CONFIDENTIAL

Prime Minister
To note
A Lazy[?]
Duty Clerk
14/2/83

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

IMF INTERIM COMMITTEE

Last week's meeting in Washington of the IMF Interim Committee went well, and the gamble of advancing it paid off. The IMF should now be better placed to play its vital role in encouraging and assisting over-extended borrowers, especially in the more advanced developing countries, to adjust their economies.

2. The main features of the additional help which is now available are:

- the direct increase in IMF quotas is from SDR61 billion to SDR90 billion - not quite the 50 per cent I was aiming for, but as near as makes no practical difference and sufficiently near to avoid any sense of public disappointment;

- this is backed by the earlier decision, taken in Paris in January, to enlarge and expand the purposes of the General Arrangements to Borrow, which increases from SDR6.5 billion to SDR17 billion;

- in addition, it is now clear that the Saudis will, as discussed during my visit to Riyadh, make additional funds available in association with the enlarged GAB: discussion of the detailed arrangements was carried forward, although not yet quite completed, in Washington last week;

- finally, Congress permitting, the quota increase should be implemented by the end of this year, ie 2 years ahead of the previous schedule. (I shall be pursuing separately the question of our own Parliamentary timetable.)

/We knew

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3. We knew from the start that the problem would be how to find a compromise between the over-ambitious hopes of many developing countries and the disappointingly low figures advocated by the United States. In the event, it proved not too difficult to persuade developing countries to go for something around a 50 per cent increase, partly because it was possible to show them that the expansion of the GAB will be a genuine additional support for IMF operations in their interests, should the need arise. The critical problem was the attitude of the United States, for the Administration had, under Congressional pressure, begun to move to a more restrictive position than in the autumn,and there was talk of a $8 billion limit on their contribution to the quota increase and the GAB. If this ceiling had held firm, a deal would probably have been impossible.

4. Secretary Regan arranged for me to meet some 15 Senators and Congressmen, and I was able to explain to them our reasons for wanting a substantial increase in IMF resources. And in the meetings I pushed Regan above the $8 billion ceiling, and as far as he felt able to go, but not so far as to leave him without reasonable hope of persuading Congress to ratify later this year. He told me at the conclusion of the meeting that he was well satisfied with the outcome - and that the President too was pleased. (I did not in the end see the President myself - for Friday's blizzard blotted out his afternoon programme.)

5. There was some discussion of the world economic outlook during the plenary meetings. Some speakers urged the need for "locomotive" reflationary action by countries which had succeeded in reducing public sector deficits and inflation. But all of us cast in this role - Germany, Japan, the United Kingdom, and the United States - argued that our policies were already leading to some natural generation of demand, and that artificial attempts further to stimulate it would inevitably re-ignite inflation. I attach a copy of the communique, which covered this debate quite satisfactorily.

/I shall

6. I shall let you have a separate note on what I learned on the visit about the prospects for the US economy.

7. Copies of this minute go to the Foreign Secretary, the Secretary of State for Trade, the Governor of the Bank of England, and Sir Robert Armstrong.

G.H.
14 February 1983

File

Econ. Pol

15 February 1983

IMF INTERIM COMMITTEE

The Prime Minister was most grateful for the minute of 14 February by the Chancellor of the Exchequer describing the results of last week's meeting in Washington.

A.J. COLES

John Kerr, Esq.,
H.M. Treasury.

DEPUTY SECRETARY
(CHIEF ECONOMIST), [illegible]
27 JAN 1983
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THE POLITICAL ECONOMY OF FOREIGN AID:

AN ALTERNATIVE VIEWPOINT

Keith Marsden* and Alan Roe*

Discussion Paper No. 20

July 1982

The Political Economy of Foreign Aid: An Alternative Viewpoint

by

Keith Marsden* and Alan Roe*

Peter Bauer has made some major contributions to development thought. His early work in Southeast Asia and West Africa was a model of systematic and objective empirical analysis. His recognition of the importance of price incentives to farmers, the key role of traders and other entrepreneurs in economic development and of the weaknesses of state marketing boards was too long neglected by mainstream economists and policymakers alike. In his recent article in the Lloyds Bank Review[1/] (joined by Basil Yamey), there is much with which the observer of the development scene can agree. But in their sweeping condemnation of aid, which they define as "official government grants and subsidized loans (in practice largely grants) for nonmilitary purposes," the authors seem to have cast empiricism aside. They attempt to link the assorted ills of some developing countries to the provision of aid but fail to provide convincing evidence of a causal relationship. They conveniently pass over the good economic performance of the majority of countries in the Third World,[2/] all of which are recipients of aid, and they seem strangely uninformed about the procedures of some of the leading development institutions.

