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**Article — Digitized Version**

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Intereconomics

*Suggested Citation:* Fasbender, Karl; Keschull, Dietrich (1987) : The economic system and economic development, Intereconomics, ISSN 0020-5346, Verlag Weltarchiv, Hamburg, Vol. 22, Iss. 1, pp. 29-33,  
<https://doi.org/10.1007/BF02929792>

This Version is available at:

<https://hdl.handle.net/10419/140061>

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# The Economic System and Economic Development

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**An increasing number of voices have recently been claiming that an economic system based more strongly on the market should be introduced in Third World countries for reasons of efficiency. What conditions need to be met in the developing countries for this to be possible? What specific measures should be taken?**

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There has, unmistakably, been a marked change of trend in the international discussion on development policy. This applies both to the question of the economic system and to the establishment of sectoral priorities. An increasing number of voices recently have been pleading, on grounds of efficiency, for a departure from the "third way" between centrally planned and free market economies which most developing countries have been following, in favour of a more strongly market-oriented economic order. At the same time, a period in which strong emphasis had been placed on industrialization is giving way to one in which attention is again turning to development opportunities arising from a more intensive utilization of agricultural resources. This means that, in addition to the "outward looking" strategies, concepts of "development from within" are again being accorded a higher priority.

In connection with the raising of the efficiency of development processes – more important than ever in view of the shortage of capital and high indebtedness – and with the provision of support for the agricultural sector, the general economic setting is obtaining increasing significance. An enquiry carried out by the HWWA-Institute<sup>1</sup> into the conditions which can be influenced by the developing countries themselves essentially points out two areas where measures can be taken with a direct bearing upon successful development:

strengthening the part played within an economy by markets and prices,

improving the effectiveness of institutions relevant to development policy.

In almost all countries, prices were used as an instrument for influencing supply and demand and for altering existing structures. What authorities underestimated, however, were the – mainly undesired – feedback effects on the economy as a whole, on other sectors and indeed not infrequently on the sector to which the measures were originally applied. The most important effects of distortions in prices of goods and exchange rates, as well as in the costs of labour and capital are outlined below.

## Sectoral Price Policy

Most developing countries pursued a sectorally differentiated price policy in relation to the goods produced in different branches of the economy.

Primarily to protect and help expand the industrial sector, domestically produced import substitutes in that sector have been, and continue to be, guaranteed relatively high prices. Price-setting is one of the most frequently used instruments. The measures, originally intended to promote domestic "infant industries", did make a crucial contribution to building up the industrial sector, but often also led to uneconomic production which was dependent on continuing protection.

On the other hand, in order to provide the urban population, domestic industry and/or export businesses

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<sup>1</sup> Cf. here and in the following Klaus Fertig, Dietrich Kebschull: Auswirkungen von Eigenanstrengungen auf den Entwicklungsprozeß, Federal Ministry of Economic Cooperation Research Reports, Vol. 70, Munich, Cologne, London 1985.

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with cheap supplies, a low price policy was pursued for basic foodstuffs and selected agricultural raw materials. However, since the agricultural produce which is the mainstay of rural areas has a positive elasticity of supply, such a policy has the effect of lowering production and reducing incomes both for farmers and for rural regions as a whole.<sup>2</sup>

The associated effects were aggravated by additional input subsidies for the industrial sector and the indirect taxation of the agricultural sector, particularly of its export products. Where, as is often the case, agricultural inputs have also been subsidized, this has not been enough to compensate for the discrimination against the sector and, moreover, the benefits have reached smaller farmers and remote regions only to a very limited extent.

### Exchange Rates

Price distortions in domestic markets also occur as a result of exchange rates which do not reflect the true scarcity relationships and are not adjusted to inflation rates. The overvaluation of the domestic currency which can be observed in almost all the countries concerned led to exports being impeded and imports being made artificially cheaper. The most use of the relaxed import situation was made by industry which was able to obtain machinery and spare parts at – in its own profit and loss terms – favourable prices, while its own products were subject to protection. Another area to benefit was the import of foodstuffs for urban consumers. Because of the structure of production, the main casualty of

excessive export prices is agricultural produce. If agricultural markets are open, overvalued currencies lead to a relatively high level of supply on domestic markets. The consequence is that prices fall and incentives to produce are reduced. In the protected industrial sector, on the other hand, the fact that imports of machinery – mostly for capital-intensive processes – are encouraged tends rather to increase production and to lower the demand for labour.

