse than overshooting	$\alpha_0 + (\alpha_D/2)(D^*/D)^2 +$ $(\alpha_N/2)(N^*/N)^2 + (\alpha_R/2)(R^*/R)^2$

Source: Author's own formulations.



What kind of policy makers did make the decisions in Indonesia regarding development? This is a particularly fascinating question, but it is hard to answer in a definitive fashion. The best guess one can make must be based on a great deal of reliable institutional history. In Indonesia, this is largely unavailable. The books and articles written on this subject deal, at best, with particular episodes. On the whole, however, a picture of at least partial commitments to genuine development objectives emerge. This picture is consistent with my own visits to Indonesia and extensive investigations with the Indonesian and non-Indonesian academics and development practitioners on the subject.

I am able also to offer some econometric evidence to corroborate the above characterisation. In Table 12.1, the last column presents the value of the Akaike Information Criterion (AIC) for each of the eight models. AIC is a model selection criterion that can be applied to any model which can be estimated by the maximum likelihood method. One simply minimises  $(2 \text{Log } L)/n + 2k/n$  where  $k$  = the number of parameters in the likelihood function  $L$  and  $n$  is the number of observations. Particularly for a nonlinear model, the AIC is a convenient econometric discriminator among different model specifications. It would seem that by this criterion at least the type VII policy maker model may be the most appropriate one for Indonesia during the period of observation. This means that both developmental and statist concerns dominated the real fiscal agenda during this period. The model also seems to be consistent with the institutional studies and my own informed observations.

Let us consider, then, the type VII policy maker first. According to the typology in Table 12.2. type VII is also a fiscally liberal policy maker. All the  $\rho$ 's are positive and significant at the .05 level.<sup>24</sup> In the presence of foreign aid, almost 50% of the additional revenue goes to nondevelopment expenditures. For bilateral foreign aid the percentage going to development expenditures is 67%, whereas 54% of aid from all other sources is spent for nondevelopmental purposes. Thus, a straightforward interpretation would have been to claim the superiority of bilateral aid over other kinds of aid in this case. However, some caution is required. We do not know whether the presence of aid pulls some money out of the domestic revenue for nondevelopment purposes. It is reasonable to suspect that for some categories of aid (generally for both Japanese and other aid) this may be partially the case. Under these circumstances, if the substitution effect is not too high (i.e., if aid doesn't completely replace development expenditures that would have been financed out of domestic revenues), only then is there an incremental effect of aid on development expenditures. Under this scenario, bilateral aid would seem to be more effective, rupiah for rupiah, than other aid. I show next that, in the case of Indonesia, this may be a reasonable conclusion.

The ratios of the parameters from the loss function (the  $\alpha$ 's) can be readily interpreted by referring to the structural equations. In the simultaneous-equations framework, given the specific objective function and constraints, the ratios of  $\alpha$ 's (e.g.,  $\alpha_D/\alpha_R$  or  $\alpha_N/\alpha_R$ ) indicate how to explain the changes in domestic revenue in the presence of foreign aid. For the type VII policy maker both  $\alpha_D/\alpha_R$  and  $\alpha_N/\alpha_R$  are significantly different from zero. The interpretation of the first of these coefficients is as follows: In the presence of foreign aid, any increase in development expenditures reduces the domestic revenue-raising effort. The quantitative magnitude is given in a nonlinear fashion by the product of this coefficient and  $(1 - \rho_R)$ . However, raising the target for development expenditures, even with aid coming in, will lead to an increase in  $R$ . The coefficient  $\alpha_N/\alpha_R$  also gives an estimate of the (partial) impact of nondevelopment expenditures on  $R$ . In this case, an increase in nondevelopment expenditures also leads to an increase in  $R$ . Also, this magnitude is further increased by the magnitude of  $R^*$ . Thus, a bureaucratic or political decision to increase  $R^*$  will lead to an increase in revenues as well. We may call the above description the aid-dependent revenue effect.

If the aid-dependent revenue effect is positive, then the presence of aid actually increases domestic revenue. In the case of Indonesia, for the model VII type of policy maker this will be true. Let us now turn to the model which has the least AIC value among the rest; this is model VI. As can be seen from Table 12.2, this is the developmental, nonstatist, and fiscally conservative type of policy maker.

Looking across the row under the headings for the various parameters, the contrast is indeed quite reassuring empirically. More than 52% of the domestic revenue goes towards development expenditures even in the presence of foreign aid. The coefficient is significant both statistically and economically. Out of bilateral aid, again in a statistically significant sense, about 61% goes to development expenditures. Of the other aid receipts, about 55% goes to development expenditures. Thus, a major hypothesis of this study is verified: the more developmental the orientation of the policy maker, the more foreign aid influences spending in the direction of development. It also corroborates the earlier finding that bilateral aid performed well in general.

Turning now to the other coefficients,  $\alpha_D/\alpha_R$  and  $\alpha_N/\alpha_R$ , have absolute values of .0213 and .0235, respectively, and both are statistically significant. Looking at the revenue equation for this type of policy maker, it is possible to see that the negativity of  $\alpha_D/\alpha_R$  (estimated) implies that revenue increases as indicator levels of development expenditures increase, although the rate of increase is quite slow. This is consistent with a developmentalist but fiscally conservative preference. Aid finances development expenditures more than domestic revenue-raising efforts. In the

absence of aid, such expenditures may drop dramatically. Nondevelopment expenditures also lead to an increase in revenue raising. This is consistent with a balancing-the-budget fiscal conservatism. It also suggests that foreign aid is only marginally diverted to nondevelopment expenditures when finance is needed. It is more likely that domestic revenues are increased more than proportionately to cover these non-development expenditures.

From the discussion of the two cases, it would seem that the developmental and statist Indonesian policy making environment contributed to the salutary effects of foreign aid. Whether the policy makers were fiscally conservative or liberal may not have made that much difference.<sup>25</sup> If we go by the evidence of budget deficits, model VII would indeed seem to be the right model, and my earlier observations would be strengthened.

These results are very much at variance with the received wisdom on the effect of foreign aid on public expenditures. Aid may have been more effective in Indonesia because of its links with infrastructure investment. It may also be the case that microlevel projects are more successfully managed through technical cooperation. There is some evidence for this.

These results also confirm Howard Pack's and Janet Pack's findings with regards to the fungibility of aid in Indonesia.<sup>26</sup> Their study does not separate out bilateral aid. But they find "that in the largest categories, aid is spent for which it is given." They also find, as in some of the models discussed above, that taxes are raised in the presence of aid. In their study, they also suggest that a drive for independence leads to the raising of taxes. It could also be the case that some aid flow requires matching funds.<sup>27</sup>

In case of Malaysia and Thailand, the results are broadly similar to those concerning Indonesia. In both countries aid led to more development expenditures. As in Indonesia, the flow of aid seems also to be associated with an increased governmental effort to raise tax revenues as well. Also, bilateral aid flows seem to perform better than their multilateral counterpart.

The effectiveness of bilateral aid flows seems to be connected largely to Japanese bilateral aid. This has been demonstrated in a series of papers.<sup>28</sup> The main reason appears to be the infrastructure projects financed by Japanese aid. Since Japanese bilateral aid is a dominant share of all bilateral aid in these economies, this result is perhaps not altogether surprising.

However, in considering the effectiveness of aid – both multilateral and bilateral – we need to go beyond infrastructure, or even beyond public investment in general. Here certain weaknesses emerge in the MIT

economies. These weaknesses have largely to do with the shortfalls in human resource development in these countries. These shortfalls are extensively discussed elsewhere, but are important to highlight here.

Another aspect of foreign assistance which is directly connected to multilateral policy-based lending is the Structural Adjustment Programmes undertaken by the MIT economies in the 1980s. Thailand and Indonesia adopted SAPs early in the 1980s (1982/83). Indonesia's second adjustment period followed in 1985–86. Malaysia undertook a privatisation policy in 1983/84 and adjustment and liberalisation in 1986 after the severe 1985–86 recession. At the time the assessment of these reforms by both IMF-World Bank and domestic experts (a few dissidents aside) was highly positive. However, with the recent financial debacles, considerable skepticism has developed with respect to the liberalisation of the financial sector in particular.

Part of the structural adjustment for Thailand also involved the re-organisation and realignment of functions of development institutions such as the NESDB. In the case of Indonesia, the key role of Bappenas in aid management was attenuated somewhat, although it continued to play a powerful role, along with the Ministry of Finance and other functional ministries in the Indonesian government. Perhaps Malaysia was the only country where there was far less a gap between the rhetoric of shared growth (partly through external assistance) and the reality through the New Economic Policy.

To the extent aid has been successful in these economies, their success has been largely the result of a conscious allocation of aid by the government's budget towards development expenditures. In a stable macroeconomic environment, with the help of supporting governmental structures, aid can be used to finance development projects that may not otherwise be financed. Yet the results discussed here suggest that perhaps both multilateral and bilateral aid can be better utilised, especially for human resource development.

## The Role of FACE

It was mentioned at the beginning of the chapter that complementarities to foreign aid are crucial for the proper utilisation of aid. Therefore we need to spell out what FACE may entail.

First of all we can divide the components of FACE into two subcategories: institutional-induced and policy-induced. In the former category are the institutional structures, capacities, and practices at the political-administrative, economic, and civil-society levels. In MIT economies

generally these institutional aspects were not as strong as in East Asia. Yet they were definitely present. The state, while not autonomous, had periods of strength. Malaysia had the strongest state capacity. Indonesia and Thailand had considerably less capacity. It is not surprising, in retrospect, that the last two, particularly Indonesia, became readily vulnerable not to only a financial crisis but to a social and political crisis as the aftermath of the financial crisis. Although civil societies remain weak in the MIT economies, there is a minimal structure of indigenous organisations complemented by some NGOs.

The second, policy-induced category of FACE is equally important. Policies of export-led development have been significant, if not instrumental, in mobilising foreign aid for investment purposes. The presence of foreign direct investment, invited by the government's opening of the economy, may also have influenced, at least partially, the channeling of aid to investment. Finally, the creation of human capital through health and education policies also played a role in MIT economies, but much less so than in South Asia or even East Asia. Of course, this only underscores the importance of these policies for creating proper conditions for utilising foreign aid.

## Conclusion

To summarise, the experience of the MIT economies in terms of their governments' response to foreign aid is, on the whole, a positive one. Although there have been leakages and institutional weaknesses remain, investment has taken place. Although firm econometric evidence is lacking, the part of investment that has been financed by foreign aid has most likely contributed to overall growth. Are there elements complementary to foreign aid that helped bring this about?