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1/ Lloyds Bank Review, October 1981.

2/ Out of 88 developing countries for which data are available, 46 achieved an average annual rate of growth of GDP of 4.5% or higher between 1970 and 1979 compared with an average of 3.2% for the industrial market economies. About a third exceeded 6% per annum. See World Development Report, 1981 (New York: Oxford University Press, 1981).

Before examining their arguments, it may be helpful if we clarify how the World Bank, which is a target of their criticism, fits into the aid system. The main arm of the World Bank is the International Bank for Reconstruction and Development (IBRD). IBRD loans are funded largely by borrowings on international capital markets (where its bonds are rated AAA) and are made to developing countries at market interest rates, currently 11.6 percent (being 0.5 percent over the average cost of funds). These loans have a maturity of 15-20 years, including a 3-5 year grace period. They are never rescheduled, there has never been a default and they finance investments in projects that must meet exacting criteria and have a high economic rate of return. IBRD lending totalled $8.8 billion in fiscal year 1981. While IBRD lending clearly does not fall within Bauer and Yamey's definition of aid, that of the World Bank's concessionary-loan affiliate, the International Development Association (IDA), does. IDA lends to the world's poorest countries (with per capita GNP of less than $681) at no interest (except for an annual service fee of 0.75 percent on the disbursed portion and 0.5 percent on the undisbursed portion) for a term of 50 years, including a 10-year grace period. IDA is funded by transfers from the Bank's net earnings, subscribed capital from member countries and contributions from its richer members. There have been no defaults on IDA credits, and it is important to note that IDA is administered by the same staff as IBRD and the same criteria are used in appraising the suitability of projects. For an IDA project to be approved, it must have an economic rate of return of at least 10 percent in real terms. IDA lending in fiscal year 1981 totalled $3.5 billion.

Bauer and Yamey score some easy debating points by erecting straw men and demolishing them. Thus they assert that aid has been advocated as necessary for the promotion of economic development and point out that some of the outstanding economic success stories (e.g., Hong Kong) owe little or nothing to foreign aid. They go on to stress the obvious--that economic achievement depends on people's own faculties, motivations and mores, on their institutions, and on the policies of their rulers. In reality, of course, most development analysts and aid practitioners do not claim that aid is an indispensable or sole determinant of economic development, or that it can compensate fully for inadequate policies and institutions. They say that aid can facilitate and accelerate the development process, both by providing additional financial resources and by helping to strengthen LDC institutions and policies, so that people have greater opportunities and incentives to use their innate abilities productively. But even where policies, institutions and other determinants of development are persistently weak, aid would still be justified if its recipients become better equipped and better off than they would otherwise have been.

Bauer and Yamey's critique of aid involves an overgeneralized and quite unfair representation of the lending practices of aid donors and development institutions. Examples of the misleading assertions incorporated in their article include the following:

> Assertion: "Taxpayers in the West, who are the real donors, have no control over its operation."
>
> Reality: Donor taxpayers are represented on the Board of the World Bank by full time Executive Directors, appointed by member govern-

ments. All projects must be approved by the Board, on which the donor countries have a large voting majority. The fact that few projects have been rejected by the Board in recent years does not signify lax control, but reflects thorough preparation and screening by Bank staff prior to Board presentation. Project loan Agreements specify the purposes and beneficiaries of the projects and lay down strict controls and conditions on the use of funds. Project implementation is closely supervised by the Bank. Bilateral aid programs are subject to detailed scrutiny by various parliamentary bodies. However, not all these programs achieve their aims or are cost effective, as the recent report on EEC aid by the European Court of Auditors has demonstrated. Some programs would undoubtedly benefit from improved project design and more rigorous supervision.

Assertion: "Aid encourages imprudent financial policies, because external payments difficulties are an effective ground for appeal for aid."

Reality: The Bretton Woods institutions are often criticized for just the opposite--taking too conservative a line on monetary and exchange rate policy. Close collaboration between the World Bank and the IMF results in financial flows being increasingly linked to the adoption of sound financial policies by the recipient countries. Commercial bank funds represent an easier option for borrowers in this respect. This is because these funds are conditioned only on borrowers' likely capacity to repay (with interest).

