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ECONOMIC DEVELOPMENT AND FINANCIAL INSTITUTIONS

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I. Introduction

There has been relatively little effort in the literature to systematically deal with the role of financial institutions and policies in the context of development.[1] Not unlike conventional macro-economics focussing on the mature industrial world, such considerations customarily assume their place in the sun mainly when we enter into discussions of the short run but are relegated to a separate and unequal status in considerations of the long run. Admittedly, business cycle problems rear their ugly head in both the rich and the poor countries; but their importance in the supply-constrained Say's Law environment of the developing world is surely much smaller--and thus the cost of the relative neglect of the financial dimension much larger.

We can perhaps achieve agreement on this without too much difficulty; but where to start and how to insert the analytical scalpel is quite another matter. This paper is not so presumptuous as to attempt a specific answer; it is intended to do little more than suggest one possibly fruitful avenue of approach. The heart of that approach is a plea for more historical and typological sensitivity. There is, we believe, relatively

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[1] For some of the few exceptions, see Raymond W. Goldsmith, Financial Structure and Development (New Haven: Yale University Press, 1969); J. G. Gurley, "Financial Structures in Developing Economies," in David Krivine, ed., Rehovoth Conference on Fiscal and Monetary Problems in Developing States (New York: Praeger, 1967); Ronald I. McKinnon, Money and Capital in Economic Development (Washington: Brookings, 1973); H. T. Patrick, "Financial Development and Economic Growth in Underdeveloped Countries," Economic Development and Cultural Change, January 1966; Edward S. Shaw, Financial Deepening in Economic Development (New York: Oxford University Press, 1973).

little mileage in analyzing the role of financial institutions in "the" developing economy irrespective of time or place. In fact, an awareness of such typological and/or historical differences may be an essential ingredient if we are to be in a position to treat the financial sector as an integral part of the development problem rather than as an isolated, if fascinating, afterthought.

We take as our starting point Kuznets' apt definition of the development problem as an attempt at transition from a long epoch of agrarianism to a long epoch of modern growth. Such a transition, if successful at all, is likely to last 20 to 50 years or more and is itself, moreover, likely to be composed of a number of distinct sub-phases during which the developmental characteristics of the society undergo substantial change. Specifically, developing societies seem to first move out of dependent (or colonial) agrarianism into independent (or post-colonial) primary import substitution; from there into either secondary import substitution or export substitution; and finally, if successful, into modern growth. Each phase or sub-phase, moreover, has differing requirements, if transition is to be achieved, with reference to the nature of the appropriate financial institutions and policies.

This is the basic framework within which we will be operating. We hasten to reassure the reader on two counts. One, we do not believe in any "inevitable" historical stages of growth; however, if one does observe marked changes in endowment, in the pattern of resource utilization, and in policy over time indicating gradual changes of the rules of the game, there is no reason to permit the ghost of Rostow to forever scare us off. Secondly, we recognize that "natura non facit saltum"--not even when countries

would like to--and that the movement from one sub-phase of growth to another must be viewed not as a quick orderly switch but rather as a gradual and irregular transition over a period of years, with many characteristics remaining unchanged, with others changing randomly, and only the behavioral center of gravity undergoing predictable variation.

In Section II we briefly describe the main outlines of the typical LDC transition process in the ideal sense and then attempt to relate it to the idealized changing role of financial institutions and policies. Historical Japanese and contemporary Taiwanese experience will be viewed as a proto-type. Section III is devoted to an analysis and explanation of the preponderance of real world deviations from this ideal pattern--on both the real and financial fronts. Philippine and Brazilian experience will be cited. Section IV, finally, is devoted to a summary of findings and to the conclusions for policy emanating from the analysis.

II. The "Deviant" LDC in Transition

The curtain of historical development may be arbitrarily raised on the so-called colonial agrarian epoch when the overseas territories have already been impacted by the investment, trade and (sometimes) political and military presence of the (then already advanced) Western world. The essential, necessarily caricatured, characteristics of that period include the existence of a raw materials or minerals intensive export-oriented enclave, complete with ancillary services and (limited) auxiliary industrial activities, side by side with a relatively large and relatively stagnant food producing agricultural hinterland. The proceeds of this natural resources-based export activity are deployed in part to finance the luxury

consumption needs of the domestic and foreign elite, in part to provide industrial consumer goods to help pull workers out of subsistence agriculture and into enclave activities, and in part reinvested in the further expansion of these activities--or reinvested abroad.[2]

The financial structure to accommodate the requirements of such a dependent economic system are as quickly summarized. With respect to the larger, relatively stagnant, agricultural hinterland, any system approaching the "circular flow" of the physiocrats makes minimum demands on financial institutions and policies. This is not to deny that the absolute volume of traditional finance for traditional purposes may be substantial in toto. To the extent domestic trade gradually expands, the demand for capital other than of the traditional wages fund variety, of course, also expands, e.g., for roads, transport, marketing facilities, etc.[3] But while the money economy is bound to be gradually displacing pure barter, to the extent little is happening on the real side, little is required on the financial side, either to lead or to accommodate.

Most of the dynamic activity--both real and financial--is focussed in the export enclave and those services and industrial activities which facilitate its functioning and expansion. An important component of that accommodating service sector activity is, in fact, the banking function, sometimes tied up

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[2]Whether or not net foreign investment takes place, or capital is repatriated, depends mainly--aside from political considerations--on the foreign demand prospects for the enclave product, relative to other opportunities facing the foreign investor. Moreover, as McKinnon has pointed out, "insofar as indigenous individuals in the colony participated in the process of bank intermediation, they were depositors rather than borrowers" (McKinnon, op. cit.).

[3]See Fei and Ranis, "Economic Development in Historical Perspective," American Economic Review, May 1969.

with management and enclave operations in the form of the East India Company proto-type--as a forerunner of the modern multinational corporation--more often an expatriate specialized bank at the service of the exporting and investing elite, foreign and domestic.[4]

For our purposes the colonial agrarian epoch is of interest mainly by way of contrast with what follows. Once political independence is achieved--after World War II in most developing countries, earlier in Latin America--governments almost invariably attempt to restructure colonial production and trade patterns to facilitate national development. This effort most often takes the, by now well-known, form of a primary import substitution sub-phase. The overriding objective becomes the creation and/or expansion of the industrial sector, especially in previously imported consumer goods, and of the services and overheads required to facilitate that expansion. The main tool is government's acquisition of control over the traditional export earnings and their reallocation to industry and overheads via exchange controls and licensing. These are the bare essentials of import substitution. Usually they are accompanied by substantial protection of the fledgling industries, either via tariffs, more often via import quotas, accompanied by expansionary fiscal and monetary policies and associated with inflation and an increasingly over-valued exchange rate--all intended to drive complementary domestic resources into the same hands.

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[4]Foreign branch banks were integrated exclusively into the system of the metropole (see E. Nevin, Capital Funds in Underdeveloped Countries: The Role of Financial Institutions, St. Martins Press, London, 1961).