In spite of institutional weaknesses there would seem to be some administrative, political, and civil-society aspects that may at least partially explain the relative effectiveness of aid. Administratively, allocative agencies, such as Bappenas (for the distribution of investments) in Indonesia, have partially channeled funds toward investment. Politically, the states in the MIT economies, while not as strong as those in the East Asian economies, can be viewed as at least "weak-strong," to use the term coined by Rudolph and Rudolph in the Indian context.<sup>29</sup>

By the "weak-strong" state, I emphasise the relatively autonomous relations of the state with the society in which it is embedded. At the same time, the "weakness" of the state arises from the gradual erosion of the autonomy as corrupt interest groups come to dominate the state

apparatus. As long as there is some correspondence between state policies and the real needs of development, foreign aid in this setting may be partially utilised for development. However, as the Asian crisis showed, the “weak-strong” states may very well end up being dominated by rent-seeking groups.

Finally, in civil society, the presence of indigenous institutions and foreign organisations may have helped as well. On the indigenous side, the presence of “quasi-cooperatives” in Indonesia and the transmission of local credit through these channels may have prevented some of the leakages from aid. Some NGOs have played a role in allocating funds as well.

It can be argued that, given the desperate present situation in Africa, foreign aid is even more crucial there than it has been in South Asia. To use Sen’s language of capabilities, because the extent of capabilities failure is so alarming in Africa, there is both an economic scope and a strong moral case for direct intervention in order to improve the basic capabilities. By preventing hunger and malnutrition, by providing people with basic health care, and by spending on creating a literate, educated population, the foundation for long-run growth can be laid.

It is clear that some of the complementary institutions related to administration, governance, and civil society need to be present or to be built in Africa in order for aid to be more effective than it has been in the past. Perhaps the encouraging lesson to draw from the Southeast Asian experience is that, even with a minimal set of relatively weak institutions, foreign aid can be utilised in a way that could lead to investment. The task for many African countries will then be to create at least a minimal set of political and socioeconomic institutions to make such effective utilisation of aid possible.

In addition, the presence of export-oriented policies and export markets certainly helped create the demand for investment in Southeast Asia. Foreign aid was also used to create infrastructure that complemented foreign direct investment.

Therefore, on the positive side, the most important overall lesson from the Southeast Asian experience may be the need to have some of the factors that are complementary to foreign aid (FACE) in place so that such aid as is forthcoming can lead to the greatest possible development impact. As many of these factors may not be present in large quantities, both foreign and domestic resources may need to be mobilised to create some of them. A kind of “strategic bunching” may be necessary where some infrastructure and human-capital creation, as well as technology adaptation, may need to be undertaken simultaneously so that a critical mass of FACE is created. Further injection of aid then can be expected to lead to a greater impact than that produced initially.

### Appendix 1: The Asymmetric Loss function Model for Allocation of Foreign Aid

Policy makers minimise a loss function subject to expenditure constraints. In most general terms, the (quadratic-ratio) loss function,  $L$ , is given by

$$\alpha_0 + \sum_i (\alpha_i)(i^j/i^k)^\beta$$

if  $j = *$ , then  $i^k = i$ ,  
 if  $k = *$ , then  $i^j = i$ ,  
 $i = R, D, N$ ,  
 $\beta \geq 2$ .

(2)

The superscripts “ $j$ ” and “ $k$ ” are related in the following way: If  $j$  (respectively  $k$ ) represents the indicator value (symbolised by  $*$ ), then  $i^k$  (respectively,  $i^j$ ) equals  $i$ . The superscripts “ $i$ ” and “ $j$ ” can be  $R$ ,  $D$ , or  $N$  (domestic revenues, development expenditures, and nondevelopment expenditures, respectively). The simplest nonlinear model, which is also asymmetric and economically meaningful, is obtained when  $\beta = 2$ . Note that for the exact fulfillment of chosen indicator levels,  $L = \alpha_0 + (\alpha_D/2) + (\alpha_N/2)$ . The policy maker is making decisions on various categories of public expenditures. Each decision will reflect on her abilities, possibly her status, or even her job. In an uncertain environment, the best she can do is to reach the stated chosen indicator value.

The loss function stated in equation (2) has the advantage of allowing for asymmetries in loss when the policy maker over- or undershoots the chosen indicator level. The loss function also allows us to examine different assumptions about the “type” of the policy maker. For example, writing the loss function explicitly as

$$\alpha_0 + (\alpha_D/2)(D^*/D)^2 + (\alpha_N/2)(N/N^*)^2 + (\alpha_R/2)(R/R^*)^2$$

illustrates a policy maker who is “developmentalist” in orientation: Undershooting the development expenditure indicator value is worse than overshooting it. At the same time, the above policy maker is a “fiscal liberal,” since overshooting the revenue-raising indicator value is worse than undershooting it. Such policy makers are not very anxious about the emergence of the inflationary gap. These bureaucrats are also “nonstatist” in that overshooting nondevelopment expenditures is worse than undershooting them. Statist bureaucrats who seek to maximise the resources which the state uses to reproduce itself would have loss functions that are asymmetric in exactly the opposite direction with regard to the composition of public expenditure. All in all, there are eight possible

characterisations. Part of our problem is to explore which of these characterisations “best” captures the behaviour of policy makers in an empirical setting.

Given the type of policy maker, the decision making problem can be described as the minimisation of a specific form of equation (2). The economic and institutional constraint to which this minimisation problem is subjected is the following:

$$N + D = R + A_B + A_M.$$

The above, of course, is the accounting identity that expenditures equal receipts. To capture the distribution of foreign aid and domestic revenues into budgetary categories, we instead write,

$$D = (1 - \rho_R)R + (1 - \rho_B)A_B + (1 - \rho_M)A_M \quad (3)$$

and

$$N = \rho_R R + \rho_B A_B + \rho_M A_M. \quad (4)$$

$(1 - \rho_R)$ ,  $(1 - \rho_B)$ , and  $(1 - \rho_M)$  are the fractions of domestically raised revenues, bilateral aid and multilateral aid, respectively, allocated to government development expenditures. These two constraints reflect alternative uses of government revenues augmented by foreign assistance.<sup>30</sup> The first constraint allows for the possibility that  $D$  can be financed partly by domestic revenues and partly by different sources of foreign aid. The second constraint assumes that domestically raised revenues and foreign aid not used for development purposes go towards nondevelopment government expenditures. The model thus involves a trade-off between development and other spending by the government. It is a theoretical model of the implications of recipient preferences that can be used to determine the fiscal behaviour of the government in the presence of foreign aid.

Solving the constrained-loss minimisation problem leads to a set of nonlinear simultaneous equations. The direction and extent of the impact of bilateral and multilateral foreign aid on  $N$  and  $D$  can be estimated.

## Appendix 2: Estimation of Indicator Levels and the Data Set

Each indicator level is estimated by specifying an equation relating the actual variable to some instruments. I then regress the actual variable on



the chosen instruments (with correction for autocorrelation). Planned  $D$  is obtained by estimating an equation where  $D$  is a linear function of GDP and total gross domestic investment in the private sector together with proxies for investment in human capital. The fitted values of the dependent variable serve as indicator levels. Planned  $R$  is found in a similar manner, by regressing  $R$  on GDP and lagged imports and then using the fitted values of the dependent variable as the indicator value. Planned  $N$  is obtained by regressing  $N$  on the lagged value of itself.

According to the theoretical approach adopted here, the policy makers respond to the availability of foreign aid by reallocating money to the various budgetary categories. Although the model assumes bounded rationality, the reallocation itself is in response to additional amounts of foreign aid and is therefore in keeping with allocation at the margin. My major concern here is to examine the allocation of finance to development and nondevelopment expenditures. An additional area of interest is the impact of aid on domestic revenue raising.

The data set comprises foreign aid to Malaysia, Indonesia, and Thailand in 1970–1996. This is the period when all three economies took off. This is also the period, for Indonesia in particular, when the New Order Government under Suharto undertook successive development efforts in Indonesia. In what follows, the Indonesian case study is described in somewhat greater detail than those studies done for Malaysia and Thailand. The results are broadly similar for all three countries. In addition to the aid data, the annual fiscal statistics on revenues and expenditures were also collected both from Indonesian and non-Indonesian sources. Among Indonesian sources are the documents of BPS (the Central Bureau of Statistics) and the Bank of Indonesia (its annual reports). The Indonesia Source Book from the National Development Information Office also served as a source of information. After reconciling the statistics from various sources, all the data were converted to constant rupiahs at 1980 purchasing-power parity prices.

For the purpose of estimating and interpreting the model correctly, the fact mentioned earlier that the policy makers work with actual budgetary data and not with the theoretical entities we have in the model becomes relevant. A translation between the two modes is necessary. Fortunately, for our purpose, however, the Indonesian budgetary categories do correspond to development and nondevelopment expenditures to a large extent. All the published categories, such as agriculture and irrigation; industry; mining and energy; transportation and communications; public works and transmigration; education, health and family planning, can be used directly. Local and regional development and expenditures also comprise a separate category. There is a large “other,” or residual, category. After discussion with the Indonesian scholars and officials, it was decided that

part of this “catch-all” category, in fact, caught some “nondevelopment expenditures.” The “catch-all” category was estimated to be between 25% and 40%. After further discussions and checking (a very time-consuming process) with the Ministry of Finance and BPS officials, an estimate of linkage to nondevelopment expenditures was arrived at for each year between 1970 and 1996.

On the revenue side, development funds including project aid are clearly marked off from the other items. The flow from income tax, value-added tax, excise- and import tax receipts constitute the major sources of government tax revenues. The tax collection system was standardised and modernised as a result of the post-1983 reform programme. Corporate and personal income taxes are now set at the top marginal rate of 35% on annual incomes above Rp 50 million. Tax revenues have risen in recent years. However, a large part of revenues has traditionally come from the oil and gas sectors. In 1987 Indonesia was the lowest taxed nation in Southeast Asia, with a tax to GDP ratio of 9.1%. By 1990, the ratio had risen to 12.5%.

The estimation procedure for each of the eight alternative preference structures given in Table 12.2 in the text is identical. In each case a non-linear, seemingly unrelated regressions estimation (SURE) procedure is followed. Akaike information criterion is given for model selection.

