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Economic Growth in the 1990s
Learning From a Decade of Reforms

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* Country notes are forthcoming on the *Lessons of the 1990s* website at http://www-wbweb.worldbank.org/prem/pas/devchallenges/countrynotes.htm and http://www1.worldbank.org/prem/lessons1990s/countrynotes.htm

Foreword

When you get right down to business, there aren't too many policies that we can say with certainty deeply and positively affect growth.

(Arnold Harberger, *IMF Survey*, July 2003: 216)

Therefore, the real lesson for the architects of growth strategies is to take economics more seriously.

(Dani Rodrik, *Growth Strategies*, September 2003: 30)

An institution whose primary business is finance and advice for poverty reduction needs a good understanding of what causes growth and what sustains it. Poverty declines rapidly where growth is rapid and sustained. Poverty stagnates where growth is tepid. A few exceptions notwithstanding, the unambiguous impact of rapid growth on poverty reduction has been confirmed again in the 1990s, and was a central theme of the May 2004 Shanghai Conference on Poverty Reduction.

Economics is an imprecise science and the nature of economic growth has changed over the course of history. Hence it is no surprise that our understanding of growth is partial and incomplete. The growth experience of the last 50 years has abundant examples of economists' inability to anticipate *successes*, such as Botswana, China, India, Indonesia, Korea, Mauritius, Singapore, and Thailand; economists' and markets' inability to predict *crises*, such as the financial crises of the 1990s; and *disappointments*, such as Latin American and African countries' unfulfilled growth potential in the last two decades. Growth is difficult to predict because it implies social transformation: a break with past trends, behaviors, and institutions that reflect deep forces in societies and how they organize themselves.

Absent definitive theories, our views on growth have been influenced by facts and changed pragmatically in the face of experience. The financial turmoil that preceded World War II, and the successful reconstruction of Europe and Japan, gave reason to believe that governments could address market failures effectively, and accelerate capital accumulation, which was believed to be the main force driving economic growth. These views guided government policies in many developing countries in the 1960s and 1970s. Starting in the 1980s, however, the costs of industrialization policies based on import substitution and extensive state interventions in the economy led to greater recognition that the costs of government failures could be larger than those of market failures. The focus of growth strategies shifted from policies aimed at expanding productive capacity and accelerating the accumulation of capital, to policies aimed at improving efficiency in the use of existing capacity. This book examines the results of this shift and the lessons to be learned from it.

We approached the 1990s with the shared conviction that economic reforms would not only reverse what for many developing countries had been the "lost decade" of the 1980s, but would also bring about the conditions for sustained growth. Best captured in the Washington Consensus and the *World Development Report 1991*, macroeconomic stability, domestic liberalization, openness to international trade, and reducing the role of the state became the principles that guided economic policies in the 1990s, in former communist countries in Eastern Europe and

Central Asia; in Latin America; in South and East Asia; in Africa and, although to a much lesser extent, in the Middle East and Northern Africa. In parallel, democratization in former communist countries, and the consolidation of democracy in Latin America, Africa, and some East Asian countries, gave grounds for optimism that free markets and free societies provided the basis for rapid and sustained growth.

The results were unexpected: they exceeded the most optimistic forecasts in some cases and fell well short of expectations in others. Domestic liberalization and outward orientation were associated with spectacular successes in East and South Asia in terms of growth, poverty reduction, and social progress, although they were implemented in a manner that departed from conventional wisdom—in terms of speed and manner of reform, large presence of the state and, until very recently, high levels of import protection. At the same time, booms and busts continued in Latin America and extended to East Asia and other regions as well. There were sharp declines followed by a prolonged and as yet incomplete recovery in former communist countries, with results varying from relative success in Czech Republic, Hungary, and Poland to costly transitions in most other countries; a second decade of stagnation in Africa; and costly and frequent financial crises: 1994 Mexico, 1997 East Asia, 1998 Brazil, 1998 Russia, 2000 Turkey, 2002 Argentina.

This draft volume confirms and builds on the conclusions of an earlier World Bank report, *The East Asian Miracle* (1993), which reviewed experiences of highly successful East Asian economies. It confirms the importance for growth of fundamental principles: macro stability, market forces governing the allocation of resources, openness, and the sharing of the benefits of growth. At the same time, it echoes the finding that these principles translate into diverse policy and institutional paths, implying that economic policies and policy advice must be country-specific and institution-sensitive if they are to be effective. Where hyperinflation is raging, or public debt demands high real interest rates, as it does in Argentina, Brazil, Jamaica, and Turkey for example, macroeconomic stabilization is the first priority. Where trade restrictions are extreme and hinder the utilization of existing capacity, as in many countries of the Middle East and North Africa, reducing them will be essential in the earlier phases of reform. Where there is uncertainty regarding the future course of economic policies, and appropriability of returns on investment, as in Bolivia, Democratic Republic of Congo, and Nigeria, financial sector liberalization will do little to channel resources to private investment. Where property rights are poorly defined and enforced, and regulation prevents the movement of domestic resources across sectors, as still is the case in some Central Asian and African countries, trade liberalization will be of little effect unless it is accompanied by complementary reforms. Therefore, which policy should be introduced, and when, varies considerably depending on initial conditions and institutional endowments.