Much has been written in criticism of the import substitution policy syndrome in developing countries.[5] We do not wish to add to it here. But, faithful to our historical perspective, we will simply assert that such a sub-phase is likely to be an important ingredient for a successful transition to economic maturity whenever entrepreneurial capacity is initially weak and physical (especially rural) infrastructure deficient. In other words, we believe that an infant industry/infant entrepreneurial argument in general has merit and that much of the criticism of import substitution along the Little-Scitovsky-Scott lines is really--and quite properly--directed towards the question of how much, what kind, and for how long.[6]

If that is the case, we can proceed to the question of the appropriate role of financial institutions and policies in the context of the primary import substitution sub-phase of transition. The banking system clearly represents an important additional instrument in the government's effort to shift resources, domestic as well as foreign, into the hands of the nascent industrial entrepreneurial class (or possibly into the government's own hands wherever the public sector is involved in overhead construction and/or in directly productive activities). It accomplishes this, in part, by holding government debt and assuming the role of docile partner to government deficit financing efforts. Floors

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[5] See, in particular, Little, Scitovsky, and Scott, Industry and Trade in Some Developing Countries--A Comparative Study, Oxford University Press, 1970. Also, Benjamin Cohen and Gustav Ranis, "Import Liberalization and Growth: The Second Post-War Restructuring," in Government and Economic Development, G. Ranis (ed.), Yale University Press, 1971.

[6] For a fuller statement, see the author's "Relative Prices in Planning for Economic Development," in International Comparisons of Prices and Output, D. J. Daly, ed., NBER, 1972, as well as the exchange with Eckstein, Ruggles and Stolper which follows.

are often placed under banks' holdings of "safe" low interest government bonds and ceilings on their holdings of other "unsafe" assets to accomplish this purpose. In this nominal sense financial institutions accommodate the government's needs, usually in the absence of an adequate fiscal capacity, to force some saving via the process of inflation and to simultaneously shift the functional distribution of income in favor of profits.

Interest rate policy represents another important instrument in the arsenal of import substitution. By keeping official rates low (often negative in real terms) governments claim to be encouraging overall investment (which, given the customarily high marginal efficiency of capital, is doubtful) while channeling the limited credit available into the hands of the new industrial elite. The Central Bank similarly shifts the foreign exchange proceeds, which must now be surrendered, to the same favored class at artificially low (overvalued) rates of exchange. There is an attempt to bring in as much foreign capital as possible--initially, aid and, increasingly with time, private capital on very favorable terms.[7] The financial system thus serves the import substitution regime's main purpose of shifting resources and providing unearned profits to the new consumer goods industries.

During this period there clearly exists a premium on "getting things done," with relatively little concern with its level of efficiency or inefficiency. It is the brute act of saving and its redirection which is the

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[7]The incentives given to private capital during this period often far exceed what is required to attract it, and carry the seeds of later dissatisfaction and conflict. For a fuller analysis, see the author's, "The Multinational Corporation as an Instrument of Development," in The Multinational Corporation and Development, Lewis Goodman and David Apter, eds., forthcoming, 1976, Yale University Press.

overriding objective, not the finer points of efficient allocation and management. Traditional raw material exports--supplemented by foreign capital--continue to provide the main foreign exchange fuel for the primary import substitution industrialization process. Domestic saving emanates from the direct reinvestment of industrial profits and from the surpluses generated by agriculture. Even the less extreme import substitution policy packages, if not single-mindedly industry-oriented, tend to discriminate against domestic food producing agriculture--e.g., via unfavorable terms of trade, infrastructural neglect, overvalued exchange rates, etc.; consequently, the contribution of agricultural saving, the main source of household saving, is likely to be limited.

More modest or flexible manifestations of primary import substitution, such as experienced by Japan in the latter half of the nineteenth century,[8] or by Taiwan in the 1950's, are, on the other hand, quite consistent with substantial increases in agricultural productivity and the substantial contribution of agricultural saving from the beginning. Nineteenth century Japanese agricultural surpluses, either captured by the government via the land tax or channeled through private hands, provided the lion's share of the system's investment funds, especially in the early years.[9] But the heavy Japanese attention to food producing agriculture, even during import

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[8]The "mildness" partially enforced by extraterritoriality which restricted Japan's ability to maintain high protective tariffs. And, perhaps luckily for Japan, Schacht had not yet been born.

[9]The land tax, for example, provided more than 70% of total government revenue in the 1870's and 1880's and rent, mostly non-consumed, close to 60% of net agricultural output. (See G. Ranis, "Financing Japanese Economic Development," Economic History Review, XI, No. 3, 1959.)

substitution, transmitted also to her colonies, seems to be rather unique.

Private saving in agriculture, if it does make a contribution, will, of course, continue to do so mainly in the form of direct investment in tangible assets such as the improvement of land via levelling, draining, etc., and the construction of other mini-infrastructure. As in the Robinson Crusoe case, in the absence of much agricultural-non-agricultural sector interaction, the preponderance of financial intermediation in this sub-phase is likely to proceed via the individual himself, or his family, and substantially back into agricultural activity. If food producing agriculture is relatively dynamic, as in Japan, some of these savings will flow into non-agricultural rural activities, for example, into silk production, cotton weaving, etc., which constituted more than 30% of the income of Japanese farmers by the end of the 19th century. In either case, the financial intermediation effort is focussed on the quantity of savings-investment, not on its quality. After all, we do not know how good Crusoe was at constructing his first fishing rod.

As is well known, this primary import substitution sub-phase of transition growth is bound to run out of steam sooner or later as LDC domestic markets for consumer goods are gradually exhausted. It is at this juncture that the society typically faces the crucial decision of whether or not to gradually shift to a non-traditional industrial export orientation, or to persist with import substitution, this time of the secondary variety--including capital goods, consumer durables and processing industries.

If recent LDC history is any guide, the majority of developing societies seem to prefer remaining on an import substitution course--if at all possible. Especially if the natural resources base is sufficiently

strong to continue to provide the fuel for this ever more capital and technology intensive process, such a societal choice is very understandable since it presents the path of least (especially political) resistance. Strong vested interests such as the new urban industrial class benefitting from the high temperatures of the import substitution "hot house," and the civil service whose power (and sometimes income) derives in large part from the typical control system are naturally loath to give it up. As long as the natural resources don't give out--either on the (domestic) supply or (foreign) demand side--growth can thus be maintained--even though, at least for the labor surplus economy, it becomes ever more inefficient. However, the costs of continuing this strategy in terms of such other increasingly important development objectives as the reduction of under-employment and income redistribution, may rise over time.[10]

In Section III, we intend to further analyze the situation in the preponderant (non-deviant) majority of contemporary developing countries which seem to have chosen secondary import substitution. But first it is, we believe, instructive to deal with the path a few deviant countries have taken at the end of their primary import substitution sub-phase, namely that of export substitution, or a shift to non-traditional exports of the labor-intensive industrial type. Japan in an earlier day and Taiwan more recently undoubtedly chose this path, mainly under the pressure of their

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[10] Much more could be said on this important subject but this essay is not the place. See, however, Chenery, et. al., Redistribution with Growth, Oxford, 1974.

fundamental long-term natural resources scarcity. It is this direction which we consider "ideal" for at least the garden variety of labor surplus developing countries--even those, like the Philippines, and much of Latin America, with a substantially better natural resources base--and which requires, in turn, "ideal" changes in their financial institutions and financial policy framework.

The export substitution sub-phase is most easily--and briefly--described in relation to the presumed change in the economy's capacity to participate in international trade on a more competitive basis. If the major intended purposes of import substitution have indeed been achieved, i.e., the maturation of a newly emerging industrial entrepreneurial class and the construction of missing infrastructure, e.g., in agriculture, in the field of financial intermediation, and elsewhere, the economy should now be ready to increasingly expose itself to competition in the international markets for industrial consumer goods.

Such changes cannot realistically be effected overnight, nor are zig-zags of policy and performance likely to be avoided; but the overall tendency is clear; if the infant industry argument has merit, the labor surplus economy should increasingly be in a position to shift from traditional land-based to non-traditional labor-based exports in its foreign trade and to a substantial increase in the level of mutual interaction between agriculture and non-agriculture on the domestic front.

