# DYNAMIC TRANSFORMATION OF SOCIETIES

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# A MULTI-GAP APPROACH TO MEDIUM-TERM ECONOMIC GROWTH IN THE THIRD WORLD

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## INTRODUCTION

Most Third World economies in the 1980s experienced tenacious economic recession, a problem that continues to date. Competing schools of economic development thought have offered differing explanations and policy prescriptions. Explanations have ranged from the neoclassicists' emphasis on microeconomic and structural distortions, to Keynesians' stress on macroeconomic mismanagement and deficiency in effective demand, to radicals' accent on the role of foreign exploitation and domestic politics. Corresponding policy prescriptions have also ranged from establishing efficiency conditions and adjusting structural distortions in the supply side to stabilizing the final demand and reforming external economic relations and domestic politics. Prescriptive approaches have included a variety of gap-growth models and balance-creating mechanisms.[1]

The purpose of this paper is to review some of the most significant macro, micro, and structural imbalances that Third World economies face as they enter the 1990s and to offer a set of remedial policies. Specifically, I shall argue that the economies

suffer from a multitude of "gaps" and that a "multi-gap" approach to economic growth in the medium-term is preferable to the "three-gap" model which built upon early gap models and was recently developed by the WIDER group.[2] The proposed approach is also superior to stabilization and structural adjustment programs advocated by the IMF and the World Bank, and to their radical alternatives.[3] The proposed multi-gap approach builds upon these models but moves beyond them by offering a synthesis in which various gaps in supply and demand are considered as inseparable policy arenas needing simultaneous attention. The approach also accounts for the current global restructuring and the opportunities and constraints it is creating for a complete rethinking of Third World development models.

## ECONOMIC GROWTH AND BALANCE-CREATING MODELS

Since World War II, numerous economic growth and balance-creating models have been proposed and practiced in the capitalist Third World, most within modernization and stages of growth frameworks.[4] Among them the following four have been widely discussed and used: (1) the early gap-growth models; (2) growth with equity model; (3) stabilization and structural adjustment programs; and (4) the "three-gap" model. A brief review of each follows.

### The Early Gap-Growth Models

The fact that foreign trade plays an important role in economic growth has been widely acknowledged. Specifically, a country's foreign trade deficit or surplus with offsetting flow of capital is said to impact its growth rate and mode of development. Conventional development thinkers have emphasized foreign trade's positive effects on foreign capital inflow and through this on employment, technology transfer and production efficiency. Radicals have dismissed the sector for its contribution to capital outflow and through this on economic decline in



deficit countries.[5] In the post-Cold War period, growing global integration has increased interdependency among nation-states, and the role of foreign trade has become the subject of renewed debates, with many development experts emphasizing its positive effects on economic growth.

Rooted in mercantilism, this notion of trade-led economic growth was first justified in terms of Ricardo's comparative advantage theory. Later when the classical labor theory of value was superseded by the utilitarian neoclassical economics, the role of trade in expansion of savings and capital formation, as the engine of economic growth, was emphasized. The Harrod-Domar economic growth model of the 1940s and 1950s reflected this new thinking.[6] According to this post-Keynesian view, the growth rate of output (G) relates to savings ratio (S) and incremental capital-output ratio (K) as in the following equation: $G = S/K$. To raise G, S must be increased given K, or K must be lowered, given S. The ideal scenario happens when both these changes occur simultaneously. K in the model, in the last analysis, stands for capital stock and its effectiveness, while S stands for savings, the level of which is determined by the size of consumption.

The model was the first to realize that the additional spending needed in the second period ($T_{t+1}$) to maintain full employment could only be calculated using the capital output ratio. It was also the first to argue that one period's capital formation is the next period's source of output, that is, investment creates the capacity for increased production in the future. However, the model's heavy emphasis on supply-side and capital formation made its application to the Third World increasingly difficult as demand-side problems and trade imbalances mounted in the late 1950s. There were other problems as well: Where will savings come in a poor economy experiencing trade deficit? How can K be lowered given the low level of Third World technology and skilled labor force? The Harrod-Domar model also neglected a careful analysis of the impact of a country's balance of payments situation on its economic performance.

It was only in the early 1960s that development economists proposed econometrics models to measure that impact in specific terms and with clear policy implications. The discovery was led by Rosenstein-Rodan (1961) who, following Harrod-Domar, argued that output expansion in the final analysis was limited by domestic physical capital stock, which can only be expanded by generating additional savings and investing efficiently.[7] In countries with a trade deficit (as measured by the difference between current account deficit and total foreign interest payments) foreign savings in the form of capital inflow (borrowing, bilateral aid, or direct foreign investment) may be used to cover the shortfall and supplement local savings, and thus investments. GNP would respond proportionally to the incremental capital-output ratio (ICOR), domestic savings rate, and volume of foreign capital inflow. Thus, this model saw the "savings-investment gap" as the main source of problems in Third World economic growth, and advocated foreign savings inflow as the main curative resource. For lack of a better term, I shall identify this approach as the "one-gap" model.

For Rosenstein-Rodan, foreign savings were needed, not only because they filled a gap, but also because they were required for the implementation of a "Big-Push."[8] This "balanced-growth" strategy was predicated upon the idea that "a minimum quantum of investment is a necessary condition of success" because unit cost of production in terms of inputs decreases significantly as output expands.[9] But for economics of scale to operate in productive lines, demand must be high. Since this is not the case, income levels for the entire economy must be raised. This in turn requires a massive, all-out investment program in both supply and demand. The strategy also assumed a highly elastic supply of capital and labor and did not envision a sudden rise in interest rates and wages. In reality, however, capital was either not readily available in the Third World, making implementation of the Big-Push strategy difficult, or where it was available the strategy did not have the desired effect. Balanced-growth thought was later challenged by Albert Hirschman and others who put



forward an "imbalanced-growth" strategy following the Soviet experience in the 1950s.[10] This strategy argued that capital scarcity in the Third World necessitates governments to make incremental investments, first for the formation of a few new units and then for creating complementary activities and removing bottlenecks that develop as a result.

The one-gap, the Big-Push, the balanced-growth and the imbalanced-growth models rightly emphasized the critical role of foreign exchange in capital formation in Third World countries and thus in their long-term economic growth. At the time, most Third World economies were experiencing balance of payments crisis following decades of import-substitution industrialization and worsening terms of trade. The models, however, failed to account for the critical role of foreign savings in current production and thus medium-term growth. In particular, import-substitution industries heavily depended on imported intermediate inputs, raw materials and capital goods. Under this condition, current production could not be sustained without adequate foreign exchange infusion to pay for foreign inputs.

It was this shortcoming of the models that the "two-gap" model originally developed by Chenery and Strout (1966) set out to rectify.[11] While underscoring the significance of the savings-investment gap (or the internal imbalance), the new model added a "foreign-exchange gap" (or external imbalance) to the analysis of why Third World economies were not growing (the "external strangulation" factor). In particular, the new structuralist model emphasized the critical role of foreign capital in both capital formation and financing of industrial inputs for current production. In *exant* national income accounting, the two gaps are not necessarily equal while in *expost* accounting the gap between the two gaps must disappear. Bacha was the first to realize this and advanced various macroeconomic adjustment mechanisms to close the gap, including output fluctuations that make output/capital ratio (OCR) an endogenous macroeconomic variable.[12]

## Growth with Equity Model

These gap models focused on economic growth through capital formation and increase in utilization rates of existing capacity, and emphasized the role of foreign exchange in implementing strategy. However, they did not adequately emphasize utilization of excess capacity, and they remained ignorant of the distributional and dependency impacts of the proposed growth process. By the late 1960s, absolute poverty was rapidly expanding among the bottom 40 percent of the population in countries where the models had produced "miracles" as in Brazil, Mexico, and Iran under the Shah.[13] Income and wealth inequality worsened in these societies leading to increased capital flight and decline in domestic effective demand and savings. Urban slums began to expand beyond their absorptive capacity as rural migrants poured in. Spatial disparity also widened as urban-centered growth process led to overconcentration in primary cities and neglected problems in rural areas and resource-poor regions. Emphasis on capital-intensive technology worsened unemployment which, at a time of rapid population growth, led to a significant decline in per capita income in these countries.

