

Chapter 1

Overview

ECONOMIC GROWTH IS A RECENT event in the history of humanity. During most of 4 million years of evolution, people made limited economic progress and their material well-being changed very little. In the last few centuries, however, goods and services started to be produced at increasingly lower cost in hours of effort. The hours of work needed to produce basic goods such as water or heat at the dawn of civilization were several hundred times those needed today (DeLong 2000). Similar increases in productivity have been achieved for an expanding range of goods and services. Most of this progress has taken place in the last two centuries, during which technological progress has been exceptionally rapid, and economic growth unprecedented (figure 1.1).

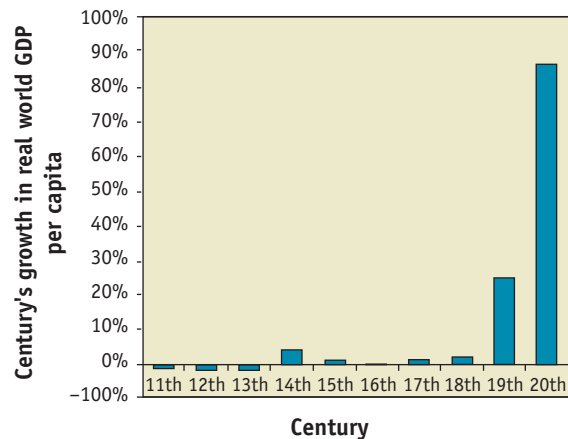
It is only in the last 50 years that mainstream economics has focused on the determinants of Adam Smith’s “natural progress of opulence” and on how growth could be accelerated. Many questions about growth still lack satisfactory answers. Yet few issues are more important for the world’s future than the ability of developing countries to raise both productivity and the rate at which they accumulate capital.

This overview chapter first briefly reviews our understanding of growth before turning, in section 2, to the facts and controversies of growth and policy reforms in the 1990s. Section 3 draws the broad lessons coming out of the growth experience of the 1990s, and section 4 offers lessons specific to key

policy and institutional reforms. Section 5 sketches operational implications. Subsequent chapters set out the facts about growth in more detail, and then examine the main areas in which economic and institutional reforms concentrated during the 1990s—macroeconomic stabilization, trade, financial sector, privatization and deregulation, modernization of the public sector, and political reforms. The chapters aim to draw lessons from gaps between expectations and outcomes. Most chapters are also followed by a Country Note that expands on issues insufficiently dealt with in that chapter, or that considers country-level perspectives.

FIGURE 11

Worldwide Growth in Real GDP per Capita, 1000–Present



Source: DeLong 2000.

1. Understanding Economic Growth

Absent definitive theories, views on growth have been shaped by facts and changed by experience. Until the 1970s, the growth strategies of developing countries focused on accelerating the rate of capital accumulation and technological adoption. Import substitution, state-owned enterprises, controls over the financial sector, central planning, and a variety of price controls and state interventions in the economy were some of the policies that governments used to take the “commanding heights” of the economy and guide resource allocation to areas thought to be most conducive to long-term growth. Confidence in governments was born from their (partial) success in addressing the Great Depression, in expanding production during World War II, and reconstructing Europe and Japan. Economists and policy makers saw that market forces disrupted growth and that governments were able to restore it, and to expand capacity efficiently. The generation of economists that followed, however, familiar with experiences of developing countries in the 1970s and 1980s, saw the waste of enormous resources in ill-conceived government initiatives, the costs of poor macroeconomic management, and the ease with which well-intentioned public policies could be diverted to serve narrow political or economic interests. Understandably, this later generation of economists and policy makers came to believe that the cost of government failures was considerably larger than the cost of market failures, that government interventions interfered with development, and that containing the role of the public sector in the economy, reducing its use of resources, and limiting its discretion were essential for economic growth.

New Growth Theory

This shift in views was supported by a new strand of academic research that started in the second half of the 1980s and gathered impetus during the 1990s, when there was a resurgence of academic and empirical work on growth.

