The Director of Central Intelligence

Washington, D.C. 20505

5 December 1984

Dear Alan,

The enclosed is per our conversation of today.

Yours,

Bill

William J. Casey

Dr. Alan Greenspan
120 Wall Street
New York, New York 10005

ECONOMIC FORCES FOR CHANGE IN THE THIRD WORLD

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NIC/AG

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Economic Forces for Change in the Third World

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Key Judgments

Third World economic policies are shifting away from the ideologically-inspired policies of the post-colonial era and toward more pragmatic approaches. This trend began in the 1970s and accelerated in the early 1980s, paralleling similar changes taking place in the industrial world and in China and Eastern Europe. With many Third World governments just beginning to initiate practical and market-oriented policies, this trend probably will be gaining momentum during the next ten years.

During the post-colonial period, many leaders of newly established countries perceived that the poverty of the Third World was a legacy of the colonial period and part of a continuing Western attempt to exploit the Third World through economic means. They viewed strong government control as the only way to achieve economic independence from the West and to solidify their political power at home. Moscow exploited these feelings by offering an alternative which featured the possibility of rapid economic progress through state domination. At the same time, comprehensive central planning in LDCs was widely promoted by Western experts and reinforced by state-to-state economic assistance provided by the West. For many years, this aid and the strong industrial country demand for LDC products allowed many Third World governments to start and operate highly inefficient and often counterproductive state-organized development programs without straining their financial positions.

However, during the past decade circumstances have changed. The LDCs encountered tough economic times: two huge oil price hikes, two recessions, higher interest rates, and massive debt. At the same time, many LDCs began to realize that:

-- Their highly centralized development policies often were a major cause of economic stagnation.

-- They had less global, collective economic power than they perceived in the late 1960s and early 1970s.

-- The Soviet economic system did not live up to expectations, and Communist countries supplied only meager amounts of economic aid and were unable to provide significant alternative markets for LDC goods.

-- The Far Eastern LDCs presented a better economic model to emulate, especially since these countries had been able to cope effectively with the recent adverse external economic circumstances.

-- Prospects for sizable new amounts of Western foreign assistance have dimmed, with aid increasingly going for security assistance, humanitarian purposes, and debt repayment.

In the wake of these changes, the already wide economic disparities among LDCs continue to increase. The poorer LDCs that account for the bulk of the group will have to depend on the emergence of small-scale, domestically-oriented enterprises as their main engine of growth. Few other LDCs, beyond the present newly industrializing countries (NICs), can be expected to achieve the critical economic mass to be able to export sizable amounts of manufactures. It is the lesser developed countries that can least afford the burden of inefficient government bureaucracies and ponderous state enterprises. In many of these countries a response is beginning to take shape. In some cases, large "second economies" consisting of small-scale, often illegal, enterprises are emerging. In other cases, LDC governments are increasingly willing to contemplate and experiment with market-oriented approaches. Within certain constraints, such as the need to maintain central government political control, the private sector is being increasingly allowed to operate independently.

This changing climate presents significant economic opportunities for the United States:

-- To increase the promotion of small-scale enterprises within LDCs and the acceptance and adaptation of new technologies.

-- To enlarge the flow of foreign direct investment, and to help state enterprises to become more efficient and find ways to relinquish some functions to the privator sector.

-- To stengthen its trade, finance and investment links with LDCs based upon a growing mutuality of economic interest.

The shift to more domestically-oriented development also will likely limit North-South trade frictions and help quiet protectionist sentiment in the developed world. Those additional LDCs that do become major exporters of manufactures (including China) will be mainly selling less sophisticated products and, as such, they will be taking away developed country markets from the current NICs.

The increasingly important evolutionary and grass roots development process, however, will create serious difficulties for both developed and less developed country governments.

-- The developed world will face the dual problem of sustaining public interest in this long-term effort and in reordering economic aid programs so that more assistance reaches the small-scale entrepreneur.

-- Third World governments will feel threatened by a loss of control caused by the diffusion of economic power. Many employees of the government and of state enterprises, as well as owners of large private firms with monopoly control over domestic markets, have a vested interest in the status quo. These circumstances will provide opportunities for aroused nationalistic and anti-Western sentiment, domestic political agitation and Soviet meddling.

These forces thus have security implications as well. They should strengthen the West's position relative to that of the Soviet Union in LDCs. Soviet domestic economic and foreign financial constraints over the next ten years will make Moscow even less able to compete in nonmilitary sectors. At the same time, US security interests will often coincide with opportunities for economic support, and security assistance can reinforce the willingness of an LDC to make a change.

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ECONOMIC FORCES FOR CHANGE IN THE THIRD WORLD

1. The setting for developed country policy toward the Third World has changed significantly in the past 10 years. By the early 1970s, a confluence of circumstances began to produce perceptible shifts in the Third World political-economic atmosphere, and in recent years these forces for change have gained momentum. The most notable result has been a tilt of LDC governments toward pragmatic approaches in choosing their economic policies. This Memorandum looks at these changing circumstances, their policy consequences, the new policy opportunities they create, and their impact on East-West competition for the Third World.

The Changing Scene

2. For nearly 30 years after World War II, the political-economic atmosphere in the Third World was influenced by decolonization and unrealistic expectations as to economic outlook. Some 100 LDCs, mainly in Africa and Asia, achieved independence, starting with India in 1947 and essentially ending when the Portuguese African colonies gained independence in 1975.

3. Many of the leaders of these newly independent countries thought that without the colonial shackles and the burdens of Western economic practices and policies, their countries could soon approach the standard of living and industrial prowess of the developed world. Spurred by economic achievements in the USSR, China, and Cuba and bolstered by the dominant elite attitudes in the West, many LDCs (mainly in Africa and South Asia) initiated grandiose development programs that emphasized strong central government control (see

Quotes

Gunnar Myrdal, a Swedish sociologist, was among the most influencial individuals affecting the thinking of LDC and Western government leaders in the 1950s and early 1960s.

"Now, what amounts to a sort of super planning has to be staged by underdeveloped countries with weak political and administrative apparatuses and a largely illiterate and apathetic citizenry. But **the alternative to making the heroic attempt is continued acquiescence in economic and cultural stagnation or regression which is politically impossible in the world today**; and this is, of course, the explanation why grand-scale national planning is at present the goal in underdeveloped countries all over the globe and why this policy line is unamimously endorsed by governments and experts in the advanced countries."

Gunnar Myrdal
Development and Underdevelopment, Cairo, 1956, p. 65. Emphasis as in the original.

The opposite view has long been held by the prominient British Economist, Sir P. T. Bauer, but his beliefs were not widely accepted until recent years.

"The historical experience" indicates that successful economic development in both the industrial and Third World "was not the result of conscription of people or the forced mobilization of their resources. Nor was it the result of forcible modernization of attitudes and behavior, nor of large-scale state-sponsored industrialization; nor of any other form of big push. And it was not brought about by the achievement of political independence; or by the inculcation in the minds of the local people of the notion of national identity: or by the stirring-up of mass enthusiasm for the abstract notion of economic development; or by any other form of political or cultural revolution. It was not the result of conscious efforts at nation building (as if people were lifeless bricks, to be moved about by some master builder), nor of the adoption by governments of economic development as a formal policy goal or commitment. What happened was in very large measure the result of the individual voluntary responses of millions of people to emerging or expanding opportunities created largely by external contacts and brought to their notice in a variety of ways, primarily through the operation of the market. These developments were made possible by firm but limited government, without large expenditures of public funds and without the receipt of large external subventions."

P. T. Bauer
Reality and Rhetoric
Harvard University Press
Cambridge, Mass. 1984, pp 4-5

quotes). This tendency was reinforced by the need to channel government foreign assistance through the recipient LDC government.

4. During the 1950s and 1960s, many Third World countries, after centuries of near stagnation, did make impressive economic progress, as well as achieving considerable improvements in education and health. Many of these gains, were attributable to rising exports in response to the developed world's exceptionally rapid economic growth, and indeed, to increased foreign assistance mainly from the West. These receipts also helped start up and indirectly subsidize the LDCs' state-dominated development programs, many of which quickly became highly ineffective and inefficient and prone to waste and corruption. In this fashion the economic costs of adopting central planning models were largely masked.