Problems also developed in the utilization of existing productive capacity which had become increasingly dependent on foreign markets for inputs, largely controlled by multinational corporations and, as a result, on foreign exchange. Since balance of payments were in deficit, only one road seemed open to Third World countries for securing the needed foreign exchange: a constant infusion of foreign savings in their economies through borrowing, aid, and/or foreign investment in various forms. However, foreign savings became increasingly less available to the Third World as their debt burden increased and whatever was earned from exports went to pay for their ballooning debt services. Meanwhile, multinational corporations shifted investments toward advanced markets as political instability mounted in Third World societies. Domestic capital also flew out, as a result of which national private savings declined; it was



already in decline because of competition from foreign savings Foreign exchange and national savings scarcity led to reduced uti lization rates and hampered attempts to modernize the existin capacity, thereby resulting in serious technological obsolescence.

The distributional problem was taken up with some urgenc and a series of "growth with equity" or "basic needs" approache were developed.[14] The new models became largely preoccupie with determining the amount of foreign capital that was neede to achieve a "socially necessary" growth rate or capacity expan sion that would satisfy a people's basic needs (food, job, clothing shelter, education, and health care). Emphasis was placed o human capital development and land reform. New spatia strategies addressed problems of rural areas, lagging regions, an large urban agglomerates. Among the proposed strategies wer integrated rural development, balanced regional development and urban deconcentration strategies with a focus on promoting in termediate cities. The dependency issue was addressed by th call for a New International Economic Order (NIEO) whic aimed at restricting the vagaries of capitalist world market specially the unfair practices of multinational corporations.[15]

While the growth with equity approaches did not attrac most Third World politicians, establishment of a NIEO was re sisted by the West, led by the United States. Meanwhile, condi tions in the Third World further deteriorated, and this was ex acerbated by repeated external shocks in the 1970s and 1980s Countries that had followed the gap models, mostly in Latin America, soon became heavily indebted, and their debt burden grew as interest rates sky-rocketed. Meanwhile, terms of trade deteriorated, depressing export earnings, while increased oil prices led to ballooning trade deficits in oil-importing Third World nations. The combined effect of these debt, interest rate, oil, and terms-of-trade shocks, along with the gradual expansion of the state sector and poverty soon led to a significant jump in fiscal deficits. As a result, the public sector reduced both its current and capital expenditures in nondefense-related activities in most Third World countries. Meanwhile, a high defense spending was maintained in the Third World and dictators from the

Right and the Left legitimized it in terms of the Cold War politics. The contraction in public sector spending led to a significant underutilization of the existing productive capacity and deterioration in social services. Consequently, prices rose while output and income declined. This led to a decline in purchasing power and demand; as a result, these economies gradually deepened into a chronic recession in the 1980s and they have not yet recovered.

Only South Korea and Taiwan, among a few other Newly Industrializing Countries (NICs) in East Asia, were able to avoid some, and only some, of these negative consequences as they successfully implemented an outward-looking, export promotion strategy. The secret of their success, however, lies in emphasizing education, land redistribution, labor-intensive manufacturing technology, and protection of domestic markets and industries. These factors combined with unfettered access to the American and Japanese markets for imports (finance and technology) and exports of manufactured products, a state-led planned development approach (command capitalism), cheap labor supply, and an undervalued currency to produce the "miracle."[16] Those who made the NICs' experience into a development doctrine for the Third World overemphasized the role of market and grossly understated the activist role of the state. They also ignored the fact that the public sector in the NICs was well disciplined and was not corrupted by the private sector. Nevertheless, even these "little dragons" were not totally immune from the problems associated with the growth strategy. Korea is, for example, highly indebted, has become a deficit country again (since 1990), is losing competition in high-tech production to Japan, the U.S., and the EEC, and is characterized by extreme income and wealth inequality. Korea, in particular, is perhaps the most concentrated case of economic development. For example, the ten largest Korean conglomerates control over 65 percent of the nation's GNP; ten top exporters account for over 70 percent of its exports; and over 25 percent of the country's population lives in Seoul city with less than 1 percent of Korea's land area.[17] It is perhaps fortunate that most wealth in Korea is concentrated in



the hands of families who specialize in manufacturing industries rather than in, say, commercial or real estate activities.

**Stabilization and Structural Adjustment Programs**

Parallel with the application of gap-growth and growth with equity approaches, the World Bank and the International Monetary Fund (IMF) expanded their intervention in the economic policies of the Third World.[18] Stabilization and structural adjustment policies were subsequently implemented in a number of countries with a view to eliminating or mitigating microeconomic distortions, macroeconomic imbalances, institutional weaknesses, and external shocks.[19] While the gap-growth models followed a supply-side approach to economic growth, IMF's stabilization and the World Bank's structural adjustment programs focused on both demand and supply sides, the former concentrating on monetary management of the economies, the latter on the macro-level fiscal management and micro-level structural distortions. Ever since their inception in the 1950s, these programs have been the subject of extensive debates, some supporting and others rejecting their usefulness for the Third World. However, recent trends indicate that these programs will be a dominant part of economic policies in developing countries and Eastern Europe in the 1990s. A synthesis of the two agencies' reform packages is given below under the title of Adjustment Programs (AP).

The AP has two major components: long-term structural adjustments (SA) and short- to medium-term stabilization reforms (SR). This latter in turn focuses on two major problems: macroeconomic imbalances (e.g., high inflation and unsustainable fiscal and current account deficits) and microeconomic distortions (such as impediments to factor mobility, barriers to competition, and price distortions, e.g. between tradeable and non-tradeable goods). These two problems are usually related to institutional weaknesses and external shocks. The former, itself an important area of the AP focus, includes problems associated with poor economic management and policies and impaired financial systems. External shocks, another area of emphasis in the AP, includes

factors such as a high rate of real interest rate, limited demand for exports, unstable commodity prices, and a reduction in foreign financing. The SA, on the other hand, is mainly concerned with changes in sectoral structures, institutional frameworks, and legal codes, among similar other measures. Examples include tax reforms, restructuring of public enterprises, privatization, social reform, and financial reorganization. A redirection of the economic production toward exports is an important component of the AP's industrialization strategy.

To restore macroeconomic balances, the AP suggests the following steps: (1) aggregate demand (tradeable and nontradeable) would have to be brought in line with aggregate supply plus sustainable external financing; and (2) inflation, rate of monetary growth, current account deficit, exchange rate, and fiscal deficit have to be reduced on a sustainable basis. Reforms in the public sector should be given top priority. To restore microeconomic balance for increasing efficiency and growth, the AP suggests the following steps: (1) appropriate incentives would have to be provided to the private sector (with a view to controlling government expenditures); (2) constraints on factor mobility should be removed (domestically and internationally); and (3) savings and investments have to be increased. The first two measures increase public fiscal burden and thus must be carefully considered; but because they tend to increase efficiency, the need for more savings will be reduced. To significantly restore growth and efficiency, investment has to increase, which demands: (1) a reduction in macroeconomic distortions as explained above; and (2) creation of conditions for new investment. The AP then details these conditions which include policies to increase: public savings, real interest and profit rates; external financing, and complementary public investment. Reducing debt and debt services and creating a credible economic environment are among other important conditions for increasing investment.