World Bank money is conditioned on the expected economic (not financial) rate of project return to the country (not borrower).

Assertion: "It is a mistake to suppose that aid goes to the poor. It is given to their governments. What happens to the aid then depends on the rulers and their interests and beliefs."

Reality: Aid is rarely, if ever, handed over on a plate to governments, to use as they wish. Donors and international development organizations determine aid objectives and select target groups among the beneficiaries. The terms are negotiated with borrowers. Donors are free to (and do) withhold aid if agreement cannot be reached on project aims. About 30% of IBRD/IDA lending is focused specifically on the poor. In addition, projects which cover a broad spectrum of income groups often incorporate institutional or policy components to ensure the access of the poor to the services, products or jobs provided by the projects. It must also be recognized that the poor can benefit from aid programs (in any field) which use resources efficiently. Furthermore, procurement practices which incorporate competitive bidding are closely supervised by the World Bank to ensure that the funds are used for their intended purpose.

Assertion: "...a long critical look at the effects of aid by those who support it would seem to be essential before they press their case for yet more aid...Such examination by the international and national aid spokesmen is not, however, forthcoming."

Reality: International institutions evaluate the effects of their aid in a very serious way. The World Bank, for example, established an Operations Evaluation Department, reporting to the Board, which is independent of the Bank in almost all respects, e.g., its Directors may not subsequently work for any other Bank department. Amongst projects completed and evaluated in the 1970s (130 projects representing $10 billion of total investment), 94% achieved their major objectives including the minimum required economic rate of return of 10%. The 49 agricultural projects evaluated have averaged an economic rate of return of 19.5%.[1/] It should be repeated that the Bank uses precisely the same appraisal and evaluation criteria for its IDA credits (which have a large grant element, using funds donated by governments) as for its loans at market rates of interest (using funds raised commercially). The suggestion that soft loans result in soft projects has been objectively examined and shown to be false.

Assertion: "The axiomatic acceptance of the virtues of aid helps to explain why blatant anomalies pass virtually unnoticed...Aid has been going to practically all OPEC countries, including the richest, when the recycling of their surpluses is said to create major difficulties for the West and the rest of the world."

Reality: This is a very misleading statement. Aid commitments to capital surplus oil exporters (Iraq, Saudi Arabia, Libya, Kuwait,

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1/ See A. W. Clausen: Address to the Board of Governors of the World Bank (World Bank, Washington, September 1981).

United Arab Emirates, Qatar) from all sources amounted to only $62.9 million in 1979 or 0.18% of total aid. These transfers are mostly gestures of friendship from neighbors and usually in the form of technical assistance. They should be contrasted with net disbursements of concessional assistance from these OPEC members of $5,018 million in 1979, or 2.8% of the combined GNP of these countries (compared with aid from OECD members amounting to only 0.34% of their GNP).[1/] The World Bank (IBRD) has made loans to only one of these countries, and none since 1973. Furthermore, the recycling of the capital surpluses of OPEC countries (by commercial banks and international agencies) has been generally effective and has allowed oil importing countries to maintain relatively high levels of output while they adjust to the new price structure. However, over the past three years, the maturity pattern and interest-rate structure of the debt accumulated by LDC oil importers has deteriorated. There is a need to convert a higher proportion of the OPEC surpluses into long-term investment rather than short-term balance of payments support. The international financial institutions could play an important role as intermediaries in this transformation.

Leaving aside the strawmen, the distorted facts and the misconceptions about the mechanics of aid, Bauer and Yamey's argument has three main elements which we can examine in turn.

1/ See OECD, Development Cooperation: 1980 Review (Paris, 1981).

Benefits to Recipients

The authors make basically two points. First, governments or private firms in the third world able to use investment funds effectively can always obtain them commercially. Aid is therefore a substitute for commercial funds and the maximum contribution of aid to economic development cannot exceed the interest and amortization payments which are avoided. Second, this contribution, even in the most favorable circumstances, is too small to affect development and to register in the national income statistics.