5. The pre-1975 years provided considerable opportunities for the Soviet penetration of the Third World. Most importantly, the Soviet system offered a model for centralized control which was important for the many shaky regimes that were trying to consolidate their political power in states lacking established institutions and often torn by tribal, ethnic, or religious strife. By the early 1970s, the Soviets had made many inroads into the Third World, although much less than they might have achieved given their opportunities. Moscow and its surrogates had over 40,000 personnel spread throughout the LDCs. Militarily, the Soviet Navy had secured the usage of harbor facilities, airports, communications stations, or port of call rights with 14 Third World states, while roughly 20 LDCs depended to one degree or another on Soviet troops or military material. (See Appendix A for a description of the Soviet economic role in the Third World.)

6. In many ways, the mid-1970s marked the end of an era for the LDCs and the beginning of a decade of transition. Slower global economic expansion and

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the substantial jump in oil prices greatly exacerbated the already considerable differences in the economic fortunes of LDCs. The newly industrializing countries (NICs) emerged as potent competitors in world manufacturing markets and the standard of living of major oil exporters rose substantially. The NICs and a number of other LDCs were greatly assisted by the enormous transfer of funds to them from OPEC via loans from the Western banking system, and by the negative real interest rates on these loans. The economic development problems of most of the poorer LDCs of Africa and Asia became much more apparent even though they received greater economic assistance from the West and OPEC. Soviet opportunities in the Third World meanwhile became less economic and more security oriented. Moscow took advantage of political circumstances in Angola, Ethiopia, Afghanistan, and later Nicaragua to displace Western influence. Most of the expansion in Soviet economic and technicial assistance went to these countries while aid elsewhere stagnated.

The Newly Emerging Atmosphere

7. One of the most significant consequences of the trends affecting the Third World is a tilt of LDC governments toward pragmatic approaches in choosing their economic policies. Experience gained during the last 30 years is producing a growing realization of the practical constraints involved in fostering economic development and is leading to increased dissatisfaction with centralized economic planning, controls, and intervention, which until the early 1970s had been widely considered the best path to follow. This changing LDC economic environment is being strongly influenced by:

-- Tough economic times. Nonoil exporting LDCs have been hurt by a number of external factors such as much higher oil prices since

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1973, the relatively deep global recessions of 1974-75 and 1980-82, and much higher interest rates since 1980. Also in recent years, the oil exporting LDCs have seen their previously fortunate financial circumstances fade quickly. In many cases, the economic impacts of higher oil prices were delayed through massive borrowing. In some instances, insurgencies and regional conflicts have undermined promising economic circumstances; for example, Lebanon, El Salvador, and Iran-Iraq. Differences among LDCs increased further. The Far Eastern NICs continued to prosper while the major Latin American countries became burdened by a heavy debt load caused in large part by high real interest rates. The kingdoms of the Persian Gulf could absorb the reduced oil earnings while the more populated countries, such as Nigeria, Venezuela and Mexico, found themselves facing financial troubles. The large number of poorer LDCs that are mainly dependent on selling raw materials and foodstuffs were hurt by the reduced demand for their products during the long global recession of the early 1980s and by the low prices that lasted even after recovery was underway. As a result, many of these countries began to really feel the burden created by their highly-inefficient, centrally-directed economies.

-- Slow growth in developed country demand for imported raw materials and tropical foodstuffs. During the 1960s, the demand for industrial raw materials expanded at an exceptionally rapid rate largely because of the torrid economic growth of resource poor Japan. Japanese economic growth cooled after the early 1970s and the worldwide trend toward greater use of synthetically produced industrial raw materials accelerated. Besides the increasing variety of petrochemical products available, ceramics, optic, and carbon fibers are beginning to replace metals in many uses. Moreover, the microelectronic revolution is moving the developed world away from "smoke-stack" industries that are the major users of metals. Demand for tropical foodstuffs, such as sugar, coffee, tea, cocoa, have tended to stagnate or grow slowly.

-- Failure of LDC development policies that emphasize state-owned industries and that are paid for by taxing farmers. These commonly pursued policies had adverse consequences for all economic sectors. Many state-owned industries and organizations became highly inefficient, uncompetitive on world markets, and created a large drain on the government budget. To pay for these outlays, governments heavily taxed the farmer. In turn, the greatly reduced profit potential for the farmer boosted the already sizable migration of people from the rural to urban areas. With the rapid growth of cities, LDC governments found that to stay in office they had to meet the interests of politically volatile city dwellers for cheap foodstuffs. They did so by taxing and pricing policies that further reduced the farmers incentive to produce. As a result, agricultural production slowed, and in some cases fell, and many LDCs found themselves increasingly dependent on imported foodstuffs, especially grain. In addition, to keep prices low in the cities, many governments failed to adjust their overvalued currency and thus hurt their country's ability to export. (See insert 1)

Insert 1

Impact of Low Prices on the Farmer

It is now widely agreed that insufficient price incentives for agricultural producers are an important factor behind the disappointing growth of African agriculture. The importance of price policy comes out strongly in project experience. A 1980 review of 27 agricultural projects undertaken by the World Bank noted "the almost overriding importance of producer prices in affecting production outcome and production levels, often cutting across the quality of technical packages and extension services. Seven out of nine projects implemented under favorable prices achieved or surpassed their production objectives; 13 of the 18 under unfavorable prices failed to do so."

-- Disenchantment with large-scale development projects. Operating and maintaining major development projects often has become a costly burden for LDC governments. The high costs and a shortage of skilled manpower have kept many medical and other social facilites from being used anywhere near capacity. New roads have been allowed to deteriorate beyond the point where they can be maintained effectively. Besides straining the local budget, large amounts of foreign exchange have been needed to pay for the imported goods to maintain roads and other projects--spare parts, machinery, fuel, etc.

-- Fading of the ideological fervor that accompanied decolonization. The earlier era of unrealistic expectations and strong anti-Western sentiment began to fade in the mid-1970s with the independence of the Portugese territories. Also by then most of mining and oil operations that symbolized foreign domination had been nationalized. By the early 1980s, most of the outspoken ideologues of the 1960s had died, had been overthrown or were largely ignored. Most current LDC leaders no longer take seriously global initiatives such as the New International Economic Order. First-Third World discussions on such issues have become backwaters, attracting little serious interest on either side.

-- Recognition of many LDCs that they have much less global economic power than they believed they had in the early 1970s. In those years, many LDCs thought they could emulate OPEC and raise the price of their raw materials. They tried and failed, and in the

Insert 2

Economic Aid and Food Producton in Africa

The decline in African per capita food production occurred over a period when the various governments and external sources of finance focused more strongly on food production projects than ever before. Between 1973 and 1980, about $5 billion in aid flowed into agriculture, $2.4 billion of which was from the World Bank. These projects have so far failed to boost output or have been offset by declines in other parts of the food economy.

early 1980s it became clear that even OPEC could not continuously push up prices.

-- Dimmed prospects for sizable new amounts of foreign assistance. In recent years, few developed country governments have or have been expected to increase economic aid significantly. Besides budgetary constraints, domestic developed country support for such an expansion has waned due to increasing indications that providing foreign aid to poorly managed LDCs does little to spur economic development and can even be counterproductive. (See Insert 2.) Since the early 1970s, an increasing share of the economic aid, and now the majority, is going for security assistance, humanitarian purposes, and foreign payments relief. More recently, the LDC debt crisis has greatly reduced expectations that sizable funds will be forthcoming from Western private financial institutions.

-- Reduced LDC expectations that they could turn to the Soviets for economic help. Many LDC leaders in the late 1950s and the 1960s hoped to follow the economic development models of the USSR, China, or Cuba and anticipated considerable assistance from these countries. It has become clear, however, that these Communist countries are poor examples to follow. They all face serious economic troubles and the Chinese and the East Europeans are turning toward a more market oriented approach. In addition, the Communist countries have supplied only meager amounts of economic aid, and have been unable to provide major alternate markets for LDC goods. By the 1980s, with Soviet economic performance

NICs
(Rapid economic growth & sizable exports of manufactures)

Brazil
Hong Kong
Mexico (a)
Singapore
South Korea
Taiwan

High Income (Above $10,000 per capita)

Bahrain (a),(b)
Bermuda (b)
Brunei (a),(b)
Kuwait (a),(b)
Nauru (b)
Qatar (a),(b)
Saudi Arabia (c)
United Arab Emirates (a),(b)

POTENTIAL NICS
(Below $2,500 per capita)

Malaysia
Philippines
Thailand

Medium Income ($2,500-$10,000 per capita)

Argentina
Chile
Libya (a)
Uruguay
Venezuela (a)

OTHERS
(Populations above 2 million)

Fast Economic Growth(c)