In sum, reforms built into the AP are of three major types: (1) expenditures-reducing policies, essentially fiscal and monetary measures. This type of reform helps bring domestic demand in



line with available resources largely by means of depressing demand; (2) expenditure- and production- shifting policies, directed toward encouraging both exports and efficient import substitution by raising the domestic price of tradeable relative to nontradeable goods. The purpose is to make tradeable goods expensive at home so that their exports can be increased, thereby bringing in foreign currency or paying debt services (which then increase country's creditworthiness and encourages capital inflow). Establishing appropriate exchange and wage rates is a major subset of this second group of policies; and (3) supply-side (growth-oriented) policies to remove the structural and microeconomic causes of macroeconomic imbalances, improve efficient use of resources in both public and private sectors, strengthen institutional capacities, promote an export-led industrialization, and increase savings and investment. This last set of policies account for over 80 percent of the World Bank's conditionality.

The AP has been criticized for its imposed character, criteria for defining development, negative impacts including social costs and difficulty of application in the Third World. In particular, critics charge that the AP advocates capitalism and global integration for developing countries without regard to their domestic conditions, injustices of the current world economic order, and the dependency problem of the Third World. A lopsided attention to macroeconomic and microeconomic imbalances also hinders efforts to increase production because of the negative consequences on demand. The AP also takes growth rates of GDP, exports, savings, and investments as indicators of economic performance, criteria that disregard distributional problems, poverty, and basic needs of the majority. The AP is also said to be very costly to the poor as it reduces their living standard and social services. Critics charge that the AP is usually imposed on developing countries in need of external assistance, has a recessive bias, leads to large drops in terms of trade, is unjustifiably anti-public sector, makes unrealistic assumptions about the response and contribution of the private sector to governments' growth objectives, and is designed to bail out the commercial banks holding Third World debts. Finally, critics argue against the export-led industrialization

advocated by the AP, asserting that the protectionist industrial world will not provide the needed market while it will compete with the weaker new-comers in Third World markets.

Advocates reject most of these charges as baseless and argue that the AP is the only hope for sustainable growth in the Third World in the medium-term. They also maintain that the AP incorporates measures that remedy most of the possible negative impacts of the shock therapy to which these countries are subjected. For example, it allows for subsidies to be targeted toward vulnerable groups. They point to the severity of the initial condition and the low level of reform efforts to explain the AP's failure and unwanted impacts. Before the reforms reach a critical mass, they are abandoned or loosened in fear of political implications. They also blame acuteness of external shocks including a high level of indebtedness. Meeting the strict conditions which are needed for the effective implementation of the AP is said to be difficult in some countries. Third World governments also lack political cohesiveness or adequate commitment and do not usually openly communicate or tend to miscommunicate the AP to their public. The communication problem is particularly harmful since the governments fail to generate enough public support for the reforms. Finally, ineffective implementation strategies are blamed including inappropriate priority and sequence for reforms. A successful implementation of the AP also requires that public sector reforms be implemented first, stabilization precede structural adjustments, and macroeconomic adjustments predate microeconomic stabilization. Most governments are said to fail to follow this particular road; instead, they mix them up as they undertake piecemeal reforms.

The World Bank and IMF also justify the AP on the grounds that national governments are constantly making adjustments to their respective economies as they make policies, introduce new laws and regulations, and undertake to form new institutions or scrap the old ones. These adjustments may be undertaken according to a certain order and logic or in their absence. In the first case, orderly adjustments may not be harmful if undertaken



within a sound conceptual framework. In the second case, disorderly adjustments will harm the economies even if it had been grounded in a good theoretical basis. Thus, the choice is not between adjustment and non-adjustment; rather it is between an orderly adjustment and a disorderly one. The AP is claimed to be an orderly reform program because its assumptions, methodology, growth strategy, and performance criteria are based on a capitalistic economic framework. The program is carefully designed and managed to systematically achieve predetermined results given specified policy measures. The AP is also justified on the grounds of the need for stabilization of the capitalist economies which naturally experience cycles of boom and bust, restoration of the efficient use of resources, correction of policies, removal of institutional impediments, and increase in resiliency to external shocks. These measures are said to constitute the preconditions for attaining sustainable growth objectives in the medium-term.

## The Three-Gap Model

Like the gap-growth models, the AP also remained (and remains) inattentive to underutilization and distributional problems. The "three-gap" model has its origin in attempts to develop a framework that accounted for these deficiencies at the same time that it incorporated the most critical aspects of the previous approaches.[20] In a nutshell, the model argues that the disappointing economic performance in most developing countries is obtained primarily because of a chronic underutilization of the existing physical and human capacities, and, secondarily, because of the lack of adequate new investments in productive sectors. These inadequacies are caused predominately by three gaps: "foreign-exchange gap," "savings-investment gap," and "fiscal gap." The three-gap model underscores the negative impact of the foreign-exchange gap which emanates from the heavy burden of debt service and balance of payments deficit. Therefore, economic growth in the medium-term is assumed to depend on the ability of these economies to raise foreign exchange as any significant increase in utilization rates would de-

mand a large amount of intermediate imports and major bottleneck-removing projects, while new fixed capital formation would require imports of capital goods.

Explanations for the foreign-exchange gap and savings-investment gap are similar to what previous gap models had offered. The fiscal gap, on the other hand, has never been an explicit component of a gap model for medium-term growth, although the AP has been attentive to it. Its origins are explained in terms of increased burden on the state resulting from debt services, welfare transfers, and the need for large public investment programs, among other state expenditures, at a time when public revenue is adversely effected by declines in export earnings and tax incomes. As a result, the public- sector borrowing requirement (PSBR) has significantly increased. The PSBR is measured as a fraction of output and is defined as the amount of funds governments have to raise within domestic financial markets to pay for their expenditures (public investments in particular) net of taxes and other public incomes.[21] How resources for the PSBR are raised is a key policy issue particularly in indebted countries. Thus, according to the three-gap model, Third World countries face a financial constraint (the interrelated fiscal and foreign transfer limitation on policy option) in addition to the old problem of external strangulation arising from debt service and trade deficit. Proponents of the model assert that removing these gaps creates the only real hope for Third World economic growth in the medium-term.

The model is predicated upon five relationships: (1) Output and capacity growth rates (which depend on current investment) are not imminently related. Indeed, production can fall below potential output (as measured by the incremental capital-output ration or ICOR) if the economy was subjected to a forceful external shock; (2) Public and private investments are seen as complementary rather than competitive.[22] In other words, public investments often crowd in the private investment rather than crowding it out as previously thought and mistakenly assumed in the AP. This is so because profitability of private investment increases as a result of public investment, and this more than offsets the pressure that public borrowing usually places on financial markets and interest rates; (3) Public revenues including taxes, rise more rapidly when the rate of capacity utilization increases; (4) Investment and thus growth are constrained by available savings which originates from net government savings (i.e., the PSBR minus public investment), net transfers from abroad, and domestic private savings. The level of the latter normally increases as capacity utilization rates increase. However, foreign capital inflow could displace national private savings, part of which could also leave the economy for a variety of reasons and in the form of capital flight (e.g., through over-invoicing of imports and under-invoicing of exports); and (5) A higher utilization rate depends on intermediate and capital goods that have to be imported. This requires foreign exchange which happens to be scarce in the Third World and which necessitates foreign capital inflow.



Given the three gaps and the above five relationships, the model asks: how capacity utilization, capital inflow, the PSBR, exchange rate, and tarde quota, among other variables, would have to change to get a proper level of production and capital formation? A complicated econometrics model is then developed to provide the response which, in the final analysis, is related to net transfers from abroad. As for removing the three gaps, the following recommendations are advanced. To remedy the foreign-exchange gap, capital inflow must exceed capital outflow. The way to achieve this is to reduce Third World debt burden and import bills, provide them with fresh long-term credit on easier terms, and promote direct foreign investment, particularly for export-promotion projects. The fiscal gap is remedied by a decrease in public spending and an increase in public income; this requires a significant restructuring of the general budget. The public sector must also discipline its fiscal and monetary management agencies, tax administrations, and financial institutions in particular. The saving-investment gap, on the other hand, is best corrected by promoting private and public savings and foreign capital to finance national investment. Private and public for-

eign interest payments must be reduced to a minimum, while transfers from abroad to the sectors should be increased. A proper macroeconomic and microeconomic environment is critical for increasing savings and investments.

