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Working Paper

Development strategies and foreign aid policies for low income countries in the 1990s

Kieler Diskussionsbeiträge, No. 152

Provided in cooperation with:
Institut für Weltwirtschaft (IfW)

Suggested citation: Hiemenz, Ulrich (1989) : Development strategies and foreign aid policies for low income countries in the 1990s, Kieler Diskussionsbeiträge, No. 152, http://hdl.handle.net/10419/48092

KIELER DISKUSSIONSBEITRÄGE

KIEL DISCUSSION PAPERS

152

Development Strategies and Foreign Aid Policies for Low Income Countries in the 1990s

by Ulrich Hiemenz

CONTENTS

- Most low income countries are characterised by a high dependence on exports of a small number of agricultural or mineral commodities. In the 1980s, the economic and social performance of these countries has been extremely dismal. Declining per capita incomes, stagnating food production, and an increasing foreign debt burden indicate a failure of development strategies applied in these countries as well as of foreign aid policies pursued by donor countries and institutions.
- Low income countries have suffered from a combination of adverse commodity price movements and an increasing inability to adjust to a changing external environment. Adjustment has been hampered by conflicting and often misguided policy signals, weak economic institutions, and a rapid deterioration of public management in general. These shortcomings were rooted in fundamental social conflicts, in particular the "personal rule" of parasitic elites or the emergence of a non-productive state class.
- A development strategy for the 1990s has to pave the way towards economic diversification and a better integration of domestic markets in low income countries. Such a strategy requires the discrimination of the commodity producing sector to be abandoned, a return to macro-economic stability, and institution building. Necessary prerequisites for success are improved access of low income countries to the markets of industrialised countries and the necessity to convince the ruling elites to sustain policy reform.
- Industrialised countries have hitherto neglected the political economy of decision-making in low income countries. Neither stricter conditionality nor more foreign aid or more sophisticated international commodity policies alone will be able to turn the tide. Policy reform has to be initiated from within low income countries with foreign donors mainly playing a catalytic role. For this reason, foreign aid policies should give priority to a strengthening of political bargaining processes within low income countries and to supporting actually implemented reform programmes.
- Such a foreign aid policy for the 1990s would require new criteria for aid allocation among countries and new priorities for aid programmes and projects. To remove politico-economic constraints and institutional weaknesses, foreign aid should focus on the development of a well-functioning domestic economic order, human resource development, and financing of poverty or ecology-related programmes. If some governments of low income countries are notoriously unwilling to improve fundamental economic conditions donors should not hesitate to reduce their efforts to the supply of emergency relief.

INSTITUT FÜR WELTWIRTSCHAFT KIEL · AUGUST 1989

ISSN 0455-0420

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CIP-Titelaufnahme der Deutschen Bibliothek

Hiemenz, Ulrich:
Development strategies and foreign aid policies for low income countries in the 1990s / by Ulrich Hiemenz.
Inst. für Weltwirtschaft Kiel. - Kiel : Inst. für Weltwirtschaft, 1989
(Kieler Diskussionsbeiträge; 152)
ISBN 3-925357-76-9
NE: GT

ISSN 0455 - 0420

I. Introduction

At the end of the 3rd UN Development Decade concerns about economic and social progress in the Third World have been aggravated. Despite considerable efforts, standards of living in the poorest segment of the developing world have on average hardly improved and the scissors between more advanced and low income countries has widened. This paper provides an analysis of the major reasons for this unsatisfactory lack of development and suggests avenues towards expanding development prospects of low income countries in the 1990s and beyond.

Recommendations for more successful development and foreign aid strategies have to take into account an important structural weakness characterising most low income economies. They do not only suffer from segmented markets and often severely distorted incentive systems, but also from a high dependence on production and exports of a very small number of agricultural and mineral commodities. The Table shows a sample of 30 low and lower middle income countries in which non-oil commodities account for over 60 per cent of total exports. In many of these countries exports of no more than 2 or 3 commodities account for about 90 per cent of trade-related foreign exchange receipts. Balance of payments positions and government revenues of such countries are highly susceptible to changes of individual commodity prices so that the vagaries of international commodity markets introduce an element of uncertainty into public development planning and private investment decision-making. For this reason, the subsequent analysis focusses on the group of highly commodity export dependent countries (HCED DCs) and highlights their development potential.

This discussion paper is the result of a brainstorming session with Professor Hartwig de Haen (Agricultural Economist, University of Göttingen), Professor Manfred Feldsieper (Specialist in fiscal and financial policies, University of Cologne), and Drs. Roland Herrmann (Agricultural Economist), Rolf J. Langhammer (Trade Economist), and Peter Nunnenkamp (Specialist in development aid policies) from the Kiel Institute, held in Kiel on 12-13 January 1989. Each participant had prepared background material for the seminar which was used in the preparation of this paper. Useful comments by my colleague Bernhard Fischer are gratefully acknowledged.