## Notes

1. I would like to thank Emma Banaria and Pat Baysa and Gyeongjei Lee for valuable assistance. All remaining errors are mine. The views expressed are my own and in no way reflect the positions of the organisations with which I am affiliated.
2. There is also a large literature on the microeconomic and project-level (mostly cost-benefit) analysis of aid. For references see Howard White, “The Macroeconomic Impact of Development Aid: A Critical Survey,” *Journal of Development Studies* 28, no. 2 (January 1992): 163–240; Paul Mosley, *Overseas Aid: Its Defence and Reform* (Brighton: Wheatsheaf, 1987). Here the focus is on the macroeconomic policies for making foreign aid work. This area is both more controversial and from the donor perspective increasingly of concern, as shown, for example, by policy-based lending.
3. Paul Mosley, “Aid-Effectiveness: The Micro-Macro Paradox,” *IDS Bulletin*, 17 April 1986, 22–35.
4. See Peter T. Bauer, *Reality and Rhetoric: Studies in the Economics of Development* (London: Weidenfeld & Nicolson, 1984). Bauer seems to suggest that this is really the only benefit of foreign aid.
5. See Edmar L. Bacha, “Growth with Limited Supplies of Foreign Exchange: A Re-appraisal of the Two-Gap Model,” in *Economic Structure and Performance: Essays in Honor of Hollis B. Chenery*, eds. Moshe Syrquin, Lance Taylor, and Larry Westphal (New York: Academic Press, 1984); Edmar L. Bacha, “A Three-Gap Model of Foreign Transfers and the GDP Growth Rate in Developing Countries,” *Journal of Develop-*

- ment Economics* 32 (1990): 279–96; Hollis B. Chenery and Alan M. Strout, “Foreign Assistance and Economic Development,” *American Economic Review* 56 (1966): 149–79.
6. See Peter S. Heller, “A Model of Public Fiscal Behavior in Developing Countries: Aid, Investment and Taxation,” *American Economic Review* 65 (1975): 429–45; Ira N. Gang and Haider Ali Khan, “Modelling Foreign Aid and Development Expenditures” (paper presented at AEA Conference, Atlanta, 1989); Ira N. Gang and Haider Ali Khan, “Foreign Aid, Taxes and Public Investment,” *Journal of Development Economics* 34 (1991): 355–69; Haider Ali Khan, “Does the Policy-Maker Make a Difference?” (paper presented at the AEA/ASSA meetings, Washington D.C., January 1995); Haider Ali Khan, “Does Japan’s Aid Work?” (unpublished paper, University of Denver, 1995); and Haider Ali Khan, “The Impact of Japanese Aid in a Bounded Rationality Model: The Indonesian Case” (unpublished paper, 1995).
  7. The *social* aspects of the capability approach are pointed out by Nussbaum in an Aristotelian context. Recently, Khan has extended this approach in a rights-based framework that is neo-Hegelian. See A. K. Sen, *Inequality Reexamined* (Cambridge: Harvard University Press, 1992); Martha Nussbaum, ed., *Women, Culture and Development* (Oxford: Clarendon Press, 1995).
  8. Lance Taylor, ed., *The Rocky Road to Reform: Adjustment, Income Distribution, and Growth in the Developing World* (Cambridge, Mass.: MIT Press, 1993).
  9. Bacha, “Growth with Limited Supplies of Foreign Exchange.”
  10. See Helen Shapiro and Lance Taylor, “The State and Industrial Strategy,” *World Development* 18 (1990): 861–78.
  11. Heller, “A Model of Public Fiscal Behavior in Developing Countries.”
  12. Haider Ali Khan, “Does Bilateral Foreign Aid Affect the Fiscal Behavior of a Recipient?” *Journal of Asian Economies* (March 1994).
  13. Heller, “A Model of Public Fiscal Behavior in Developing Countries.”
  14. Haider Ali Khan and Elichi Hoshino, “Impact of Foreign Aid on the Fiscal Behavior of LDC Governments,” *World Development* 20 (1992): 1481–88.
  15. Gang and Khan, “Foreign Aid, Taxes and Public Investment.”
  16. Heller, “A Model of Public Fiscal Behavior in Developing Countries”; Paul Mosley, John Hudson, and Sara Horrell, “Aid, the Public Sector and the Market in Less Developed Countries: A Reply,” *Economic Journal* 97 (September 1990): 616–41; Gang and Khan, “Foreign Aid, Taxes and Public Investment”; Khan and Hoshino, “Impact of Foreign Aid on the Fiscal Behavior of LDC Governments.”
  17. Paul Mosley, John Hudson, and Sara Horrell, “Aid, the Public Sector and the Market in Less Developed Countries,” *Economic Journal* 97 (1987): 616–41.
  18. Obviously, there can be some complementarity between development and non-development expenditures. For example, within provisions of an infrastructure, legal and other kinds of services and certain types of regulatory environment for “normal” business activities could be very productive.
  19. Hal Hill, *Indonesia’s Industrial Transformation* (Singapore: Institute of Southeast Asian Studies; Allen & Unwin, 1997).
  20. Since 1992 CGI.
  21. Thomas Sargent, *Bounded Rationality in Macroeconomics* (Oxford: Clarendon Press, 1993), 21; 3; 160.
  22. See Khan, “Does the Policy-Maker Make a Difference?”; Khan, “Does Japan’s Aid Work?”; and Khan, “The Impact of Japanese Aid in a Bounded Rationality Model,” in particular for discussions of tests for cointegration and other issues related to spurious regression with time series data.
  23. This is done in order to avoid unnecessary repetitions. As emphasised in the text, the

institutional mechanisms for aid use are more important than slight differences in estimated parameter values.

24. From here on, wherever the phrase “statistically significant” occurs, it will mean significant at the .05 level unless otherwise specified.
25. It is not possible to say definitively what the type of the policy maker was without further information. The Indonesian government professes fiscal conservation, and there is some evidence of efforts to increase taxes, as mentioned above. However, there also seem to be chronic budget deficits.
26. Howard Pack and Janet Rothenberg Pack, “Is Foreign Aid Fungible: The Case of Indonesia,” *Economic Journal* 100 (1990): 188–94.
27. Peter Cashel-Cordo and Steven G. Craig, “Donor Preferences and Recipient Fiscal Behavior: A Simultaneous Analysis of Foreign Aid Fungibility and the Flypaper Effect” (Canisius College, Buffalo, N.Y., 1992, manuscript); Anne Booth, “Survey of Recent Developments,” *Bulletin of Indonesian Economic Studies* 24, no. 1 (1988): 1–26.
28. Khan, “Does the Policy-Maker Make a Difference?”; Khan, “Does Japan’s Aid Work?”; and Khan, “The Impact of Japanese Aid in a Bounded Rationality Model.”
29. Lloyd Rudolph and Suzane Hoeber Rudolph, *In Pursuit of Lakshmi: The Political Economy of the Indian State* (Chicago: University of Chicago Press, 1987).
30. One would like the allocation of aid among budgetary categories to be the outcome of a utility maximising problem. Incorporating fungibility into a decision making problem as a subproblem is extremely difficult. Use of a single budgetary constraint a priori assumes that aid is 100% fungible. While not directly addressing the fungibility issue, our approach does not a priori assume 100% fungibility; it does look at the allocation of aid among budgetary categories.

## Foreign Aid, Debt and Development in Sub-Saharan Africa: Experiences and Challenges

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*Samuel M. Wangwe*

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The increasing integration of national economies into global markets has altered dramatically and promises to continue doing so, including the volume and character of international resource flows and foreign aid. Globalization is carrying with it the threat of continued marginalisation of Sub-Saharan Africa (SSA) from the global development process. First, SSA faces marginalisation in trade, as preferential trading arrangements are diluted by moves in the direction of multilateral trading arrangements and hence multilateral tariff reductions. As a whole, Africa's share in world trade, the bulk of which is still confined to the exportation of primary goods and the importation of nonprimary, intermediary, capital, and consumption goods, has declined considerably in the last three decades. It varied from 4.1% to 4.9% in 1960–65, fluctuated around 4.4% during the 1970s, and declined consistently to 2.3% in the 1990s. Second, the region faces marginalisation in investment, one of the critical ingredients of development, since Foreign Direct Investment (FDI) flows to regions with perceived higher returns. SSA received FDI flow worth U.S. \$1.8 billion in 1994 (the size of the flows to New Zealand), while North Africa received U.S. \$1.3 billion, implying that meagre flows of FDI in the continent continue to be concentrated in a small number of countries endowed with resources, especially oil.<sup>1</sup> FDI inflows to Africa as a whole reached U.S. \$4.6 billion in the mid-1990s, most of it concentrated in a few countries (e.g., Egypt, Morocco, Nigeria). Total FDI flows have more than tripled in 1991–95, reaching U.S. \$90 billion in 1995.<sup>2</sup> However,

over time the share of Africa in total FDI flows to developing countries has been declining from 16% in the 1970s to 10% in the 1980s and down to 5% in the 1990s.<sup>3</sup> By 1998, FDI formed only 7% of GDI in Sub-Saharan Africa and 1.3% of GDP, compared to 12.4% and 3.9%, respectively, in East Asia. Trends in North Africa were better than those for Sub-Saharan Africa. Third, the region faces marginalisation in rapid global technological advances because of the absence of requisite financial as well as human infrastructure to support such advances in the region. For instance, the global information revolution and, in particular, the communications sector have by and large bypassed Africa, given that Africa has only 2% of the world's telephone lines, most of which are in a few large cities.

At the regional level, significant changes in the socioeconomic and political conditions have taken place and are still taking place in Africa. Structural Adjustment Programmes (SAPs), which have involved substantial reforms in national exchange, commercial and credit policies, as well as various institutional arrangements, are being undertaken in virtually all the region's economies. SAPs, which are mainly attributed to the economic crisis in the continent that became apparent in the early eighties, had the following main goals: getting prices right, shifting corporations from public to private ownership and from administrative controls to market orientation, shifting from import substitution to export orientation industries, and shifting from import-intensive industrialisation to resource-based manufacturing. In the political arena, there has been a notable trend towards multiparty systems and more accountable governments, dating from the 1990s.

From the 1980s, improvement in economic performance in SSA countries has coincided with the opening of countries to foreign investments and with efforts to increase participation in world trade. Political and economic reforms are improving the possibilities of SSA's entering the new millennium much more integrated with the world in the areas of trade, finance, investments, and communications. Foreign aid has been one of the most significant external links for much of SSA. This chapter examines the trends of foreign aid, the experiences of aid effectiveness and aid management, and the debt problem, and it draws some lessons from these experiences.