Up to then, thinking about growth had been dominated by the Solow model, the basic model with which we still think about economic growth, in which growth is a function of the accumulation of capital, accumulation of labor, and productivity growth. This model leaves out much of what needs explaining. In particular, it views long-run growth as entirely determined by exogenous factors, independent from structural characteristics of the economy such as openness, scale, and saving rate, and, most important, from the policies influencing such variables. Also, while left unexplained in the model, productivity growth drives the empirical story. Solow himself estimated that technological change explained more than half of per capita output growth in the first half of the 1990s in the United States. Calculations by the World Bank indicate that it explained one-third of the increase in per capita income in East Asia up to the early 1990s (World Bank 1993). Other exercises reach similar conclusions on the large role of productivity gains in growth experiences.

At first the New Growth Theory seemed to hold the promise of linking policies to growth performance. It appeared at a time when evidence was accumulating—from the growth experience of the 1970s and 1980s—suggesting that the accumulation of capital was not a panacea, and that misguided policies were costly for growth. The new evidence provided the conceptual foundation for aggregate cross-country regressions, which throughout the 1990s sought to capture the effect of policies on long-term growth (Barro 1991; Temple 1999) and provided the strongest intellectual foundation for the view that better policies would deliver faster growth.

A number of empirical problems became evident, however, related to the crude manner in which policy variables enter the cross-country regressions; the fact that differences in the institutions underlying policy design and policy implementation are not captured; the lack of robustness to changes in time periods and specifications; the crudeness of the assumption that the same model explaining growth in the Republic of Korea or Brazil could be used for Bolivia or Rwanda; and the

poor predictive power of policies as indicators of performance.

If, as suggested by the growth regressions, policies matter for growth, policy improvements should lead to higher growth. Both in the 1980s and 1990s, policies improved relative to other decades, but growth performance remained well below that of the 1960s and 1970s (Easterly 2001). More recently, empirical research has argued that when a measure of “institutional quality” is included in cross-country regressions, the explanatory power of other variables, including all measures of “policies,” becomes negligible (Acemoglu, Johnson, and Robinson 2001; Rodrik, Subramanian, and Trebbi 2002; Easterly and Levine 2003; and IMF 2003e). This suggests that “good” institutions matter more for growth than “good” policies—that “institutions rule.”

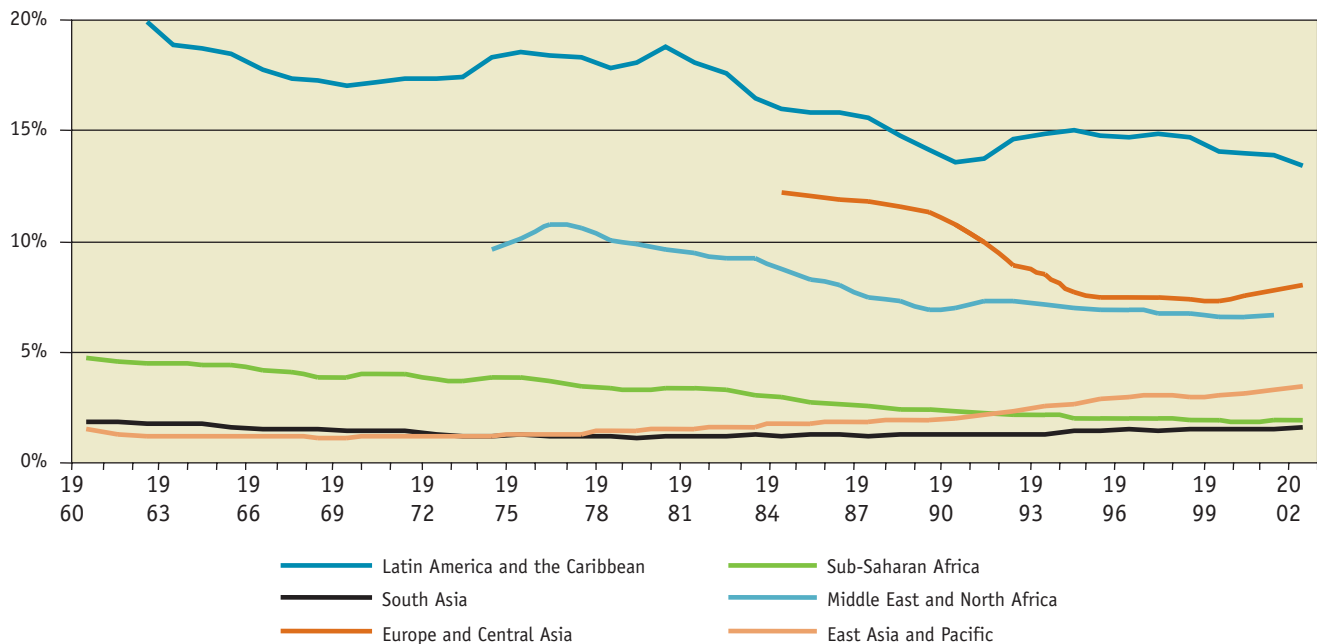
In hindsight, the breakthroughs expected from the New Growth Theory have not materialized.