### Labour and Capital Costs

Tendencies in favour of using labour-saving technologies are reinforced by increases in wage rates in urban centres, which are usually also the main industrial centres. There are quite a number of countries where, for political reasons, such wage increases are in excess of productivity gains.

In many cases the high-price policy in the labour market – especially for skilled and specialist staff – stands face-to-face with a low-price policy for capital. Indeed there are many countries in which this, together with high rates of inflation, leads to negative real interest rates. This once again works in favour of labour-saving investment in the – mainly urban – industrial and service sectors. The consequence is that structural distortions

<sup>2</sup> Cf. on the effects of price distortions on the agricultural sector and rural areas, among others, Dietrich K e b s c h u l l : Zur Rolle der Landwirtschaft bei der Entwicklung der Binnenmärkte, Lecture given to the Verein für Socialpolitik in November 1986 (publication under preparation), and Karl F a s b e n d e r : Überlegungen zu Preisverzerrungen auf den Märkten für Auslands- und Inlandskapital, in: DSE: Erzeugerorientierte Märkte und Preispolitik in den ärmsten Entwicklungsländern, Feldafing 1985.

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Large octavo, 236 pages, 1986, price paperbound DM 46,-

ISBN 3 87895 302 X

V E R L A G W E L T A R C H I V G M B H - H A M B U R G

occur between industry and agriculture, the towns and the rural areas, and the utilization of labour and capital.

In many countries the excessive demand for credit generated by interest rate policies outstripped the available supply, thus not infrequently helping to bring about credit rationing measures favouring the state, public undertakings and large industrial concerns. Special credit programmes for agriculture, small industries and craft trades have not been able to compensate for this imbalance. Economically worthwhile investments – often more labour-intensive – had to be abandoned due to the false economic setting.

The effects are all the more persistent in that the low interest rates on savings which are attendant on the favourable interest rates on loans provide little incentive for an increase in the propensity to save; this creates a capital gap which can at best temporarily be bridged by raising credit abroad.

The largely intentional price distortions imply for public and semi-public institutions a wide range of administrative, control and distributive measures. To alleviate undesired side-effects, it has often proved necessary to create a complex system of subsidies (including tax concessions), import restrictions, export promotion measures, special exemptions, loan programmes, etc. Thus price distortions lead to dirigism, which in turn paves the way for still more dirigism. A vicious circle develops.

The more pronounced and long-lasting price distortions and the associated measures, the greater are the demands they place upon the bureaucracy. Apart from the fact that the complex and comprehensive requirements could only be met with substantial frictional losses even in advanced countries – the EC's agricultural market controls serve as a telling example here – increasing bureaucratization also increases the dangers of abuse and corruption. In many developing countries disadvantageous effects flow from the only limitedly effective institutions, particularly for small and medium-sized businesses and for rural regions, the latter having only a sparse cover provided by institutions which are inadequately staffed and financed.

### Effects on the Economy as a Whole

All in all, it can be stated that prices not reflecting the relationships of scarcity in the various goods and factor markets together with institutions of limited efficiency have contributed substantially to structural distortions in many developing countries.

The prime beneficiary – as intended – has been

investment in the industrial sector, as this is thought to generate favourable effects for foreign trade, employment and growth. High, protected selling prices combined with inputs cheapened due to overvalued currencies, to negative real interest rates and to additional subsidies, give companies an impression of profitability which, in terms of the economy as a whole, they do not have. Capital-intensive investments are favoured relative to labour-intensive methods of production, the compulsion to produce cost-effectively is reduced, imports which eat up foreign currency reserves are encouraged, efforts to raise the savings ratio are hampered and, last but not least, there is a greater incentive to borrow from abroad. Hence industry's contribution to growth, employment and exports, contrary to the aims of the exercise, is substantially diminished.