## Trends in Foreign Aid

Foreign aid, that is, the international transfer of funds (loans and/or grants) from one government to another or from multilateral agencies to a government with the aim of facilitating and accelerating recipient

Table 13.1 Aid Flows by Developing Region 1990–2000

Region	Share of Aid Flows to All Developing Countries				Share of Regional GNP			
	1990	1998	1999	2000	1990	1998	1999	2000
East Asia and Pacific	17.0	17.7	20.1	20.0	0.8	0.4	0.4	0.3
Latin America and Caribbean	10.2	9.2	9.9	9.1	0.4	0.2	0.2	0.2
Middle East and North Africa	19.9	11.6	9.5	9.9	2.0	0.7	0.7	0.8
South Asia	12.2	12.5	9.8	10.1	1.3	0.8	0.8	0.8
Sub-Saharan Africa	37.2	32.3	27.8	27.2	5.8	3.9	4.2	4.1
Europe and Central Asia	3.5	16.5	22.9	23.7	0.1	0.6	0.6	0.6
All developing countries	100.0	100.0	100.0	100.0	1.0	0.6	0.6	0.5

Sources: OECD DAC, World Bank Data System, and World Bank Staff Estimates.

countries' development, appears to be losing its popularity to flows of private capital in filling the resource gaps in developing countries. Financial flows are increasingly being dominated by private capital flows to developing countries. For instance, in 1996, private capital flows exceeded U.S. \$240 billion, which equaled six times their level at the beginning of the decade. In the preceding five years, they had overtaken and dwarfed the levels of Overseas Development Assistance (ODA).<sup>4</sup> This trend has continued into the twenty-first century. Africa has largely been bypassed by these expanding private capital flows, a situation that has not helped to offset the impact of the global decline in the volume of ODA flows.<sup>5</sup>

In Sub-Saharan Africa, civil conflicts and delays in implementing reforms caused a sharp drop in net aid flows to Côte d'Ivoire, Guinea, Kenya, Niger, and Togo. But some reforming countries (e.g., Tanzania, Uganda, and Zambia) saw net aid flows rise, although modestly.

Prospects of future aid flows to SSA remain uncertain because of budgetary pressures in many donor countries, competing claims on donor resources, and changes in the ranking of strategic and economic interests, especially following the end of the cold war. The European Commission (EC), the traditional aid giver to Africa has changed the distribution and composition of ODA in favour of other regions. Although volumes of aid flowing from EC to SSA have not shown any clear trend, the region has lost its share from 70% at the beginning of the 1970s to 60% in the 1980s

Table 13.2 Aid Flows to Sub Saharan Africa 1980–98 (Million of US\$ – 1995 Prices)

Year	Net ODA from All Donors, Real	Net ODA from DAC Donors, Real
1980	13,233	7,872
1990	26,784	16,532
1991	26,686	17,430
1992	25,196	16,245
1993	22,542	14,127
1994	23,962	14,654
1995	20,746	12,290
1996	18,262	11,676
1997	17,068	10,610
1998	17,949	11,317
1975–1984 (Average Annual % Growth)	2.4	7.5
1985–1989 (Average Annual % Growth)	6.9	6.7
1990–MR (Average Annual % Growth)	-17.2	-17.6

Source: World Bank, African Development Indicators, 2001.

and down to 44% in 1994–95.<sup>6</sup> The shift of EC aid flows has favoured central and eastern Europe and the new independent states. All these regions accounted for about 25% of all EC aid disbursements for 1994–95.<sup>7</sup>

## Effectiveness of Aid and Its Management

The record of the last fifty years, from the date of the Marshal Plan, shows that the efforts of recipients to help themselves have been instrumental to their success. Development assistance has successfully complemented many achievements, such as the green revolution, the fall in birth rates, improved basic infrastructure, improvement in health, and reduction of poverty.<sup>8</sup> Properly applied in a conducive environment, aid works.<sup>9</sup>

Has aid to SSA been effective? The answer depends on what aid was intended to achieve. As a tool of transferring resources, the results have been mixed. As a project-funding gap filler, the answer has been positive. When aid was primarily intended to bridge the gap between the country's investment target and domestic savings, it did help to bridge that gap, in



gross terms. As an externally derived resource, aid also contributed to bridging the foreign-exchange gap in import-dependent economies of SSA. But over a long period, even those seemingly positive achievements started to be put to the test. Indeed, the frequent reliance on project rehabilitation in the 1980s is an adequate testimony to this conclusion. The need to adopt Structural Adjustment Programmes in many countries in Africa, beginning in the 1980s, bears further testimony to the challenges of achieving the intended objectives in the same policy environment. Also, when a yardstick of graduation, is applied, unlike in Southern Asia, no country in SSA has been weaned from aid. Botswana is probably the one country which is nearing independence from aid. With the onset of the adjustment regime in the 1980s, the goals of aid became a lot more blurred and the effectiveness of aid much more complicated to evaluate. Both donors and SSA countries should address this issue through improved resource use planning and macroeconomic management, as well as accountability in the use of resources. It is important to recognise the role of long-term investment commitment in ensuring sustained growth.

A study of the experiences of eight countries in SSA<sup>10</sup> indicate that in all of them, except Botswana, there have been more failures than successes.<sup>11</sup> However, the case studies also demonstrate that aid to Africa has some notable achievements to its credit. Alongside many disappointments, aid has financed many development projects and programmes which achieved reasonably high internal rates of return, including schools, clinics, health posts, bridges, roads, manpower training programmes, etc.<sup>12</sup> In addition, foreign aid has been decisive in helping certain countries and communities get through times of extreme stress. However, there is also evidence of futility and even perversity in results of official aid.<sup>13</sup>

The rest of this section examines the macroeconomic environment, the management capacity of recipient countries, aid relationships, and the major challenges of aid to Africa.

### *The Macroeconomic Environment*

The first factor that helps to explain the success of aid is the extent to which it is designed and implemented in the context of macroeconomic stability. The eight country case studies in Africa on aid effectiveness clearly demonstrate a perhaps even more important negative impact of macroeconomic instability on aid.<sup>14</sup> Particularly when it is prolonged, economic and fiscal crisis undermines the quality of public sector management, which also has a negative effect on the quality of aid. Long-term economic disequilibrium results in a weakening of the government's planning and budgeting functions.<sup>15</sup> International assistance is only use-

ful in supplementing domestic resources within the context of a disciplined national policy environment that encourages the efficient and equitable use of all available resources, both foreign and domestic. In the presence of such conditions the need for external assistance is greatly reduced. In the absence of such conditions, aid is of little help and is usually counterproductive.

A study carried out by the World Bank in 1998 found that good policies are positively associated with aid. Aid was found to be effective where sound policies were adopted. However, it was also found that allocation of aid, especially aid from bilateral donors, was not significantly influenced by the soundness of policies which recipient countries pursued. These and similar findings have led to proposals that allocation of aid should be more selective in favour of countries which pursue sound policies.

The selectivity proposal raises two other challenges. First, the question arises, Who defines good policies? In the recent past the donors and, in particular, the International Financial Institutions (IFIs) have exerted considerable influence in defining good policies in SSA. The policy index that was adopted by Burnside and Dollar (1997) was constructed from only three variables (budget surplus, inflation, and openness). These variables are rather too narrow. In practice, sound policies mean much more than the three variables covered. This policy index will need to be subjected to more critical discussion. The gravity of this challenge is somewhat reduced by recent findings which have showed that there is a high correlation between the policy index constructed from these three variables and the one constructed from a more complex set of variables.<sup>16</sup> The second challenge is the question whether countries, which pursue bad policies at present, should be abandoned altogether or whether there are ways of assisting them to shift from bad-policy regimes to good-policy regimes. It is quite possible that even a country pursuing bad policies today may benefit from current assistance that increases the chances of its developing the kind of society which can create conditions for good policies to be adopted in the future. The path taken from bad to good policies will be influenced by the nature of conditionalities adopted in aid administration. This influence should be an important consideration.

### *Management Capacity of Recipients*

Aid programmes are more likely to be successful when the recipient government has the capacity to identify and articulate its own priorities and programmes and has the ability to implement, monitor, and evaluate the resulting programmes in the context of its own planning and budget-

ing. The case studies of seven countries in Africa show that their capacities for harnessing and managing their resources effectively are generally deficient.<sup>17</sup> These findings are corroborated by results of subsequent studies, one covering eight countries in SSA<sup>18</sup> and the other covering ten countries.<sup>19</sup> In the absence of central state management capacity among recipients, donors try to fill the gap. For example, donors often resort to a host of parallel aid management systems to perform the tasks they do not believe available state structures are capable of undertaking. Over time, this becomes a self-fulfilling prophecy for donors, since capacities and resources are, in fact, transferred to these parallel structures, which begin to attract the most skilled and ambitious local technocrats, to the detriment of even the strongest central state institutions. Soon, even the government prefers these parallel structures to its own structures for project implementation.<sup>20</sup> Aid effectiveness rests on trained and experienced manpower as well as efficient aid-channeling procedures. Though everybody recognises this dictum, there is a need to put it into practice. SSA countries need to put greater emphasis on capacity building in economic management and policy research institutions as they form the foundation for generating ideas and programmes for running the economic system. Several issues are to be addressed: the role of expatriate technical assistance, the training of staff, and sustainable office technology and remuneration. With respect to the TICAD theme, consideration should be given to strengthening trade, export, private investments, and tourism promotion.

### *Aid Relationship*

The nature of aid relationships between donors and recipients has critical influence on aid effectiveness. The results from seven country studies in Africa suggest that the aid relationship between African governments and donors has been unequal and characterised by the passivity of recipients and the dominance of donors.<sup>21</sup> A subsequent study of eight countries in SSA has found similar results.<sup>22</sup> The unequal nature of the relationship has probably contributed to misunderstanding, resentment, and, quite often, conflict between the partners. In the context of SSA aid, conditionality has been one-sided, largely determined by the donor. The way conditionality has been designed has not helped it to effectively improve policy. While this finding provides an important caution, when properly designed, conditionality can enhance the chances of better policies and stronger private capital flows. Conditionality can be designed to serve both as a signal and as a commitment mechanism.<sup>23</sup> Efforts should be made to shift the focus from disbursements to an assessment of results on the ground and to tie incentives and penalties within the donor in-

stitutions to outcomes rather than the level of financial aid disbursed. In this context, the New Partnership for Development (NEPAD), which was adopted by African heads of state in 2001, put considerable emphasis on the criticality of changing aid relationships to promote ownership by African countries. In this respect, Tanzania has taken the lead, whereby Tanzania and its donors have been redefining aid relationships since 1997, based on a report of independent experts led by Professor Gerry Helleiner of the University of Toronto. The Helleiner report addresses the issue of aid relationships between Tanzania and its donors, and it has formed the basis of discussions in annual Consultative Group meetings and has become an important input in the preparation of the Tanzania Assistance Strategy, which contains a framework for development cooperation. The document provides a framework guiding aid relationships between Tanzania and its development partners. The process of improving aid relationships is continuing under the Independent Monitoring Group, comprising local and foreign experts acceptable to the Tanzania government and its development partners.

### *Major Challenges of Aid to Africa*

Effectiveness of aid to Africa encounters four main challenges. The main ones are the lack of ownership of the development agenda, poor aid coordination, deficiencies in managing resource allocation and public expenditure, and the proliferation of aid projects.