Algeria (a)
Cameroon
Colombia
Costa Rica
Dominican Republic
Ecuador (a)
Egypt
Guatemala
Indonesia (a)
Iraq (a)
Iran (a)
Ivory Coast
Jordan
Kenya
Lebanon
Malawi
Morocco
Nigeria (a)
Pakistan
Panama
Papua New Guinea
Paraguay
Sri Lanka
Syria
Togo
Tunisia
Yemen Arab Republic (No. Yemen)

Slow Economic Growth

Afghanistan
Angola
Bangladesh
Benin
Bolivia
Burma
Burundi
Cent. African Republic
Chad
El Salvador
Ethiopia
Ghana
Guinea
Haiti
Honduras
India
Jamaica
Liberia
Madagascar
Mali
Mozambique
Nepal
Nicaragua
Niger
Peru
Rwanda
Senegal
Sierra Leone
Somalia
Sudan
Tanzania
Uganda
Upper Volta
Yemen, Peoples Democratic Republic (So. Yemen)
Zaire
Zambia
Zimbabwe

MINI-STATES
(Populations below 2 million)

Medium Income ($2,500-$10,000 per capita)

Bahamas, The
Barbados
Cyprus
French Polynesia
Gabon (a)
Guadeloupe
Martinique
Netherlands Antilles
New Caledonia
Trinidad & Tobago(a)

Low Income (Below $2,500 per capita)

Anguilla
Antigua & Barbuda
Belize
Bhutan
Botswana
Cape Verde
Comors
Congo
Cook Island
Djibouti
Dominica
Equatorial Guinea
Fiji
Gambia, The
Grenada
Guinea-Bissau
Guyana
Kiribati
Lesotho
Liberia
Macau
Maldives
Mauritania
Mauritius
Oman
Reunion
St. Christopher & Nevis
St. Lucia
St.Vincent & the Grenadines
Sao Tome & Principle
Seychelles
Solomon Islands
Suriname
Swaziland
Tonga
Turks & Caicos Islands
Tuvalu
Vanatu
Western Samoa.

(a) Major oil exporting country
(b) Also Mini-States
(c) Annual growth of GDP per capita more than 2% from 1960 to 1980.

Figure 2
Developing Countries: Literacy Rate
(Percent of Adult Population)

0-25	26-50	51-75	76-100
Afghanistan	Algeria	Bolivia	Argentina
Angola	Bahrain	Cameroon	Anguilla
Bangladesh	Botswana	Dominican Rep.	Antiqua & Barbuda
Benin	Brunei	El Salvador	Bahamas
Bhutan	Cape Verde	French Guinea	Barbados
Burundi	Central African Rep.	Gabon	Belize
Chad	Congo	Guadelope	Bermuda
Comoros	Egypt	Honduras	Brazil
Djibouti	Ghana	Indonesia	Burma
Ethiopia	Guatemala	Iraq	Chile
Equatorial Guinea	India	Jordan	Colombia
Gambia	Iran	Lebanon	Costa Rica
Guinea-Bissau	Ivory Coast	Lesotho	Dominica
Haiti	Kenya	Malaysia	Ecuador
Liberia	Libya	Martinique	Fiji
Malawi	Madagascar	Mauritius	Guyana
Mali	Maldives	Nicaragua	Hong Kong
Mauritania	Morocco	Peru	Jamaica
Mozambique	Nigeria	Saudi Arabia	Kiribati
Nepal	Papua New Guinea	Seychelles	Macau
Niger	Qatar	Solomon Islands	Mexico
Oman	Rwanda	Swaziland	Nauru
Pakistan	Sao Tome & Principe	Syria	Panama
Senegal	Uganda	Tanzania	Paraguay
Sierra Leone	Zambia	Tunisa	Singapore
Somalia		United Arab Emirates	South Korea
Sudan		Zaire	Sri Lanka
Togo		Zimbabwe	St. Christopher & Nevis
Upper Volta			St. Lucia
Vanuatu			St. Vincent & the Grenadines
Western Sahara			Suriname
Yemen Arab Rep (North Yemen)			Taiwan
Yemen, People's Dem. (Rep. of South Yemen)			Thailand
			Tonga
			Trinidad & Tobago
			Uruguay
			Venezuela
			Western Somoa

(TO BE MAP)

faltering, the free enterprise style of the NICs began to replace the Soviets as the economic model to emulate. For their part, the Soviets further emphasized the security nature of their assistance to LDCs, in part because they had become bogged down in helping their allies and surrogates counter antigovernment forces.

Lessons Learned

8. The changes and experiences of the past 30 years have provided some key lessons about LDC economic dynamics. Most notably, the wide and growing disparity among LDCs has become clear, and the factors influencing economic progress have become better understood. More recently, these two lessons have led many observers to recognize the importance of small-scale enterprises in spuring economic gains, especially in the case of those countries with limited skilled manpower resources.

Economic Diversity Among LDCs

9. Economic differences among LDCs have long been sizable no matter how measured--GNP, per capita income, population, educational attainment, or value of natural resources. During the past 10 years these differences have become more stark and have become greater than those in the developed world. Per capita income, for example, now ranges from $100 (Bhutan, Chad, Ethiopia) to some $20,000 for Persian Gulf sheikdoms. By comparison, the much narrower developed country range is between $5,000 and $15,000.

10. Other areas of considerable diversity include:

-- Literacy . Most countries of Africa's Sahel have literacy rates of 10 percent or less, while the NICs have rates exceeding 80 percent. (See Figure 1)

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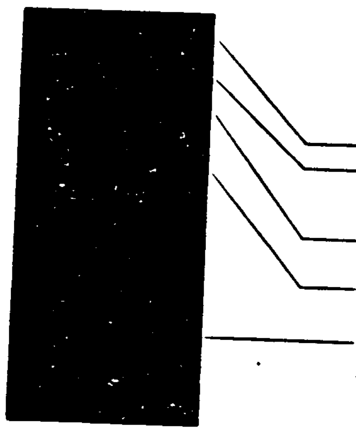
Figure 2
Major LDC Exporters of Manufactures to the Industrial World, 1982

Percent of Total Sales of ~~$62~~ 68 Billion



Value of Exports Billion US $	~~Region~~ Country	Percent of Total
Less than 0.5		10
0.5–1	Thailand, Argentina, Pakistan, Tunisia, Morocco	5
1–3	India, Malaysia, Philippines	10
3–5	Mexico, Singapore, Brazil	19
10–15	Taiwan, Hong Kong, South Korea	56

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-- Population. India has more than 750 million people, and Brazil's and Indonesia's populations top 100 million. More than a third of LDCs have populations of two million or less. Many mini-states have less than a half million people.

-- Exports of Manufactures. The NICs account for more than 75 percent of LDC exports of manufacturers. Only about 15 LDCs sell more than a billion dollars in such goods annually while the vast majority sell less than $100 million. (See Figure 2)

-- Natural Resources. About 15 LDCs have sufficient oil reserves to be major oil exporters, and another 10 countries earn sizable sums from other minerals. Similarly, only a few LDCs have become major exporters of foodstuffs, and most are net importers.

The Important Elusive Elements of Economic Progress

11. Experience during the past 30 years indicates that while the elements of economic progress cannot be easily pinpointed, the most important seem to be those related to societal factors. These are intangible and not easy to quantify. Those countries achieving rapid economic growth, such as the NICs, tend to possess a hard working and well educated labor force, as well as strong entrepreneurial drives which are reinforced, or at least not discouraged, by government actions. Such conditions are particularly strong in the Far East countries of Korea, Taiwan, Hong Kong, and Singapore, whose cultures are based on the values of hard work and heirarchic Confucian traditions of social and political responsibility.

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12. Economic analysis is a useful tool, but no analysis could have predicted that the basket cases of the 1950s (Japan) and the 1960s (Korea) would emerge as industrial powers. No one looking at Peru, even today, would have believed that semiliterate, communally oriented peasants from the Andes would migrate to squatter land in Lima and create a thriving "second economy." (See Appendix B for a series of examples of governments moving toward market-oriented economies or creating them by pursuing ineffective central government policies.)

13. Most of the more precise elements that are usually thought to affect economic progress often are misleading or are replete with exceptions. For example, the sizable amounts of foreign exchange earned from abundant natural resources often have not been a key to development. Countries such as Zaire and Colombia with their large natural resources have failed to show much economic progress, while South Korea and Hong Kong with a paucity of such resources have done extremely well. In fact, an abundance of natural resources often hinders economic development as the largess undermines entrepreneurial tendencies in favor of social-welfare outlays. This so called "Dutch Disease" has inflicted Mexico, Venezuela, and Nigeria.