Nonetheless, in the process, greater clarity was reached on the facts about growth, analysts paid greater attention to the role of institutions, and studies brought the issue of inequality—both within and between countries—increasingly to the fore.

Growth in Developing Countries: Divergence, Variability, and Unpredictability

Research during the 1990s was able to extend the availability of data over long periods. This made it clear that growth was not a linear process, and that it did not conform to the theoretical prediction that per capita income in developing countries would eventually converge with that of industrialized countries. In fact, there has been “divergence big time” in the evolution of per capita incomes (Pritchett 1997), both between industrialized and developing countries and among developing coun-

FIGURE 12
Economic Growth in Perspective, 1960–2002



Source: WDI 2003.

Note: Regions' GDP per capita is shown as a percentage of the OECD GDP per capita (total regional GDP over total population).

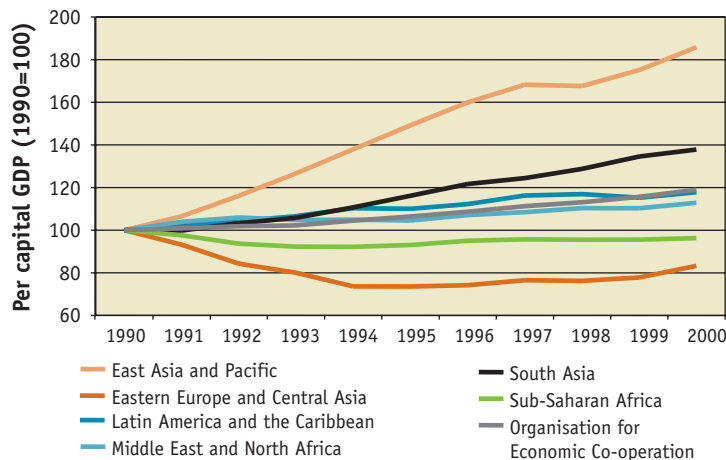
tries themselves. This is the case whether the period being considered is the last 40 years (figure 1.2) or the last 10 (figure 1.3).

As a result, worldwide inequality has changed from being the result almost exclusively of differences among people *within* countries to being the result primarily of differences *across* countries (figure 1.4).

The consideration of growth over longer periods also highlights the *variability* of growth in developing countries. The experience of Latin America since the 1980s, the collapse of growth in Africa in the last two decades, and the economic collapse of Eastern Europe after several decades of sustained growth stand in sharp contrast to the stability of growth among industrialized countries, which have grown at roughly a constant rate (except for the interruption of World War II and recovery years) for more than 100 years. It also contrasts with the experience of East Asian countries. What is remarkable about East Asia is not that it experienced a crisis in 1997, but that it experienced so few crises over the preceding decades. By and large, developing countries have one year of negative per capita growth roughly once every three years. In East Asia, the average is

FIGURE 1.3

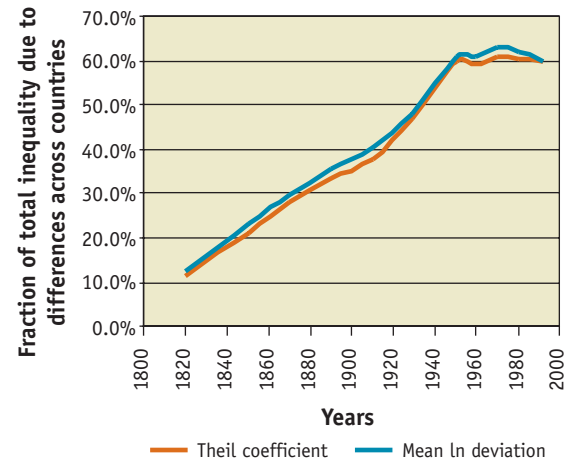
Regional Perspectives on Growth in the 1990s



Source: WDI 2003.