The first assumption, as a generalization, is incorrect for several reasons. Commercial banks' strength lies in providing general banking services for depositors and short-term working capital for business. They tend to confine their project lending to established firms which can provide substantial collateral, have an excellent track record behind them and generate high financial returns.[1/] Commercial lending is also limited by conservative banking practices (such as exposure limits and capital ratios). Even in countries with reasonably strong euro-credit ratings, commercial banks are often unable to find sufficient project-lending possibilities (due to their limited identification/appraisal capacity) to take up a substantial portion of their desired levels of country exposure. As a consequence, they provide large amounts of general budgetary financing and thereby provide more

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1/ For example, a leading U. S. commercial bank allocates 75% to 80% of its energy-related loans in the Asia-Pacific Region in the form of corporate credits, which are approved on the borrower's reputation or financial strength. The remaining project lending is assessed on the viability of a given scheme and its ability to generate enough cash flow to pay for itself. See The Asian Wall Street Journal, February [illegible]

of a blank check to governments than is the case with official aid agencies. Furthermore, private financial institutions are often unaware of the feasible and frequently high economic rates of return in the social sectors (e.g., health and education). They are also deterred by the problem of "appropriability" of such returns which "stick" with private persons and do not generate a repayment capacity in the borrower agency. As a result of all these factors, the type and number of investment projects which commercial banks are willing to finance often fall well short of the viable investment opportunities within the third world and should not be taken as measures of its absorptive capacity.

The most obvious manifestation of this is the extremely high degree of country concentration of commercial bank lending. Eight countries accounted for 60% of total commercial bank debt outstanding in the third world in 1979. The low-income countries (per capita GNP of $370 or less), representing 69% of total third world population, received only 1.9% of commercial bank loans (medium and long-term) to developing countries in 1980.[1/] By contrast, 87% of the World Bank's concessional lending (IDA) went to low-income countries in 1981.[2/] Because of its analytical capacity and long familiarity with these economies, it was able to identify projects satisfying the minimum requirement of a 10% economic rate of return in all these countries, including the very poorest. Official aid institutions are not simply "picking the plums," i.e., financing projects which would otherwise qualify for commercial loans. In many, if not most cases, aid

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1/ See World Development Report 1981, Chapter 5

2/ See World Bank Annual Report, 1981. The remaining 13% of IDA commitments were allocated to "lower middle-income" countries, those with a per capita GNP of between $371 and $680 as measured in 1979 U. S. dollars.

supports new ventures and investment in areas which do not fit into current commercial bank lending practices or criteria. However, there is a growing number of projects being financed jointly by commercial banks and official aid organizations. Increasing reliance is being placed by commercial banks on the project identification, appraisal and supervisory capacity of aid institutions like the World Bank (supported by its ex-post evaluations and its no-default record). In 1980, 23 commercial banks were participating in cofinancing arrangements with the World Bank. Total funds supplied by cofinancers amounted to $6.5 billion in 1980, covering 93 projects.[1] Many of these projects would not have got off the ground on the basis of commercial bank activities alone.

One can conclude that, far from replacing commercial resource transfers, a substantial proportion of official aid supplements and indeed acts as a catalyst for these transfers. A study of the Multilateral Development Banks (MDBs) published by the U. S. Treasury Department in February 1982 notes "The MDBs...act as a catalyst for private investment and other private capital flows, as well as trade and technology flows."

Turning to the second point, namely the size of the benefits derived from aid by the recipients, these may be estimated in two ways. First, insofar as the total flow of financial resources to developing countries is in excess of the level of commercial loans and direct private investment which would have taken place independently (in the absence of aid programs and aid institutions), the difference may be taken to represent supplemental investment funds which generate additional output and incomes. If this difference

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1/ See Co-Financing: A Review of World Bank Co-financing with Private Financial Institutions (Washington, World Bank, 1980).

is assumed to be at least equivalent to the volume of official aid, the impact on certain groups of countries is significant and certainly large enough to be measured in their national accounts. For the low income group of countries as a whole, official development assistance (ODA) was equivalent to 4.8% of their GNP in 1978. If India is excluded, the proportion was 7.2%. Aid represented 16.9% and 35.9% of total imports for the two groups respectively. Above all, it accounted for roughly 23% and 37% of their gross domestic investments.[1/] Thus on conservative assumptions about the average productivity of aid funds, between a fifth and a third of their GDP growth may be attributable to aid. It should also be noted that ODA represented 71% of net external financial receipts by low-income countries in 1978, whereas commercial loans and credits and direct private investment combined accounted for only 17%.[2/]

Even if the more unrealistic assumption were taken (that aid merely substitutes for commercial transfers), the savings in amortization and interest charges would still be appreciable for low income recipients. The total cost (spread over the life of the loans) of converting the 1978 level of official aid to low-income countries (excluding India) into commercial loans of 10-year maturity and 15% interest would be the equivalent of 12.6% of their combined 1978 GNP. If aid had not been available for these countries over the past 20 years, the annual cost of servicing an equivalent volume of commercial debt would be a substantial burden, despite the effect of inflation in lowering real costs of principal repayments.