14. Literacy rates often are an important indicator of a country's ability to make economic progress but not an influence in all cases. Zaire's rate is nearly double that of the Ivory Coast, but the latter is one of the most economically dynamic countries in Africa. Similar discrepencies can be found in the case of foreign direct investment. South Korea has received little of these inflows while the amount going to Mauritania has been rather sizable.

15. Even the degree of government involvement in the LDC sheds little insight. In fact, government outlays as a share of GNP usually rise as the country develops. The share is much higher in Singapore, Malaysia, and South

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Korea than it is in Bangladesh, India, or Paraguay. Government ownership of the steel capacity is as high in South Korea as in India. Yet the South Korean industry is much more efficient than in India. Brazil's economy expanded rapdily during the 1970s, in part because of the growth of its state enterprises. In the 1980s, when the country was seriously affected by a foreign debt crisis, these same enterprises were considered a major economic burden.

16. Some aspects of government involvement in LDC economics, however, are clear:

-- Lesser developed countries (i.e., other than the NICs and other rich LDCs) can least afford the burden of government bureaucracies and state-owned enterprises. These poorer countries tend to end up with bloated bureaucracies, stiffling regulations, and crippling corruption. In India, Liberia, Benin, and Tanzania about 50 percent of the nonagricultural salaried jobs are in government. In Algeria during the 1970s, producers of fruit, vegetables, and grains were strictly forbidden from moving their goods across provincial boundaries, creating considerable supply difficulties. The World Bank found that state-owned enterprises dominate domestic credit markets in poor economies because of their borrowing privileges. In the late 1970s they were responsible for 40 percent or more of domestic credit outstanding in Benin, Guinea, Mali, Senegal, and Bangladesh.

-- The creation of a favorable economic environment by LDC governments is more important in enhancing economic progress than is the share of GNP the government absorbs.

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17. By blending the positive but elusive elements of growth with the considerable diversities among LDCs, such countries can be categorized according to their growth potential, and in a manner that is useful for considering economic policies toward each group. (See Table):

-- The rapidly expanding NICs and the oil-rich countries in the Persian Gulf and elsewhere that have achieved a level of economic sophistication or income that approaches that of the developed world (14 countries). The NICs have economic structures that are at least equivalent to the poorer developed countries such as Spain and Greece. Their exports of manufactures have reached sizable proportions in developed country markets, and they become major growth markets for developed country goods. Saudi Arabia and a few other Persian Gulf countries have become major players in international financial markets as well as in the International Monetary Fund. The links of these newly emerging economic powerhouses with other LDCs are similar to those of developed countries. For example, Brazil and South Korea sell relatively large amounts of manufacturers to LDCs and the Persian Gulf countries are major suppliers of financial assistance.

-- Those LDCs that could within a decade or so reach NIC or high income status (8 countries). Argentina, Chile, Uruguay, and Venezuela have the best resources to expand manufactures greatly. Along with the successful NICs they have a high literacy rate, per capita income levels above $2,500, an abundance of skilled workers, and a sophisticated economic and financial infrastructure. But these countries are going to have to overcome serious past political and economic troubles. Argentina and Chile have been hurt by domestic political problems, and Uruguay by a failure to diversify its exports of manufactures. Venezuela has failed to develop a competitive manufacturing sector because the incentive to do so has been undermined by the many years of high oil income. All four countries have seen their export competitiveness damaged periodically by overvaluations of their currency. The ASEAN countries of Malaysia, Thailand, and the Philippines also have a good chance to expand exports of manufacturers. They have created an environment to follow the path of the NICs. Much will depend on their ability to achieve a sustained period of political stability. Libya could easily become a high income country (more than $10,000 per capita), if the government wisely uses its oil wealth to assist its relatively small population.

-- Those countries with populations of more than two million that seem likely to sustain moderately rapid economic growth--above 2 per capita a year--but are still decades away from developed country status. There are 27 countries in this category; for example, Ivory Coast, Tunisia, Indonesia, and Pakistan.

-- The large number of LDCs (37) with populations of more than two million that remain poor and seem to be making little progress in sparking economic development. Among this sizable group, there probably are a few countries which have the potential to reach the fast growth category. They are the ones that have attained high literacy rates and/or have demonstrated strong entrepreneural instincts for a portion of the past 20 years. These include El Salvador, Jamaica, and Peru. India is a special case because of its sizable population--some 750 million. Certain areas of the country (more populous than most LDCs) have a well developed industrial infrastructure, but taken as a whole, the country remains poor, backward and has a low literacy rate.

-- The many ministates. About 10 of these countries have achieved a middle income level ($2,500-$10,000 per capita) because of tourism, oil refining, subsidies from the French, and being near the United States. Another 40 will have to find special niches in the world economy if they want to achieve higher income levels.

Growing Importance of "Second Economies"

18. In many of the less successful LDCs, ineffective and inefficient state controls and enterprises have led to a rapid rise, especially in the growing cities, of small-scale and often illegal economic endeavors (as retail outlets and transporters of people and goods). These "grass roots" and seemingly chaotic movements in many cases end up providing the best means for economic development. In many cases, "second economies" are producing a vast new class of entrepreneurs and a much broader development process. Although most ventures do not develop beyond a rudimentary state, a number of dynamic medium or large sized businesses emerge, and the process installs more modern business practices that are passed on through family owned and operated enterprises.

19. In addition, this broad-based development soon moves beyond trading. Rather than simply distributing goods bought from others, many traders begin

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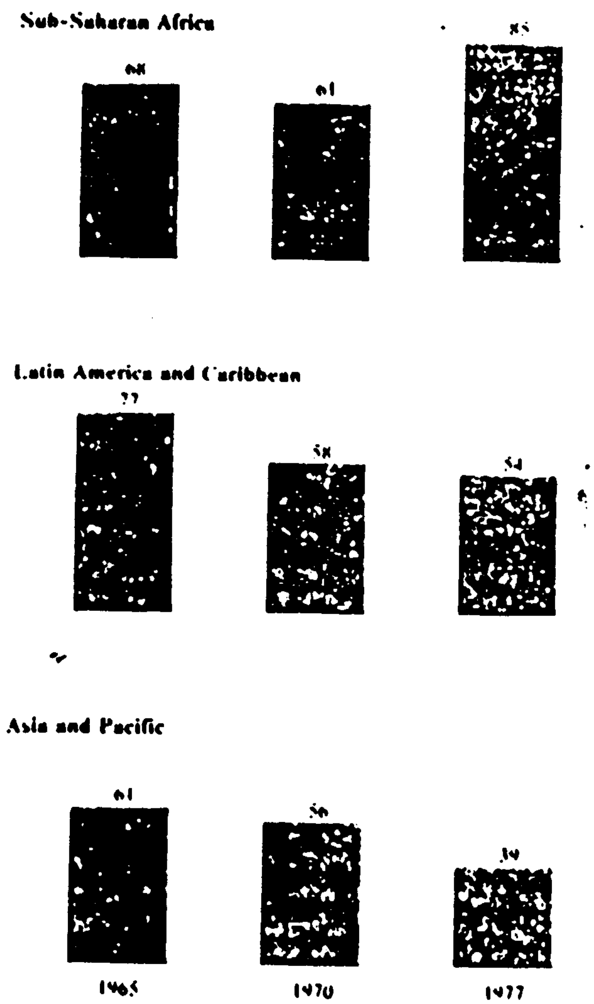
African Dependence on Agricultural Mineral Exports

Many of the countries that will probably continue to specialize in primary commodities are in Sub-Saharan Africa. Indeed, African countries have become more dependent on a small number of commodities for exports in recent years, whereas countries in Latin America and Asia have generally reduced their concentration on commodities. For example, coffee, cocoa, and cotton exports as a share of total Sub-Saharan agricultural exports rose from 46 percent in 1964-66 to 63 percent in 1978-80, and the percentage of countries in which three or fewer commodities account for more than half of Sub-Saharan total exports increased from 61 percent in 1970 to 85 percent in 1977.

LDC Regions: Trends in Commodity Exports Concentration

Percent of countries where three major commodities account for 50 percent or more of total exports



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Illustrations of a growing willingness to make the changes needed to cope with the economic problems ahead.

- African LDCs are finally beginning to realize that many of their past policies have reduced food production and that structural changes will have to be made. Already, state farms have been handed over to private management in Mozambique, and Mali and Zambia increased agricultural prices to encourage farmers to produce more food.

- A major shift occurred in Algerian agricultural and distribution systems in 1980. Free markets were allowed to spring up in all major cities. Land owned by state enterprises were turned over to people who expressed a willingness to develop it. Prices paid farmers are being allowed to rise and consumer subsidies are being cut.