The changes in the general policy package required to accommodate this change in the production and trading pattern are equally clear: gradual liberalization of a number of markets previously controlled,

directly or indirectly, by government, mainly on behalf of the new industrial class. Specifically, we would expect foreign exchange controls to yield to tariffs, and tariffs in turn to be gradually lowered, while the exchange rate is initially devalued and then maintained at a more realistic level (if necessary, by frequent quasi-routinized, e.g., quarterly, adjustments); simultaneously we would expect there to be less need for deficit financing as both the government's tax base and fiscal capacity and the system's voluntary saving potential increase--hence a reduction of inflationary pressures; finally, and most important from the point of view of this paper, we would expect monetary reform to take place, focussing on substantially higher rates of interest and the consequent reduction of subsidies and the role of credit rationing in investment decisions.

With the reduction of inflation and monetary reform yielding more realistic real rates of interest, the differentials between official credit markets and the unofficial or "parallel" markets are bound to diminish, and the scope for an expanding network of financial intermediation likely to increase substantially. With domestic credit as well as foreign capital now priced more realistically, the market can be expected to have a larger (though still by no means exclusive) hand in determining allocations and enterprise survival patterns.

All this, of course, depends on the existence of the proper dynamically flexible institutional framework--whether it is to lead or to accommodate the increased desires of households and unincorporated businesses.[11]

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[11] See Patrick's distinction in "Financial Development and Economic Growth in Underdeveloped Countries," op. cit.

Government intervention, in fact, shifts from the force-feeding of designated industrialists, via the assignment of unearned profits, to the subsidization of a more and more varied and sophisticated institutional construction program by the public sector. Increasingly as the real economy becomes more export and efficiency-oriented, the brute act of saving, fairly well served by intermediation through the family in agriculture and by the reinvestment of industrial profits in both rural and urban industry gives way to the need for greater efficiency in the allocation process. This is tantamount to the increased need for a specialized financial intermediation network serving the ever more demanding requirements of differentiated industrial activities. To return to our homely Robinson Crusoe analogy, interdependence in a competitive inter-island market would sooner or later require him to seek out efficient investors to match his saving effort.

If markets, especially foreign, are to be continuously expanded, the system will require an equally expanding and increasingly specialized financial intermediation network. Specialized banks, insurance and pension funds, savings and loan institutions--finally even bond and stock markets--can be expected to increase in importance as the portfolio needs of savers become more and more sophisticated and the distance between them and the equally more sophisticated investors grows. Thus, the relationship between money, quasi-money and GNP and that between the assets of all financial institutions and GNP, Goldsmith's financial intermediation ratio, are all likely to rise in periods of rapid LDC growth, as the economy makes its way through export substitution to economic maturity. While Goldsmith is not sure about the

direction of causality, he has found that the rate of growth of financial intermediation is positively associated with the rate of growth in real terms.[12]

Japan's historically mild import substitution during the early Meiji period gave way to an increased export orientation, accompanied by a larger role for market forces, near the turn of the century. While raw silk was the main export crop initially, cotton textiles constituted 35% of her total imports, and Japan did not become a net exporter of cotton yarn and cloth until about 1900. The policy shift from government ownership of major industries and the favoring of large scale private industries via subsidies and preferential interest rates took place during the same period. Japanese experience illustrates that, if the period of protection under mild import substitution is used well, much of the infrastructure required for later successful export substitution will have been laid and can continue to be gradually expanded thereafter. One example, of course, is in agriculture where early public sector irrigation, research and education investments had a substantial and sustained pay-off. Another is in the area of the creation of an appropriate financial infrastructure. Postal savings were organized early in the Meiji period, taking advantage of the well-understood (and trusted) functions of an integrated national postal system. Small savers in large numbers (if not large amounts per capita) were attracted by this form of intermediation which, along with the land tax, helped finance government infrastructural expenditures. Increasingly in the course of

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[12]See Raymond W. Goldsmith, op. cit., p. 48.

the 19th century, public and private commercial branch banking was established in rural areas,[13] savings banks spread, government bonds were issued to households (instead of only to banks) and an increasingly diversified banking system took shape. Special banks were created for foreign trade, for longer term investments in overheads, in industry and in the colonies. As Patrick has pointed out: "between 1868 and 1914 Japan's financial system... developed rapidly into a modern, pervasive, variegated system, providing a wide spectrum of financial services."[14]

The effective channelization of agricultural surpluses, aided by substantially positive real rates of interest (see Table 1), continued to be important in Japan after the turn of the century. The agricultural sector remained a substantial net contributor to non-agricultural investment and, increasingly, industrial profits as well were committed to financial intermediation, especially via banks, in place of the virtually exclusive pattern of the reinvestment of industrial profits of the 19th century. On the other hand, we may note that securities markets and corporate bonds played no major role until after World War II.

The successful overall performance of the Japanese economy during this period is well known. Agricultural labor productivity increased in a sustained, if unspectacular, fashion throughout the period, as did GNP (see Table 1), keeping well ahead (low rates of) population growth.

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[13] Sometimes in the form of "quasi-banks" which were multi-purpose institutions growing out of trade and cash crop related credit advances.

[14] H. Patrick, "Japan, 1868-1914," in Banking in the Early Stages of Industrialization, Rondo Cameron, ed., New York: Oxford University Press, 1967. This seems to be borne out in current unpublished research by Goldsmith. See also the high level of monetization (not including time deposits) reflected in Column 1, Table 1.