FIGURE 1.4

Fraction of World Inequality Accounted for by Differences across Countries



Source: Bourguignon and Morrison 2002.

half that rate. Korea has only had only three years of negative per capita growth since 1961.¹

The variability of growth helps to explain why growth in the developing world is so difficult to predict. Instances of economists (including, for example, 1977 Nobel Laureate James Meade on Mauritius) making highly inaccurate predictions have become part of the economic folklore. Many of the economic successes of today—Bangladesh, Indonesia, Korea, or Mauritius—were considered “basket cases” in the 1960s, when Africa’s growth prospects were seen as superior to those of overpopulated Asia—a view captured in *Asian Drama* (Myrdal 1972). In the later 1990s, just before the second most dramatic economic crisis in its history, Argentina was seen as a model for developing countries and believed to have found the path to sustained growth. At a more technical level, World Bank growth projections, as well as growth projections by other forecasters, tend to be systematically overoptimistic (a point that was highlighted in the World Bank’s *World Development Report 1991*).

While a rare occurrence thus far, sustained growth has improved the lives of millions. Coun-

tries where sustained growth has taken place (mostly in South and East Asia, including Bangladesh, China, Indonesia, India, and Vietnam) account for a large proportion of world population. Out of 117 countries with populations of more than half a million people, only 18 have been able to sustain growth rates exceeding industrialized countries' growth and hence narrow their per capita income gap with those countries.²

Institutions

Defined as the rules and norms constraining human behavior (North 1990), institutions include the informal rules and norms that govern personal and social behavior and the formal rules and norms governing economic, social, and political life. Institutions enable societies to organize themselves and function in an orderly manner by solving problems central to life in society, particularly agency problems, containment of predation by individuals or the state, and collective decision making. Societies' performance depends on how effectively their institutions resolve these problems.

The importance of institutions for economic prosperity is not a novelty learned from the 1990s. From different perspectives, Adam Smith, Karl Marx, and Max Weber highlighted the role of institutions in the development of a market economy and formation of a capitalist society. Economists dealing with development in the 1950s and 1960s were aware that the development challenges faced by a plantation economy differed from those faced by a society where economic and political power were not concentrated (Rostow 1952, 1960; Adelman and Morris 1965). Latin American economists of the Structuralist school saw in the legacy of colonialism, embedded in institutions serving the interests of a small, landed elite, the source for economic performance inferior to that of the United States or Canada (Furtado 1963). This imbalance formed a part of the justification for an activist state: inflation helped to mobilize resources from the wealthy elite who resisted more efficient forms of taxation; states sponsored investments in manufacturing, particu-

larly in capital-intensive industries, because old economic interests resisted change and were unwilling to take on risks inherent in new industrial activities; price controls did not have serious economic consequences because the concentration of wealth precluded the redeployment of resources in response to changes in demand (Seers 1962).

While there are some *functions* that institutions need to perform in any society, the *form* through which institutions can perform these functions can vary considerably (Virmani 2004). Most of the empirical work on the importance of institutions leaves open the question of how to improve institutional performance. Merely adopting some other country's laws and formal regulations is no guarantee of achieving the same institutional performance. Recently, accession to the World Trade Organization and integration into regional supra-national entities such as the European Union and the New Economic Partnership for Africa have strengthened incentives for institutional improvements. East Asian countries have long realized the importance of institutional change and innovation, and the 1997 crisis made this realization all the more acute, creating renewed impetus to modernize institutions, including political institutions. But for most developing countries, improving the quality of their institutions remains a challenge.