While the three-gap model is very useful, the wide variation in the experiences of Third World nations makes any claim to its universal application untenable at best. For example, most Third World countries face more than just these three gaps; often institutional and infrastructural bottlenecks are equally troubling. Moreover, being a prospective model and focused on the supply-side (that is production) and foreign sector, the model fails to account for many demand-side problems and domestic structural imbalances and distortions that have been responsible for the Third World's poor economic performance in the 1980s. Undue emphasis on existing production also could negatively impact technical development and productivity in the Third World in the long-term. The model fails to incorporate distributional concerns although it professes to be concerned about them. Finally, proponents of the model seem overoptimistic about the possibility of a major net inflow of capital to developing countries. As was well indicated during the Persian Gulf crisis, developed countries, the U.S. in particular, continue to control the direction of the flow and use of world surpluses (largely from Japan, Germany, Taiwan, and the oil-producing Persian Gulf Arab states).

## TOWARDS A MULTI-GAP APPROACH

While the gap-growth models and the AP cover a wide variety of economic growth problems in the Third World, none gives a complete representation. Their combined explanations, however, do give a fairly comprehensive picture. Nevertheless, when the Third World case is considered in the light of the present problems, the need for a more elaborate approach cannot be denied: unmet demand abounds, production remains low, inequalities are widening, economic imbalances and distortions are rampant, and the economic management structure has been significantly altered



in favor of a growing state control. Moreover, economic problems are influenced by an equally complex set of forces at macro and micro levels, in supply and demand sides, and with domestic and external roots. They include a variety of political, institutional, cultural, and infrastructural (specially transportation) bottlenecks, external shocks including fluctuations in single-export prices, shortage of skilled work force, and managerial inconsistencies. Other problems include dependency on the world market, huge military expenditures, gigantic environmental problems, and population pressures. Complicating these problems have been political repression and the lack of a suitable political culture and development strategy. Clearly, some of these problems are long-term and extra-economic in nature and must be addressed within a new development paradigm for the Third World. Others, however, can be incorporated into an approach that aims at economic adjustment and growth in the medium-term.

Building upon the gap-growth models and the AP, I propose a "multi-gap" approach to address Third World economic adjustment and growth problems in the medium-term. In particular, I argue that Third World economies suffer from eight sets of structural and temporal gaps in both supply and demand sides at macro and micro levels. They include: supply-demand (inflation) gap, distributional gap, foreign-exchange gap, fiscal gap, savings-investment gap, human-capital gap, economic-management gap, and technological gap. These economic gaps are interrelated and influenced by domestic and external factors. By extension, I argue that any policy prescription for economic normalization and growth should include a comprehensive program of gap mitigation and balance-creating mechanisms. It should account for domestic roots and mutual reinforcement mechanisms of these gaps and their global environment. In the following pages, I review these gaps and their consequences for the economy, causal factors underlying them, and the inter-gap linkages. I also outline policies that are needed to remove the gaps or mitigate their impacts. Finally, conditions for the successful implementation of the proposed approach are presented.

## The Supply-Demand (Inflation) Gap

Aggregate demand is far greater than aggregate supply in most Third World economies. Given a high level of private liquidity, this problem has led to inflation and a high imports bill. The Third World's gross domestic product as a whole and in real terms declined in the 1980s. Since 1989, the economies have been growing again and significant improvements are reported for some countries. As a result, the Third World budget deficit has been reduced, inflationary pressure somewhat curtailed, and non-oil exports slightly increased. Despite these and other improvements, the supply-demand (inflation) gap remains a major source of concern for Third World economic planners and policy makers. Underutilization of existing capacities has been at the root of this imbalance. In the 1980s, most industries operated significantly below their theoretical capacity, and the economies were faced with a huge investment backlog. The underutilization problem is in turn caused by a variety of bottlenecks, most notably the shortage of foreign exchange, the lack of a skilled work force, and a low level of public development expenditures. That is, the supply-demand (inflation) gap has its origins, in part, in the foreign exchange gap, human-capital gap, and fiscal gap in many Third World economies.

The human capital problem exists at various levels, but most notably for people who can conceptualize, manage, and operate complex organizations and processes. The foreign exchange problem, caused by decline in export earnings, affected current production as governments adopted austerity policies that favored defense-related economic sectors. Many industrial units which did not produce essential goods were not given foreign exchange by governments, and many public enterprises were shut down to save foreign exchange for strategic units. Most Third World industries depend on foreign markets for between 65 to over 85 percent of their inputs, including intermediate inputs which are critical for current production. The fiscal problem affected current production as public deficit soared, and governments cut back on their development spending including productive investments. Militarism, along with an expanding bureaucracy and certain subsidized markets, led to a significant increase in the Third World's current spending which, given a largely stagnant public income, produced a huge budget deficit. Various infrastructural, managerial, and institutional obstacles also contributed to the decline in GDP as they exacerbated the underutilization problem.



However, not all of the decline in the Third World's GDP can be explained by underutilization. The lack of any major capital formation was also significant. At the root of this problem was the savings-investment gap (see below) and a variety of other economic and extra-economic factors. In the prevailing political chaos in many countries of the Third World, the private sector refrained from putting its ballooning liquid assets and savings in fixed investments and productive uses. Super-profitmaking opportunities in the service sector exacerbated this trend. Decline in public investment further crowded out private investment as public investment could have improved the industrial profit rate. Meanwhile, the foreign-exchange gap (see below) would not allow governments to import capital goods and technology.

Other important factors in the GDP decline included economic dependency and unevenness, and governments' inability to formulate consistent and stable economic policies. As the GDP declined, aggregate demand steadily increased in both absolute and relative terms (relative to GDP). This happened despite a significant decline in real per capita income and a growing income concentration in many Third World countries in the 1980s. Rapid population growth and urbanization coupled with militarism and an expanding bureaucracy were among the major influences. Additional stimuli came from a rising public expectation and unrealistic promises by the regimes. Most of the increase in effective demand came from non-productive consumption and from the public sector. This lopsidedness notwithstanding, the increase in effective demand could have stimulated production if economic conditions were normal.

However, in an environment of economic decline and dependency and in economies facing foreign currency shortages, the sup-

ply-demand imbalance led to a chronic shortage of many commodities. Coupled with a huge budget deficit, restrictive government policies against imports, and a huge jump in private liquidity, the shortage then led to double-digit inflation. Private liquidity has indeed been far greater than real GDP in many Third World countries in the 1980s, a problem that reflects a very skewed income distribution. The primary result has been hyperinflation in free market prices and uneven profit rates in favor of services and trades. As budget deficits have declined in recent years and private liquidity has come under control, inflationary pressure has somewhat subsided.

Correcting the supply-demand (inflation) gap depends on how well governments remedy other gaps in the economies, particularly the foreign-exchange gap, savings-investment gap, and the human-capital gap. This is because any significant increase in utilization rates in the medium-term demands a large amount of intermediate imports and major bottleneck-removing projects, while new capital formation requires imports of capital goods and additional savings. These projects in turn require a skilled work force that can only be developed by improving technical and vocational education. Equally significant is the elimination of institutional weaknesses of Third World governments in an attempt to improve efficiency in economic management, a condition that demands structural adjustments in various public policies and organizations. Among the most needed reforms are eliminating parallel public agencies and functions, trimming and regrouping expanded bureaucracies, introducing technocratic criteria in selecting managers, and instituting performance incentives.