Table 1

JAPAN

5-Year Moving Average Centered on	M GNP (current) (1)	Real GNP Growth Rate (2)	Rate of Non-Agricultural Labor Absorption (% change from previous year) (3)	Inflation (% price change from previous year) (4)	Interest on 6-month time Deposits (Avg) Nominal (5)	Interest on 6-month time Deposits (Avg) Real (5)	Interest on Secured Loans (Avg) Nominal (6)	Interest on Secured Loans (Avg) Real (6)	Gross Saving Rate (% of GNP) (7)
1887			3.9	- .3	5.3	5.5	9.8	10.1	12.6
1888		3.6	3.8	1.1	5.0	3.9	9.6	8.5	12.6
1889		4.4	3.7	2.6	4.9	2.3	9.7	7.1	13.0
1890		2.7	3.6	0	4.8	4.8	9.6	9.6	13.7
1891		3.4	3.5	.5	4.7	4.2	9.0	8.5	13.5
1892		3.0	3.4	0	4.8	4.8	8.8	8.8	13.5
1893		4.9	3.3	.6	4.8	4.5	8.8	8.2	15.7
1894		2.8	3.2	3.4	4.9	1.5	8.7	5.3	16.5
1895		2.9	3.1	7.1	5.2	-1.9	9.1	2.0	16.5
1896		2.5	3.0	8.5	5.7	-2.8	9.9	1.4	16.8
1897		3.0	3.0	6.8	6.0	- .8	9.8	3.0	17.0
1898		1.5	2.9	7.3	6.3	1	10.1	2.8	14.9
1899		2.4	2.9	4.9	6.7	1.8	10.6	5.7	14.0
1900		2.3	2.8	3.4	6.9	3.5	10.6	7.2	13.6
1901		1.6	2.8	2.7	6.7	4.0	10.1	7.4	13.1
1902		2.4	2.8	4.3	6.5	2.2	10.0	5.7	11.3
1903		1.8	2.7	2.6	6.3	3.7	9.7	7.1	9.7
1904	.224	1.0	2.6	3.4	5.9	2.5	9.1	5.7	9.6
1905	.230	2.1	2.6	4.7	5.6	.9	8.7	4.0	10.1
1906	.231	2.5	2.5	3.1	5.7	2.6	8.9	5.8	10.4
1907	.238	.8	2.5	1.8	5.6	3.8	8.9	7.1	12.1
1908	.241	3.0	2.4	1.1	5.4	4.3	8.6	7.5	14.2
1909	.240	3.3	2.4	2.2	5.1	2.9	8.2	6.0	14.5
1910	.237	2.6	2.3	1.2	5.1	3.9	8.1	6.9	14.3
1911	.235	2.2	2.3	2.5	5.1	2.	7.9	5.4	14.2
1912	.233	1.8	2.2	1.7	5.3	3.6	8.0	6.3	14.4
1913	.227	1.7	2.2	.3	5.4	5.1	8.2	7.9	15.3
1914	.227	3.1	2.1	.4	5.4	5.0	8.3	7.9	17.4
1915	.227	4.9	2.1	3.9	5.2	1.3	8.2	4.3	20.8
1916	.230	6.5	2.0	10.2	5.0	-5.2	7.9	-2.3	23.6
1917	.226	7.3	2.0	18.4	4.9	-13.5	7.7	-10.7	24.6
1918	.233	6.7	2.7	20.6	5.2	-15.4	8.1	-12.5	24.8
1919	.245	5.7	2.7	17.3	5.5	-11.8	8.6	-8.7	22.5
1920	.260	3.4	2.7	12.4	5.9	-6.5	9.0	-3.4	19.5
1921	.276	.7	2.7	5.3	6.1	.8	9.5	4.2	16.3
1922	.293	2.2	2.7	-1.1	6.3	7.4	9.8	10.9	15.1
1923	.297	1.8	1.9	-1.8	6.3	8.1	9.7	11.5	13.9
1924	.291	.6	1.8	-1.0	6.3	7.3	9.6	10.6	13.8
1925	.287	1.8	1.8	-1.0	6.3	7.3	9.6	10.6	13.8
1926	.282	4.0	1.8	-1.6	6.1	7.7	9.4	11.0	14.3
1927	.282	1.6	1.7	-2.2	5.8	8.0	9.1	11.3	15.0
1928	.285	2.4	1.7	-4.5	5.5	10.0	8.6	13.1	15.2
1929	.291	2.4	.4	-5.9	5.2	11.	8.1	14.0	14.9
1930	.290	2.6	.3	-5.3	5.0	10.3	7.7	13.0	14.3
1931	.287	3.4	.8	-4.0	4.7	5.7	7.2	11.2	14.2
1932	.283	5.1	1.8	-3.2	4.5	7.7	6.8	10.0	13.8
1933	.275	5.9	2.2	- .7	4.3	5.0	6.5	7.2	14.2
1934	.265	6.3	2.7	2.1	4.1	2.0	6.2	4.1	15.2
1935	.262	6.7	2.9	3.4	3.8	.4	5.8	2.4	15.6

Notes:

(1) M ≡ (cash currency and depocit currency).
Cash currency = currency in circulation - cash holdings by financial institutions
Deposit currency = demand deposits of all banks - checks, etc. held by banks.
(source: Historical Statistics of Japanese Economy, Bank of Japan, 1962 [HSJE]).
GNP (current): at market prices (in Estimates of Long-Term Economic Statistics of Japan Since 1868, K. Ohkawa, et al, ed., Tokyo, Toyo Keizai Shinposha, 1974, Vol. 1 [LTES]).

(2) From LTES.

(3) Refers to those employed less those engaged in agriculture and forestry. (From Hundred-Year Statistics of the Japanese Economy, Tokyo, Bank of Japan, 1966.)

(4) Change in consumer prices from previous year (from LTES, op. cit., Vol. 8).

(5) Tokyo banks: from HSJE.

(6) Tokyo banks: through 1929: "loans on deeds" from HSJE; from 1930: "loans on bills" from HSJE.

(7) Series disregards statistical discrepancies, from LTES. GNP (current) as in (1)

Saving rates, initially modest, rose to more than 20% by World War I; the sustained, if unspectacular, nature of this balanced export-oriented growth path yielded rates of labor reallocation sufficiently rapid to culminate in the end of the labor surplus condition by that time.[15]

Turning to Taiwan, the case of a contemporary LDC moving along a more sharply delineated "ideal" path, we may note (see Table 2) that typical, relatively low, real interest rates in official markets--along with a much higher informal market--were adhered to during the import substitution sub-phase of the 1950's, though nominal rates were set higher than in most post-war LDC's in the effort to curb the inflationary psychology. At the same time productivity in agriculture increased consistently,while land reforms and infrastructural investments combined to prepare the ground for fuller participation later on.

The shift from import to export substitution, accommodated by major changes in the policy package,occurred in the early 1960's. Stabilization and a decline in the rate of inflation was followed by devaluation coupled with import control liberalization and a substantial increase in the nominal rate of interest. As a consequence, the real rate of interest rose from an average of 10% in 1958-1960 to close to 15% in 1963-65. At the same time the interest rate in the unofficial or"parallel" markets, deprived of some of their monopoly content, declined from levels of 50% on average in the late 50's to the vicinity of 25% per annum in the 60's.

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[15]At least in agriculture. The controversy on the date of the "turning point" need not detain us here. (See R. Minami, "The Turning Point in the Japanese Economy," Quarterly Journal of Economics, August 1968.)

Table 2

TAIWAN

3-Year Moving Average Centered on	M_2 / GDP (current) (1)	Real GDP Growth Rate (2)	Rate of Non-Agricultural Labor Absorption (% change from previous year) (3)	Inflation (% price change from previous year) (4)	Interest on Deposits (Average of 6 month and 1 year rates) Nominal (5)	Interest on Deposits (Average of 6 month and 1 year rates) Real (5)	Interest on Secured Loans Nominal (6)	Interest on Secured Loans Real (6)	Gross Saving Rate (% of GI (7)
1954	.114	8.5	4.1	10.1			26.9	16.8	8.4
1955	.121	7.0	2.1	7.4			24.6	17.2	8.7
1956	.130	6.8	0	9.3			23.1	13.8	9.3
1957	.157	6.2	7.5	6.4			22.4	16.0	9.6
1958	.183	7.1	5.0	6.5	16.4	9.9	21.0	14.5	9.7
1959	.200	6.7	4.0	10.1	15.9	5.8	20.3	10.2	10.4
1960	.217	6.9	3.4	12.3	14.7	2.4	18.9	6.6	11.5
1961	.241	6.9	3.4	9.6	13.5	3.9	18.0	8.4	12.7
1962	.279	8.1	3.4	4.1	12.0	7.9	16.5	12.4	14.1
1963	.310	9.7	4.9	1.5	10.9	9.4	15.7	14.2	16.2
1964	.337	11.1	3.3	.6	10.2	9.6	15.0	14.4	18.4
1965	.364	10.8	2.2	.6	9.7	9.1	15.0	14.4	20.1
1966	.391	10.1	4.7	1.8	9.4	7.6	14.7	12.9	21.2
1967	.408	9.4		3.9	9.1	5.2	14.4	10.5	22.3
1968	.420	9.4	5.1	4.9	9.1	4.2	14.2	9.3	23.0
1969	.433	9.7		5.0	9.1	4.1	13.6	8.6	24.1
1970	.473	10.4	3.1	3.7	9.0	5.3	12.9	9.2	26.0
1971	.531	11.2	12.1	3.7	8.5	4.8	12.0	8.3	

Notes:

(1) M_2: line 34 (money) + line 35 (quasi-money) + line 45 (time and savings deposits) in International Financ Statistics, various issues.