The study concludes that valid general principles do not imply generic "best practice" policy or institutional solutions. It also echoes the finding of *The East Asian Miracle* that selective government interventions can contribute to growth when they address market failures, where the conditions exist for them to be carried out effectively, and where they are also subject to institutional checks. Overall, the basic message is that in the search for sustained growth, there is no escape from reforms, and nor are there universal formulae: what is needed are country-specific applications of reforms chosen selectively and sequenced appropriately, based on

rigorous economic and social analytical work, and recognizing the country's institutional strengths. This is a tall order. But so is the search for sustained growth.

The authors examine the impact on growth of key policy and institutional reforms: macroeconomic stabilization, trade liberalization, deregulation of finance, privatization, deregulation of utilities, modernization of the public sector with a view to increasing its effectiveness and accountability, and the spread of democracy and decentralization. They draw lessons both from a policy and institutional perspective and from the perspective of country experiences about how reforms in each policy and institutional area have affected growth.

Regarding macroeconomic policies, for example, the findings emphasize the importance of the institutions underlying macroeconomic stabilization, the risks associated with external financial liberalization, the disruptions associated with episodes of exchange rate appreciation, and the sometimes excessive focus on minimizing inflation in the short term—which then came at the cost of public spending that might have both increased growth and made stability more durable.

Regarding trade, the analysis highlights the fact that countries that have successfully integrated into the world economy have followed different approaches and also adopted a range of complementary policies, making it difficult to pin down the exact relationship between trade integration and growth. Whether openness is the cause of, or a result of, rising incomes is still a matter of debate. But successful countries such as China and India have benefited considerably from integration into the world economy and access to external markets.

From across the policy reform experiences in different areas, common themes emerge regarding the importance of institutions. The chapter on finance attributes the main reason for results below expectations to weaknesses in institutions. Several chapters stress the need for effective checks on predatory behavior by the state and by the private sector. Predation is important in explaining the outcomes of privatization, the performance of the public sector in the delivery of services, and the quality of the investment climate.

As well as examining the impact of specific policies on growth, the volume also draws lessons about growth considering the entire spectrum of policies and institutional reforms. It concludes that the emphasis of the 1990s on reforms to improve *efficiency* in the use of capacity—while warranted at a time of extremely large distortions—was not counterbalanced with sufficient focus on the forces driving *expansion* of capacity. Whereas efficiency gains can bring about short-term growth, sustained long-term growth can only be achieved through expansion of capacity: accumulation of physical and human capital, and technology improvements. Key in this process are the quality of the investment climate and the confidence with which economic agents can forecast returns in the future.

Perhaps the lesson of lessons of the 1990s is that we need to get away from formulae and realize that economic policies and institutional reforms need to address whatever is the binding constraint on growth, at the right time, in the right manner, and in the right sequence, instead of addressing any constraint at any time. This much more targeted approach requires recognizing country specificities, and calls for more economic, institutional, and social analysis and rigor than a formula-based approach to policymaking. In the World Bank in the last few years, these perspectives have already been translated into new analytical and operational instruments such as

poverty and social impact analysis, and country-driven poverty reduction strategies, which seek to bring analytical rigor and empirical accuracy to the evaluation of policy reforms, and country specificity into growth strategies. But in these areas, and others, mainstreaming this approach to reforms for growth will need growing attention over time.

The lessons drawn in this volume confirm the importance of market incentives for resource allocation, of openness, and of macro stability, but they highlight the diverse ways in which these principles can translate into concrete policy and institutional choices. They also echo Albert Hirschman's view that: *"development depends not so much on finding optimal combinations for given resources and factors of production as on calling forth and enlisting for development purposes resources and abilities that are hidden, scattered, or badly utilized."*

The lessons have implications for the understanding and practice of economic policies and advice and, in particular, for the World Bank's analytical, strategic and operational work—including for the formulation of growth strategies focused on relaxing the most binding constraints instead of making all policies "best practice". They also have implications for behavior—in particular the need for more humility. And, last but not least, they highlight the need for a better understanding of non-economic factors—history, culture, and politics—in economic growth processes. The operational implications of this work will be explored separately.