Fairness, Growth, and Institutions

Another important strain of ideas in the 1990s came from the resurgence of interest in inequality as an apparent influence on growth and institutional performance. A recent body of literature suggests several channels through which inequality affects economic growth. Fairer societies offer their citizens more public goods, more social support, and more social capital. Hence they are more capable of sharing the costs and benefits of improving economic policies, and in turn facilitating consensus building and decision making (Deaton 2003a). Fairness also facilitates agreement on the provision of public goods that have strong beneficial side effects on society, such as health services, water supply, or

waste disposal. Other channels through which inequality affects growth are market structures and microeconomic incentives. A better distribution of wealth reduces credit constraints, and broader availability of credit is found to have a significant and positive effect on growth rates. If individuals are limited in their borrowing capacity, reallocating capital toward the poorest will increase aggregate productivity.

Even if one concludes that greater equality influences growth positively, there is still considerable ignorance about the means through which greater equality can be achieved. Governments have long sought, with varied degrees of success, to redistribute income through land redistribution, employment programs, subsidies, and promotion of broad access to credit, infrastructure, health, and education. The large, underresearched area for further study includes questions related to the impact of public spending on equity, both in a static sense (incidence of public spending) and a dynamic sense (changes in individuals' earnings potential).

Recent literature has emphasized the important links between the distribution of assets in a society and the institutions that emerge. Knowledge is still rudimentary about how institutions emerge and are established in a society, but economic research in the 1990s has provided some insights. First, economic incentives influence what type of institutions emerge and when. The enforcement of property rights to land, for example, will depend on the benefits of enforcement relative to its costs, which for each owner depends on the extent to which other owners enforce their property rights. In an extractive economy, for example if landowners in general do not enforce their property rights, it is uneconomical for one landowner to enforce his: workers will find it attractive to exploit land and appropriate the rents for themselves. Only when this coordination problem is resolved will economic incentives be sufficient for enforcement of property rights (Hoff and Stiglitz 2001). Second, concentrated economic and political interests influence institutions. This can be seen from experiences with land distribution in Latin America, and also from the United

States in the early 1900s, when the government decided to regulate matters hitherto left to private parties and the courts; the reason for the shift was a perception that judges and the courts, having been corrupted by powerful economic interests, were unable to render fair and equitable judgments. *World Development Report 2001* provides other examples of how economic incentives affect the emergence of institutions that sustain the functioning of markets, and the different coordination or risk-reducing problems that they are meant to resolve.

2. Facts and Controversies of the 1990s

At the beginning of the 1990s, most economists working on development and many policy makers shared the conviction that more efficient use of resources would lead to growth. This was believed to require, first, macroeconomic prudence, domestic liberalization, and outward orientation, which in turn required freeing market incentives and opening the economy. Hence fiscal deficit reduction, realignment of exchange rates to eliminate black market premia, lifting controls on prices, deregulation of interest rates and liberalization of the financial sector, and reduction of tariffs and other restrictions on imports all became central to the policy reform programs implemented in the 1990s.

Second, conventional wisdom held that to achieve greater efficiency required a reduction in the role of the state. There was evidence that the state discretion that was inherent in growth strategies based on infant industry, import substitution policies, and the growth of public enterprises had been misused more often than anticipated, had often been captured by narrow interest groups, and served as the source of endemic corruption. Addressing this problem required reducing state discretion, downsizing governments, and encouraging a much greater role for the private sector. Hence privatization, deregulation, elimination of quantitative restrictions and of licensing requirements, and dismantling agricultural marketing boards and

other forms of state monopoly all became central to reform programs. Seeing the need to strengthen the organizational effectiveness of the state, and the efficiency with which the state used public resources, reformers rationalized government functions and undertook civil service, legal, and budget reforms. Democratic processes were expected to provide checks and balances and further incentives to this process.

Third, it was believed, reforms had to be rapid. Earlier, some of the first authors to argue in favor of abandoning the *dirigiste* framework of early development economics (notably Little, Scitovsky, and Scott 1970; McKinnon 1973) had argued explicitly in favor of a gradualist reform strategy (in respect to trade and the financial sector, respectively).³ But in the course of the 1980s the economics profession began to be influenced by the enthusiasm of leading politicians for “the magic of the market.” Arguments in favor of “big bang” and “shock treatment” became prominent. By the time that the transition to a market economy got under way in the former socialist economies, “a belief in gradualism had almost become tantamount to a confession of a lack of reforming virility” (Williamson and Zaghera 2002).