- A new government in Sri Lanka changed economic strategies. Most trade and payment controls were dismantled and the exchange rate was devalued by 44 percent.

- Bangladesh is moving from government to private channels in distributing fertilizer to the farmers.

- State-owned enterprises have been turned over to private firms in Pakistan, Somalia, Sudan, Zaire, the Philippines, Jamaica, and Chile.

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to produce easily made goods, such as clothing, by contracting with individuals to make specified products at home. Later they establish their own manufacturing establishments. Thereafter, small scale machine shops and other support businesses begin to appear to service the burgeoning manufacturing sector. This development process is particularly important in poorer countries lacking natural resources and an highly educated and disciplined labor force.

Outlook

20. We believe the ongoing forces, discussed in the previous sections, will continue to drive LDC economic policies toward more pragmatic approaches during the next 10 or so years. It is very unlikely that developed country economic expansion will return to rates achieved during the exceptional years between 1950 and 1973. For the bulk of LDCs, no new major sources of funding are expected, such as foreign aid, bank lending, or windfall profits from surges in oil prices. Technological changes within the developed world will hold down purchases of many key raw materials, and the global demand for many food items produced by LDCs probably will grow slowly, at best.
(See Insert 3.)

21. In fact, it seems likely that the impact of these forces will grow, and that the trend toward pragmatism will become stronger. The era of more pragmatic economic policies is still in its initial stages but gaining strength. (See Insert 4.) While attitudes clearly have shifted toward more realism, concrete actions are just beginning to be undertaken by LDCs other than the 15-20 that have accepted such ideas for some time. In some cases, a shift is occurring as the old-guard political elite who came to power during the decolonization period are replaced by a new generation of technocrats.

The most dramatic shifts are taking place in countries whose governments previously had been most devoted to centralized-socialistic economic development models--Algeria, Congo (Brazzaville), Guinea, Mozambique, and Sri Lanka. India and Bangladesh are among major LDCs countries moving in the same direction but less dramatically. Moreover, throughout the Third World (as in the First World), LDCs are seriously contemplating ways of reducing the economic and financial burdens created by their highly inefficient state enterprises.

22. The growing economic diversity among LDCs will mean that the important role played by exports will change. As we have seen, beyond the present NICs, few LDCs possess the capabilities to rapidly expand their exports of manufacturers and sell the sizable amounts now being sold by the NICs. Those major LDC exporters of manufacturers (including China) that do emerge will be selling mainly less sophisticated products and moving into developed country markets served previously by the present NICs. The more established NICs likely will continue to prosper by upgrading their product lines. The newer export-oriented LDCs thus will create less contentious trade problems for the developed world than did the present NICs. The NICs meanwhile probably will create trade issues that are much more akin to those contested among developed states.

23. In the rest of the Third World, countries will have to emphasize small-scale, domestically-oriented entrepreneurs as their main engine of growth. Such a thrust is necessary if these countries are going to achieve the critical mass in terms of the elusive elements of economic progress needed to attain NIC status. A study by Jane Jacobs points out that urban areas give rise to economies of scale and concentrations of buyers and sellers which spur savings and economic growth. Nearly all LDCs possess the ability to move in

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Constrasting Public Policies in Tanzania and Kenya

The dramatic impact of government policies is demonstrated in Kenya and neighboring Tanzania. The two countries have similar agricultural resources, traditions, and population growth rates. While its policies have not always been ideal, Kenya has offered its farmers price incentives and an effective market-oriented infrastructure in most recent years. As a result, food production has risen and, in several recent years, Kenya has exported food surpluses. The drought cut last year's crop 15 percent but produced no real food shortages.

In contrast, Tanzania uprooted its scattered farmers and concentrated them in Ujamaa villages--where they were supposed to receive water projects, machinery, and extension and social services. When the government proved unable to provide the services, the result was a sharp drop in farm output and an increase in soil degradation. Production of export crops plummeted as villages increasingly retreated into subsistence production. The resulting foreign exchange crisis is now so severe that Tanzania cannot import food or fertilizer--nor transport either through its countryside.

this direction, although government policies and political upheavals have often thwarted such developments. Entrepreneurs flourished in many West African countries until government policies discouraged their efforts. Central America, especially El Salvador, was beginning to develop entrepeneurial strengths and to achieve considerable economic growth in the 1970s, but these gains were set back by the region's political turmoil. The alternative to greater emphasis on small-scale entrepeneurs is the reliance on state controlled organizations, a practice which many LDC leaders now realize has failed. Thus, it becomes less a matter of "whether" than of "to what extent" market development can occur if economic progress is to take place. (See Insert 5.)

24. By its very nature this largely pragmatic and grass roots economic development process will evolve slowly and will remain much less of a noticeable phenomenon than the achievements of the NICs. The exceptions will be countries--such as Algeria and Mozambique--that are undertaking dramatic shifts from socialist to market-oriented economies. For those governments switching gradually to pragmatic approaches, however, their policy changes will not generate much notoriety. In addition, the gains stemming from the broad based development process are nearly impossible to measure and therefore often ignored. "Second economies" are just beginning to be recognized in terms of their development potential and the cushion they provide during hard economic times. More public notice will likely continue to be taken of the considerable adverse impact of this development process--for example, the poor living conditions in the rapidly expanding shanty towns that surround many key LDC cities.

25. This evolutionary process could threaten LDC governments. Many leaders will fear a loss of influence over their economy. There will be a great

temptation to regulate the proliferation of small-scale entrepreneurs. Government ability to control the increasingly inefficient state economic organizations will be reduced in part because strong vested interests have developed within these organizations that want to retain the status quo. Even more important, the dynamic "second economies" have spawned an uncontrollable economic sector that has become too big to eliminate and too diffuse to control. To many LDC governments, the emergence of these small scale entrepreneurs looks chaotic and provides opportunities for the growth of opposition groups.

26. In many cases, while political control will remain firmly in the hands of central governments (most likely some form of authoritarian power), a division of power between the political leaders and the newly evolving broad-based economic communities will likely develop. The private sector increasingly will be allowed to operate independently of the government as long as its participants do not become involved in antiregime acts or movements. Spain under Franco and Brazil under military rule are prime examples where such a division of interests lasted for many decades and was successful in economic terms. Among other LDCs such a pattern is clearly taking hold; for example, South Korea, Taiwan, Singapore, and Ivory Coast.

27. Although the trend toward pragmatic approaches will likely be unrelenting, it will not always be smooth and will be characterized by occasional setbacks. Within the expected highly unstructured and dynamic development process, the potential for domestic political agitation will remain high. Uneasy governments, especially those that fear losing control over their nation's economy, are likely periodically to fan nationalistic sentiment in an attempt to recoup their position. They will be strongly supported by interest groups in their countries that benefit from the status

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quo. In some countries, the appearance of a large entrepreneurial class, often from a minority group, will accelerate already deep racial or tribal strains. Influences such as excessive religious fundamentalism--as in Iran and Sudan--will set back the achievement of broad-based economic progress. Countries that have some years to go before developing viable political institutions--mainly in Africa--will be most vulnerable to domestic political upheavals. Within this increasingly diffuse and tension laden milieu, the Soviets can easily find groups to do their bidding. Using these groups, the Soviets probably will be able to expand antigovernment propaganda and exploit internal differences.

28. Occasional government attempts to reestablish authority over this amorphous development process also will have a temporary adverse impact on economic development. Experience with such attempts, however, indicates that broad-based development soon emerges with even greater strength, because second economies grow in response to government efforts to interfere with market forces. A Marxist type police state--such as Cuba--is most likely to avoid the more pragmatic development approach for the longest period, but at the cost of scant long-term economic progress and increasing dependence on external economic assistance.

Implications for US and Western Policy

29. The changing political-economic circumstances in LDCs present significant economic opportunities for the United States to strengthen its links with LDCs. This favorable climate essentially arises from a strong and growing mutuality of economic interests. LDC leaders are becoming increasingly aware that their economic fortunes are tied to the West and that the East provides little in the way of a credible alternative. This view is

Insert 6

Some projects guaranteed or financed by OPIC over the past few years, that illustrate the development potential of small investments:

- In Thailand, a project to dry, pelletize, and ship tapioca for export will provide training and employment for 185 people in a poor rural area, transfer new technology, and increase foreign exchange earnings.

- In Costa Rica, expansion of acreage for a tropical houseplant export project will generate some 500 new jobs and is expected to earn $10 million in foreign exchange over a five year period.