#### *Low Level of Recipient Ownership*

Structural Adjustment Loans under SAPs brought with them substantial increase in aid to SSA. Aid reached 11% of GDP by 1994, compared with only 1% in other LDCs. The SAPs were fast disbursing, but high levels of aid in many SSA countries undermined self-sustained development. In the end, the SAPs engendered apathy on the part of the recipients, which, in turn, encouraged donor agencies to take over project planning and execution tasks, thereby jeopardising the long-term sustainability of projects. The worst result of dependency has been the syndrome characterised by an abandonment of initiative and leadership by the recipients and an abdication of the same to the donors, especially to the IMF and the World Bank during the reform period. Recently both donors and African countries have recognised the dangers of this state of affairs. Low ownership of the development agenda and of development management is common across Africa. Major policy formulations have either been made by donors or have been influenced by donors. In many African countries, the period in which SAPs were introduced witnessed the lowest level of ownership of the policy agenda. During this period,

donor influence largely came through the design of economic recovery programmes, policy framework papers, and public expenditure reviews.

The ownership by the recipients has been reduced even further by the lopsidedness of the system of conditionalities. African countries have been on the receiving end in the conditionality relationship. Aid conditionalities have been donor-driven rather than being a product of discussions, mutual agreement, and genuine commitment. Once again, aid conditions should be made simpler and more amenable to monitoring the performance of actors, donors, and recipients alike. Sanctions against bad performers should be meted out selectively in order to protect innocent groups and to ensure that past development gains are not wiped out by temporary aid stoppages. Important aid conditions that affect the society's vital interests should be adopted after obtaining wide national support through suitable democratic machinery. Donors tend to dominate the aid process and to pay inadequate attention to the government's own preferences. This situation is aggravated by the weakness in the capacity for economic management and by the high degree of aid dependence.

Aid should not be used to undermine the responsibility of the recipient country to assume its role in development management. To reverse the current degree of aid control by donors and the passivity of recipient countries, the latter should be encouraged to promote responsibility for policy formulation and frameworks in which broad criteria for projects/programmes spending of aid can be defined. The policy formulation process can accommodate donors' views regarding areas of preference or concentration to be harmonised at RT or CG meetings. Thus, the plans would form the basis of future aid allocation. As a reflection of their commitment in the medium-term, donors should indicate tentative multiyear resource commitments. They should be persuaded to untie their aid and increasingly provide it as programme aid so that project-by-project allocation can be left to the recipient country's Ministry of Finance to decide as part of its budget management. Donors will feel assured if effective resource utilisation is guaranteed through the strengthening of the Ministry of Finance as well as of auditing and of central procurement and accounting organisations. In recent discussions, a consistent plea has been expressed for the self-articulated aspirations of Africans to be taken more seriously as a basis for building a new partnership between Africa and the donors. Issues of equality, mutual respect, transparency, reciprocity, and a willingness to learn from both sides have been stressed.<sup>24</sup>

#### *Poor Coordination of Aid*

The large number of donors that African countries have to deal with and the proliferation of projects have increased the risks of duplication and

waste. A common predicament that affected aid delivery was the lack of aid coordination among the donors. It not only affected aid results but also sabotaged national planning and added to the cost of aid administration. Too often African governments have not effectively coordinated the aid effort.<sup>25</sup> Donor aid coordination falls under three categories: intra-governmental coordination, interdonor coordination, and government-donor coordination. Intragovernmental aid management is weak in the overall aid management process. The problem is exacerbated by the relative strength of donor aid management in the form of parallel administrative controls and project management. There are two types of interdonor aid coordination. First, donors may coordinate their own activities. Second, the government may coordinate donors. Of these two, the former has a formal existence, while the latter is very weak.

A major constraint to the achievement of aid coordination is the lack of demand for it. A local constituency demanding improved aid coordination is only beginning to emerge. Also, an interest in the possibility of playing one donor against another and getting access to that donor is not consistent with the move towards aid coordination. For instance, some recipients may know very well that aid coordination will demand a greater justification of their aid requests. Besides, on the side of the donors, there are indications that some are not keen to be coordinated, since coordination is perceived to be constraining freedom of action on their part. Donors and some sections within the recipient countries do not place a high priority on the coordination of aid.

Over the years African countries have had to accept the necessity of adapting their methods and procedures to suit the management requirements of donors. Demanding national ownership by Africans has coincided with most donor demands of Africa to pursue a particular governance model. This situation is likely to present complications in practice. It is challenging to reconcile demands for national ownership with the insistence on universal human rights, Western forms of multiparty election and political accountability, since these are subject to varying interpretations. Another tension arises between the longer process of the development of the capacity of ownership and the urgency to achieve specific targets and outputs which do not include capacity building.<sup>26</sup>

However, it should be emphasised further that aid coordination remains a primary responsibility of the recipient. Effective aid coordination can be achieved by formulating a clear national aid strategy. Some of the key elements of a national aid strategy include the following: the national objectives, strategies and priorities; an articulation of roles of the recipient, the donors, and the implementing agencies; a stipulation of the modes of disbursement and accountability; and the areas of focus and concentration.

*Deficiencies in the Allocation of Resources*

The inability of the government to cover their recurrent costs and to fulfill their reciprocal obligations undermines the impact of aid in many African countries. Although the level of education and training has improved in Africa over the years, the management capacity of public institutions has remained limited. A major factor that has been counteracting the positive effects of improved education and training is the economic crisis itself, which has pushed governments to reduce various recurrent expenditures, including public service salaries. In several countries salaries in real terms have been reduced by an amount up to a factor of ten over the past two decades.<sup>27</sup> The economic crisis challenges civil service reform and redressing the imbalances between recurrent and capital expenditures. These are challenges to the quality of budget management. African governments and donors continue to plan inadequately for reciprocal and recurrent expenditures. In most countries, aid activities are not fully integrated into national budgeting and planning exercises. Also, donors often fail to recognise the problems and fail to plan for the withdrawal of aid.<sup>28</sup> In several countries, recent initiatives in improving public financial accountability systems and public expenditure management through Medium Term Expenditure Frameworks (MTEF) and Public Expenditure Reviews (PER) are promising steps towards improving resource allocation systems. In addition, the Poverty Reduction Strategy Papers (PRSP), which were introduced in 1999/2000, have contributed to sharpening the focus on prioritisation in the allocation of resources. Improving budget management and public expenditure management is a promising step in the direction of a more efficient management of resources (local and foreign). Improvements in public financial management and in financial accountability are needed for enhancing the level of the confidence of development partners in Africa. Such confidence is needed for ownership to take root in the environment of new partnerships in development cooperation.

*Proliferation of Parallel Aid Projects*

Aid contributes too rarely to effective institution building because local institutions are bypassed in the design and implementation of projects. Although these arrangements appear to solve the immediate problem of the capacity to manage projects, they tend to undermine ownership and sustainability.<sup>29</sup> In addition, they even weaken the already weak administration and management capacity. Such projects become islands of development, increasingly isolated from the reality of the environment in which they operate; consequently, they become increasingly difficult to phase out, leading to a continued dependency and an absence of sus-

tainability.<sup>30</sup> Proliferation of projects is partly a result of the failure (perceived or real) of institutional capacities and budget management systems through which project resources can be managed effectively. If project management has to be integrated into the budget management system, it is important to convince donors to move more in this direction. Most of them expect to be assured that public financial management and accountability systems are in place and are working. This assurance constitutes a major challenge for Africa.

## The Debt Problem

Total outstanding debt for Africa stood at U.S. \$270 billion in 1990, of which SSA accounted for U.S. \$177 billion (Table 13.3). By 1996 the total African debt had increased to U.S. \$329 billion, with a debt-service ratio of 25.06% for amortisation payments on long-term debt and interest payments and a total debt of 57% of GDP.<sup>31</sup> The total external debt of SSA increased from U.S. \$60.6 billion in 1980 to U.S. \$235.5 billion in 1995, with a debt-service ratio of 14.5% (up from 9.8% in 1980), a debt-

Table 13.3 Total External Debt (Millions of US\$ – Current Prices)

Year	Sub-Saharan Africa	Sub-Saharan Africa (Excluding South Africa)	All Africa
1980	60,612	60,612	111,893
1990	177,052	177,052	270,026
1991	183,248	183,248	274,133
1992	182,281	182,281	271,092
1993	188,412	188,412	275,093
1994	221,424	199,753	315,483
1995	235,514	210,156	335,046
1996	231,319	205,269	329,269
1997	221,371	196,150	313,502
1998	229,983	205,271	323,954
1999	227,558	202,657	319,017
1975–1984 (Annual Average)	54,892	54,892	98,717
1985–1989 (Annual Average)	136,754	136,754	228,409
1990–MR (Annual Average)	209,816	195,025	302,655

Source: World Bank, African Development Indicators, 2001.



GNP ratio of 81.3% (up from 30.6% in 1980), and a debt-to-exports ratio of 241.7% (up from 91.7% in 1980).<sup>32</sup> External debt for SSA remained relatively steady in 1995–1999, standing at U.S. \$227.5 billion in 1999.

Compared to that of the whole of Africa, the debt stock in SSA has been growing more rapidly. Its outstanding indebtedness to bilateral creditors grew by over U.S. \$23 billion during 1986–90 despite the cancellation of its concessional debt, while its indebtedness to multilaterals grew by U.S. \$14 billion.<sup>33</sup> Between 1983 and 1990 African countries paid back over U.S. \$180 billion, an amount exceeding their total debt stock in 1982 by U.S. \$40 billion.<sup>34</sup> The debt burden is enormous in relation to the SSA economy and debt-servicing capacity. A total of sixteen African countries were categorised as unsustainable and possibly stressed (AfDB 1996). These countries are eligible for debt relief under the Heavily Indebted Poor Countries (HIPC) initiative. But the real challenge has been for such countries to meet the HIPC conditionalities and to access the facility in reasonable time.

SSA debt is mainly that from official creditors. In 1990, out of the total debt (disbursed and outstanding) of U.S. \$162.9 billion, the bulk of it was official bilateral aid (U.S. \$4.6 billion) and multilateral aid (U.S. \$42.9 billion), while private (including guaranteed) debt stood at U.S. \$54.8 billion.<sup>35</sup>

The implications of the debt burden on development in SSA are far-reaching. At a time when budgetary constraints have become more binding under SAPs, considerable amounts of budgetary expenditure are allocated to external-debt servicing (e.g., 30–35% in Tanzania). These allocations have very high social-opportunity costs. In Tanzania, for instance, debt servicing siphons off an amount four times the funds spent on basic health and nine times the allocations to basic education.<sup>36</sup>

Several initiatives have been proposed to address the African debt problem, but they have not brought significant relief to date.<sup>37</sup> Conditionalities for accessing the various facilities (e.g., HIPC) have made it difficult to effectively access some of them. Most SSA countries have not been able to meet scheduled debt obligations (to both official and private creditors), resulting in mounting arrears. Most of these countries remain dependent on continual debt payment rescheduling. This need to re-schedule payments is more procrastination than progress in solving the debt problem. The debt problem will ultimately be resolved through a revival of growth in the economy and exports. But the debt burden has become a major inhibiting factor in the realisation of a recovery of growth and exports. There is a need to devise new and more effective ways of reducing dramatically the African debt burden (bilateral, multilateral, and private).