Table - Highly Commodity Export Dependent Developing Countries: A Preliminary Sample (a)

	Share of commod-ities in total ex-ports, 1986 (per cent)	Up to three principal commodities exported in 1983/84(b)			
		food	beverages	agricultural raw materials	metals & minerals
Low Income Countries					
Benin	76	vegetable oil (11)		cotton (10)	
Bolivia	98				tin (23), ores (15)
Burkina Faso	87	oil seeds (15), cereals (6)		cotton (55)	
Burma	87	rice (24)		wood (26)	
Burundi	88		coffee (85), tea (5)		
Ethiopia	99		coffee (61)	hides (10)	
Ghana	98		cacao (61)		aluminium (14)
Honduras	89	fruit (35), fish (6)	coffee (23)		
Kenya	84		coffee (29), tea (28)		
Liberia	99			rubber (19), wool (5)	
Madagascar	88	spices (27), fish (7)	coffee (39)		
Malawi	84	tobacco (51), sugar (10)	tea (20)		
Mali	70	animals (29), veg. oils (3)		cotton (56)	
Mauritania	99	fish (47), animal feeds (4)			iron (46)
Niger	97	animals (12), tobacco (3)		uranium (79)	
Rwanda	99	spices (39)	coffee (32), tea (9)		
Senegal	71	veg. oils (26), fish (17)		fertilizers (14)	
Somalia	99	animals (89), fruit (6), fish (2)			
Sudan	94	oil seeds (30), cereals (12)		cotton (24)	
Tanzania	83		coffee (39)	cotton (12)	copper (7)
Togo	80		cacao (18)	fertilizers (46)	
Yemen, PDR	99	n.a.			
Zaire	94		coffee (11)		copper (35)
Zambia	97				copper (84), metals (4), zinc (2)
Lower Middle Income Countries					
Côte d'Ivoire	91		cacao (29), coffee (23)	wool (10)	
El Salvador	77		coffee (54)	cotton (5)	
Nicaragua	89	sugar (7)	coffee (31)	cotton (29)	
Papua New Guinea	94	veg. oils (10)	coffee (14)		ores (45)
Guatemala	63	sugar (9), veg. oils (6)	coffee (32)		
Costa Rica	64	fruit (31), meat (4)	coffee (24)		

(a) The sample contains countries in which non-oil commodities account for over 60 per cent of total exports. Excluded are countries with no recent comparable data, small islands, major oil exporters and territories. - (b) SITC 3 digit-level. The figures in parenthesis indicate the percentage share of each commodity in total exports.

Source: The World Bank [1988b]; UNCTAD [1987].

II. What Went Wrong?

1. Development Trends

The economic performance of HCED DCs has been very poor since the first oil price shock in 1973. While commodity price bonanzas at least helped overall economic growth to keep pace with population growth in the 1970s, the decline of commodity prices after 1980 was accompanied by a stagnation of officially recorded economic activities and consequently by a drastic decline of per capita income. Sub-Saharan Africa, for instance, hosting the largest number of HCED DCs experienced a fall of per capita income of annually 2.9 per cent in the 1980s after an annual increase of 0.5 per cent in 1973-80. As a result, 1987 per capita incomes amounted to about three quarters of the level achieved by the end of the 1970s. Per capita food production was at best stabilised at a rather low level. In a large number of countries it dropped below the level achieved in 1980. A corollary to these domestic developments was an increasing foreign debt burden in most HCED DCs [IMF, 1988].

Such an economic performance coupled with political unrest, ecological vulnerability and frequent short-term natural catastrophes has caused fatalism and resignation in low income countries as well as a feeling of helplessness among donor countries and institutions. However, the economic potential of these countries is much larger than suggested by official data, and there are signs of an unabated responsiveness of individuals to economic incentives. Capacity underutilisation, capital flight and brain drain as observed in most HCED DCs are clear indications of the availability of human and financial capital that has not been productively employed. In addition, there is evidence that the volume of economic transactions must be much higher than officially recorded. Rural as well as urban producers of goods and services have increasingly resorted to subsistence production, informal markets and underground activities. Excessive governmental regulations have provided ample incentives to earn rents from circumventing controls. Estimates for Ghana, for instance, suggest a rise of parallel market activities from 1 per cent of official GDP in 1976 to 32 per cent six years later [May, 1985, p. 9].

In a nutshell, the economic and social situation of low income countries is definitely critical but not necessarily hopeless if the available development potential of these countries can be used more efficiently in the future. To achieve this goal is not simply a question of appropriate national or international commodity policies. Commodity dependence is rather a structural symptom of low income economies than the root of backwardness. What is needed is a far more sweeping approach to development which seeks to overcome human capital shortages and to build an economic and social framework less hostile to individual and societal achievement than the present one.

2. Reasons for the Present Malaise

In the 1980s, HCED DCs have suffered from a combination of adverse external tendencies and internal bottlenecks. Declining and volatile terms of trade, protectionist behaviour of developed countries and mounting external debt problems have been aggravated by an increasing inability of these countries to adjust to a changing external environment. International commodity initiatives like commodity agreements, compensatory financing or preferences granted under the Lomé Convention have provided trade-tied aid for HCED DCs, but have also tended to freeze the production and export structure in favour of the supported products. An opposite bias has emerged from agricultural policies in industrialised countries as well as macro-economic and agricultural policies implemented in the countries themselves. They have discriminated against agricultural production and in particular against commodity exports. In addition to these conflicting policy signals, adjustment has been hampered by market segmentation, insufficient linkages among sectors, government market intervention sometimes bordering on state economic management, high unit cost of labour, inefficient public enterprises, mounting budget deficits, and a rapid deterioration of public management in general [World Bank, 1988a, Chapter I].

These shortcomings are largely the result of fundamentals characterising most low income countries: high and accelerating population growth rates (often above 3 per cent per annum), political instability sometimes associated with political violence and border conflicts, segmentation of societies along tribal boundaries, and most importantly, "personal rule" of parasitic elites [Jackson, Rosberg, 1982; 1984] or the emergence of a non-productive state class living on rents [Elsenhans, 1981]. The overriding responsibility of the latter interest groups for economic decline and social decay has been amply demonstrated in the literature [e.g., Sandbrook, 1985; 1986; Wheeler, 1984; World Bank, 1988a, Par. 1.5] and has to be taken into account when formulating development aid strategies. The neglect of the political economy governing decision-making processes in low income countries has time and again dealt severe blows to structural adjustment efforts carried out under the auspices of IMF and World Bank.[1]

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1 According to the World Bank [1984; 1988b, p. 28] the adjustment process towards relative prices reflecting scarcities has been already started with "impressive efforts" but with such "severe constraints" and "uncertain global prospects" that increased aid and debt relief should be made available by the developed countries.