GDP (current): book value, at current prices from Taiwan Statistical Data Book, 1973 [TSDS]. 1972 GDP used in calculations is preliminary estimate.

(2) Same as for GDP (current) in (1); 1972 GDP used in calculations is preliminary estimate.

(3) Not 3-year moving average; is % change from previous year only.
For 1952-1966: refers to those employed (aged 12 and over) less those aged 12 and over engaged in agricul
For 1967-1972: refers to those employed (aged 15 and over) less those aged 15 and over engaged in agricul forestry, and fisheries (since 1969, including servicemen). (From TSDS.)

(4) % consumer price change in year from TSDS.

(5) Average of (a) 6-month time deposits at banks (year-end interest rate per annum) (Source: The Republic of China, Taiwan Financial Statistics Monthly, April 1975 [TFSM]).

(b) 1957-58: 1-year preferential time deposits from A. G. Chandarvarkar, IMF Staff Papers (197 18:83.
1959-1969: one year savings deposits in banks at year end (assumed compounding monthly at the monthly interest rate for year end).
1970-1972: one year savings deposits in banks (year-end interest per year)[from TFSM].

(6) Nominal rates; effective rates may be higher:
1953-55: secured time loans in banks at year end (assumed compounding monthly at the monthly interest rate for year end) from TFSM.
1956-69: same as for 1953-55, except "secured loans" instead of secured time loans.
1970-72: secured loans at banks (year-end interest rate per annum).

(7) From TSDS. GDP (current) as in (1).

While elements of credit rationing, of course, persisted, such changes in interest rate policy--even sharper in the case of South Korea where the policy changes occurred a few years later--do imply a much enhanced role for private saving via official intermediation channels and greater scope for the use of government monetary policy. As both Taiwan's and Korea's experience in the 60's showed, once saver confidence has been reestablished, the relationship between interest and saving rates probably weakens, saving becomes more closely tied to changes in the level of income, and interest rates safely decline somewhat again.

At the same time (i.e., the 60's), the institutional structure of financial intermediation became more diversified and sophisticated, and household savers for the time had really viable alternatives to the unhappy choice between direct investment and acceding to the government as a monopsony borrower. As a consequence, the gross saving rate for Taiwan, less than 10% in 1954-58, rose to more than 20% by the end of the 60's. Of this remarkable total, 70% came from household saving, more than 80% of which, in turn, made its way through financial channels.

During this period, the real performance of the economy picked up considerably. Agricultural labor productivity spurted (from 2% to 4% plus); the rate of labor reallocation, as indicated in Table 2, increased substantially; and the growth rate moved from 7% to approximately 10% annually. While overall exports grew at rates in excess of 30% annually by 1970--with more than 25% of the GDP exported--what is even more interesting is the tremendous shift in composition from traditional land-based to non-traditional labor-based commodities. By 1970, labor intensive industrial goods constituted more than 80% of total exports,

in contrast to 25% in the early 1950's. This major restructuring of output and export patterns meant that, by the end of the 1960's, employment in the industrial sector had increased at such a rate that, in spite of still substantial (if declining) population growth, the surplus labor conditions came to an end, as indicated by rapidly rising unskilled real wages after that point.

A well-developed growing network of rural financial intermediation, via cooperative banks, farmer associations and commercial branch banking was, moreover, extremely helpful in ensuring that much of the industrial sector growth followed an efficient low cost pattern, much of it directed towards the expansion of rural industries, especially in food processing and in subcontracting for larger, including export-oriented, firms. It is a striking characteristic of the Taiwanese industrialization pattern that it remained efficiently labor intensive through most of the 60's providing employment to some of the poorest farmers; as a consequence, more than 50% of farm family income was derived from non-agriculture by the end of the 1960's and the distribution of income in Taiwan remained one of the best in the world during this period of rapid growth.[16]

In the (milder) case of historical Japan as well as in the contemporary case of Taiwan, we may thus note some approach to the idealized pattern described earlier. On the real side we encounter a gradual shift from land-intensive

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[16]The Gini level near .3 is remarkably low by LDC standards--mostly in the .5 range. Even more interesting is that the initial rise anticipated by Kuznets did not take place. This contrast, for income distribution, of a secondary import substitution vs. export substitution choice is currently under study but cannot be dealt with here. (See, however, J.C.H.Fei, G. Ranis, and S. Kuo, "Growth and the Family Distribution of Income by Factor Components: The Case of Taiwan," Economic Growth Center Discussion Paper No. 223, March 1975 (revised April 1975).)

exports fuelling import substitution, to labor-intensive exports, with agriculture finally participating more fully via sustained productivity increase, and labor being reallocated, until the economy's labor surplus condition is ultimately exhausted and the transition to modern growth has been successfully negotiated. On the financial side, this requires the continued growth of a more and more complex financial intermediation system accommodating--and/or inducing--the generation and channelization of the agricultural surpluses, with organized money markets gradually reducing the importance of parallel or dual markets, especially in rural areas, and providing fairer access to all comers. During this relatively market oriented export substitution sub-phase, we can thus expect the economy not only to obtain a higher level of efficiency but to be able to support a larger total effort, whether measured in terms of labor reallocation, rates of saving, or growth.

III. The "Non-Deviant" LDC in Transition

While the above export substitution path approaches some sort of idealized sequence, it has, in fact, been followed by only a small minority of so-called "deviant" LDC's. Most contemporary developing economies can be said to have more or less maintained their import substitution policy syndrome after the inevitable end of their primary import substitution sub-phase of development. As was pointed out earlier, the choice of secondary import substitution at this point essentially means "more of the same"--except more so. What is required basically is continuity of the policies previously in vogue--including with respect to financial institutions and policies. Specifically, in non-agriculture it means satisfying the ever

increasing appetite, for capital and technology, of the new capital goods, durable consumer goods and processing industries--especially, of course, those in the hands of prime borrowers--and continuing to accommodate to the rising requirements for overheads of the public sector; in agriculture, it essentially means maintenance of the force feeding of subsidized credit to large farmers, with relatively little attention to the effects on participation, on agricultural productivity, on default rates, or the generation of inter-sectoral saving.

We, of course, recognize that these "choices" of growth paths, and of accompanying policy packages, are never quite as clear-cut as all this in real life, but tend to fade into each other at the edges. But while there certainly exist substantial elements of both secondary import substitution and export substitution in the overall production and trade structure of most LDC's, the contrasts painted here are both meaningful and instructive. The performance of such "typical" countries as Brazil and the Philippines is sharply differentiable from the deviant minority we were discussing in the last section.

A labor surplus LDC which continues to persevere in traditional exports-fuelled secondary import substitution long after its changing endowment would seem to render it capable of beginning to shift to non-traditional industrial exports is likely to encounter ever increasing capital and technology requirements along the way. This means, in turn, that the burdens placed on the system's financial institutions, especially in terms of the quantity of saving which must somehow be generated and channeled, are substantially increased. The capital requirements for processing, durable

consumer and most capital goods industries are generally substantially larger than those applicable to non-durable consumer goods. Lumpiness is more pronounced and public sector overhead and urbanization costs likely to increase. With the financial intermediation network, on the other hand, retaining, more or less, its import substitution characteristics previously described, the supply of domestic saving is not likely to increase pari passu. In fact, the resulting continued state of "financial repression," as Shaw calls it, means that neither the increased participation of households and of other medium and small savers nor the higher quality of allocation forced by greater competitive pressures is likely to occur as long as the official policy of artificial low deposit and lending rates persists. Instead, there is an even greater likelihood of resort to inflationary financing, public and private, at home, plus even more fervent attempts to attract capital from abroad, via special tax treatment and favored access to domestic loan capital. Consequently, both the choice of technology and of output mix are likely to become more and more distorted in terms of a basic endowment which can be expected to shift only gradually from its labor-abundant/capital-and-skill-short characteristic.