In the agricultural sector, as we have already seen, price distortions and the institutional framework have a downward effect on both production and incomes. Economically worthwhile and frequently labour-intensive investments are shelved. In addition, overall economic goals such as raising food production for domestic needs and reducing social and regional disparities are made more difficult to realize. Taken as a whole, then, the costs for the economy at large must be seen as higher than the (hoped-for) sectoral benefits accruing to industry.

The above catalogue of effects of price distortions and inefficient institutions which does not claim to be exhaustive, is confirmed by empirical analyses.<sup>3</sup> However, an analysis conducted in selected developing countries by the HWWA-Institute on the corrective measures taken in this regard and their varying degrees of success also clearly demonstrates that a great number of influences played a part in determining whether the result was positive or negative. Progress is crucially determined not only by the endowment with natural resources but also by how well individual efforts made by the countries concerned are in tune with their own situations. An important aspect here is how measures mutually complement each other and how they are supported institutionally.

In addition to the factors specific to individual countries, exogenous influences are also significant.

<sup>3</sup> Cf., among others, Ramgopal Agarwala: Price Distortions and Growth in Developing Countries, World Bank Staff Working Papers No. 575, Washington D.C. 1983; also Manfred Holthus, Klaus Stanzel: Kriterien zur Einschätzung von Verschuldungslagen – Die "Bonität" von Entwicklungsländern, in: Udo Ernst Simonis (ed.): Externe Verschuldung – interne Anpassung, Berlin 1984, p. 257 ff.

Thus developments in international markets and the policies of the most important trading partners frequently decide, especially if the country is closely integrated into the world economy, between success or failure of particular efforts developing countries may undertake.

Given these causal links, one has to conclude that although economic development in individual countries is, in the first instance, determined by their own strategies and concepts, it is always also the result of many other – more or less accidental – influences. It would therefore be premature to draw generalized conclusions from one or a small number of “success stories”. As an example, there are also countries with strong price distortions – such as Colombia or the Ivory Coast – where remarkably high growth rates have been recorded.<sup>4</sup>

On the other hand, measures intended to strengthen the role of prices and improve institutional efficiency make sense and can be recommended in all cases. In carrying out the necessary adjustments and associated structural changes, consideration must be given to the specific socio-economic environment as well as to the regional, structural and target group related approaches.<sup>5</sup> This is especially important in the institutional sphere, where unduly hasty changes may generate effects opposite to those one is seeking to achieve. The general policy recommendations below must always therefore be viewed against the specific background in each country and the possibilities which stem from it.

### Price Policy Recommendations

Markets are the most important medium for converting scarcity relationships into realistic prices, which in turn are essential to rational economic behaviour. Under economic aspects, then, unbiased markets are imperative. A central area in developing countries' own efforts ought therefore to involve expanding and strengthening markets together with reducing existing price distortions in goods and factor markets and preventing further distortions from arising. Should pronounced price distortions already be in existence, the attempt must be made to eliminate them in such a way as to avoid negative consequences in the economic and social spheres. A stage-by-stage approach would therefore normally be preferable.

<sup>4</sup> Cf. here and in the following Klaus Fertig; Dietrich Kerschull: *Auswirkungen von Eigenanstrengungen*, op. cit.

<sup>5</sup> Cf., among others, Karl Fasbender, Sabine Wiermann: *Integrierte ländliche Regionalentwicklung* (publication under preparation).

To avoid the development of new price distortions, but also to raise planning security, it is essential at the same time to combat inflation in an efficient way. When regulating the dosage of measures, care must be exercised in considering the consequences for the individual groups within society. Possible negative social and economic effects especially need taking into consideration if inflationary processes have already been in motion for some time and are wide-ranging. When adjustment measures are designed to work over the long term but can be expected to generate negative effects in the short term, the question of political stability is extremely significant for the enforceability of the measures. Instruments which appear to be inappropriate in all cases are price controls and temporary price freezes, as these do not attack inflation at its root causes and therefore only create a backlog of inflationary pressure.