III. Major Elements of a Development Strategy in the 1990s

1. Basic Principles

A return of HCED DCs to sustained growth can ultimately not be decreed, ordered and engineered by governments or development plans. Economic development rests to a large extent on initiatives of individual economic agents, particularly on responses of farmers, entrepreneurs and traders to national and international economic incentives. Government policies and development aid do have to play an important, though supportive role only. The stage for recovery has to be set by domestic policy reform and greater efforts to mobilise domestic resources. Aid flows of whatever magnitude can neither be a substitute for sound macro-economic management and appropriate incentives nor will they be sufficient to finance the required investment. However, a continued and reliable support by multilateral and bilateral donors will remain indispensable given the already high debt burden of these countries and their limited access to private international capital markets.

The subsequent proposals for policy reform are formulated in terms of general guidelines for the design of country-specific programmes since HCED DCs are a fairly heterogeneous group of countries. These guidelines rest on two assumptions:

- Assessments of international commodity markets provide strong support for the hypothesis that innovations promoting commodity-saving techniques and a delinking of commodity consumption from economic growth in industrialised countries are irreversible, at least in the case of mineral commodities. The prospects for producers of agricultural commodities appear less gloomy; but they, too, face a number of external barriers, i.e., declining oil prices improving the competitiveness of petro-based substitutes, the vagaries of agricultural protectionism in developed market economies as well as saturation tendencies and low income elasticities in consumer markets. Short-term windfalls as a result of, for instance, exchange rate movements or exogenous supply bottlenecks (e.g., coffee) cannot offset the long-term trend against primary commodity exporters.
- Low income countries are endowed with the critical minimum of individual initiative and entrepreneurship as borne out by vibrant subsistence and informal sectors. In most instances, however, these activities have remained economically inefficient because they are concentrated locally, suffer from high transaction costs or sub-optimal market sizes, and lack access to technology.

For these reasons, the goal of a development strategy for the 1990s is to pave the way towards economic diversification of production and a better integration of domestic markets. There is scope for a rehabilitation of commodity production in some countries and for the exploitation of new commodities in others, which is urgently needed to generate the investable funds required for an agricultural-led economic development path according to the comparative advantage of most HCED DCs. Policy reform along the lines elaborated below will promote investment in new agricultural and in non-agricultural activities as well as encourage the development of both import-substituting and exporting sectors. Diversification will ultimately improve the capability of these countries to cope with external shocks, to benefit from high income elasticities of demand in industrialised countries and NICs [Balassa, 1983; Balassa, McCarthy, 1984; Riedel, 1984; Bhagwati, 1988], and last but not least, to attract badly needed private foreign investment.

2. The Role of the Commodity Producing Sector

Since prices of food and primary goods tend to decline in real terms over the long run, it is often argued that investment in the commodity producing sector is a losing proposition. This view has to be challenged on two grounds. Firstly, commodity producers in HCED DCs are heavily discriminated against by export taxation and general agricultural policies [Kerr, 1985; Schiff, 1988] as well as by inward-looking industrialisation and macro-economic policies [Oyejide, 1988; Kerr, 1985; Akiyama, 1988].[1] Policy-induced discrimination has reduced the profitability of commodity production and exports and led to a loss of shares in export markets. Secondly, despite a long-run fall in the terms of trade for traditional commodity exports, price elasticities of export demand for **individual** low income countries will often be infinite or at least substantially higher in absolute terms than the price elasticity of import demand in world markets [Koester et al., 1987].

These observations support the conclusion that the commodity sector can earn additional foreign exchange and even generate surpluses of investable funds provided disincentives for commodity production and exports are dismantled. In addition to indirect taxation, particular weight has to be attached to exchange

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[1] The World Bank's Project on "The Political Economy of Agricultural Pricing Policies" provides convincing empirical evidence on this issue for a large sample of developing countries [see Krueger et al., 1988; Schiff, 1988]. It is shown in Schiff [1988] that the effect of the indirect, economy-wide interventions generally dominates the direct effects. See also World Bank [1986] for a similar view.

rates.[1] For HCED DCs the exchange rate is determined by foreign exchange earnings received for exports of primary commodities, import protection granted to manufacturing activities and interventions in foreign exchange markets which all work in favour of an overvaluation of the national currencies. Such an overvaluation is equivalent to a tax on (traditional and non-traditional) exports. Devaluation in real terms, e.g., by sterilising foreign exchange earnings from commodity export and by trade liberalisation raises the price of tradables relative to non-tradables and reduces import demand and demand for foreign exchange. Incentives would increase for agricultural production in general as well as for agricultural and non-protected manufactured exports and the production of import substitutes since devaluation of the national currencies lowers the price of labour, land and capital in international currency, changes the income distribution in favour of scarce factors of production, and promotes capital formation financed out of increased profits.

If policy reform is instituted the expansion of the commodity sector is expected to be self-financed and not a target area for development aid. The commodity producing sector has rather to assume the role of a nucleus for domestically-financed diversification of economic activities and integration of markets. The focus of aid should be on supporting the implementation of policy reform and the stabilisation of fragile institutions.