- In Rwanda, expansion of a tea factory will create 103 jobs, generate $3.4 million in foreign exchange earnings, and provide an expanded market for 3,000 farmers who belong to the cooperative which sells tea to the factory.

- In Haiti, two plants currently employ more than 400 Haitians who use traditional weaving skills to make parts for high quality office furniture.

- In Pakistan, a project to produce pharmaceutical products will ultimately employ 139 workers and save the Pakistani Government $35 million in foreign exchange annually.

- In the Dominican Republic, expansion of a meat processing plant will provide 51 new jobs and will improve the quality and quantity of meat available to the domestic market, as well as some for export.

- In Sudan, expansion of a small cargo service business will create 26 new jobs and include training and equipment maintenance and operation.

- In Peru, a fish processing plant will produce a high protein food ingredient for local consumption and export and will create 125 jobs in an area of high unemployment, while at the same time generating signifcant foreign exchange earnings.

- In Kenya, a high bread flour and vegetable seed production and processing facility will create some 80 jobs and support government plans to increase agricultural productivity and labor intensive products.

- In Sri Lanka, expansion of a rubber tire manufacturing company will create 92 local jobs and introduce advanced molding technology to the country.

- In the Yemen Arab Republic, a small contract well drilling business will drill, construct, and service water wells for private agricultural and industrial use.

- In Honduras, expansion of a small condiment packing and processing project will create an estimated 30 jobs.

- In Egypt, a plant to assemble electronic video components will provide training and employment for 122 people in a rural area in addition to earning $1.5 million annually in foreign exchange.

- In Guatemala, expansion of a small frozen vegetable processing and packaging business will increase the local network of contract growers by 300 and will generate foreign exchange. In addition the company also provides technical and financial assistance to its network of 1,200 local contract growers.

Insert 7

LDCs: Means of Harnessing the Technology Revolution

- As far as food supplies are concerned, irradiation has the potential to reduce signifcantly spoilage which some experts calculate represents the equivalent of 30 percent or more of total LDC food production.

- A second green revolution could easily be in the offering if the genetic revolution is maintained at its present pace. Improved drought and disease resistent seeds, could not only ensure healthier crops but also could lead to greater growing areas.

- Prospects for irrigation could be greatly enhanced as new technologies are applied to the area of desalinization engineering. This coupled with the greater use of fiber-reinforced long-range piping, could noticeably increase acreage suitable for cultivation in many areas of the Third World at low costs.

- Advancements in biotechnology could ease energy problems in the LDCs. On the one hand, biotechnology has the potential to reduce the need for petroleum as a feedstock for organic compounds. On the other hand, it could aid in oil recovery as microrganisms are developed to lower the viscosity of residual oil and produce carbon dioxide to repressurize wells.

Insert 8

Brazil: A Successful Use of Technology by the Private Sector

In 1975 the international oil situation prompted the creation in Brazil of the National Alcohol Programme-PROALCOOL-to increase the national output of alcohol destined for industrial and automotive use.

Although the government coordinated and provided incentives, in all other aspects PROALCOOL was given over entirely to private enterprise, a unique decision for the otherwise state-controlled energy sector.

The results were impressive. Brazil's alcohol production multiplied 15 times in less than nine years, and in 1984 was equivalent to 127,000 barrels of oil daily or was 14 percent of total oil consumption. This saved US$ 1.4 billion in foreign exchange.

In social terms, alcohol production has been important in improving and developing the country's economy, creating enterprises in new areas, while maintaining social stability in traditional cane-growing regions such as Brazil's Northeast.

A total of 500,000 workers are directly involved with the current alcohol crop, and more indirectly.

strengthened by the tilt of LDC governments toward more pragmatic economic approaches and the continuous expansion of market oriented second economies. Strong ties will continue to exist in the other direction, too, since for most Western developed countries, the LDCs provide dynamic export markets and still play a key role in supplying some raw materials.

Potential Opportunities

30. The possibilities for strengthening developed country ties with the Third World by building on ongoing economic forces can be grouped as follows:

-- Assisting the trend toward a more market-oriented agricultural sector. This possibility is noteworthy in terms of both changes in LDC attitudes and actions taken to remove constraints and burdens on the agricultural sector. In some cases, state operated marketing boards and organizations have been disbanded or allowed to wither. More often, restrictions that hold down the price paid farmers have been removed or liberalized as governments cut consumer subsidies on staple foods.

-- Fostering the development of small-scale enterprises. LDC governments have done little to encourage this possibility, in part because they see such a trend as eroding their political power. Most assistance for small-scale enterpeneurs has been indirect--e.g., improving the country's roads. Often it has involved a negative reaction to government policies--second economies have evolved by selling goods and services at more realistic prices than those set by the government. LDC governments have established a few effective financial and other institutions,

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and Western governments are finding increasing means of assisting private enterprise (OPIC and the IFC for example). The bulk of available funds, however, are still used to back large-scale enterprises. (See Insert 6.)

-- Pinpointing the available technology that could help the two areas above. Significant new technologies are being developed that can be adapted to particular LDC social-political circumstances. Many relate to improving agricultural output or exports--for example, the ability to keep farm goods at peak freshness for longer periods through preservation techniques. Inexpensive or mobile satellite receiving stations are being used in LDCs to improve communications and to tap developed country or local data bases. (See Insert 7 and 8.) By and large, however, the application of new technologies to conditions in LDCs is still in its infancy.

-- Helping state entreprises to become more efficient or finding ways to turn over their functions to the private sector. While this possibility has received considerable attention, actual divestures of state owned enterprises have been limited so far. Many LDC governments are seriously thinking about possible ways of ridding themselves of burdensome state enterprises or of making them more efficient, but they have not found politically or economically feasible means to do so yet.

Insert 9

Major LDC Recipients of Foreign Direct Investment (1980-1982)

Those LDCs receiving more than $200 million <u>per year</u>

Argentina
Brazil
Chile
Egypt
Malaysia
Mexico
Philippines
Saudi Arabia
Singapore

Those LDCs that are receiving foreign direct investment equal <u>to more than 1% of GNP</u>

Brazil
Chile
Egypt
Malaysia
Mexico
Philippines
Saudi Arabia
Singapore
Botswana
Cameroon
Costa Rica
Fiji
Gabon
Guatemala
Oman
Sri Lanka
Tunisia

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-- Finding the means to help the numerous ministates boost their economic activity. Although this difficulty affects many LDCs, the question is being largely ignored. Attracting tourists and becoming an offshore financial center so far have helped some of these small LDCs. Two earlier attempts at forging common markets eventually failed because of political disruptions--East Africa and Central America.

-- Assisting in enlarging the flow of foreign direct investment to LDCs. Many LDC governments have liberalized their investment laws while others have provided greater incentives for the foreign investor. Although the amount of foreign direct investment placed in LDCs has accelerated in the past decade along with improvements in LDC attitudes, the decision to invest still depends mainly on how firms weigh anticipated market opportunities against political risk. (See Insert 9)

-- Encouraging LDCs to recognize the importance of policies that foster entrepeneurs. These would include realistic exchange rates, more open credit markets, minimal regulations, and price and wage controls.

31. Although the new opportunities clearly abound, they will be particularly hard to exploit. LDC regimes will be very reluctant to allow large numbers of foreign experts into the country to assist small-scale enterprises. Even if the foreign presence is small, LDCs will be suspicious of direct foreign contacts with small businesses. Local businessman who have

Kenya: Preference for the State-to-State Aid

President Moi of Kenya criticized the United States as being the "only" donor which attempts to direct resources to the private sector, rather than through the Treasury as other donors do. In a July 1984 discussion with Aid Administrator McPherson, President Moi said "Kenya would not give up control of the movement of grains during the drought." The President said that middlemen traders (read Asians) were "evil."

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monopoly control of some aspects of the LDC economy, a common phenomenon in many LDCs, will also attempt to restrain foreign efforts that could spur potential competitors.

32. Problems will also exist from the developed country point of view. Traditional aid efforts have tended to exclude help for grass roots development. This reflects the natural use of state-to-state channels and the tendency to fund large-scale development projects because the results are clearer to see and easier to measure. State-to-state aid can also more easily be tied to donor country exports, often a domestic political necessity in maintaining foreign assistance spending. In addition, foreign businessmen are not inclined to become involved in helping small-scale operations that are mainly domestically oriented. Finally, the LDC economic gains from this expected development process are likely to evolve much more slowly than the NICs achievements, and will be much less dramatic. The developed countries, thus will face the dual problem of reordering assistance for LDCs and sustaining public interest in the effort.