The accompanying relative neglect of food producing agriculture frequently leads not only to non-support from that sector--either via the domestic saving or foreign exchange route--but to the need to divert resources to the importation of foods. Ultimately, unless the outlook for the further expansion of natural resources-based exports is good--and/or foreign capital inflows make up the difference--customary rates of growth may not be long maintainable. And even if they are, increasing problems of maldistribution and unemployment

in the more and more capital-intensive labor surplus economy are bound to create more and more social and political stress and strain. Thus, for one reason or another--and possibly both--even countries which have been navigating "successfully" through secondary import substitution waters, i.e., at 6%-8% growth rates, may sooner or later find themselves in difficulties.

The post-World War II experience of the Philippines (see Table 3) may be viewed as representing one such case in point. Primary import substitution which started seriously after the War began to run out of steam by the end of the 1950's. Faced with a sharp deceleration in industrial growth and the inability to depend on a sluggish primary export sector to provide the necessary foreign exchange, the Government initially opted for devaluation and decontrol in the early 1960's. However, for a number of reasons, including the failure of food-producing agriculture to provide the necessary support in the form of productivity and saving increases, and government unwillingness to provide for real import liberalization by tackling the highly protective tariff structure, this incomplete venture into export substitution proved unsuccessful. Largely as a consequence, decisions, especially after 1968, can be said to have taken the Philippines firmly down the secondary import substitution path. Two decades of heavy protection have thus left the Philippines with an increasingly capital-intensive geographically highly concentrated industrial structure relying for its continued--if every more costly--growth on the expansion of traditional exports. In spite of respectable overall growth rates, in excess of 6% in most years, not only social but even private rates of return in the

Table 3

PHILIPPINES

	3-Year Moving Average Centered on	M_2 / GDP (current) (1)	Real GDP Growth Rate (2)	Rate of Non-Agricultural Labor Absorption (% change from previous year) (3)	Inflation (% price change from previous year) (4)	Interest on Deposits (Average of 6 month and 1 year rates) Nominal (5)	Interest on Deposits (Average of 6 month and 1 year rates) Real (5)	Interest on Secured Loans Nominal (6) (a)	Interest on Secured Loans Real (6) (b)	Gross Saving Rate (% of GDP (7)
A.	1954	.182	8.7		-1.5					11.9
	1955	.186	7.7		2.1					11.8
	1956	.195	5.7		1.9					12.6
	1957	.198	5.1	1.5	2.2					13.1
	1958	.205	4.8	-4.7	.3					13.7
	1959	.207	4.7	7.3	2.1					13.4
	1960	.217	4.7	1.2	3.0					15.1
	1961	.234	2.7	8.0	4.4			7.8	3.4	16.9
	1962	.250	5.0	3.5	5.7			8.0	2.3	19.2
	1963	.253	4.5	7.6	7.7			8.0	.3	20.1
	1964	.244	6.1		6.3			8.3	2.0	20.3
	1965	.241	4.9		5.2			8.8	3.6	20.2
	1966	.257	3.9	6.2	4.7	5.8-6.3	1.1-1.6	9.4	4.7	20.0
	1967			-2.3						
B.	1968	.282		6.7	3.6	6 - 6.3	2.4-2.7	9.9	6.3	21.3
	1969	.285	3.1	-7.0	8.5	6.3-7.	-2.2- -1.5	10.4	2.1	21.4
	1970	.277	5.1		16.3	6.5-7.7	-9.8- -8.6	11.0	-5.3	21.1
	1971	.265	4.8			6.5-8.0		11.4		20.8

Notes:

(1) M_2: line 34 (money) + line 35 (quasi-money) + line 45 (time and savings deposits) in International Financial Statistics, various issues.
GDP (current): at current prices.
For Section A: Statistical Reporter (1969), Vol. 13, No. 1 (SR)
For Section B: N.E.D.A., The National Income Accounts 1967-1972 (Manila: 1973) [NEDA].

(2) Same as for GDP (current) in (1) for A: million ₱ of 1955
for B: million ₱ of 1967

(3) Not 3-year moving average; is % change from previous year only
"Non-agricultural" refers to employed persons in labor force not engaged in agriculture, forestry, hunting and fishing.
1957-1968: figures are for October--from 1971 Statistical Handbook of the Philippines (Bureau of the Census and Statistics, Manila).
1969: figure calculated from May 1968 to May 1969 from The BCS Survey of Households Bulletin, May, 1968, No. 25 and May 1969, No. 27.

(4) 1953-1957: % consumer price change in Manila (December to December).
1958-1971: % consumer price change for Philippines (December to December) from Statistical Bulletin (Central Bank of the Philippines); various issues.

(5) Interest on time deposits in commercial banks at year end. From Philippine Financial Statistics (Central Bank of the Philippines), December 1973.

(6) Nominal rates for commercial banks (average for year); effective rates may be higher. From Sharing in Development: A Programme of Employment, Equity, and Growth for the Philippines (Geneva: ILO, 1974).

(7) Same as for GDP (current) in (1).

industrial sector have been declining. Even more significant has been the increase in underemployment and the worsening distribution of income.

The strikingly dualistic characteristic of Philippine development extends as well to its financial institutions and markets. A highly organized official market catering mainly to the large-scale urban industrial sector, on the one hand, and plantation-style export crops, on the other, exists side by side with unorganized markets serving small industrial enterprises (rural and urban) and food-producing agriculturalists. Nominal annual rates of interest at saving banks, governed by usury laws, remain in the vicinity of 12%-14% (with effective rates somewhat higher) while interest rates in the informal markets vary between 60 and 400 percent.[17] Interest rates offered to depositors are also regulated and even more in disequilibrium. Within the official market, small savers can obtain no more than 6%-8% nominal, but larger savers do have access to both commercial and government deposit substitutes which earn substantially more. In addition to the disequilibrium low levels of both organized sector deposit and loan rates, we may thus note the large legally induced "spread" creating what must be regarded as a regulated banking oligopoly.[18]

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[17] Contrast this with an estimated real rate of return (before taxes) on assets in manufacturing around 15% by the end of the 1960's leading to an average nominal rate of return of between 20% and 25% minimum (see Sharing in Development: A Programme of Employment, Equity and Growth for the Philippines, G. Ranis, ed., Geneva: International Labour Office, 1974).

[18] The argument by the banks that the present "spread" is necessary as compensation for services rendered as financial intermediaries must be judged to be largely spurious. Banks needing such a spread must be operating highly inefficiently, and the economy would generally stand to benefit from the elimination of same, which would result from the more competitive behaviour of the group.