3. Requirements for Diversification

Empirical evidence of the past three decades has clearly highlighted the importance of a stable macro-economic environment, i.e. stable monetary and fiscal policies, and the critical role of prices for economic development [World Bank, 1988a, Par. 2.10]. However, adjustment to new economic parameters takes considerable time in segmented and distorted markets, and progress towards broadening the structure of production and exports will require more than "getting the prices right":

- Budgetary discipline and appropriate incentives for diversification will require a review of virtually all government activities [Leonard, 1987]. Major issues are a

[1] For the utmost importance of exchange rate policies on structural change in general and the recovery of the agricultural sector of HCED DCs in particular, see Hussain, Thirlwall [1984]; Acharya [1978]; Nashashibi [1980]; Bond [1983]; Kincaid [1984]; Gulhati et al. [1986]; Oyejide [1986]; Tshibaka [1986]; Kimaro [1988]; Chhibber [1988].

dismantling of excessive encroachment on private activities, privatisation of government activities (including marketing boards), a rationalisation of pay systems for public servants, a substantial reduction of the size of the civil service especially at the unskilled level [Lindauer et al., 1988], improvements of the tax and customs administrations, and a restructuring of government revenues from indirect (export taxes, duties) to direct and progressive taxation of income or land.

- Segmented markets and weak intersectoral linkages result from barriers to access within and among countries. Measures have to be designed or strengthened that ensure the freedom of establishment, access to jobs both in the private and the public sector, and greater mobility of factors of production even across borders. Constraints originating from artificial colonial or tribal boundaries can be overcome by regional co-operation[1] in such areas as improving physical infrastructure and rights of access, facilitating information and communication or promoting joint training and research.
- Uncertainty about or non-existence of property rights severely limit private risk taking, i.e. capital formation. Efforts towards institution building and the protection of individual or collective property rights are, therefore, essential for a positive response to an improved incentive system.
- Diversification will place greater emphasis on human capital and entrepreneurship. Human resource development will, therefore, be a major challenge for the 1990s. Analytical capabilities for private and public decision-making, receptivity to technology transfer, and workers' motivation and discipline are all in short supply in low income countries. These bottlenecks require investment in education, on-the-job training and research activities.
- Individual welfare of citizens of poor countries will hardly improve substantially unless population growth can be held at bay. If population growth rates are not reduced, income per capita could easily stagnate even under most optimistic assumptions concerning supply responses to appropriate relative prices.

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[1] In light of the dismal experience with regional integration schemes both in Latin America and Africa, customs unions and free trade areas do not seem to be feasible. Such attempts mostly ended in stagnation or even failure since particularly smaller and less developed member countries were anxious that other member countries could reap benefits from integration "at their cost" [Langhammer, Spinanger, 1984, Chapter I]. Vested interests in protected economic activities and an anticipated shortfall of customs revenues not offset by compensation payments have proven to be arguments strong enough to abandon intra-regional trade liberalisation.

4. Bridging the Transition Period

Problems related to the above long-term strategy are manifold. They centre around short-term costs of policy reform for poor segments of the society and the willingness or ability of governments to resist pressure groups suffering from a reduction of their real income and privileges. Even assuming a strong and reform-minded government the period of transition until production can fully respond to real depreciation and changing relative prices is expected to be long. In most low income countries substantial efforts in the production and dissemination of knowledge (induced technical progress) will have to go along with the development of complementarities among sectors (e.g., transport, commerce). Controversies exist with regard to the time span needed for transition. Estimates differ widely across countries [Nashashibi, 1980; Bond, 1983; Kincaid, 1984; Kimaro, 1988; Chhibber, 1988] but even limited experience with often half-way aborted experiments suggests that short-term adjustment problems can only be overcome by a tremendous effort coupled with substantial external financial and technical assistance.

The problems of surviving the transition period can be translated into a number of constraints and open questions:

- How can ruling elites be convinced of the necessity of sustaining policy reform and which political and social institutions are required to enforce reform measures?
- How can budget deficits be kept at bay? The loss of earnings from import duties and export taxes is aggravated by increasing expenditures for debt services following a devaluation. Savings accruing from a dismantling of subsidy payments and a re-organisation of the public sector may at least initially not be sufficient to close the gap in the budget. This makes a tax reform all the more urgent, but external assistance is also being called for.
- Adjustment lags and short-term vagaries of international commodity prices may cause temporary balance of payments problems which could threaten the continued inflow of necessary imports. To prevent such bottlenecks, export earnings should be stabilised (possibly with external assistance) and measures have to be taken to defeat the widespread export pessimism. To this end an assessment of commodity and trade policies in industrialised countries is on the agenda which discourage the expansion of traditional and non-traditional exports from HCED and other poor developing countries.

- Higher agricultural product prices may lead to an increasing gap between food requirements and purchasing power of the poor. Therefore, food security becomes an imperative mandate both for local government and donors.
- Many low income countries are endowed with vast, but particularly vulnerable natural resources. Efforts must be made by local governments and donors to establish ecological stability and economic sustainability of these resources. Poor rural population groups need alternative technologies and sources of energy which reduce the tendencies of deforestation and horizontal expansion of land use which are often the only means of securing a minimum level of living for the poor.

IV. Agenda for External Assistance in the 1990s

1. Lessons from the Past

Declining per capita incomes are a clear indication that project and programme aid as well as structural adjustment loans have failed to promote a sustained growth process in low income countries. Some observers, like Lord Bauer, even consider development aid as one of the roots of deteriorating economic conditions while the majority of observers maintains that aid has at least prevented poverty from turning into catastrophe [e.g. Levy, 1988]. Even if the latter were true such a "success" does not offer any medium-term perspectives for development aid policies of industrialised countries. The role of aid would be reduced to emergency relief without any hope for a final solution of the crisis.