Impact on East-West Competition for the Third World

33. On balance, we believe the ongoing economic forces at work in the Third World will strengthen the developed West's position vis-a-vis the Soviet Union in that region and somewhat reduce the chances of takeovers by Marxist-type police states or demagogues that would rely heavily on Moscow. While LDC economic links with the developed West will remain strong and probably grow, Moscow will have even less to offer than before:

-- The likely continued poor economic performance of the Soviets (and most of their allies) will make the Soviet economic model even less attractive than it has been for the past 10 years, nor are the

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Soviets ideologically or institutionally equipped to respond to opportunities to assist growth of LDC private sectors.

-- The Soviets will be unable to provide much of a growth market for LDC exports. LDC export expansion will take place mainly in consumer manufactures, and the Soviets are unlikely to purchase many of these items, especially given their expected foreign exchange constraints. Soviet efforts to remain self-sufficient in raw materials will keep purchases of these goods low. Only imports of bauxite-alumina probably will show a sharp rise. While the Soviets will continue to import sizable amounts of grain, such purchases will benefit only the few LDCs that possess an ability to export these amounts, such as Argentina.

-- The Soviet ability to supply oil to LDCs will diminish with slowing domestic production and increased needs at home. While the Soviets will greatly increase the amounts of natural gas they sell, transportation by pipeline restricts exports to Western Europe. Most LDCs on the periphery of the USSR have ample supplies of natural gas.

-- Economic aid provided by Moscow is unlikely to expand significantly. Expected foreign exchange stringencies will seriously limit Moscow from providing any sizable amounts of the most valuable form of aid--hard currency loans. Growing domestic shortages of goods and manpower will limit commodity and project aid.

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34. In sum, Soviet domestic economic and foreign financial constraints expected during the next 10 years are likely to make Moscow even less inclined than at present to accept costly new burdens like Cuba and Vietnam. The Soviets currently are trying to trim outlays throughout their empire and are hesitant in providing substantial economic support for their newest client states--Angola, Mozambique, and Nicaragua. Despite its reluctance, Moscow would supply emergency aid if it thought it was a necessary element in maintaining a pro-Soviet state--for example, the mid-1984 supply of oil to Nicaragua.

35. At the same time, the economic forces at work will mean security issues will play an even greater role than present in the East-West competition for the Third World. Moscow will have to rely even more heavily than it already does on arms and security assistance to sustain its influence in the Third World. The unsettling nature of the broad based development process will make LDC governments uneasy about their ability to maintain power and will probably tilt both developed and Communist aid toward security assistance. Many LDCs will fear real or imagined Soviet meddling. Some will turn to the Soviets for security assistance as a means of neutralizing the suspected Communist interference. Most LDC governments, however, will turn to Western developed countries for finding ways to allow LDC governments to cope more effectively with a development process that increasingly defies control. Often, these security requests will coincide with economic support, and security assistance can reinforce the willingness of LDCs to make a change in economic policies.

APPENDIX A

Changing Soviet Economic Role in LDCs

1. The decolonization period that lasted from 1947 to the mid-1970s presented the Soviets with many strategic opportunities in the Third World. Many leaders of newly established Third World countries had a personnal bias against the West. They perceived that the poverty of the LDCs was in essence either a legacy of the colonial period, or part of the continuing Western attempt to dominate the Third World through capitalistic-dominated institutions. Moreover, many LDC leaders quickly found that they could use the possibility of a Soviet presence to attract more aid from the West.

2. Moscow for its part, could exploit anti-Western feeling by arguing that not only was the USSR not a colonial power, but that its collectivist system represented an effective counter to the Western imperialistic model. Even more importantly, the Soviet system offered a model for centralized control and state domination which was seen by LDC leaders as essential in fractious ex-colonies which were often little more than administrative fictions. State planning was also widely accepted in the developed world as the only plausible development path for LDCs. Finally, Moscow could point to the strong growth record of the Soviet Union--GNP increased more than 5 percent a year from 1955 to 1970--as proof of the superiority of the Socialist model. Rapid Western economic growth during the same period was downplayed by the bias of Third World leaders and the sizable LDC export earnings resulting from the strong Western demand for LDC agriculture and mineral products helped pay for the costs of pursuing socalist policies.

3.. The Soviet ability to use economic means to influence LDCs began to wane soon after the last major decolonization move--Angola and Mozambique in 1974. In many LDCs, the harsh economic realities of development became evident, especially with the ending of the era of extraordinarily rapid economic growth in the Western world. By that time, many of the anti-Western Third World world leaders had left the scene. The more pragmatic new leaders realized that Moscow was suppling meager amounts of economic aid, was unable to supply alternative markets for LDC goods, and was a poor development model to emulate.

4. The picture is clear:

-- Soviet and East European economic aid amounts to less than 5 percent of the assistance provided non-Communist LDCs. Aid from these countries did increase from $0.8 billion in 1975 to $1.8 billion in 1983, but 80 percent of the increase went to new client states of Afghanistan, Ethiopia, and Nicaragua. Aid to other major recipients--India, Turkey, and Iran--stagnated.

-- A similar picture emerges for economic technicans and workers in LDCs. They rose from about 30,000 in 1975 to more than 120,000 in 1984 with 80 percent of the gain accounted for by Libya, Iraq, Algeria, and Afghanistan.

-- The USSR commercial trade with LDCs is much less than that of South Korea and such Soviet trade is equal to only 5 percent of US transactions with LDCs. Only six of more than 110 LDCs export to or import from the USSR more than 10 percent of their total.

-- The more recent poor domestic economic performance of the USSR has undermined its credibility as the socialist model for the Third World.

5. With the Soviet economy likely to grow slowly for many more years, Moscow is likely to be stingy with its economic assistance and to continue to give the bulk of that aid to its allies--Angola, Afghanistan, Ethiopia, Nicaragua and South Yemen. The relatively high costs of maintaining its political position in these countries will mean that there will be little left over for the others. In addition, the Soviet ability to exert influence throughout the Third World will continue to depend heavily on more proven tools--supplying arms and supporting insurgents.

6. At the June 1983 Plenum of the Central Committee, Andropov--replying bluntly to frequent LDC complaints of Soviet tightfistedness in nonmilitary economic assistance--put the Third World on notice not to expect much in the way of such aid from the USSR. This posture, of course, was not intended to signal less Soviet involvement in the Third World. Arms exports--mainly for hard currency--are likely to remain high. But, economic assistance is being channeled even more than before to the USSR's Communist allies and leftist client states.

7. Over the next decade, the USSR will face a policy dilemma--how to maintain a balance between pressure to cut economic assistance to Third World allies and the need to keep these regimes viable. The USSR's reluctance to extend significant economic assistance to its clients is likely to create or exacerbate strains in bilateral relations and could limit Soviet willingness or ability to exploit opportunities in the Third World. Some states--Angola,

Ethiopia, Mozambique, and South Yemen--are unhappy with Soviet stinginess on development aid and are looking elsewhere for help. Although these regimes are tied to the USSR by their urgent need for substantial military assistance and will continue to be dependent for years, Soviet reluctance to furnish meaningful economic aid might provide openings for the United States and other Western states to gain leverage.

Economic* Trade with LDCs, 1983
(Billions $)

	US	S. Korea	USSR	Other Communist Countries*
Exports	65.5	6.8	3.2	7.0
Imports (cif)	94.7	7.4	5.4	6.5

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* East European (Albania, Bulgaria, Czechoslovakia, East Germany, Hungary, Poland, Romania), Cuba, North Korea, Mongolia, and Vietnam

	Exports	Imports
Albania	negl	negl
Bulgaria	0.5	0.5
Cuba	0.3	0.3
Czechoslovakia	1.0	0.6
East Germany	0.6	0.7
Hungary	1.2	1.0
North Korea	0.1	0.1
Mongolia	negl	negl
Poland	0.9	0.5
Romania	2.3	2.5
Vietnam	0.1	0.3
	7.0	6.5

Trade with Cuba, 1982

	Exports	Imports
USSR	3.9	4.5
Other Communist	1.1	1.4
Developed	0.6	0.4
LDCs	0.3	0.3
	5.9	6.6

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* Excludes military

LDC: Economic* Trade with the USSR and Eastern Europe, 1983

Share of LDC Total	LDCs (Number)	LDCs (Percent)
Both exports or imports less than 1%	52	47
Either exports or imports as much as 1.1% - 2.0%	23	21
Either exports or imports as much as 2.1% - 5.0%	18	16
Either exports or imports as much as 5.1 - 10%	12	11
Either exports or imports above 10.0%	6	5
Total	111	100