### Exchange Rate Adjustments

A point which appears particularly important is to adjust the currency's external value on a relatively steady basis. A prime reason for this is that the difficulties in making an exchange rate adjustment grow with the duration and scope of the overvaluation typical of most developing countries. In cases of pronounced overvaluation, a procedure involving several phases would appear more promising than one drastic devaluation as a clean break, the idea being not to overburden the domestic economy in carrying out the necessary corrections to productive structures. The best approximation to free-market floating for such purposes seems to be the introduction of a “crawling peg”. From a development policy point of view it is necessary, as it was with the reduction of price distortions, to examine on a case-by-case basis the extent to which the necessary devaluations will have to be cushioned by economic and social adjustment programmes. Thus it is not only monetary institutions which will have important tasks to fulfil in this context.

### Capital and Labour Costs

Matching interest rates to true scarcity relationships ought to serve both the internal mobilisation of savings and an efficient allocation of credit. How great the positive effects of the corresponding adjustments will be depends substantially on the scope and the working methods of the financial institutions.

To promote the accumulation of savings and the provision of loans among the frequently neglected rural

population, decentralization of the banking systems would appear to be essential. This should go hand in hand with relaxation of the high degree of state influence which has so far been evident in the financial sphere. The prerequisites for this are an adequately trained management in the banks and the latter's ability not only to assess risks but also to take them on.

However, to reduce the substitution of capital for labour, not only interest rates but also the level of real wages should be made to reflect conditions of supply and demand. Thus wage increases over and above the rate of growth in labour productivity cannot be recommended. This needs to be taken into consideration when support is given to trade unions and some form of worker participation is encouraged. Furthermore, conditions in the organized and non-organized labour markets ought to match one another.

### **Institutional Requirements**

The significance of institutions concerned with pricing, foreign exchange and monetary policies has already been indicated. For most developing countries, however, it is not solely for the purpose of "administering" price distortions that the reduction of bureaucratic impediments and red tape is essential. The training measures which have often already been introduced for this purpose with a view to improving levels of staff qualification – particularly on the middle levels – are undoubtedly just as necessary as the improvements in work opportunities which are also now in evidence. Nevertheless, without reduction in price distortions and the dirigistic measures associated with them, there remain tight limits to the efficiency of even a qualified administration. In this context, therefore, it appears appropriate to confine the state's activities to tasks which cannot, or not adequately, be performed by the private sector – also with a view to mobilizing private resources.

Tax systems also need to be re-examined with regard to their allocative and distributive effects. The concentration upon indirect taxation and customs duties which has been typical in the past has the effect of distorting prices and fuelling inflation. Import and export duties, in particular, have so far almost exclusively served to provide revenue for the state. However, because they simultaneously restrict the scope for growth to a great degree by inhibiting exports, priority should be given to adapting them to the needs of development policy.

In reforming the tax system in developing countries, stronger emphasis needs to be placed on direct

taxation. In the economically more advanced countries especially, there are substantial untapped reserves here which can be used to mobilize capital for the development process. Direct taxes represent an important means of avoiding the necessity to draw extensive credit from abroad. Of course, this presupposes the existence of an efficient tax administration.

A further area where state institutions play an especially important part is in development planning. The plans they develop influence the decisions of all economic agents. In cases of repeated planning errors the entire economy may be thrown into a state of uncertainty, substantially reducing private business's willingness to become more active. Realistic planning, therefore, which takes account of the special conditions in the country concerned, is just as significant as are clearly delineated areas of responsibility between the planning and implementing authorities and a greater decentralization of decision-making processes.

### **Starting-points for Cooperation**

The general economic setting can either encourage or impede public and private development activities. What is needed in most developing countries – as has been shown – is a reduction in the impediments arising from price distortions in the various factor and goods markets and from the lack of efficiency of development institutions.

The necessary corrective measures usually fall into the countries' very own areas of responsibility. However, the step-by-step reduction of structural distortions and of the one-sided subsidisation of the urban population needs to be cushioned by economic and social measures. Here, as well as in the institutional field, there are both worthwhile and necessary points of departure for intensified economic cooperation between the industrial nations and multinational development organizations on the one hand and the developing countries concerned on the other.

The creation of general economic conditions appropriate to development needs will bring about substantial increases in productivity and growth. This applies also to the agricultural sector. However, for the policy reform to be really successful, it will also be necessary to eliminate the highly protectionist agricultural policies of the industrial countries, which in many cases pose an obstacle to competitive production in developing countries. Thus the demand that these anachronistic agricultural policies be reformed cannot be repeated often enough.