The adoption and implementation of the Trinidad Terms, which pro-

posed a two-thirds reduction in the stock of the official bilateral debt of SSA, should be the immediate objective of creditor governments. In addition, the Trinidad Terms should be enhanced by reducing interest rates.<sup>38</sup> For a number of SSA countries, their debts are unrepayable, thus putting at stake their future borrowing from abroad. Debt initiatives implemented so far have not dented the root of the problem, since they have consisted mainly of debt-rescheduling exercises. Also, recipient countries have not participated fully in the debt reduction efforts for fear of jeopardising debt forgiveness for their individual countries.

The HIPC initiative has been generally welcome, though reservations have been raised with respect to the criteria for selection, the depth of the measures, and the sequencing of eligible countries. Also it is not certain whether most SSA countries have learnt useful lessons to guide their future borrowing behaviour. It was against this background that the enhanced HIPC was initiated and tied to PRSP to ensure that debt relief is linked to credible policy frameworks for poverty reduction. PRSP has a poverty focus, and its coverage reflects comprehensive development frameworks and encourages ownership and participation in its formulation and implementation. It is hoped that debt relief accompanied by credible policies stands a better chance of steering SSA countries out of debt. Since the implementation of PRSP is very recent, it is too early to review its effectiveness.

## Conclusion

The main challenges are to make foreign aid more effective for bringing about development and to have a strategy for countries to graduate from aid dependence. The inhibiting force of the debt burden needs to be addressed urgently in order to release resources for development. The following specific challenges need to be addressed: ownership of the development agenda; management of the conflict between short-term imperatives and the longer-term objective of attaining sustainability; building the capacities for policy analysis and development management; a redefinition of conditionality so that it will link more appropriately to agreed-upon criteria of performance by all partners; a redefinition of the structure of aid relationships and addressing the perverse incentive structures which govern prevailing bureaucratic behaviour and procedures on the part of both donors and recipients; devising new and more effective ways of reducing dramatically the bilateral, multilateral, and private debt to allow allocation of resources for development and, in particular, for recovery of the growth of the economy and of exports to be realised.

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## From Recovery to Accelerated Development: Some Key Issues for Twenty-First Century Africa

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The latter part of the 1990s and the opening years of the new decade have witnessed a much welcome economic recovery in Sub-Saharan Africa (SSA)<sup>1</sup> after almost two decades of decline. Growth in real Gross Domestic Product (GDP) has averaged over 4% annually over 1995–97 and around 3% during 1998–2001, compared to about 1.5% yearly in 1990–94. There have also been significant improvements in containing the rate of inflation and in the current account deficit of the balance of payments. Significantly, this overall recovery has not been systematically aided by exogenous factors like terms of trade gains or changes in weather.

In looking at key issues in the future development of Africa, it is crucial, however, to situate this recent recovery in a proper historical context. As the 1998 UNCTAD *Trade and Development Report*<sup>2</sup> points out, Africa's growth performance was, on the average, quite strong for over a decade – from the mid-1960s until the first oil price shock in 1973. GDP growth in SSA averaged about 4.5% per year during the period, although that average was lower than in other developing regions (with the exception of South Asia). In addition, that growth was accompanied by encouraging trends in investment performance and export revenues. Given the experience of the last two decades or so in SSA, it can be concluded that, since the 1970s, the economy, on the whole, has failed to recover systematically because of a combination of economic vulnerability and weak domestic policies. Economic vulnerability was, and remains, rooted

in overdependence on primary export commodities and in the overall lack of diversification. As more recent studies<sup>3</sup> have reemphasised, this vulnerability is also significantly related to adverse geographic factors such as the tropical location of SSA and its large number of land-locked countries. Weak domestic policies, on the other hand, originated substantially from what an observer has characterised as a “mistrust of market economies and unreconstructed instinct to over-intervene and over-regulate.”<sup>4</sup>

Many individual analysts and institutions have associated the recent recovery in Africa with the various macroeconomic and structural policies that have been implemented in a relatively large number of countries over the last decade or so. These policies, ranging from control of fiscal deficits to price and trade liberalisation and to privatisation of public enterprises, have been associated with improved growth and microfinancial performance. Countries that have implemented these policies more rigorously have, on the whole, registered stronger performance – although the outcome in some cases reflects special factors (such as recovery from armed conflicts and the discovery and exploitation of natural resources like oil).

This welcome recovery is based, to a significant extent, on greater utilisation of existing capacity, and it is also clearly inadequate for addressing the widespread poverty in the continent. In comparison to the recent average annual growth rate of about 3% to 4%, the population continues to increase at about 3%. As the 1998 UNCTAD report points out, even if the growth of the past few years could be sustained in the next decade, that would not have much of an effect on widespread poverty and would constitute little more than the recovery of ground lost during the past twenty years.<sup>5</sup> It will be difficult for many African countries to meet the primary Millennium Development Goal of reducing by half the 1990 levels of poverty by 2015.

Apart from output growth, many countries in the region still have very large external imbalances which also reflect heavy dependence on external assistance. The saving-investment process in the region remains weak – given the desirable range in the rate of aggregate growth. There has not been significant improvement in the ratio of investment to GDP which, on average, has remained below 17% through the 1990s. This may be compared to the corresponding ratio of nearly 28% for Asia (excluding Japan). In addition, developing countries have not had much success in tapping into foreign capital – which increased sharply in the latter part of the 1990s. Although there has been an increase in foreign capital from a small base, the share of SSA as compared to that of other subregions of the developing world remains quite small.<sup>6</sup>

These and other challenges that remain have led Africa's leaders to adopt (in Abuja, Nigeria, in October 2001) the New Partnership for Africa's Development (NEPAD), a policy framework for the economic recovery and sustainable development of the region. But NEPAD must serve, as it was intended, to accelerate progress on the ground – to help improve the lives of ordinary African men, women, and children. Within the context of globalization, this chapter discusses pro-growth and poverty reduction policies – major issues that will determine the success of the NEPAD process.

## Key Issues in African Development

As SSA looks to the early decades of the twenty-first century, it is clear that the overarching objective for its economy is the regeneration and acceleration of growth to reverse decisively the long-term decline of the past and to reduce poverty. The continent's experience up to the first oil price shock in the early 1970s and the more recent one during the latter part of this decade<sup>7</sup> provides grounds for optimism. Indeed, in the 1990s, a group of ten countries which have been categorised as good performers were able to raise their average real GDP growth rate from about 2.5% per year in 1990–94 to 7% over 1995–97. A recent report also argues that countries which have made key economic reforms have seen rises in GDP and declines in poverty.<sup>8</sup> Countries of the CFA zone, as a group, were able to reverse the negative growth of the earlier period and attain an average real expansion of about 5% over 1995–97. This reversal, of course, followed a major delayed adjustment of the exchange rate and the accompanying demand-management measures necessary for validating the real exchange rate change.

The long-term decline between the 1970s and the early 1990s is a painful reminder, however, of the very present dangers of reversal in the ongoing momentum in policy and structural reforms and of destabilising external shocks. The design of pro-growth and antipoverty policies through partnerships will be crucial, therefore, in the coming decade and beyond. This design no doubt represents a complex set of issues, some of which we shall be exploring shortly. An encouraging dimension in this regard should, however, be pointed out: The human and technical capacities for managing development policies, though still inadequate given the task at hand, have improved substantially since the postindependence years of the 1960s and 1970s. There is, therefore, a stronger basis for shaping and managing the requisite policies, if other supportive elements in society are present. But, of course, the presence of these other ele-

ments, such as a conducive political framework and good governance generally, cannot be simply assumed. With the average annual rate of output growth dropping from about 2.5% in 1965–73 to about 2% over 1980–94. This latter growth rate is well below that of the growth in population. The trend in output growth is indeed problematic, given the pro-growth and antipoverty strategy required for Africa. Since the proportions of agricultural growth in GDP and of the growth of agricultural and rural population to total growth are relatively large, medium-to-long-term aggregate growth, as well as improvements in living standards, would, realistically, have to be significantly based on better performance in agriculture.

Also important in looking at the possibilities for accelerated and sustained economic growth in Africa is the problem of structural vulnerability. This, as mentioned earlier, originated from the very limited diversification in the economy and from natural disadvantages, which imply limited flexibility in responding to possible adverse external shocks in order to defend an underlying growth dynamic. Let it be understood, of course, that the existence of a reasonably strong domestic-policy framework and capacity would assist an economy in better withstanding the adverse effects of an external shock. All in all, however, SSA has not succeeded in effecting significant structural changes both in terms of export composition (i.e., abandoning its overdependence on primary commodities) and of industrialisation. The importance of this issue is not related to the old dichotomy of agriculture vis-à-vis industry but related to the more pertinent question of the composition of national output vis-à-vis the evolution of national and global demand. For faster and sustained growth, the composition of national output has to change in ways that are consistent with the dynamic aspects of demand, both national and global. Related to national output and demand is the specific long-term problem of inadequate growth in agricultural value-added in SSA. There has been deterioration in agricultural performance,<sup>9</sup> with the average annual rate of output growth dropping from about 2.5% in 1965–73 to about 2% over 1980–94. This latter growth rate is well below that of the growth in population. The trend in output growth is indeed problematic, given the pro-growth and antipoverty strategy required for Africa. Since the proportions of agricultural growth in GDP and of the growth of agricultural and rural population to total growth are relatively large, medium- to long-term aggregate growth, as well as improvements in living standards, would, realistically, have to be significantly based on better performance in agriculture.

Beyond pro-growth and poverty reduction policies and the imperatives of effecting structural change, Africa will also need to situate its development efforts explicitly in the evolving contexts of globalization and the



new political realities. Africa will have to find ways and means of gainfully opening up to these evolving contexts and competing in the global economy; otherwise they will face the risk of increased marginalisation.

The foregoing considerations point to a cluster of strategic issues that would be the key to African development in the coming decade. They may be outlined under five headings: pro-investment policies; the role of the state and governance; enhanced regional markets; greater economic openness; and diversification and agricultural growth.