Eighteen Major LDC Traders with the USSR and Eastern Europe (% of LDC trade)

	Exports	Imports
Afghanistan	55	24
Argentina	23	1
Bangladesh	10	4
Brazil	5	3
Cyprus	6	3
Dominican Rep.	8	negl
Egypt	5	4
Ethiopia	negl	26
Gambia	negl	6
Ghana	34	negl
India	12	6
Iran	N.A	6
Malta	5	2
Morocco	5	8
Reunion	8	negl
Sudan	7	1
Syria	16	8
Uruguay	7	2

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* Excludes military

USSR Economic* Trade with LDCs, more than $150 million, 1983

	Exports (% of total)		Imports (% of total)
Afghanistan	5	Afghanistan	4
Brazil	5	Argentina	32
Egypt	5	Brazil	13
Ethiopia	7	Ghana	5
India	30	India	15
Iran	17	Malaysia	6
Morocco	7	Singapore	4
Others	24	Syria	4
		Other	17
Total Value	$3.2 Billion		$5.4 Billion

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* Excludes military

Soviet and East European Economic Credits and Grants drawn by LDCs

	1975	1983 (Billion $)	Change 1975 to 1983	(Percent of Total)
Afghanistan	negl	0.4	0.4	40
Egypt	0.1	0.1	-	
Ethiopia	negl	0.2	0.2	20
Nicaragua	negl	0.2	0.2	20
Nigeria	negl	0.2	0.2	20
India	0.1	0.1	-	
Iran	0.1	0.1	-	
Turkey	0.1	0.1	-	
Other	0.4	0.4	-	
	0.8	1.8	1.0	100

Soviet and Eastern European Economic Technicians and Workers in LDCs

	1975	1984 (Thousand)	Change 1975 to 1984	(Percent of (Total)
Afghanistan	0.9	5.3	4.4	5
Algeria	5.6	11.4	5.8	6
Angola	negl	3.5	3.5	4
Iraq	2.6	15.3	12.7	14
Libya	5.8	54.7	48.9	55
Nigeria	0.2	6.4	6.2	7
Other	17.4	25.2	7.8	9
	32.5	121.8	89.3	100

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Appendix B

Case Studies

Governments can provide incentives for the development of an indigenous economy or can provide such a stifling economic atmosphere that an illegal "second economy" arises so that the populace can earn a livelihood. South Korea, Taiwan, and Ivory Coast are examples of the former, Peru and Burma of the latter. China has features of both as its partial liberalization has created a sizable second economy. Case studies of Peru and China are shown below.

Peru

1. Peru today is an exceptional example of the ability of an indigenous market economy to take root without any external advice or assistance in a developing country environment that is essentially hostile to its growth. The Peruvian economy and society have traditionally been defined by two major forces. In the urban areas, the direction of industrialization has been set by privileged, conservative oligarchs who operate highly protected and subsidized industries for which the government has erected legal barriers from both internal and external competition.

2. The poor in the rual areas, on the other hand, come from a tradition imbued with the Inca mentality of collectivism and cooperative undertakings. Indeed, this fact has been well exploited by the leftist groups including the Sendaro Luminoso (The Shining Path) who have used traditional economic patterns as a basis for modern Marxist prescriptions and recruitment.

3. Interestingly, however, both the left and the right agree on a dominant role for the government in economic affairs, and both have cooperated in attacking the growth of economic liberalism. When the rual poor arrive in the cities, however, they find access to the legal marketplace barred by a dense bureaucracy that favors the entrenched businessmen of the traditional private sector. After actually going through the required 310 legal steps to set up a small clothing enterprise, someone without experience or political connections would have to work 40 hours a week for more than six months, and pay eight unavoidable bribes, merely to register to do business. Rather than lose themselves in this legal morass, most poor immigrants to Peru's cities ignore the law and earn a living in the informal sector. Today, two out of every three urban workers are employed in this sector.

4. In this environment, a second economy has grown to the point that it is now nearly 50 percent larger than the legal economy. Although the small independent entrepreneurs involved in this illegal economy have no recourse to the established legal or banking system, rarely own the land on which they build and work, and receive no government incentives, they dominate the economic life of the country. The second economy assembles cars and builds the machine tools needed by the automotive industry. It operates nearly all public transportation, including 85 percent of the bus system. About 90 percent of the clothing business and 60 percent of housing construction is in this system. None of these activities are in any way subsidized, thus the only justification for their existence is earning a profitable livelihood. A majority of workers now go to work in the second economy where wages are comparable with the legal economy.

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5. Perhaps most interesting is the land situation. In Peru, most land is government owned, and most of the millions of migrants are squatters on government land. Yet squatters build houses and even office buildings, and a majority of new construction is on untitled squatter land with nearly half of Peruvian housing construction done by illegal contractors.

6. It is important to examine the means by which this second economy can operate and grow:

-- It has established a financial system, which despite higher risks (and thus costs) and the lack of access to capital markets, grows apace with that of the formal banking system.

-- While there is no formal court to adjudicate commercial or land ownership disputes, there is an underground system which functions fairly and effectively using "moonlighting" judges, working for a fee paid by both sides.

-- In spite of the absence of legal title to land, there is a system of deed registration which allows "title" to squatter land that can be used as collateral for loans from "banks" and even passed on to ones heirs. Indeed, even prime street vending spots are registered and can be bought, sold, or used as collateral. These spots have sold up to $750.

7. This transformation has taken place without government paternalism and central planning, without a formal financial and legal foundation, and without even a philosophical tradition of capitalism. There is no Peruvian Adam

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prohibitive red tape and government regulation which are extremely costly to the people of Peru.

China

8. In 1978, the third plenum of the 11th Central Committee began a process of reform that is increasingly unleashing market forces in the Chinese economy. In China's rural areas, "responsibility systems" were introduced which permitted farmers to sign contracts with the state on what they would produce and market surplus production freely. This has resulted in an economic boom in the countryside. In the past three years agricultural production has increased by over 30 percent even though the sown area in grain has been reduced. Rural income has jumped rapidly.

9. Reform of the urban industrial economy lagged behind, though the stage was being set for change there also. On 20 October 1984, the third plenum of the 12th Central Committee issued a "Decision on the Reform of the Economic Structure" which, if carried out as planned over the next five years, will change the face of Chinese socialism. The economic system most likely to emerge will mix free market regulation with Soviet-style planning in a fashion similar to that of Hungary.

10. This decision aimed reform at four undesirable features of China's Soviet-style planned economy: (1) the lack of clear distinction between functions of government and industry; (2) excessive and rigid state control; (3) an inadequate role for prices and markets; and (4) the practice of "absolute egalitarianism." What Beijing envisions is an economic structure where major assets continue to be state owned, but where enterprise managers are free to respond in a competitive way to market signals.

11. Under the new system, state guidance will become "rough and flexible" but enterprises will have far greater managerial responsibility and will be responsbile for profits and losses. Enforcement of state guidance plans will be accomplished mainly through the use of economic levers such as interest rates, bank lending policies, and taxes. Besides issuing the general plan, the state will continue to appoint and remove key enterprise managers and will determine which firms will be subsidized and which will be forced to merge or shut down when financial problems arise. Consequently, Beijing will retain considerable control. Nevertheless, enterprises will have much more control over what and how much they produce, their finances, and over hiring and firing workers, and even setting product prices.

12. The key to the reform is overhauling China's irrational price structure. Beijing will gradually reduce the number of items subject to state-set fixed prices, except for some essential products. Prices will be allowed to float, but only in an incremental way, since the regime wishes to avoid panic buying, or hoarding and speculation. Gradually Beijing hopes to bring its raw material and energy prices into line with world prices.

13. What about the rise of the second economy? Marxist rhetoric precluded the Chinese from admitting its existence prior to the reforms, but evidence now suggests that it is becoming increasingly prominent. The large numbers of trials and executions in China for "corruption" show that fairly large amounts of money and commodities have been involved.

14. The unleashing of private entrepreneurship has contributed to the second economy, since many entrepreneurs take advantage of the state marketing system to illicitly acquire goods for private sale. An elaborate system of kickbacks has been established so that workers in the state system can also

profit. While there are no figures available on the size of this economy, those who have lived and traveled in China report that it is widespread.

15. We can expect that the urban reforms will enhance this tendency. Because the overall scheme will remain socialist in nature, the market and private forces that coexist will enable clever entrepreneurs to enlarge the second economy. There is every reason to expect that the Chinese of China will be just as effective as the Chinese in the rest of Asia at finding ways to make money.