1/ See OECD. Development Cooperation: 1980 Review, op.cit., table IV.9 and World Development Report, 1981, table 5.

2/ See OECD, Development Cooperation; 1980 Review, op.cit., table IV, 10.

Costs to Recipients

Bauer and Yamey assert that the slight benefits of aid are likely to be swamped by damaging repercussions because it (a) reinforces the politicization of life in the Third World, (b) encourages a waste of resources, (c) impairs the international economic position of the recipients by driving up the exchange rate, and (d) causes the pauperization and de-skilling of whole societies.

These are real dangers but are by no means inevitable or directly attributable to aid. Aid is generally channelled through governments but, as noted above, aid donors specify its purposes and beneficiaries and supervise project implementation closely. Sixty percent of World Bank aid for rural development goes to private agents (small farmers) and private enterprises receive the bulk of the subloans provided by the financial intermediaries used in Bank industrial lending operations. Ex-post evaluation has shown that resources have been used efficiently in aid projects on the whole. Governments have played a leading role in the development of some of the most successful LDCs, e.g., Korea and Taiwan, and these countries received large amounts of aid, especially during the "take-off" periods. Effective government leadership is exercised in these cases by policies which create the right market signals and incentives for the private sector rather than by direct government intervention in the production process or by regulatory controls. It is true that most infrastructure projects (roads, power, telecommunications and water supply), accounting for about 23% of World Bank commitments in 1981, remain within the public sector. However, the Bank has consistently advocated greater reliance on market mechanisms and "scarcity pricing" for public as well as private goods and

services.[1/] It has made policy reform a condition of its lending operations in several countries. But fundamantal readjustments cannot be accomplished overnight. Policy changes require substantial, often protracted, diagnosis and dialogue. International agencies must emphasize consensus and cooperation. Their approach must be pragmatic and nonpolitical.

If poor countries were to be deprived of aid, the risks of undue politicization and "destabilization" of their economies would seem to be greater. These countries would be faced with the choice between raising taxes to meet their budgetary deficits and to service the debt from higher levels of commercial borrowing (if obtainable--which is unlikely in the case of the poorest countries), or cutting back on their public sector investment and imports of capital goods. Higher tax rates would have negative "supply-side" effects on investment levels, entrepreneurship and effort which surely Bauer and Yamey would deplore. Reducing investment and capital-goods imports would result in the stagnation of real income, which could spark off political conflict in countries with a large proportion of their burgeoning population already below the poverty line.

1/ See Economic Development and the Private Sector (Washington, World Bank, 1981). Bauer and Yamey argue that "aid reinforces the disastrous politicization of the life in the Third World" because "it intensifies the hold of government over the rest of society by increasing the money, patronage and power at its disposal." We would point out that government expenditure (capital and current) represented a substantially lower percentage of GDP in low-income countries (22.6%) than in industrialized countries (44.3%) in 1977. And partly because of aid, the tax burden on individuals and companies in poor countries (14.7% of GDP) was little more than a third of the latter's (37.9%). Problems arise in some countries because of the distorting effects of government regulations and controls on private sector decisions rather than from the size of the government budget. See Accelerated Development in Sub-Saharan Africa, op.cit., table 4D.

Their point about the exchange rate effects is also weak. There is no apparent correlation between the incidence of overvalued currencies and aid receipts. A large number of developing countries increased their exports of manufactures rapidly during the 1970s, at an average rate of 13% per annum in real terms overall.[1/] This argues against persistent overvaluation of exchange rates caused in some way by aid flows. All these successful exporters were aid recipients. The Bretton Woods institutions have consistently urged the adoption of realistic interest and exchange rates and lower tariff barriers. Bauer and Yamey recognize that any negative effects on exchange rates would be offset if aid transfers enhanced the productivity of local resources, but state that this is "extremely improbable." Yet the evaluation reports cited earlier provide ample evidence of output and productivity growth resulting from aid projects. At the macro level, contrary to what the authors suggest, several studies have shown that long-term growth is associated with capital deepending.[2/] The volume of investable funds _is_ important as an engine of economic progress. The lower rate of growth of the low-income compared with the middle-income developing countries over the past two decades reflects lower ratios of gross domestic investment to GDP. Excluding China and India, the

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1/ See Keith Marsden, "Exports of Manufactures Boost Growth and Jobs in the Developing Countries," _World Bank Development Review_, July 1981.