A Decade of Significant Change

The 1990s provided ample opportunity for these views to be implemented. The Russian Federation, Eastern Europe, and Central Asia embraced capitalism and a new generation of leaders made it a priority to rebuild their economies on the basis of capitalist principles, markets, and privatized firms. Regarding the speed of reform, while there were divergences, the balance of opinions supported rapid rather than gradual reform. China, the largest developing economy, continued the reforms it had begun in 1978 with further liberalization of the domestic economy, and increased openness. After its crisis in 1991, India, the second-largest developing economy, speeded up liberalization started in the 1980s. President Collor of Brazil announced a radical program of economic reform aimed at

reducing hyperinflation and reversing several decades of state-led import-substituting industrialization. In Argentina, President Menem set the country on a course of eliminating hyperinflation through a currency board as well as ambitious market reforms, which saw the privatization of state-owned businesses and liberalization and opening of the economy. In Bolivia, reforms by Paz Estensoro that had brought hyperinflation to a halt in the mid-1980s were continued in the 1990s, regardless of the parties in government. In Africa, the devaluation of the African Financial Community (CFA) franc increased competitiveness and many other reforms were implemented throughout the region. In Tanzania, President Mkapa started an ambitious program of reforms. In South Africa, the transition to a multiracial democracy was followed by steps toward liberalizing the economy.

Leaders such as Rawlings of Ghana and Museveni of Uganda strengthened fiscal fundamentals, achieved macroeconomic stability, liberalized the economy, and reduced the role of the state. Privatization, retrenchment of the public sector, and liberalization of trade were the focus of economic policy changes in countries as diverse as the Central African Republic, Ghana, and Tanzania. Reforms in the Middle East and North Africa were less ambitious but were nonetheless significant in the Arab Republic of Egypt, Jordan, Morocco, and Tunisia. On the political front, democracy spread in former communist countries and Africa, and was consolidated in Latin America. These and other changes gave rise to expectations that the 1990s would accelerate growth and social progress in the developing world.

Rapid Growth, Take-offs, and Social Progress

India and China, together accounting for 40 percent of the developing world's population, grew fast in the 1990s for a second decade in a row, as did many other countries in South and East Asia, including Bangladesh, Sri Lanka, and Vietnam. Chile continued to grow in Latin America, Tunisia in North Africa, and Botswana and Mauritius in Africa. New high performers appeared and annual

gross domestic product (GDP) growth for the decade was rapid in an array of countries: Mozambique (7.8); Uganda (6.8), Dominican Republic (6.0), Tunisia (5.0), and Poland (4.5). Countries affected by the crisis in East Asia made an unexpectedly rapid recovery.

Notwithstanding unevenness across regions, the incidence of poverty continued to decline throughout the 1990s—more rapidly in East Asia than in South Asia and more rapidly in South Asia than in Latin America. In Africa, however, the incidence of poverty increased slightly. Growth was the main force behind virtually all cases of significant reductions of poverty, including in China and India. But particularly in Latin America, there were instances such as Brazil and Bolivia where social indicators improved without significant growth.

Alongside these positive developments, however, there were several negative surprises.

“Transition Recession” in the Former Soviet Union and Eastern Europe

The transition from a communist, centrally planned economy to a capitalist one was expected to be difficult. But the depth of the output collapse was not widely predicted. The length of the transition—in which many countries in 2003, more than a decade later, remain far below their previous levels of output—was not widely forecast. Nor was the variability among countries in the depth and duration of the output collapse. Though recoveries have started to emerge—in the Czech Republic, Hungary, and Poland, for example—it will take years, and in some cases, decades, for most former Soviet countries to regain their per capita income levels prevailing at the beginning of the transition.

Continued Stagnation in Sub-Saharan Africa

The failure of growth in Africa—either of powerful and rapid growth in a single large country or in a substantial number of smaller ones—was a surprise. Despite good policy reforms, debt relief, continued high levels of official assistance, promising developments in governance, and a relatively supportive external climate, no take-off has ensued. While some

positive developments occurred in the later 1990s, such as in Mozambique, Tanzania, and Uganda, and still persist at the time of writing, it is too early to conclude that Africa has turned the corner.