Governments also need to devise specific measures to promote the supply-side of the economies and create a favorable climate for productive private investment. Recent policy shifts away from the maximum utilization of existing capacity in favor of new capital formation is wise only if the underutilized capacities are either renovated or scrapped because of technological obsolescence. Units that do not fall into these categories must be fully utilized on a priority basis, taking into account their job-



generating and income-generating potentials. Capacities left u derutilized will only contribute to low productivity and wast reduce the morale of their managers and employees, and eat u otherwise scarce public savings.

Policies that attempt to reduce effective demand are harmf as they create recession and harm the majority of the people wh live below the poverty line. Unfortunately, governments seem i tent on closing this gap by largely depressing demand in an a tempt to reduce their current expenditures. This mistaken polic is rooted in the anti-consumptionist attitude of many Thir World leaders and the advice from the World Bank and IM Governments hope to remedy the liquidity problem by polici that direct private investment to production, away from non-pr ductive activities. A precondition for the success of this corre approach is the creation of differential profit rates in favor industrial investments. Thus, various fiscal and monetary me sures (controls as well as incentives) would have to be introduce Other fiscal reforms and a well-designed selective de-nationa ization policy could also help reduce private liquidity and thu inflation. Governments are also trying to increase the confiden of the private sector in public policies. Another important me sure that has been neglected by governments is a well-designe program of welfare and income redistribution. This is needed t prevent aggregate demand from decreasing as aggregate suppl expands.

### The Distributional Gap

The ballooning double-digit unemployment rate and inflatio along with a declining GDP and a growing population have re sulted in a substantial increase in the incidence of absolut poverty. In many Third World countries over 65 percent of th working-class population lived below the poverty line in th 1980s, taking into account both the subsidized markets and fre market prices.[23] The middle-class salary earners also lost mos of their purchasing power in the 1980s as growth in their incom lagged behind inflation rates. The decline in income and pur

chasing power has not been equally distributed among various segments of the society and as a result Third World societies have increasingly become polarized into a two-class society of the rich and the poor. The bottom 10 percent of the population receives no more than 1.5 percent of national income, while the top 10 percent receives over 35.0 percent in many countries. Among those who became richer in the 1980s, merchants and traders in control of distribution channels are the most notable. In sharp contrast, the groups who have suffered the most decline in their incomes include the urban poor, farm laborers, workers in construction and industry, and public employees. Statistics also indicate a growing imbalance between urban and rural families in terms of income and consumption expenditures.

To remedy the situation, many governments introduced such measures as food subsidies, a minimum wage legislation, and restricted social security benefits. Many welfare foundations have also been created to look after the poor. The less developed provinces and rural areas received larger socioeconomic development funds on a per capita basis. While not all these measures were fully implemented or successfully applied, governments also introduced policies that tended to exacerbate socioeconomic inequalities including the IMF/World Bank stabilization and structural adjustment programs. This is why significant redistributive reforms are urgently needed in the medium-term to close the ever-growing inequalities.

Governments need to consider family planning with utmost seriousness, increase production, expand job-generating activities, control inflation, and retarget toward the poor some of the across-the-board subsidy measures in basic needs areas that are being eliminated. Redirecting economies away from nonproductive toward productive activities is another critical step. The nonproductive orientation of the economies has created significant distortions in the sectoral structure of income and employment with depressing effect on wages in industries. These and other redistributive measures should not be conceived as a welfare program; rather they should be designed with a view to expanding effective demand and developing a more productive human capital.



**The Foreign-Exchange Gap**

Demand for foreign exchange is greater than its supply, a problem that reflects Third World negative trade balance and a large outflow of capital from the economies relative to what flows in. Most Third World countries either have no significant capacity to earn foreign exchange, or if they do, they largely depend on a single export commodity whose price is determined in the world market, totally outside control of Third World states. Revenue from these exports declined in the 1980s because of a decline in demand in the West and as a result of deteriorating terms of trade. The decline, in turn, forced governments to reduce foreign exchange allocations for nondefense-related economic sectors, at the same time that they increased demand for defense-related imports. Decline in imports of industrial inputs led to a further decline in domestic production of tradeable and non-tradeable goods, thus reducing exports earnings while increasing import bills. As a result, the Third World's balance of payments has been in deficit for most of the 1980s.

A significant effect of the balance of payments deficit has been a reduction in public savings and consequently public investment. The states' inability to borrow in long-term capital markets because of the debt crisis further exacerbates the problem. The foreign exchange imbalance also led to a significant depreciation of Third World currencies. The resultant black market in foreign currencies and gold became an effective means for illegal capital transfer from many Third World countries. The foreign exchange gap also led to underutilization of the existing capacities which depend on foreign markets for most of their inputs, from capital goods to intermediate inputs and raw materials. The resulting decline in GDP at a time of increased demand created new pressure for food imports and thus for foreign exchange, generating a vicious circle.

Governments have attempted to cope with the foreign exchange gap through exchange control, introduction of a multi-tier exchange rate system, imports control, and strict allocative and austerity measures in the use of foreign currencies. Although

ıese measures have helped, many governments plan to increase ›reign borrowing in the coming years. Exchange control is also eing relaxed and a single-exchange rate policy is seen as more esirable to the current often multitier system. A policy of at-acting Third World industrialists abroad is expected to bring in ew capital and technology while reducing capital flight.

An export-promotion industrialization policy has also become referable to the previous import-substitution policy. The policy f maximum utilization of existing capacities is also being re-laced by a policy focused on capital formation. Non-industrial nports are being reduced while attention has shifted toward nport of technology and capital goods. National currencies are eing devalued, and the countries' international trade has been beralized to a significant degree. Foreign capital inflow is now ıcouraged, and new laws allow joint-ventures and protect owner-ıip and profit repatriation in many countries. The current en-ıusiasm for foreign borrowing and free trade will certainly in-'ease the Third World's international debt and lead to a sub-antially increased debt-service burden and capital flight in the ear future. A prudent policy will avoid this path and instead cus on promotion of direct foreign investment, or a buy-back echanism, and maintain a certain degree of control on the coun-ies' international trade and financial flows.

So far attempts to promote foreign investment, particularly r export-promotion projects and in the free economic zones that e being established in many parts of the Third World, have oduced meager results. It is possible that the effect of the new ıicies will appear with a long time lag and that foreign in-stors are waiting for further liberalization and more meaning-l reforms and incentives. But, the new open-door policy in the ıird World is also conditioned on changes in the attitudes of e West toward Third World exports. The breakdown of the SR has created new challenges for some Third World countries d the newly independent states could become important mar-ts for some of their exports. Third World governments have re-ıtly given priority to projects capable of generating foreign ex-



change. Governments also plan to maintain a sustainable level of export earning by building a more conciliatory relations vis a vis the West.

However, these export markets face uncertain conditions to say the least. Even if the Third World improved relations with all the states in the West and was successfully reintegrated into the capitalist world economy, there is no guarantee that its access to world export markets will increase, particularly for high-tech commodities. Many Third World governments have taken this route and failed miserably; they have all ended up in huge debts. A few successful cases in East Asia could not be taken as good examples; even there new problems have developed. For example, Korea is facing stiff competition from the OECD countries and has again become a deficit country with a huge foreign debt. While protectionism is on the rise, the Third World's scientific and technological backwardness make it impossible for them to compete in the highly advanced global market even if the world opened its door wide to these latecomers.