The preceding sections have shown, however, that many poor countries possess the capability to return to higher economic growth and better standards of living for the population as a whole provided an improved economic policy management is implemented on a sustained basis. This precondition is imperative not only for a more efficient use of local resources but also for the impact on overall development that foreign aid can make. All financial flows are at least to some degree fungible, and wrong economic incentives encourage a misappropriation of aid flows for military spending, luxury consumption, inefficient prestige projects or even capital flight as was observed repeatedly in the past.

Frequently aborted IMF and World Bank adjustment programmes have proven that an appropriate macro and sector policy management cannot be imposed externally. The strategic policy changes towards encouraging economic diversification and market integration have to come from within the countries concerned with external donors mainly playing a catalytic role. Except for technical assistance in policy analysis and policy implementation, there is little industrialised countries could directly contribute to setting the wheel in motion. Their main task with respect to the long-term success of diversification efforts is to provide an external economic environment encouraging entrepreneurs and investors in low income countries to engage in new activities.

2. Improving the External Economic Environment

To provide access to all markets of industrialised countries and to secure an uninterrupted availability of imports is an essential and indispensable part of support for low income countries. Investors in these countries should be confronted with undistorted world market prices, and they must be assured of a continued open trading environment.

It is widely established that agricultural policies in industrialised countries have lowered world prices in international agricultural markets and thereby distorted the shadow price of food production in developing countries [Matthews, 1985; Valdés, Zietz, 1980]. An empirical analysis [Tyers, Anderson, 1988, pp. 197 ff.] shows that policies implemented in the EC-12, the EFTA-5, the US and Japan depressed world market prices for wheat, coarse grain, rice, meat, dairy products, and sugar by between 3 and 61 per cent in 1980-82. In addition, industrialised countries have contributed significantly to the instability of world prices in agriculture by insulating their domestic markets from the world market, thus avoiding stabilising adjustments of their producers, consumers and traders to changing world market conditions. These policy-induced instabilities raise the market risk of HCED DCs in food trade.

A lowering of the agricultural protection levels in OECD countries, as proposed in the Uruguay Round of the GATT negotiations, would be a market-oriented step towards increased self-sufficiency in food in HCED DCs. Given a price-inelastic import demand for food in these countries, a reduction of agricultural protection in OECD countries will lead to rising import expenditures in the short run. However, short-term income gains from protectionist policies must be balanced against medium-term inefficiencies in resource allocation as low world market prices discourage local agricultural production which otherwise would contribute to economic diversification in HCED DCs. For individual countries undistorted world market prices could even lead to food exports and an increasing export diversification.

The claim for opening markets of industrialised countries for all products and services from low income countries seems redundant given far-reaching special and general preferences for this group of countries (Lomé Convention, Caribbean Basin Initiative, GSP). This view is misleading on several grounds. General tariff preferences have been granted only to specific HCED DCs for a limited number of agricultural products. In addition, special trade arrangements agreed upon in the Lomé Convention cover only sugar, beef, rum, and bananas. These specific trade arrangements imply the provision of trade-tied aid [see also pp. 19 f. below], and especially the Sugar Protocol and the Beef Protocol induce substantial income transfers to individual commodity producers [Koester, Herrmann, 1987, Section 5]. Such transfers tend to freeze the export structure of HCED DCs as they provide an incentive to specialise in the traditional export products. As an instrument of redistribution, the hidden transfers are inferior to a targeted aid policy that is oriented on indicators of need.

As far as non-traditional products are concerned, protectionist instruments embodied in preferential trading arrangements are subtle but by no means ineffective since they have discouraged efforts to establish internationally-competitive lines of production and nourished export pessimism of potential investors above all in economically weak countries [McQueen, 1982; Agarwal et al., 1985, Chapter IV]:

- Rules of origin are less restrictive for low income countries than for advanced developing countries but still too restrictive given their stage of industrialisation. They prevent these countries from attracting "finishing touch" activities which can be a first step towards developing an indigenous industrial sector.
- There is a continuing threat that OECD countries might apply quantitative restrictions. Bangladesh's clothing exports to the UK [Spinanger, 1988] and other examples from the past Lomé Conventions (i.e., so-called facultative ceilings ("Ligne ACP") for some textile exports [Promethée, 1983, p. 113]) contradict those who believe that in particular least developed countries have nothing to fear.

Moreover, tariffs applied in OECD countries increase with increasing stage of fabrication. This escalation effect hinders HCED DCs to attract export-oriented investments in the processing of commodities. Escalation effects have not been removed in multilateral trade negotiations [Yeats, 1987].

To strengthen the case for a liberalisation of OECD imports and a deregulation of commodity policies the OECD Secretariat should further increase its role as a surveillance body. An important step in this respect was the computation of producer and consumer subsidy equivalents in world agriculture [OECD, 1987]. In addition, comprehensive liberalisation and deregulation schedules could be worked out by the OECD which clearly pinpoint the need for action in individual OECD member countries. Enforceability of such programmes will, however, remain an important problem, since neither the OECD Secretariat nor other international institutions have effective sanctions at their disposal. A feasible way out may consist of a commitment of OECD countries to compensate low income countries for refused liberalisation by additional (contingent) aid payments combined with a change of voting rights for member countries in the IMF and the World Bank. Under a modified rule, the principle of "one country - one vote" would be applied in decisions on contingent aid allocations provided the OECD Secretariat notifies that the liberalisation programme has been violated by a member country. The maximum aid to be allocated under this modified rule would be given by the estimated welfare losses of recipient countries due to refused liberalisation.