### *Pro-Investment Policies*

In the medium- and long term, the regeneration and acceleration of growth in SSA will have to depend on factors beyond the greater utilisation of existing capacity and related short-term measures. Regeneration and acceleration will, above all, require the enhancement of the saving-investment process and growth in total factor productivity. Significant progress will have to be made in mobilising greater domestic and external resources for attaining critical levels in investment rates. The challenge is, therefore, one of systematically creating a clearly pro-investment climate on all fronts – political, administrative, and narrowly economic – for significantly raising the investment rate while improving the rates of return to all the factors of production. Progress on these fronts would significantly depend on the actual availability of resources and on incentives for private investment.

If it needs to be mentioned, there is strong empirical evidence of the close link between investment and growth in developing countries over the long run.<sup>10</sup> In the case of Africa,<sup>11</sup> the estimate for the elasticity of growth with respect to the investment/GDP ratio ranges from 0.3 to 0.6. The overall failure to raise the investment ratio in the 1990s has, therefore, meant depressed growth performance. The empirical evidence also indicates the specific importance of private investment. For Africa, one study<sup>12</sup> has estimated the rate of return to be 50% to 60% higher for private capital than for public capital.

The improvement of a pro-investment environment in the context of Africa would start by building on the gains that have been made in recent years in establishing a less distorted and more stable macroeconomic environment. The reduced domestic uncertainty resulting from this effort would need, however, to be complemented by other political and institutional requirements pertaining to greater political stability, conducive legal structures, and effective contract enforcement mechanisms. It should also be added that the combined macroeconomic, political, and institutional measures would assist in addressing the capital flight problem.<sup>13</sup> An estimate<sup>14</sup> indicates that SSA is one of the regions most affected by capital

flight, with 70% of privately owned wealth (excluding land) having been held abroad in 1992. Although the problem is clearly beyond the frameworks of markets and investment returns, some of the wealth may indeed respond to conducive policy and institutional changes.

Beyond the concerns of a broad framework for investment, the mobilisation of resources for financing investments is equally important. In SSA, investment has clearly been constrained by the low domestic savings rate which, in the 1990s, has averaged about 16% compared, for instance, to over 30% in Asia (excluding Japan). Policy and institutional measures to increase domestic savings, especially in the recent context of declining aid flows, are therefore particularly important for faster growth in SSA. The principal areas for action are financial-sector reforms aimed at building efficient financial institutions and financial instruments and the pursuit of conducive interest rate policies. It is necessary to reverse the negative real interest rate policies of the past, which could assist neither the savings process nor the financing of investment in the long run. In the corporate sector, a range of fiscal instruments could be used to encourage the retention and reinvestment of profits.

The attraction of foreign capital – foreign direct investment (FDI) in particular – should be the next target, given the very small relative share of FDI for SSA and the sharp drop in overseas development assistance (ODA). It is well known that FDI would normally bring with it the additional benefits of technology, managerial expertise, and international marketing possibilities. The factors that are critical to the attraction of FDI are similar to those relating to domestic private investment – macroeconomic and financial stability and a conducive institutional and regulatory framework. It is important to stress in this regard that it is necessary to reduce the perceived risk of policy reversals by providing credible commitments and increasing the cost of renegeing on these commitments.<sup>15</sup> In addition, Africa should position itself for greater competitiveness in attracting FDI through enacting wide-ranging measures to reduce transaction costs for investors (transport costs, telecommunication costs, etc.) and through strategically investing in physical infrastructure and the acquisition of human skills.

A more robust pro-investment climate that requires much reduced domestic uncertainty is further impeded in many Sub-Saharan countries by the debt overhang. The excessive debt service stands in the way of a country's external viability and reduces otherwise investable resources for economic and social development. For many countries of the region, there is, therefore, a pressing need to move with decisive speed to implement debt reduction initiatives in order to assure greater external viability and enhanced domestic and foreign investment. The initiative for

the Highly Indebted Poor Countries (HIPC), developed and promoted by the Bretton Woods Institutions, has been a welcome recent step; but, as has been expressed in many quarters, it requires stronger up-front action and a faster pace of implementation.

From a slightly different angle, the issue of debt reduction may be seen from the broader perspective of concessional-resource availability for financing investment in low-income countries. Closely related to this resource is the question of policy conditionality to be associated with such assistance. With respect to debt reduction, the appropriate conditionality for assisting in quickly creating a pro-investment climate would be *ex ante* rather than *ex post* in nature, designed within a development partnership framework and aimed at reducing domestic uncertainty<sup>16</sup> as well as augmenting investable resources. With respect to aid more generally, what is called for is policy conditionality based on genuine partnerships between recipients and aid donors in order to ensure domestic ownership and sustainability of the policies and development programmes. This approach would assist the formulation of credible and sound policies that are necessary<sup>17</sup> for assuring that foreign assistance does result in growth benefits for recipient countries.

### *The Role of the State and Governance*

A sustained pro-investment climate would, in turn, require progressive establishment of what have been called “developmental states.” Such states would systematically create a set of institutions which aim to promote entrepreneurship, profits, and capital accumulation without compromising a wider set of development objectives beyond those narrowly prescribed by business interests.<sup>18</sup> In the specific circumstances of SSA, a pro-investment climate would additionally require capacity building in the public and private sectors, apart from the general requirement of resisting the capture of state agencies by special interest groups. By implication, a developmental state would also reflect critical aspects of good governance, paying attention to issues relating to social development and to matters like corruption, which adversely affects growth by reducing private investment<sup>19</sup> and worsens the social composition of government expenditure.<sup>20</sup>

Various measures to strengthen the state and manage public resources more efficiently have been taken in many African countries. This process has been assisted by the recent domestic and international pressures for democratisation. Additional impetus<sup>21</sup> has come from the threat of marginalisation (on the part of the ruling elites) following the rapid pace of globalization and from a more inclusive process in national policy dia-

logue (partly espoused by bilateral and multilateral financing agencies). However, much more remains to be done to increase the number and “depth” of developmental states in Africa.

Specifically in strengthening the state in a pro-investment direction, two related aspects would be especially important: the creation of a competent and independent state bureaucracy and the building of closer ties between such a bureaucracy and the emerging private sector.<sup>22</sup> The more recent efforts aimed at restoring the quality of the civil service in many countries of SSA must, therefore, continue and, where necessary, must be supported in frameworks of international-development partnerships. Apart from measures required to make civil-service positions competitive and attractive in terms of career, other measures should aim at reasonably insulating the core bureaucracy from political pressures and at providing learning environments for the improvement of future policies.

With respect to forging government-business ties, a national government would first need to diffuse a sense of shared commitment to a collective project of national development and then seek a concrete set of ties that would enable specific agencies and enterprises to conceive and implement joint projects.<sup>23</sup> Policies of “rent creation” and discipline of the private sector would be called for in order to better manage profits and investment. The underlying development principle would be to ensure that short- or medium-term measures necessarily taken to initially attract or protect the private investor do not become permanent policies that would be inimical for an efficient and competitive economy in the long run. In order to manage “productive” links along these lines between government and enterprises, various instruments of dialogue and analyses (special councils, conferences, etc.) would need to be instituted and actively managed.

Apart from an efficient state bureaucracy and its desirable relationship with private enterprise, a “developmental state” in SSA would need to address the broader imperative for capacity building, especially in respect to policy analysis and management. Part of the problem in the region has been that the analytical bases of development policies have been overly donor driven. It is now broadly agreed that in order for policies to be sustained they need to be locally formulated, by and large, and, therefore, locally owned. Furthermore, the more meaningful development cooperation that is being increasingly advocated, based on partnerships rather than on “unilateral” conditionality, similarly requires local capacity that is able to undertake both general and strategic analyses.

Major roles of a state in SSA should, therefore, be developing skilled human resources for tackling these broad and strategic tasks, strengthening key institutions, and contributing to creating an enabling regula-

tory and policy environment. The objective of creating such an enabling environment would also call for capacity-building perspectives beyond immediate or utilitarian purposes. It would call for analytical and policy capacities in units independent of the government and within the private sector, in order to attract broader thinking, analyses, and policy dialogue. Capacity-building efforts would also need to be situated in the increasingly international contexts of globalization in such critical areas as trade and investment. Seen within this larger framework, the task of capacity building in SSA would call for international partnerships in these areas, perhaps representing a new area of emphasis (away from technical assistance) regarding aid in the coming decade.

### *Enhanced Regional Markets*

In the search for strategic dimensions of a pro-investment environment and opportunities for faster growth in SSA, greater regional cooperation and integration is still being indicated by various analysts<sup>24</sup> as one key area. In a historical context, there have been, on the whole, limited successes in achieving the immediate objectives of cooperation and integration schemes (established at various times in parts of SSA), such as raising the level of intraregional trade and the higher aim of raising the average rate of economic growth for the cooperating countries. In spite of the modest gains, however, there has been, in recent years, a new and positive mood, strongest at the subregional level, for economic cooperation and integration. This mood culminated in the ratification of the Abuja Treaty in 1994, establishing the African Economic Community.

The new and positive mood for economic integration in the continent should indeed be welcome, as one looks ahead into the likely realities of the twenty-first century. The Africa that has severely suffered from the “lack of growth” for so long should seize every opportunity to expand internal markets, to attract greater investment, and to raise significantly the rate of economic growth, or it can risk being increasingly marginalised in the rapidly evolving world of global competition. Regional cooperation and integration (RCI) is one important opportunity to be seized by African countries in their quest to participate meaningfully in the global economy. In order for the renewed positive mood for RCI to endure, however, the integration process will have to deliver stronger results – in part through bringing economies much closer – than the current evidence indicates.

The overall weak results on the integration front point, on the whole, to the hard reality that over the years African economies have not in a significant sense succeeded in “pulling” their economies together to achieve even some of the intermediate objectives such as greater intra-

regional trading. The higher-level objective of accelerated economic growth has, like a mirage, remained equally elusive. Economies could, of course, have applied other mechanisms individually to attain more reasonable growth rates without relying much on formal cooperation and integration ties. Such policies are said, for example, to be those of the countries in the Association of Southeast Asian nations (ASEAN), each of which enjoyed high rates of economic growth and, without very formal institutional support for regional integration, raised intrabloc trade in recent years to about 20% of total trade. The ASEAN countries were able to experience increases in trade shares within the bloc by relying on general pro-growth factors, like foreign capital and private entrepreneurship, assisted by some commitment to regional cooperation. For a long time, the majority of African countries have, by contrast, neither achieved reasonable growth rates nor made major strides in regional integration. In these unsatisfactory circumstances, therefore, it would be appropriate to step back and reexamine the potential that stronger regional cooperation and integration still results in raising the rate of investment, encouraging market efficiency, raising intraregional and international trade, and ultimately supporting a stronger growth dynamic (the highest objective). In this sense, RCI can be seen as an instrument that has a significant potential to contribute to the desperately needed revival of growth and the reduction of poverty in SSA countries.