The growth of financial institutions, measured either by the Goldsmith financial intermediation ratio or the (easier to obtain) relationship between M_1, M_2 and GNP, first accelerated and then (by the late 60's) reversed direction. The banking system became more diversified and non-bank financial institutions grew substantially, but most of the growth, qualitative and quantitative, continued to affect the two enclave sectors. An examination of the distribution of loans actually made by the official banking system illustrates this further. Between 1958 and 1967, for instance, the smallest 20% of the loans absorbed less than 1% of the loans made, while the largest 20% of the loans absorbed more than 90% of loan value.[19] Little financial intermediation was directed towards extending the capillary activities between these and agricultural plus small-scale (including rural) non-agricultural activities.[20] The gross saving rate rose steadily towards a peak of 21% in the late 60's but has declined more or less consistently thereafter (19% in 1972). Yet the increasingly capital-intensive and skill-intensive character of the industrialization process has heightened capital requirements and lowered the (social and even the private) rate of return. Increasingly, in its efforts to prolong the import substitution regime, the Philippines has been forced to try to find new raw material sources (e.g., bananas and now oil). In the absence of a major break-through by virtue of the bounty of nature, we can thus anticipate an increasingly costly industrial development pattern, with the terms of trade

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[19] Default rates, among farmers, in the Philippines were in the 50-75% range in the mid-60's (see Gimenez, Mariano E., "Credit Delinquency," The Rural Banker, Vol. XIII, 9-10/1965, p. 47). Contrast this with the 5% level for Taiwan (Shen, T. H., The Sino-American Joint Commission on Rural Reconstruction: Twenty Years of Cooperation for Agricultural Development (Ithaca: Cornell University Press, 1970), p. 205.

[20] The fastest growth was recorded in investment houses, trust funds and finance companies, less subject to fixed interest rate policies, but which effectively exclude participation by potential small savers. The same thing is true for such short-term papers as bankers' acceptances and Central Bank certificates of indebtedness, a market which serves institutional investors and wealthy families only.

deteriorating further and, given the secularly stagnant food producing agricultural sector, an increasing proportion of export proceeds having to be diverted to the importation of food. Moreover, given the inherently labor surplus condition of much of the Philippines, continuation along the present narrow growth path would, even in the advent of a new natural resources bonanza, be politically difficult to maintain in terms of the negative employment and distributional outcomes which can be expected.

The post-War experience of Brazil (see Table 4) may be viewed as representing another historical illustration of the path most LDC's have, in fact, chosen. After transiting from primary to secondary import substitution in the 50's, Brazil by the early 60's was experiencing all the previously stated symptoms of increased industrial inefficiency accompanied by increased financial "repression." On the real side we may note increasing industrial capital-output ratios and stagnant, if high, saving rates--with the contribution of households, given severe inflation, minimal. Financial intermediation remained relatively stagnant, with Goldsmith's financial intermediation ratio falling from 70% in 1948 to 55% in 1963.[21]

By the early 60's (see Table 4), even the rate of growth, fuelled by the reinvestment of industrial profits, the effects of public sector deficit finance and increasingly reluctant foreign investors, was becoming somewhat anemic. By the mid-1960's corporate self-finance amounted to more than 8% of GNP. Brazil's balance of payments problems had begun to mount and her inflation seemed out of control.

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[21]In fact, Goldsmith found that less than 3% of gross national saving was channeled through these intermediaries. For a relevant discussion of the Brazilian case, see Andre F. Montoro, "Some Aspects of the Recent Development of the Brazilian Financial System," Dissertation Draft, Yale University, 1975.

Table 4

BRAZIL

3-Year Moving Average Centered on	M_2 / GDP (current) (1)	Real GDP Growth Rate (2)	Inflation (% price change from previous year) (3)	Finance Company Interest Rate for Borrower Nominal (4)	Finance Company Interest Rate for Borrower Real (4)	Bill of Exchange Yield Nominal (5)	Bill of Exchange Yield Real (5)	Gross Saving Rate (% of GDP) (6)
1961	.282	8.4	43.2	23.9	-19.3			
1962	.271	5.7	60.1	28.6	-31.5			19.9
1963	.255	3.2	74.8	35.2	-39.6			21.0
1964	.250	2.4	69.2	37.8	-31.4			22.2
1965	.238	3.6	54.9	37.8	-17.1			21.1
1966	.240	4.2	32.6	34.9	2.3	72.8	40.2	20.3
1967	.239	6.4	29.6	34.3	4.7	65.3	35.7	21.8
1968	.255	7.7	23.5	33.9	10.4	57.0	33.5	23.2
1969	.264	9.3	21.6	33.1	11.5	55.1	33.5	
1970	.275	9.9	19.6	31.0	11.4	53.8	34.2	
1971	.301	10.4	18.6	28.4	9.8	52.4	33.8	

Notes:

(1) M_2: line 34 (money) + line 35 (quasi-money) + (time and savings deposits at end of year). Figure for 1965 savings deposits not known. Lines 34 and 35 from International Financial Statistics, various issues. Time and savings deposits from Boletim do Banco Central do Brasil (January 1974), Vol. 10, No. 1.
GDP (current): at current prices from Conjuntura Economica (1973), Vol. 27, No. 12 [CE]. 1969-1972 GDP's are preliminary estimates.

(2) From CE, 1969-1972 GDP's are preliminary estimates.

(3) Refers to General Price Index (Aggregate Supply)--(December to December change) from CE.

(4) To 1966 from NESS
1967-70: (Rio de Janeiro) 180-day loans for working capital compounded monthly at the average December monthly interest rate from Boletim do Banco Central do Brasil (1974), Vol. 10. No. 9 [BOLETIM].
1971-72: (Rio de Janeiro) 360-day loans for consumer credit compounded monthly at the average December monthly interest rate from Boletim.

(5) 1967-70: (Rio de Janeiro) 180-days maturity; compounded monthly at the average December monthly interest rate from [BOLETIM].
1971-72: (Rio de Janeiro) 360-days maturity (year-end % interest rate per annum) from Boletim.
To 1966: refers to 6-month exchange bills from W. L. Ness in Economic Development and Cultural Change (1974), Vol. 22, No. 9 [NESS]

(6) Flow of funds savings estimate from NESS.

In the post-1964 period a new (military) government initiated a series of reforms, including devaluation of the exchange rate and partial abrogation of the anti-usury laws, which permitted a modest increase in the nominal rate of interest along with other components of a so-called export substitution or liberalization oriented policy package. At the same time, both the relative size and degree of diversification of the financial intermediation network increased significantly, accompanied by a narrowing of the interest rate spread between official and unofficial markets, on the one hand, and between lending and borrowing rates, on the other. Real interest rates gradually became substantially positive for the first time (see Table 4) as inflation declined from 70% levels to around 20% and nominal rates of interest rose as high as 50% for the case of finance company instruments.[22] Saving and loan associations and other specialized intermediaries assumed real importance for the first time--as witnessed by the fact that commercial banks were responsible for 94% of all loans to private borrowers in 1964, but for only 61% of a much larger total by 1972. Government bonds, previously sold almost exclusively to the banking system, now began to attract private customers--especially after the so-called monetary correction was introduced in 1968.[23] Both the M_2/GDP ratio and the saving rate reversed trend as a result of the reforms. What followed was a marked improvement in growth performance and, though we lack annual data, the rate of surplus labor absorbed in non-

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[22]By using the device of letters of exchange whose legal return was fixed but which could sell at a substantial discount.

[23]This permits the indexation of government bonds along with many other monetary instruments. The overall role of indexation is a most interesting but large subject and cannot really be dealt with in the context of this paper.

agricultural activities undoubtedly increased. Much of this additional labor absorption was reflected in such labor-intensive areas as footwear and related to a substantial export boom in recent years.