3. Basic Guidelines for Development Aid Policies

The main focus of multilateral as well as bilateral aid will have to be on encouraging the implementation of reform programmes in the short to medium term. During this period, foreign aid can make an essential contribution towards stabilising the economic framework in which both domestic and foreign private investors have to operate. In this sense, aid will be instrumental in improving the investment climate in low income countries in times when additional private investment is most urgently needed. Irrespective of the size of required aid flows[1] this approach implies a number of general policy guidelines which essentially apply to both bilateral and multilateral donors:[2]

- **Selectivity.** Donors should accept the empirical evidence that aid cannot contribute to economic and social development unless the economic incentive system is appropriate. If some governments are notoriously unwilling to put their economic

[1] In the context of this policy paper estimates of the resource gap in low income countries were not feasible. The recent World Bank Report on Sub-Saharan Africa [1988a] notes that a doubling of present aid flows may be required for this region until the year 2010.

[2] For similar recommendations concerning US co-operation with developing countries, see Smuckler et al. [1988].

house in order donors should not hesitate to disband support for these governments or at least reduce their efforts to the supply of emergency relief. If such a clear-cut policy decision does not seem to be feasible because of foreign policy considerations, funds disbursed for these reasons should clearly be separated from development-oriented budgets and institutions.

- **Premium approach.** If policy reform is initiated from within the countries concerned donors should be prepared to reward domestic efforts by increasing external support. Empirical evidence suggests that financial support for governments undertaking economic reforms has lagged behind their needs in the past [Gulhati, Nallari, 1988]. According to this evidence, it was at least partly due to lacking aid response, particularly by bilateral donors, that policy reforms were abandoned or stagnated in several African countries such as Malawi, Zaire, Zambia, and Uganda. A reward of reform efforts will, of course, require the specification of criteria upon which aid disbursements can be based. Letters of intent should no longer be accepted as sufficient proof of reform-mindedness.
- **Flexibility of country quotas.** The above suggestions imply greater flexibility in aid allocations among low income countries. Country managers in aid institutions countries should have more discretion to suspend or increase aid flows depending on political and economic developments in individual countries. The impact of more flexible aid policies applied by individual donors would, of course, be strengthened by donor co-ordination. However, co-ordination is costly and achieves little when bilateral aid allocations are influenced by non-developmental considerations [Gulhati, Nallari, 1988, pp. 1171 ff.]. Alternatively, an appropriate allocation of aid from all sources could be facilitated if institutions such as IDA would focus their own aid allocations on total aid flows received by individual countries. Under a scheme of "compensatory aid allocation", IDA would grant more or less funds depending on bilateral aid allocations and the perceived needs of the countries concerned.
- **"Software" orientation** of aid programmes and projects. As politico-economic constraints and institutional weaknesses were identified as major bottlenecks for development in HCED DCs external assistance should be geared towards institution building, human resource development, control of population growth and other poverty-related areas (see the subsequent sections). "Hardware" requirements such as physical infrastructure should rather be derived from software oriented-programmes than to be anticipated as independent tasks. It follows from this suggestion that direct support for diversification at the sectoral level (such

as credit programmes or product-specific marketing assistance) is not considered as a priority area for bilateral aid in the 1990s (see also pp. 20 f. below).

- **Credibility** of donor policies. Greater transparency of aid allocations among countries and between projects or programmes are expected to have a twofold advantage. Recipient governments become convinced of the development-orientation of donor policies, and the credibility of aid policies is increased at home in OECD countries. An appropriate way to improve transparency is to publish country and feasibility studies prepared under the auspices of aid administrations.

These guidelines provide the background for detailed recommendations on bilateral and multilateral aid policies presented in the subsequent sections. It is assumed below that balance of payments support and structural adjustment loans continue to be supplied by IMF and World Bank, at terms, however, in line with the aid philosophy elaborated in this paper.

4. Supporting Institution Building and Human Resource Development

The success of policy reform in low income countries hinges on the mobilisation of domestic support for reform, a free flow of information about government decision-making, enforceability of individual rights against public institutions, and unhampered mobility as well as improvement of, in particular, human and financial resources. The institutional prerequisites for smooth adjustment are lacking in most of these countries to varying degrees. Attempts to design an appropriate institutional framework suffer from deficiencies in the theory of institution building and the heterogeneity of the countries concerned. Institutions depend to a substantial degree on socio-cultural influences and, thus, escape a rigorous economic analysis. However, empirical evidence has suggested some major areas of concern which provide a yardstick for country-specific institutional requirements. Generally speaking, external assistance can be instrumental in creating and stabilising an improved domestic economic order, promoting human capital accumulation and establishing intra-regional institutions among neighbouring countries.

A well-functioning **domestic economic order** comprises a wide range of political and institutional aspects. In most low income countries, there is a lack of transparency within the society which reduces access to information and impedes the articulation of interests. Therefore, measures protecting the freedom of the press, promoting diversity of written or broadcasted opinion, increasing the flow of relevant economic information (e.g., broadcasted price information) or facilitating the establishment of special interest groups such as farmers' or producers' associations, should be attributed a high priority in institution building activities of external donors. Another similarly important area concerns the definition, protection and enforcement of property rights. Support is needed for cadastral surveys, land-registration authorities, courts and other independent executive bodies. And finally, donors should engage in facilitating the emergence of a well-functioning private capital market. If surpluses generated in the commodity exporting sector are to be channelled into other productive activities, the private capital market has an important allocative role to play. Provided local governments can be convinced to deregulate financial markets, there will be several avenues for external donors to encourage the domestic intermediation process such as improving and up-dating accounting systems, credit procedures, branch networks, stock exchange facilities, and temporary financial support for the introduction of financial innovations. Along the same lines, there may be scope for increasing the attractiveness of low income countries for foreign investors which, of course, depends on a removal of domestic policy barriers to foreign investment in the first place.