This does not mean that the Third World should not attempt to expand its export production and markets. However, it should not try to compete in the global market using imported technology. This means that the Third World should not attempt to enter the high-tech exports markets for the time being. Even if it was able to successfully develop and market such commodities, the net effect could well be a loss of foreign exchange for the economies as most inputs, including technology, will have to be imported at exorbitant prices. Rather, the Third World should begin its outward-looking policy by expanding its export production in areas where it already has a comparative and competitive advantage. Even then the Third World needs to target its export production so that it can develop and master the technology in a short time. In the meantime, the Third World has to advance its R&D and scientific basis if it wants to expand at some future time in the direction of high-tech exports. This will in turn depend on the ability of governments to expand higher education, encourage scientific research, and provide the necessary conditions for the return of their expatriate scientists, re-

earchers, and industrialists. An education-first strategy within democratic environment is the first, most important condition or development of high-tech knowledge and exports. The Third Vorld needs to build science cities, industrial parks, institutions f higher education, and research laboratories before it can hope o become a player in the highly specialized and competitive global market.

### The Fiscal Gap

Public expenditures are far greater than public income in many arts of the Third World, which alludes to the huge budget leficit and the consequent public debt. The deficit has largely een financed by borrowing from Central Banks and spent on non-roductive uses, contributing to the countries's hyperinflation. Vhile export revenues declined in the 1980s and its share in the udget dropped, governments' tax revenues did not increase, lthough their share in the budget did rise during the period. In e 1980s, only a small percentage of the countries' GDP went to xes, compared to the figures for advanced countries. Governents have found it very difficult to collect taxes on wealth, ccupation, and income from the private service sector. Indeed, ost taxes are collected from employees on fixed income and roductive firms, a rather limited pool at a time of declining dustrial value added and per capita income and soaring flation.

Meanwhile, militarism, expanding bureaucracy, and the subdized markets led to a significant increase in the Third World's rrent expenditures largely at the expense of its development penditures. The impact has been the most depressing on the nans' production and consequently public revenues. To remedy the cal gap, governments are reducing public spending while ineasing public income, largely through higher taxation on the iddle class and a better tax administration. This policy has reired a significant restructuring of the general budgets with rerd to their priorities and focus. For example, subsidies are being eliminated and in some countries targeted toward the poor. Monies for public enterprises are also being substantially reduced in an effort to make them more independent and efficient. But instead of targeting the ever expanding non-productive bureaucracies, governments are targeting their productive branches for saving money. Moreover and despite growing corruption, measures to discipline the public sector and create a sense of fiscal and monetary accountability among public employees remain absent.



Fiscal reforms should particularly focus on taxing the wealthier sectors of the economies particularly those in non-productive services such as financial brokers and retail intermediaries. They should also lead to a detailed determination of the public sector's borrowing requirement (PSBR), defined as the amount of fund the public sector needs to raise within domestic financial markets to pay for its investments net of taxes and other public incomes. How this money is raised is a key policy issue. Determining the PSBR is also a complicated job since it, in the final analysis, depends on projections for capacity utilization rates in the economies and on various other direct and indirect determinants of public revenues. It is important to note that the fiscal gap in many debtor developing countries is largely rooted in debt services, unnecessary public investments, and the growth of public operating expenditures. To remedy the gap, therefore, public investments should not be targeted; rather current expenditures should be cut and that in well-targeted areas. A reduction in public investments will indeed be counter-productive as it will crowd out private investments, leading to a decline in production and government revenues.

### The Savings-Investment Gap

The need for investment in productive sectors is far greater than available savings for the purpose in many parts of the Third World. This problem indicates a significant transfer of available savings to non-productive activities and/or abroad. Governments have also reduced their development spending and use most of their available savings for operating expenditures. In

ercent of GDP, development spending has declined by a signifi-
ant percentage in the 1980s. Even this declining amount has been
sed mostly for completion, repair, utilization, and expansion of
xisting capacities rather than the creation of new ones. In other
vords, it has been largely spent on current production, not for cap-
al formation. Although reduction in public investment could be
esirable, in most cases it crowded out private investment since
e infrastructural projects needed to improve profitability of
e private sector were not undertaken.

Meanwhile, most of the available foreign exchange went to
roduce necessities, buy defense-related items and maintain or
nprove utilization rates of the existing units. The problem was
xacerbated since the banking system failed to attract the ex-
anding private savings. Most such savings were shifted to prof-
able projects in services and trade, or were kept in various liq-
id forms for speculative purposes and transfer abroad. The per-
ived political instability also worked against private long-
rm investment in productive sectors. As a consequence, Third
Vorld's gross domestic fixed capital formation (GDFCF) de-
ined as percent of the GDP in the 1980s. Gross domestic savings,
owever, declined less drastically over the same period. A major
nsequence of the declining GDFCF has been a rather significant
op in the nations' economic productivity. The meager GDFCF
s had little effect on changing the highly imbalanced dualis-
structure of Third World production technologies which con-
ue to suffer from the lack of a clear policy, particularly con-
rning issues of transfer, adaptation, and development.

Governments are correcting the saving-investment gap by pro-
oting private and public savings and foreign investment to fi-
nce national development projects. For the measure to succeed,
ivate and public foreign interest payments must be reduced to a
nimum, while transfers from abroad to the sectors should be in-
ased. This may indeed happen in the short-term. But as for-
gn borrowing increases and the maturity dates arrive, the re-
rse could indeed take place. The only way to avoid this is to
e foreign savings as industrial inputs or direct foreign invest-



ment. To significantly restore growth and efficiency, investment has to increase, which demands: (1) a reduction in macroeconomic distortions; and 2) creation of conditions for new investment. The former is best achieved by the following steps: (1) aggregate demand (tradeable and nontradeable) must be brought in line with aggregate supply plus sustainable external financing; and (2) inflation, rate of monetary growth, current account deficit, exchange rate, and fiscal deficit have to be reduced on a sustainable basis.

Conditions for new investment, on the other hand, may be created by: (1) an increase in domestic savings, initially through the public sector by reducing expenditures and increasing revenues. Productivity and profitability are considered among the major determining conditions for increasing domestic savings. Increased investment efficiency will reduce the need for more savings and external financing. The private sector only starts saving after growth gets underway. Savings also respond to a positive real interest rate; (2) an increase in external financing, not just by means of borrowing, which these days are rate, but encouragement of direct foreign investment, joint venture, and buy-back mechanisms. Helpful measures are: establishing free economic zones, removing protective trade measures, instituting laws protecting foreign ownership and profit repatriation, and establishing a competitive exchange rate; and (3) complementary public investment in infrastructures and social services (human capital in particular) in order to crowd in private investment.

Investment may also be increased by stimulating demand for it, a condition that will prevent capital flight. Establishing an appropriate rate of profit and a correct real interest rate is another critical measure. The relationship between the two rates must be well balanced. Reducing debt and debt services is another important measure to stimulate investment. Debt overhang creates uncertainties about sustainability of the balance of payments situation and about the macroeconomic stability, thwarting the recovery of private investment. Creation of a credible economic environment is also pivotal, including clear rules for taxation and property rights and unambiguous regulations in

trade and production (e.g., a tariff policy and a labor law). Private investors must be convinced that reforms are lasting and that legal and bureaucratic impediments will go one after another; they usually wait before making irreversible investment decisions. Getting a commitment from a few private investors helps as it increases the confidence of a larger group. Note that the size of the private investment may initially decline due to changes in incentives or a lack of confidence in government's reforms. The effect could be an increase in private consumption or a shift of resources to quick-return projects as in services.

Promotion of private investment is a step in the right direction. This policy demands that governments invite foreign capital and Third World businessmen abroad to join with domestic capitalists to expand private investment. However, unless the policy is accompanied with reforms in socio-political spheres, the net effect could be more dependency, exploitation, and repression than at present. Businessmen, foreign or domestic, will ask for tighter security for their investments and a more disciplined work environment than hitherto exists. They will also plan to make more money and at a faster pace in a less certain environment in which they will be operating in the beginning. Various laws for attraction and protection of foreign investments also allow for large profit repatriation. Third World expatriate businessmen would want an even bigger profit rate to quickly compensate for their actual and opportunity costs. This high-exploitation method would also conform to governments' desire to achieve quick economic growth. But it will exacerbate the already extremely skewed income and wealth distribution in the countries, leading to political instability.