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Preface

At the start of the 1990s, many economists working with developing countries thought the road ahead was clear. What for many countries had been the "lost decade" of the 1980s made it evident that government interference in the economy—in the form of controlled prices, rationed foreign exchange, distorted trade regimes, repressed financial markets, state ownership of commercial enterprises, excessive government spending—led to enormous waste of resources and impeded growth. Hence, the logic went, reducing this waste, correcting distortions, and rolling back the state would ensure developing countries' return to sustained growth. Much of this vision is reflected in John Williamson's "Washington Consensus". The Consensus was meant to synthesize the reforms which at the beginning of the 1990s most economists in Washington—in the World Bank, the International Monetary Fund, the US Treasury, and in some of Washington's think tanks—believed were needed for Latin American countries to emerge from cycles of high inflation and low growth. The Consensus was formulated while in some influential parts of the world, the current of opinion was shifting towards a smaller role for governments. Privatization and deregulation were taking hold in the UK, in the US, and in Eastern Europe and the former Soviet Union, then undergoing a historical and political transformation.

The Consensus had been formulated for Latin American countries, and its creator emphasized that it was to be applied judiciously, not mechanistically. The Consensus quickly took on a life of its own, however, and became the expression of what economists in Washington, but also elsewhere, thought virtually all developing countries needed to grow and develop. This thinking guided much of the advice by international financial institutions and other agencies involved in development. Key aspects of the Washington Consensus were reflected in the World Bank's *1991 World Development Report*, although that report stressed the importance of achieving the right balance between government and market, rather than choosing between them, and was generally less sanguine about the impact of specific reforms. The Washington Consensus was not the only point of view among economists. But it was the dominant view, making it difficult for other views to be heard.

The Consensus provided the framework for much of the reforms implemented during the 1990s by a wide spectrum of countries around the world. By and large, the variance in results has been much greater than expected—with some countries managing to sustain rapid growth with just modest reforms, and others unable to grow even when implementing a wide range of reforms. A common reaction has been that countries that grow have reformed enough, whereas those that are unable to find the path to sustained growth have not.

For many economists and, perhaps more importantly, for policymakers to whom these economists provide advice, this interpretation is not entirely satisfactory. While there is no question that some of the principles of the Washington Consensus—macroeconomic stability, domestic liberalization, and openness—lie at the heart of any sustained growth process, the options for putting these principles into practice vary considerably. Which options should be chosen depends on initial conditions, the quality of existing institutions, the history of policies, political economy factors, the external environment and, last but not least, the art of economic policymaking. The range of options puts the onus on economic analysis to guide policymaking effectively. In dealing with growth processes, economists have no formula. They have broad

principles and tools—in the same way that principles and tools can be used to build an airplane. If not appropriately put to use, the airplane may not fly, or may not weather storms well. The manner and sequence in which these principles and tools are used will determine whether specific growth country strategies will succeed or not.

This is the central message coming out of the work presented in this draft volume. The volume is part of a three-pronged exercise the World Bank undertook, to learn from the experience of the 1990s from three perspectives: (1) analytical (this book); (2) policy (13 policymakers, who were at the forefront of policy implementation in the 1990s, used their experience to draw lessons about economic growth during a one-year cycle of lectures at the Bank); and (3) operational (12 former Bank country directors drew lessons from their work at the Bank in a series of papers, to be published separately). The project initially was meant to help the Bank's economists to interpret and think through the experience of the 1990s, and draw lessons from that experience. As the project progressed, we realized it could be of wider interest.

At this point the draft volume has been reviewed internally, and also externally by a panel of three external reviewers: Ricardo Hausmann, Ravi Kanbur, and Devesh Kapur. The draft is being put on the World Bank's external web site as part of a process of consultation and discussion before it is finalized. The plan is to hold discussions in several countries with economists from both developing and more developed countries, including from Algeria, Brazil, the European Union, India, Senegal, Tanzania, international institutions such as the International Labor Organization, and bilateral development agencies such as the US Agency for International Development. Comments will also be gathered through the external web site. These external consultations and discussions are expected to last until early in 2005, following which the book will be finalized and published.

We encourage you to keep abreast of changes on the study web site http://www-wbweb.worldbank.org/prem/pas/devchallenges/countrynotes.htm (for internal viewers) and http://www1.worldbank.org/prem/lessons1990s/countrynotes.htm (for external audiences). Your comments and views are welcome.

Gobind T. Nankani and Roberto Zagha