Human resource development represents another major element in the software approach to economic and social development. In the past, aid policies of industrialised countries have been mistaken insofar as they were concentrating on secondary education. However, it is mainly vocational training and primary education that have been shown to increase productivity and to change the generative behaviour of the population. External aid for improved primary education and vocational training could involve the development of adequate curricula, the training of teachers and the supply of teaching equipment. Non-governmental donor organisations (NGOs) may play an important role in this respect. As far as higher education is concerned emphasis should be put on the transfer of management and marketing know-how and technologies for processing of commodities. More importantly, however, appears to be substantial support for establishing and maintaining commodity-related research activities. Agricultural technologies are far less transferable among continents and countries with different climatical conditions than other technologies, and indigenous research has been neglected in most HCED DCs until recently. Furthermore, external assistance may help to stop and eventually reverse the brain drain observed in many of these countries by supporting a more adequate research infrastructure with sufficiently attractive job opportunities.

Institution building and human resource development have an intra-regional dimension. They are prime targets for establishing **intra-regional institutions** since investment and maintenance costs easily exceed the resources available to individual countries. Intra-regional co-operation must also focus on facilitating the free flow of information and resources among countries. External donors can contribute to improving communication networks and institutions, rationalising energy investment, strengthening ecological co-operation and joint food security policies as well as removing physical barriers to the movement of goods and factors of production. Further details on these issues will be elaborated below.

5. Balance of Payments Support

The devaluation of the national currencies will reduce balance of payments deficits by diminishing imports and increasing exports. No exports will be forthcoming in a number of countries, however, even if free access to markets of industrialised countries is guaranteed in the long term as long as these countries are not free to pursue an **appropriate exchange rate policy**. For various member countries of the Franc Zone there is ample evidence that the national currency is grossly overvalued [Devarajan, de Melo, 1987] and that access to the French capital market can - at least no longer - offset the damaging effects of the overvaluation. Support for long-term economic development in low income countries should, therefore, include negotiations among industrialised countries about ways towards achieving more flexible exchange rate regimes for francophone Africa.

HCED DCs receive balance of payments support in the form of international agreements for specific commodities and through compensatory financing schemes. **International commodity agreements** have - all in all - proven to be rather unsuccessful in reaching their primary targets [Gilbert, 1987]. Two of the agreements, the International Tin Agreement and the International Cocoa Agreement of 1980, broke down. Prices were enforced which exceeded the medium-run equilibrium price and the commodity authorities ran out of funds. A third agreement, the International Sugar Agreement, has never been an effective market stabiliser as major producing countries did not participate. But even the two agreements which are often pointed to as success stories, the International Coffee Agreement (ICA) and the International Natural Rubber Agreement (INRA), are relatively inefficient in reaching their primary objectives or have strong negative side-effects on factor allocation [Herrmann, 1988; Burger, Smit, 1988].

In principle, **compensatory financing schemes** are superior to buffer stock or export quota policies. They can stabilise national export earnings directly, whereas market price stabilisation can stabilise national export earnings only under specific conditions. No intervention in international commodity markets is necessary and, hence, compensatory financing can avoid the aggregate welfare losses associated with price-changing commodity agreements. However, empirical analyses show that the compensatory financing facility of the IMF and the STABEX system laid down in the Lomé Convention are far from being optimal compensatory financing schemes [Finger, Derosa, 1980; Koester, Herrmann, 1987]. In many cases, both schemes did not or not sufficiently stabilise national export earnings as a consequence of substantial time-lags in compensatory payments and financial constraints. Furthermore, existing compensatory financing schemes are no pure stabilisation schemes but contain implicit income transfers which are distributed independently of indicators of need. [1]

On the basis of this experience, it cannot be recommended to introduce new international commodity agreements. If industrialised countries cannot avoid the renewal of existing commodity agreements they should focus on a strict separation of redistributive and stabilising elements. Commodity agreements should then deal with price stabilisation as opposed to price support and compensatory financing with earnings stabilisation and not earnings support. For compensatory financing schemes, this means that their stabilising role should be strengthened. The IMF and STABEX funds could be enlarged and an increased use of the advance-payments rules could improve their stabilising efficiency. The implicit grant element in compensatory financing schemes should be reduced and a compensation could occur by increasing budgetary support.

Important commodity-related decisions have to be made under the **Common Fund** which will be created in 1989 or 1990. The Fund's objectives are to finance buffer-stock activities laid down in international commodity agreements ("First Account") and other measures in the commodity field ("Second Account"). Originally, the "First Account" was planned in order to finance the buffer-stock schemes of ten core commodities to be introduced under the Integrated Commodity Programme (ICP). As the ICP failed, OECD countries put now more emphasis on the "Second

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1 Credits are granted under more favourable conditions than on commercial markets. Significant grant elements are involved in the EC scheme where earnings shortfalls are generally compensated for by interest-free credits without, in many cases, any repayment duty. The grant element in the IMF scheme is lower but still important; the interest rates the IMF charges are clearly below market interest rates.

Account". It is envisaged to stimulate commodity-related technical progress or marketing activities. Given the guidelines elaborated above, however, the planned measures under the "Second Account" are as problematic as those under the "First Account". As a form of commodity-related aid, they are inferior to a targeted aid. Commodity-related measures under the Common Fund should be oriented at risk reduction and not at income redistribution. One might think of technical assistance which strengthens the use of commodity futures and options markets by HCED DCs in order to stabilise commodity earnings.