### The Human-Capital Gap

The need for a skilled work force is greater than its supply in the Third World, indicating the lack of adequate educational facilities and distortions in labor markets. Meanwhile, the supply of unskilled labor has been expanding at a far greater rate than



demand for this type of labor. The Third World's population continues to grow at a fast rate. A large percentage of the population is below 15 years of age. The size of active population has also steadily grown. Most of this growth is in urban centers where unemployment is already high and rural migrants tend to go *en mass*. Consequently, many thousands of people were added to the job market each year, while only a portion found jobs. Thus, for every working Third World individual, there were five to seven who were either not working or were underemployed. A very large percentage of the unemployed are under thirty years of age and most are concentrated in urban areas where 80 to 90 percent of the new job entrants live. Women's unemployment rate is much higher than that of men and those employed are concentrated in lower-paid services. The public sector has created most of the new jobs, while the private sector's contribution has been negligible; it has also been almost totally concentrated in nonproductive and low-wage paying services.

Another major problem in the labor market is the lack of a skilled work force. Experienced and educated managers are the most scarce. Unfavorable political and economic situations have forced many technocrats out of their native lands, and those who remain are absorbed in defense operations, sent into early retirement, or have left productive units and the public sector for a higher return in various private service activities. Meanwhile, the countries' educational systems are too weak to produce the needed experts. There is also a shortage of college and university graduates in applied fields and technicians in various crafts. Even this limited number of graduates are not fully employed. In addition, the job market is distorted; the nonproductive sectors have attracted most of the skilled workers available, as a significant number work outside their profession in order to earn more money.

Thus, the Third World lacks not only a high-level work force but also people with basic skill such as technicians. There are two routes that the Third World can take to remedy its human capital gap: expand education and training at home, and encourage expatriates to return to their homeland. Governments have

planned for a significant expansion of education and higher education; technical training and vocational schooling are also being emphasized. However, plans focus on an extensive expansion of education in terms of its coverage; what is also needed is an intensive expansion in terms of quality and variation. Governments must also introduce fiscal policies that make job-creation, wages, and work environment more attractive in the productive sectors.

In the short run, however, the Third World's best bet is to focus on the millions of its educated people who live abroad. Thus far attempts to reverse the brain drain have not paid off at any significant level. Third World scientists and researchers have not shown great willingness to return under the given domestic conditions. Disparity in living standard and wages between the Third World and the West are major obstacles. The expatriates also demand socio-political reforms as a condition for their return, although this demand is not always explicitly acknowledged. Unfortunately, most governments' current policies do not adequately emphasize the return of these people.

Instead, governments have focused on Third World businessmen abroad who seem to care more about the security of their capital and a higher profit rate than (say) democracy. But if governments only invited the businessmen back home but not the educated Third World expatriates, then its economies would become fully dependent on the capitalist world market for all that they consume, from knowledge and technology to industrial processes and low-order inputs such as food and intermediate goods. Such a result would not conform to a nationalistic plan for the Third World's future. Thus, attraction of educated Third World expatriates should be seriously pursued as part of a larger development paradigm and policy of reversing the brain drain problem, at least in the long-term. This demands a specific plan of action which should at the least include measures for elimination of domestic push factors and expansion of international cooperation.



**The Economic-Management Gap**

The State has disproportionate economic responsibility compared to the private and cooperative sectors, a problem that alludes to economic mismanagement in many Third World countries. The public sector is generally expanded beyond its technical or managerial capabilities. With the growth of imbalances, government was forced to intervene, and, as a result, its weight in economic activities increased. Public employment makes up a large part of the total employment in the Third World. The public sector in many Third World countries controls most large-scale industries, many of which are not profitable. What, however, makes the public sector play godfather in the economic sphere is its total control and ownership of the main export staples. As a result, governments earn, and control the expenditure of, a large percent of foreign exchange. The significance of this control over foreign exchange becomes more evident when we note that Third World industrial production depends on foreign markets for a huge share of its inputs (between 65 and 85 percent), from raw materials to capital goods and technology.

Most strategic projects and activities both in defense and non-defense sectors are also controlled by governments. These include defense and "basic" industries, mining, and infrastructures such as electricity and water, telecommunication and mail services, air and sea transport and railroads. They also control most institutions of higher education, most health services and structures, a lion's share of social and administrative services, and a significant part of non-residential construction. The only important sectors in which governments maintain a minority position are agriculture, housing, domestic trade, and household and professional services. While the private sector's productive activities did not increase in the 1980s, cooperatives were marginally expanded in agriculture and consumer services. In the absence of appropriate state planning, and with restrictions on market mechanisms and cooperatives, the economies could not be efficiently and effectively managed. Consequently, the Third World has had neither a planned nor a market economy during the last several

decades.

The economic-management gap is being remedied by de-nationalization and de-regulation of the economies. Criteria as to what to de-nationalize and where to de-regulate are not yet clearly spelled out. It just happens that the huge bureaucracies are for the time being left untouched by the privatization policy and a policy that aims at reducing the size of the state. Yet, it is at least partly because of the inflated bureaucracy that fiscal wastes and inefficient management prevails. There is not as yet any attempt to democratize the countries' management style, sectorially or territorially, to allow for a fuller public participation. All that is being emphasized is that the private sector should be expanded along with the market forces. What measures the public has to institute to guarantee a more responsible behavior on the part of the expanding private sector (which in the past has been very irresponsible indeed) also remains to be identified.

Governments need to formulate a more coherent framework of public-private partnership. Appropriate legal codes, incentives, and enforceable planning are being instituted and these are certainly needed. They are not, however, sufficient; more has to be done at both the legal and institutional levels. Meaningful sectoral reorganization is needed, particularly in the financial sector where the banking system has not been able to channel private savings into productive uses. Governments must encourage establishment of new private credit and saving institutions under their strict regulation; meanwhile, the largely informal practice of the non-banking funds have to be curtailed. The private sectors need to develop a more nationalistic and responsible attitude toward the economies and the nations. But this may not occur unless the states are made more accountable to the people. This change will, in turn, require that the states discipline themselves, increase their dependency on taxes against export incomes, substitute criteria for relationships in promotion of their officials, and eliminate the wide-spread corruption.



**The Technological Gap**

The available technology is inappropriate for a growth orientation in Third World economies, which points to technical and process obsolescence of most industries there. This problem is at the heart of inefficiency and low productivity in the countries of the Third World, second only to the mismanagement factor. Third World industries are marked for their technological obsolescence and limited technological development. The Fordist production systems (primarily assembly operations in mass-produced consumer durables) are either obsolete and worn out, dismantled as part of an effort by governments to reduce technological dependency, or are sitting idle for the most part awaiting inputs to arrive from foreign markets. Where such industries operate they largely do so with a minimum of utilization rate and maintenance and without any significant alteration or technological improvement. Decline in foreign exchange, lack of adequate attention to higher education and research, Western economic nationalism, and anti-dependency leaders are among major influences on the countries' technological lag.

Meanwhile, any positive impact originating from the small net addition to the countries' capital formation in recent years could only materialize in the long-term as it is largely made in basic and defense-related industries. Even then the growth effect of such investments will be minimal as they are not concentrated in any high tech production or leading industries. On the contrary, they are primarily made for completing the old projects, expanding the existing capacities, and improving the countries' maintenance and repair capabilities. Another major change in the industrial structure of the Third World took place at the level of small establishments directed to producing household items and spare parts for larger firms; however, their impact on the nations' technological advancement will be equally insignificant in the medium-term. The highly imbalanced dualistic structure of the countries' production technology will, therefore, continue to suffer from the lack of a clear policy, particularly concerning issues of transfer, adaptation, and development.