2/ See, for example, Simon Kuznets: _Modern Economic Growth: Rate, Structure and Spread_ (New Haven, Yale University Press, 1966) and Wontack Hong: _Trade Distortions and Employment Growth in Korea_ (Seoul, Korea Development Institute, 1979).

investment ratio for low income countries averaged 14% compared with 23% for middle-income countries.[1/] Both groups used their available capital at roughly equal levels of productivity overall (measured by incremental capital/output ratios). But the capacity of low income societies to put aside domestic savings is severely constrained by basic consumption needs just to assure survival.[2/] Transfers of investment funds from abroad (official and private) have proved to be vital elements in maintaining and increasing output and income growth in these countries. Of course, capital coefficients are not fixed. Productivity is influenced by many factors. Investment is a necessary but not sufficient condition for sustained economic growth. It must be accompanied by appropriate policies and incentives, an increase in the supply of the complementary factors of production and institutional adjustments. That is why World Bank stresses these nonfinancial elements and helps to strengthen them.

Finally, Bauer and Yamey cite the examples of the Navajo Indians and the U. S. trust territory of Micronesia to suggest that "pauperization" and "de-skilling" result from giving aid directly to the poor. In reality, a very small part of official aid flows go as direct income or consumption transfers. The aid flows which do go in this way come mostly from the voluntary charities which Bauer and Yamey favor. Most official aid, and particularly that from multilateral bodies, takes the form of investment in productive assets or skill formation. Millions throughout the Third World have been able to use their skills in jobs created by higher levels of investment.

1/ See World Development Report, 1981, table 5.

2/ Low-income countries (excluding China and India) have made good progress in raising their average ratio of gross domestic savings to GDP from 8% in 1960 to 15% in 1979 but were still well below the level in the middle-income developing countries (25%). See World Development Report, 1981, table 5.

Benefits to Donors

Bauer and Yamey deny that aid can benefit donors. Their argument falls in two parts, short-term and long-term. In the short-term, they doubt whether the recession in the industrialized countries could be cured or ameliorated by increased government spending. But if this were possible, they say, it could be done more effectively by domestic spending (with fewer "leakages") than by aid transfers aimed at expanding international trade. Their point may have been generally valid in the past, but there are some symptoms of the current recession which should respond positively to external stimulus. The present recession was induced, in part, by restrictive monetary policies designed to combat high levels of inflation and to reduce balance of payments deficits arising from the sharp increase in the price of oil and the substantial trade surpluses maintained by some of the major oil exporters. In this situation, conventional Keynesian measures to increase domestic demand could have negative effects in some industrialized countries. Their trade deficits would tend to widen because consumer demand has a high import propensity at the margin.[1/] And pressure on the prices of those domestic products (e.g., foodstuffs) with an inelastic supply in the short term would ensue.

Aid transfers, however, stimulate exports from the donor countries by allowing the oil-importing developing countries to finance deficits on their current accounts. The increase in exports from donor countries directly attributable to the short-term effects of aid often exceeds the size of the

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1/ Imports represent more than 30% of GDP in the UK, Sweden and the Netherlands, for example.

aid program itself. This is because aid projects usually require counterpart contributions by the recipient governments or enterprises and increasingly bring in additional funds from private sources as cofinancing. For example, in the 93 World Bank co-financing operations during 1980, the World Bank contribution of $4,798 million was supplemented by $16,737 million from co-financers and other sources to meet total project costs of $21,535 million.[1/] A high proportion of total project allocations is spent on equipment and services (insurance, shipping, consultancy, etc.) supplied by the donor countries (even without formal "strings" attached). These exports not only help to reduce the trade deficits of the donors, but also emanate from those particular sectors of their economies with substantial surplus capacity of men and machines at present. Developing countries take between 40 and 60 percent of total exports from industrialized countries in textile and leather machinery, railway rails, steel tubes and pipes, iron and steel castings, metal tanks and boxes, electrical power machinery, electrical distributing machinery, railway vehicles, ships and boats and machinery for specialized industries.[2/] These engineering industries are most severely affected by recession because of the accelerator effect.[3/] So enhanced aid transfers would help to raise the level of output and employment in the industrialized countries without rekindling the wage/price spiral. Thus aid can be a useful means of strengthening political support for those unpopular domestic policy instruments required to restore monetary stability, which is a prerequisite for sustained, long-term growth in the West.