6. Budgetary Support

Budgetary support to low income countries will in the first place be a matter of structural adjustment loans granted by the World Bank. It needs to be stressed again that direct support should be made contingent on progress in deficit reduction through, e.g., a phasing-out of subsidies, reduction of the size of the civil service or privatisation of government activities. However, bilateral donors can also play an important supplementary role:

- Exchange rate adjustments are easily discouraged because they increase debt service obligations in local currency and, therefore, tend to kindle domestic inflation. Debt service should be limited to those obligations that had existed under historical exchange rates. Another way to alleviate the foreign debt burden for HCED DCs are debt-for-nature swaps which will be discussed below in greater detail.
- Further debt relief should be granted by bilateral donors by defering debt service payments due and by extending grace periods of disbursed credits. Debt cancellation is, however, to be avoided since such a policy creates severe moral hazard problems within and among low income countries [Buiter, Srinivasan, 1987; Nunnenkamp, 1988].
- Special importance has also to be attached to financial and technical assistance for tax reform and for improvements of the customs and tax administration.
- And finally, industrialised countries can provide indirect budgetary support by financing poverty or ecology-related programmes such as "food for work" or ecological preservation measures (for details, see subsequent sections).

7. Compensation Payments

Structural adjustment as advocated in this paper means that exchange rates are realigned to deal with shortages in foreign exchange, that agricultural prices are at parity with international prices, that public expenditures are reduced, and that markets are allowed to operate more freely. Although these programmes can be expected to foster income and employment in the medium run, the very poor may substantially suffer from the policy changes in the transition period. Increasing food prices and a reduction of transfer payments may lead to a deterioration of the income and nutritional status of the very poor both in rural and urban areas.

Temporary support for these groups has to be designed in a way not to spoil incentives for re-migration from urban to rural areas and for increasing food production. All poor would benefit from a phased reduction of food subsidies which focusses on non-subsistence products in the early stages. Food aid should, however, only be provided in rural areas since support granted to urban poor would cement the status quo. Food aid to rural areas can be disbursed in the form of food-for-work programmes (e.g., for maintaining the ecological balance) or as aid targeted to specific groups (poor children, women, landless labourers, etc.). The more successful the targeting is, the less food aid will distort market incentives, as it will create additional demand for food which would otherwise not exist. Such a re-oriented approach would be quite different from the existing food aid policy. As is well-established, current food aid policy is largely oriented at the donor's goals of surplus disposal or strategic policy considerations. Hence, it is to a large extent a permanent instrument inducing the well-known disincentives for domestic food production.

8. General Poverty-Related Measures

Social development of low income countries suffers from a number of poverty-related problems which cannot be elaborated in detail in this paper. The most important one is excessive population growth. By all indicators there are no short-term solutions to changing the generative behaviour of people. Nonetheless, external donors should strive to continue support for improving hygienical conditions, health care and other measures that offer at least long-term chances to ultimately reduce population growth. In many of these areas, there may be chances for a cost-reducing cooperation among neighbouring countries.

Another area of increasing concern is the preservation of the economic potential of low income countries by environmental protection. Especially in low income HCED DCs, natural resources are often underrated assets and the long-term costs of excessive exploitation are shifted to future generations. Deforestation, for example, is encouraged by accounting systems which neglect the public use aspects of the environment (health, quality of life). Ecological policies of these countries should be supported by external aid as citizens of industrialised countries assign a higher priority to world-wide environmental protection than citizens of low income economies.

Aid may take the form of lump sum payments to compensate for income losses which are due to domestic ecological policies. Even if such aid is made contingent to controllable changes of resource use several problems may still arise. Extensive monitoring is necessary to enforce the commitment of HCED DCs to avoid excessive exploitation of natural resources. It is open to question whether aid payments will reach those who suffer from income losses in the first place. And, moral hazard may induce the governments of these countries to abandon formerly implemented ecological policies unless external aid is granted for these measures as well.

One way of containing such problems could be to make aid conditional on the establishment and enforcement of property rights. Property rights may be granted to international ecological organisations such as the World Wildlife Fund or to regional cooperative bodies. By assigning regional organisations a central role, the concern of HCED DCs' governments to maintain national sovereignity may be reduced. Transfers of property rights could at least be considered in cases where the exploitation of natural resources results from large-scale logging or other forms of overuse of widely unpopulated areas. Conflicts with the local population would be minimal in such cases. Other types of exploitation of natural resources, e.g., fire, overgrazing, shortened fallow periods etc., may require different legal procedures and, most important, provision of alternative sources of employment and income for those poor segments of the rural population who have so far depended on these scarce natural resources for their food security and survival.

The enforcement of environment relief should also be encouraged in the context of debt-nature swaps. In this case, OECD countries would grant debt relief in exchange for property rights on natural resources as well as in exchange for a successful and controllable reversal of past trends in environmental damage. Since dept-nature swaps frequently involve a substitution of domestic for external debt additional aid payments may be required; otherwise overall debt service obligations of the public sector of low income countries may even increase.

V. Concluding Remarks

The recommendations presented in this paper are based on the generally acknowledged observation that the substantial support granted by external donors to low income countries in the past has produced at best marginal results here and there, but was not able to halt the economic and social decline of these countries. The search for reasons of this development has led to the conclusion that present aid policies applied by industrialised countries put too much emphasis on assistance to the commodity sector taking the macro-economic and sector-policy framework as given. Donors have neglected the political economy of decision-making in low income countries while overtaxing the existing texture of their societies. It is argued that neither more foreign aid nor more sophisticated or modified commodity-oriented policies alone are able to turn the tide. What is needed is a sweeping re-orientation of aid policies in the 1990s. Priority should be given to a strengthening of political bargaining processes within low income countries and to institution building at all levels of society. It is expected that progress in these directions improves the capabilities of these countries in coherent, rational economic policy formulation and enforcement of economic policies which are necessary preconditions for a return to sustained economic growth and social development.

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