Four major areas<sup>25</sup> seem, from theory and from the African experience, to be indicated for greater policy emphasis and action in order to realise the potential that RCI may have for raising regional investment and promoting growth. First, greater macroeconomic and institutional coordination would facilitate market unification for the cooperating countries, thereby maximising the growth benefits of integration. However, both the institutions and the relevant policy-coordinating organs would have to be actively governed at high policy-making levels to ensure effectiveness and a continuing impact on the integration process. The second area with considerable potential is one in respect to the coordination of investment in infrastructure and natural resources. The potential gains<sup>26</sup> would be raised from unit cost reductions that might be realised by way of scale economies in an infrastructural provision; from considerable reduction in the opportunity costs of unmet demand, since regional cooperation facilitates an enhanced supply of infrastructural services; from trade benefits for the cooperating countries through the exchange of infrastructural services; and from reduced uncertainties usually associated with the planning of long-term infrastructural investments (since there would be regional export/import possibilities). The third area of potential is private-sector promotion that would become more viable

within larger regional markets and which, in turn, could contribute to otherwise public-sector domains like infrastructural investment. Fourth, external assistance – both bilateral and multilateral – could be aligned more closely with integration efforts for greater development impact.

### *Economic Openness and Competitiveness*

Regional cooperation and integration would help SSA in a sustained way if the cooperation framework was conceived within the context of what has come to be called “open regionalism.” For part of the development problem in the region has been the relatively high barriers to foreign trade,<sup>27</sup> which have reduced efficiency and productivity growth as well as prevented infant industries from graduating to higher levels of maturity. Therefore, the appropriate approach would be to use a regional cooperation framework to resolve some of these problems in a more viable and phased manner. Initially, trade barriers should be easier to reduce among cooperating countries which are at a fairly similar stage of development, giving the group of countries the time to promote learning and to develop managerial and other capabilities before opening up substantially to the rest of the world.

An “open regionalism” approach would, however, work as a caution against overreliance on the regional market in order to avoid the well-known limitations of import substitution strategies. The regional market would, therefore, be seen in this context as a springboard from which the cooperating countries can build a stronger basis for competitiveness and exports. Development experience indicates that one key policy instrument for assisting developments in an open regional market is the real exchange rate. The rate is particularly important in SSA, where other institutional and technological capacities are still weak.<sup>28</sup> The maintenance of competitive real exchange rates within cooperating countries (vis-à-vis the rest of the world) should, therefore, be an important policy for enhanced macroeconomic and institutional coordination within integration schemes.

It has been observed that the use of the exchange rate and other policies to liberalise trade will be of limited benefit to Africa as long as the countries lack not only the supply but also the human and institutional capacity to take advantage of new opportunities.<sup>29</sup> An important aspect in enhancing Africa’s competitiveness is, therefore, the building of institutional and human capacities for managing in a globalized context: the practical aspects of the international trading process, the meeting of international product standards, a fuller participation in the WTO framework, and so on.

*Diversification and Agricultural Growth*

Policies to enhance economic openness and competitiveness should assist in promoting exports, both traditional and manufactured, and growth. In particular, a competitive exchange rate would increase and protect the profitability of export production, thus attracting investment into the export sector and diversifying the structure of production – into processed, new, and manufactured products. But it is difficult to envisage significant progress on this front without situating the whole process in the broader context of accelerating overall economic growth for a given country. What is called for in diversifying an economy and its exports is increased investment and new technologies, the same factors beyond economic openness that have been emphasised in accelerating overall economic growth. Indeed, it has been observed that the rapidly declining share of SSA countries in world trade in the past two decades or so is not so much a reflection of the failure of their correspondingly small share in global output.<sup>30</sup> The promotion of economic diversification and export must, therefore, be seen as part and parcel of the overall effort to raise aggregate growth through increasing investment and total factor productivity.

It is partly for this reason that any discussion of diversification must inevitably relate to agriculture, which in a typical country in the region accounts for 70% of total employment, 40% of merchandise exports, and one-third of GDP. Part of the explanation for the weak aggregate growth performance in Africa over the years is found in the historically low rate of growth of the agricultural sector that led to the loss of market shares in world exports. Better policies to promote stronger agricultural growth would thus not only lead to general economic improvements arising from trade but also create possibilities of diversification within agriculture. These policies (and related institutions) need to address the major weaknesses that have been identified with African agriculture: seriously inadequate public and private investment in the sector, very weak physical and research structure, inadequate marketing and support systems, the basic issue of price and other incentives, and so on. A stronger agricultural-growth framework would also present diversification possibilities into products which have a dynamic potential because of their high unit values and high-income elasticities of demand. Apart from the domestic and external trade benefits that would result from it, a more diversified agriculture would make it easier to progress to the strategic objective of reducing poverty in a more conducive context of agricultural and rural development.

Diversification efforts outside agriculture would have to be guided by fairly country-specific endowment situations. Mineral exploration and production, for instance, have in recent years indicated good promise in a



number of SSA countries. But significant mineral exploitation does require substantial resources and technology, a requirement which implies that the promotion of foreign direct investment should be high on the development agenda for countries in a position to benefit from that route. With respect to industry, possibilities for processed and manufactured exports are particularly important in moving the composition of exports towards products with higher-income elasticities of demand. In SSA, most countries seem to export fewer manufactures relative to primary products than would be analytically predicted from their resource endowments.<sup>31</sup> This means, among other things, that SSA could possibly increase such manufactured exports in the short run simply by efficiency improvements. But that increase is only in the short run. A sustained expansion in the share of manufactured exports would require a combination of domestic private and public investment, foreign direct investment (for technology, management, and marketing), and the pro-investment policies mentioned earlier.

## Conclusion

The overarching economic issue in SSA in the opening years of the twenty-first century is the acceleration of broad-based growth to raise living standards and reverse the threatening trends in poverty. Key aspects in this objective must be the enhancement of the saving-investment process and growth in total factor productivity. Africa also needs to position itself to benefit from the unavoidable process of globalization in trade and investment. The political economy of all this implies that the state has to play a strategic role in shaping pro-investment, pro-poor policies and in building critical human and institutional capacities to manage development affairs in the context of globalization. The state also needs to forge strategic partnerships with the domestic and international sectors, with the bilateral and multilateral donor agencies, and among neighbouring states for the widening of regional markets.

## Notes

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# Acronyms

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ABCDE	Annual Bank Conference on Development Economics
ACP	African, Caribbean and Pacific
ADB	Asian Development Bank
AERC	African Economic Research Consortium
AfDB	African Development Bank
ASEAN	Association of South East Asian Nations
ASEAN-4	Association of South East Asian Nations
Bappenas	National Planning Board (Indonesia)
BI	Bank Indonesia
BIBF	Bangkok International Banking Facilities
BIS	Bank of International Settlements
BOI	Board of Investment (Thailand)
BOT	Bank of Thailand
BPS	Central Agency of Statistics (Indonesia)
BWIs	Bretton Woods Institutions
CFA	Communauté financière africaine
COMESA	Common Market for Eastern and Southern Africa
COMTRADE	UN Commodity Trade Statistics Database
DAC	Development Assistance Committee
DFID	Department for International Development
EC	European Commission
ECOWAS	Economic Community Of West African States
EOI	Export Orientation Industrialization
EOI	Export Orientation Industrialisation
EPZs	Export-Processing Zones

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ERPs	Effective Rates of Protection
EU	European Union
FACE	Foreign Aid Complementarity Elements
FCDU	Foreign Currency Deposit Unit
FDI	Foreign Direct Investment
FIDF	Financial Institution Development Fund
GATT	General Agreement on Tariffs and Trade
GCA	Global Coalition for Africa
GDI	Gross Domestic Investment
GDP	Gross Domestic Product
GNP	Gross National Product
GSP	General System of Preferences
HIPCs	Highly Indebted Poor Countries
HPAEs	High-Performing Asian Economies
ICAPM	International Capital Asset Pricing Model
ICEG	International Centre for Economic Growth
ICRG	International Country Risk Guide
ICTs	Information and Communication Technologies
IDE	Institute of Developing Economies
IDRC	International Development Research Centre
IFC	International Finance Corporation
IFIs	International Financial Institutions
IMF	International Monetary Fund
IMP	Independence of Malaya Party
INST VAR	Institutional Variable
INTECH	Institute for New Technologies
ISI	Import Substitution Industrialization
ISI	Import Substitution Industrialisation
JETRO	Japan External Trade Organization
JPPCC	Joint Public-Private Consultative Committee
LDC	Less Developed Country
MDGs	Millennium Development Goals
MFA	Multifibre Agreement
MNC	Multinational Corporation
MNE	Multinational Enterprise
MTEF	Medium Term Expenditure Frameworks
MVA	Manufacturing Value Added
NAFTA	North American Free Trade Agreement
NBER	National Bureau of Economic Research
NEP	New Economic Policy (Malaysia)
NEPAD	New Partnership for Africa's Development
NGO	Nongovernmental Organization
NGO	Nongovernmental Organisation
NICs	Newly Industrializing Countries
NICs	Newly Industrialising Countries
NIEs	Newly Industrializing Economies

NIEs	Newly Industrialising Economies
NTBs	Nontariff Barriers
ODA	Overseas Development Assistance
ODC	Overseas Development Council
ODI	Overseas Development Institute
OECD	Organisation of Economic Cooperation and Development
OECD	Organization of Economic Cooperation and Development
OECF	Overseas Economic Cooperation Fund (Japan)
PDA	Petroleum Development Act (Malaysia 1974)
PER	Public Expenditure Reviews
PPP	Purchasing Power Parity
PRSP	Poverty Reduction Strategy Papers
PSBR	Public Sector Borrowing Requirements
PTA	Preferential Trade Area for Eastern and Southern Africa
R&D	Research and Development
RCI	Regional Cooperation and Integration
RER	Real Exchange Rate
RIDA	Rural Industrial Development Authority (Malaysia)
RISDA	Rubber Industry Smallholders Development Authority (Malaysia)
S&D	Special and Differential
SADCC	South African Development Coordination Conference
SAPs	Structural Adjustment Programmes
SE Asia	Southeast Asia
SECs	Securities and Exchange Commissions
SMEs	Small and Medium Sized Enterprises
SOAS	School of Oriental and African Studies
SOE	State-Owned Enterprise
SSA	Sub-Saharan Africa
TICAD	Tokyo International Conference on African Development
TNCs	Transnational Corporations
TPOs	Trade Promotion Organizations
TPOs	Trade Promotion Organisations
UMNO	United Malays National Organization
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNECA	United Nations Economic Commission for Africa
UNIDO	United Nations Industrial Development Organization
UNU	United Nations University
US	United States
WDI	World Development Indicators
WDR	World Development Report
WIDER	World Institute for Development Economics Research
WTO	World Trade Organization

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