Nevertheless, as in the case of the Philippines in the early 60's, it is not at all clear whether Brazil has really determined to gradually shift to an export substitution type of growth path, whether she is backsliding or simply experiencing random oscillations in policy. Certainly, the experience of the most recent past provides room for doubt. Perhaps most important is the fact that the level of effective protection of Brazilian industry has undoubtedly again increased substantially, that more than 60% of the spectacular increase in exports in the early 70's was in primary products, and that an increasing proportion of her industrial exports was in the durable consumer and processed goods area and heavily subsidized.[24] Certainly Brazil's current emphasis on high technology and capital intensive industries, e.g., in petro-chemicals, atomic energy, etc., in the presence of a still very substantial overhang of surplus labor, seems to argue in favor of the interpretation that the center of gravity may be shifting back towards a policy of secondary import substitution--if somewhat milder than in many other direct-controls-oriented LDC's. Growth rates are beginning to decline again; but, perhaps more significant is Brazil's unfavorable, and apparently worsening, income distribution record.[25]

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[24]Such subsidies are provided by the government in terms of differential interest charges, tax exemptions, rebates, etc. Moreover, multinationals are asked to export below cost in return for continuing to enjoy guaranteed high profits in the domestic market. Such "pushing out" of industrial exports may be termed "export promotion" to distinguish it from the more organic dynamic resource endowment-sensitive process of "export substitution."

[25]See Al Fishlow, "Brazilian Size Distribution of Income," American Economic Review, May 1972.

IV. Summary and Conclusions

As we have tried to show in an admittedly somewhat heuristic fashion, the appropriate developmental role of financial institutions and policies cannot be satisfactorily assessed independent of time and place. Instead, for the typical labor surplus economy, we have tried to differentiate among the functions to be performed in each phase of the transition process. This, in turn, has permitted us, with the help of some real world illustrations, to differentiate between an idealized or "deviant" and a more realistic or "non-deviant" pattern in the actual evolution of financial institutions and policies in the contemporary developing world.

The contrasts between these two sets are substantial and instructive. The deviant LDC utilizes its primary import substitution sub-phase not only to protect its fledgling entrepreneurs but also to construct the financial and physical infrastructure required subsequently, pays due attention to agricultural productivity increase, and transits before long into export substitution. It requires the help of a policy reform package and a financial intermediation structure flexible with respect to the changing tastes for real and financial assets as well as changing investor competence. The non-deviant LDC elects to move from primary to secondary import substitution, a move which implies an increasingly capital and skill intensive growth path and pressure for a continuation and, in fact, intensification of the existing policy package. This includes the relative neglect of agriculture and, with low participation by households and relatively narrow official intermediation markets, heavy reliance on public, corporate and foreign saving in satisfying rapidly growing industrial capital requirements.

Both sets of countries may show relatively good growth performance, but the first as a consequence of a gradual shift to fuller human resources utilization, the second via enhanced reliance on the natural resources base and/or foreigners. Pronounced differences are likely to appear even for those blessed with really abundant natural resources, i.e., in the income distribution and unemployment dimensions of development; and certainly for those not quite so lucky there arise questions as to the longer term prospects of maintaining a satisfactory rate of growth itself--at least without incurring a prohibitively high structure of foreign debt.

If all but the really exceptional cases (e.g., the oil countries) are thus likely to run into increasing difficulties--as they, in fact, have--why, it may well be asked, does the majority of LDC's not shift their policies towards export substitution and away from secondary import substitution?[26] A large part of the answer is, we believe, that it is politically difficult to do so. The changes contemplated threaten not only the unearned profits of the new industrial elite but also the controls-related power (and incomes) of the bureaucracy. Small wonder that policy-makers--who are presumably just as human as the rest of us--would prefer to avoid taking the unpleasant medicine of devaluation, credit and import liberalization if it can be avoided. The actual (or putative) availability of a friendly Mother Nature--and/or foreign donors--is ideally suited to strengthening the natural temptation to leave things more or less as they are. Policy makers in our

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[26]It could, of course, be because the reasoning underlying this paper is seriously deficient; but this possibility is arbitrarily excluded.

"deviant" minority group of LDC's, it should be noted, are not necessarily smarter or more virtuous, but rather more "up against it," without recourse to the same pleasant alternatives. Thus while, in theory, additional resources--whether via the bounty of nature or foreign lenders--should be all to the good, i.e., provide an additional potential advantage to a country contemplating a painful transition from one sub-phase to another, it may, in fact, not work that way in the realm of political economy. This is, in fact, akin to a generalized version of the so-called "Kuwait Effect" on a country's exchange rate and balance of payments.

All this, of course, does not imply, that the majority of contemporary LDC's do not consider exports--especially industrial exports--highly desirable and are willing to go to some lengths to achieve a better performance in this regard. Even such strong proponents of import substitution strategies as Prebish have substantially moderated their views in recent years. But the difference is that the exports being generated by and large result from policies which "push out" exports artificially without a basic change in the import substitution environment. Notice, for example, that a substantial portion of the industrial exports of such countries as Brazil and Mexico in recent years has not been in the field of relatively labor intensive non-durables but in such capital and skill intensive areas as durable consumer goods. This attempt at an export orientation--which may be called "export promotion"--is thus not to be confused with "export substitution" caused by the gradually evolving play of comparative advantage, as liberalization replaces infant industry protection--but is rather the result of policies intended to subsidize industrial exports while maintaining the hot-house temperatures of import substitution.

Institutional devices are often created to help promote exports, e.g., the use of interest rate differentials and"special windows". Fiscal incentives are given and, finally, companies, including the multi-nationals, are pressured directly to export a certain portion of their output, even if below cost, in exchange for the guarantee of the maintenance of high unearned profits on the rest of their output in the protected domestic market. Thus the increased value of industrial exports by itself does not necessarily signal a switch to a more endowment sensitive growth path; nor does the establishment of additional specialized financial facilities to encourage industrial exports. An examination of value added at international prices will indicate that "crimes" committed in the name of export promotion can be just as costly as those committed in the name of the no longer as fashionable import substitution. As long as the golden goose of natural resources abundance doesn't give out--and/or the political problems attending a worsening distributional outcome can be handled--negative value added on both fronts can be "afforded." In any case, without the--often admittedly painful--changes in policy described earlier, the transition to a more efficient, broadly participatory growth path cannot be effected.

What is required, in short, is an uncommonly high degree of statesmanship. Mobilizing the rural sector early and in a sustained and persistent fashion; building the financial infrastructure required for the effective channelization of the resulting surpluses; and, finally, permitting the industrial sector to help finance its own future growth via export substitution all imply government actions challenging old habits and deeply entrenched interests. Small wonder that the greater the opportunity provided by natural resources or foreign capital the greater the temptation to use it instead to help postpone the day of reckoning.

Navigating towards economic maturity via some approximation to the idealized path sketched here--both real and financial--thus requires both technical competence and the political will to secure the necessary agreement among the various parties to the social contract. That some groups, e.g., small farmers, medium-scale entrepreneurs, and other economically disenfranchised elements would be likely to benefit from the proposed change of strategy is clear enough. But the fact that even the landlords and large-scale industrialist class stands to benefit, over the longer term, from a more rational interest rate policy, for instance, is less obvious. Such a change in the environment will call for a change in the <u>way</u> profits, or rents, are earned but not necessarily in the volume or even in the relative shares. A shift from monopoly to earned profits is likely to mobilize substantial underutilized entrepreneurial,managerial and innovative resources for the first time and thus lift the entire performance of the system onto new tracks. The alternative may well be that, in spite of all efforts to prop up declining rates of return, dwindling domestic markets and the increasingly difficult process of fuelling import substitution while pulling along a recalcitrant agricultural sector, will eventually boomerang for the very urban industrial class it is intended to protect.

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