1/ See Co-Financing, op.cit.

2/ See United Nations Yearbook of International Trade Statistics, 1979.

3/ For example, the index of production in the machinery industry in the United Kingdom stood at 77 in the third quarter of 1981 (1975 = 100) compared to 103 in total industry. See OECD: Indicators of Industrial Activity, 1981-IV.

This brings us to the question of the long-term benefits derived by aid donors which are likely to be more significant. Bauer and Yamey reject the idea that the South can be an "economic frontier," claiming that the West is the engine of growth for the South, and not the reverse. In truth, in an interdependent world, growth stimulants come from all sides. Who can doubt that the unprecedented post-war industrial expansion in the West was aided by the increased supplies of cheap energy and raw materials from the South? Who can believe that these resources could have been developed efficiently (for the benefit of both parties) without Western technology and know-how?

But dynamic shifts in comparative advantage take place and the international division of labor must respond. Western capital and labor are currently being underutilized in the domestic production of some manufactured goods (e.g., medium-quality textiles, clothing, cutlery, footwear) and components (electronic sub-assemblies) which can be made more efficiently in developing countries. At the same time, the transfer of resources to the high-technology sectors (within agriculture and services as well as industry) in which the West has comparative advantages is being retarded. Neither group is benefitting fully from these opportunities because of (a) trade barriers, including subsidies to declining industries in the industrialized countries and high levels of protection for some products in the developing countries and (b) scarcity of capital, skills and foreign exchange required to expand output in the Third World. The growth of real incomes is therefore being held back globally. 1/

1/ The World Bank has projected that successful structural adjustment in the industrialized countries (e.g. containing inflation and promoting [illegible] growth), combined with reduced protectionism and a doubling of capital [illegible] developing countries could raise the average annual rate of GDP growth from [illegible] to 3.6% in the industrialized countries, and from 4.5% to 6.1% in developing countries during the 1980s. See World Development Report, 1981, Chapter 2.

Bauer and Yamey accept the arguments for removing restrictions on trade and on the inflow of private foreign capital and personnel to the Third World. We believe that if they examined the aid record objectively they would recognize that, despite its imperfections, it has proved to be a valuable supplement to private resource transfers and that both donors and recipients have derived significant benefits. International aid can indeed be a "positive sum game" in which all participants emerge as winners in the long run. 1/

Two final points need to be made. First, there are Third World countries, as Bauer and Yamey point out, which have generated and will continue to generate quite remarkable improvements in their economies through sound domestic policies and where aid has played a secondary, perhaps even a negligible role in the development process beyond a certain stage. Earlier "graduation" of such countries from aid eligibility may be desirable. However, this is not the general situation and it is unrealistic to believe that the mere fact of curtailing aid flows could contribute significantly to an increase in the number of countries able to pull themselves up by their bootstraps. Second, most of our arguments depend upon aid being administered efficiently, with close attention to its productive impact in recipient countries and being used to encourage recipients to adopt more appropriate (and normally more market-oriented) policies than might otherwise be the case.

1/ Per capita incomes in the industrialized countries would rise by over $2,500 (in $ 1980) by the end of the century for each percentage point increase in their average GNP growth rate. A small proportion of that increment, transferred as aid and private capital flows to developing countries, would go a long way to eliminating absolute poverty. A 6% GNP growth in the developing countries, assuming constant income shares (i.e. no income redistribution) and a slackening of population growth, would bring most of the poorest 40% above the poverty line. See Keith Marsden, "Global Development Strategies and the Poor: Alternative Scenarios", International Labour Review, Vol. 117, No. 6, November-December, 1978.

On the whole, World Bank assistance is administered along those lines and the conservative critique which Bauer and Yamey's writings reflect is likely to make this even more true in the future. Our purpose in this response is not to attempt to deflect these desirable trends but to avert the case for a complete rejection of aid as a highly valuable international institution, being built up on arguments which are valid only in support of improvements in aid practices. The over-generalizations and misrepresentations in Bauer and Yamey's paper are mischievous because they completely fail to draw this distinction.