A major consequence of the technological lag has been a significant drop in the nations' productivity. Governments have been attentive to the technological gap and intend to rectify it by an outward-looking and integrative strategy, application of flexible specialization in certain export-oriented industries, investment in R&D and research parks, formation of free economic zones, and maximum utilization of national resources. Promotion of an export-oriented strategy, foreign investment, selective trade liberalization, international cooperation, and devaluation of domestic currencies are among other supportive measures that governments are introducing.

While appropriate at a more theoretical level, implementation of these measures could create significant problems for the economies if countervailing measures are not introduced to mitigate the negative impacts that would certainly follow from an outward-looking strategy. The export-promotion industrialization and the post-Fordist flexible specialization technology policy must be targeted toward high tech investments and where the Third World has a comparative advantage and can compete in international markets. Such a policy would require significantly higher investments in R&D, higher education, and Third World's further integration in the capitalist world economy. Returning Third World expatriate scientists in the West is the most important step that governments should take in addressing the nations' technological backwardness.

Protective measures should be instituted and reinforced; import-substitution in efficient industries and firms must be fully supported and continued; and export-promotion should be based on a policy of getting export "prices wrong" and on the Third World's comparative advantage. This should be carefully assessed given the ongoing restructuring in the world's supply-demand situation and the unprecedented and minute technological revolutions. Clearly, the situation calls for increased public intervention and investment particularly in R&D, infrastructures, higher education, and industries. However, what is needed even more in the short-run is the introduction of a suitable



incentive policy to redirect private investment toward productive uses and technological advancements.

## CONDITIONS FOR IMPLEMENTATION

The multi-gap approach just outlined is best implemented if certain conditions are met. The initial economic condition is a critical factor. A careful diagnosis of the main impediments to growth, including macro and micro conditions have to be made. The severe the imbalances are the less effective the approach could be if not properly designed. For example, the reform effort must reach a critical mass and larger distortions and imbalances should be singled out for larger reductions. Strength of external shocks are equally important: the greater their effect, the more difficult it is to implement the approach effectively. Economic policy makers must particularly keep an eye on future export markets. A higher export base will assist in better program implementation as it can help absorb some of the external shocks and provide a safer environment. This is why supporting policies aimed at improving the balance of payments situation are most critical. Such policies should gradually eliminate the need for balance of payments financing. Another important factor is the level of indebtedness. The higher this is the more difficult it is to implement the approach effectively. This is because the higher burden of debt service will constrain the foreign exchange situation, and the acquisition of additional credit will become increasingly difficult.

It is not always easy to implement the strict conditions that are needed for a proper implementation of the proposed approach, particularly with respect to institutional reforms at all levels of the public sector. This is particularly true because political divisions do not permit governments to take decisive policy positions. The problem is even more complicated if there is a lack of strong, unquestioned commitment to the approach. In addition, governments must own the reform from the start and be convinced of its success. It is also important that governments

fully understand the problems and the proposed approach. Note that the approach reduces the size of Governments in an attempt to increase its efficiency. governments must be able to fully justify the reform for the public and must be completely open about it (both with respect to measures being taken and sources of problems being addressed). The fact that the approach will eventually produce capitalism, promote the private sector, and increase foreign trade and investment has to be underscored and defended.

The public must know why the approach is being applied and how it will benefit from the program. If governments think this is the best approach, they must let the public know and explain why. The resulting hardship must be explained to the public in full, particularly to those most negatively effected. Governments must advance policies that are targeted toward mitigating negative consequences for these groups, the poorer economic classes in particular. These policies must be fully explained to the public. The real beneficiaries of the reforms must be mobilized and made into political supporters. Implementation has to be decisive and prompt; there is more support for the reforms built into the approach in the beginning. The approach must undertake to implement a realistic program: it must be restrictive enough to be consistent with financing and other available resources and flexible enough to avoid social and political fallouts which make the reforms unsustainable. Close monitoring and evaluation of the approach being implemented is a critical condition for attainment of the right results. Note that the ultimate support for the condition the approach attempts to develop will depend on its success in benefitting the majority; so, successful implementation is the key.

Proper reform sequence is critical. The public sector should receive priority, that is, the reform should begin by reducing the public deficit, introducing fiscal reforms in tax regulations, and generating public revenue as expenditures are reduced. Similarly, priority should be given to implementing institutional reform to reduce the size and increase the efficiency of the public sector, converting public enterprises into private or mixed ones,



and improving national integration by better communication and transport networks. Structural adjustments and stabilization reforms built into the approach should not be confused with each other; they are different in mechanism and nature. Yet, they are not always mutually exclusive; rather they are complementary in most cases and reinforce one another's impact and influences.

The same dialectical relation holds between macro and micro reforms; however, if macro adjustments are not made first, particularly in countries where macro imbalances are very large and they face financial instability, then micro adjustments, that is increase in efficiency and growth, may not be successfully implemented because the supply response to changing incentives will be severely curtailed. The reform program should focus on restoring macro balances and creating a supportive macro framework where: inflation is sustainably low and predictable, real interest rate is appropriate, real exchange rate is competitive and predictable, public sector savings rate is compatible with the resource mobilization requirements of the approach, and the balance of payments situation is perceived as viable.

Finally, as I noted in the beginning of this paper, the Third World faces two types of challenges as it approaches the 21st century: long-term and medium-term. The proposed multi-gap approach is designed to face up to the medium-term challenge of economic growth. For this to become possible, however, the countries of the Third World must formulate a new development paradigm as a general guide for medium-term policies and actions. Such a paradigm can only be developed with a view to the trends in the current global restructuring discourse. Opportunities and constraints that this discourse can generate for the Third World's national independence and integrity, development, democracy, and social justice must be carefully considered. These trends may be summarized as follows.

The emerging world system is multipolar and bi-centric, including a "state-centric" and an "NGO-centric" subsystem.[24] This system is caught between two diametrically opposing tendencies of integration and disintegration. The resulting instability has made military force ineffective at the same time that it has

turned economics into a new field of force. Since militarism has become counterproductive, economic development and technological superiority are the way to the future. With increased economic competition, protectionism has intensified. Democracy has become a potent force while dictatorship is a dwindling power. Negotiation is now superior to war and violence. We can expect an increased "peace dividend" and demand for disarmament for development in the 1990s. This will entail a shift of resources toward civilian production and services.[25]

Ideological rigidity about the role of public and private sectors in the development process is waning; their partnership is now the subject of theoretical enquiries. Paternalistic assumptions about human nature and a good society are under attack. The current gap between planning and market forces is being bridged in new approaches. Outward-looking and integrative strategies are preferred to self-reliance and isolationism. The role of culture, gender, religion, and ethnicity in development is now underscored. More attention is being paid to human development. The positive contribution of foreign capital to the development process is being emphasized. The IMF's stabilization and the World Bank's structural adjustment programs are expected to become widely practiced in the Third World. Meanwhile, the idea of a pluralistic economy alongside the emerging political pluralism is gaining increasing acceptability.

These trends imply that a comprehensive, autonomous and democratic course of development has become more feasible than in the past. They also indicate the global nature of domestic problems and policies. Further, they invite attention to new realities and modes of operation. Thus, a development paradigm that is based on a moralistic view of human nature, the use of offensive force, maintenance of the *status quo* in favor of a small elite group, a bipolar or unipolar world system, and an inescapable choice between socialism or capitalism is simply irrelevant to the present complex world where a wide range of possibilities and constraints are emerging.[26] The real challenge for intellectuals and policy makers in the Third World is to theorize



and apply this new paradigm as the basis for implementation o the proposed multi-gap approach.

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