Financial Crises

Financial crises in the 1990s were less predictable than in the 1970s and 1980s. Macroeconomists, bank restructuring experts, and emerging-market private traders rolled from crisis to crisis: from Mexico during 1994–95, to Korea, Malaysia, Thailand, Indonesia during 1997–98, Russia in 1998, Brazil in 1998, and Turkey in 2001 to the latest and perhaps most worrisome of all, in Argentina during 2001–02. The evolution of spreads in the months preceding the financial crises suggests that few were anticipated.

Delay in Recovering Growth, Particularly in Latin America

It was hoped that the “lost decade” of the 1980s would be reclaimed in the 1990s. Macroeconomic stabilization, fiscal austerity, trade liberalization, and privatization were expected to lead to rapid growth. Although growth was the fastest in two decades until 1998, its collapse thereafter following the reversal in capital flows created the general perception that the growth payoffs have been smaller than expected.

Argentina: The Collapse of the Hard Peg

Argentina was the most successful example of a trend in the 1990s to create macroeconomic stability by legal and institutional changes intended to reduce the scope and latitude of government’s discretion. Exchange-rate arrangements that set a fixed rate for *peso* convertibility were not only incorporated into law but also made especially difficult to alter, and changes were made in the operation of the central bank to make these limitations a reality. As part of a package of reforms, this convertibility plan eliminated Argentina’s hyperinflation and, for a period, it restored economic growth.

Once Argentina achieved stability with growth, there was considerable discussion—particularly

after the devaluation of Brazil's *real* in January 1999—as to whether the country should abandon its rigid exchange rate system. Views diverged among economists. Looking back, the former Governor of Argentina's Central Bank described the abandonment as a marriage to be broken when it was going well (Mario Blejer, World Bank 2005b). For fear that markets could overreact, Argentina's authorities maintained the system. When the plan collapsed, the result was politically and economically costly by design. Thus the damage was not a surprise. But the demise of the convertibility plan itself was a surprise, for two reasons. First, its initial successes had suggested longevity was possible; it had reduced rapid inflation and initiated a boom in the early 1990s, and it had weathered the “Tequila” after-shocks of the Mexican crisis reasonably well. Second, while the end of convertibility was costly by design, its actual cost exceeded the most pessimistic forecast.

Interpreting the Results

From a growth perspective, the net result of the contrasting experiences of the 1990s is that developing countries as a group grew faster than in the 1980s. In East and South Asia this reduced the income gap with industrialized countries, but in other regions, the gap increased. In Latin America, there were clear gains up to 1998, reversed in the late 1990s and early 2000s (figures 1.2 and 1.3).

Analyzing policy reforms of the 1990s, several studies (Loayza, Fajnzylber, and Calderon 2002; Lora 2001a; Easterly 2001) find that countries that improved their policies—strengthening macroeconomic management, opening up their economies, liberalizing their financial sectors—grew faster in the 1990s. However, they also find a large unexplained negative effect associated with both the 1990s and the preceding decade. Together with analysis of individual country experiences and overoptimistic forecasts by international financial organizations and private entities, these studies give an empirical base to perceptions that the economic policy reforms of the 1990s yielded results below expectations.

It has been suggested that lower OECD growth might have depressed developing countries' growth in the 1990s (Easterly 2002). In reality, the 1990s was favorable for developing countries, even if not every country found ways to benefit. Exports from developing countries as a group grew much faster than in previous decades. Real interest rates were lower. Debt obligations claimed fewer resources, and foreign direct investment and financial flows to developing countries were much larger. If commodity prices affected developing countries adversely, the damage was not dramatic and should have been offset by the increasing share of manufacturing exports—except in a small group of least developed and Sub-Saharan African countries that remained highly dependent on agricultural exports.

All in all, while external factors played a role, explanations of performance must be sought primarily in developing countries' domestic policies.

Good performance has been associated with domestic and external liberalization; Chile, India, China, and other countries in East Asia are all more open than in previous decades and have moved toward greater reliance on market forces. But many aspects of these countries' policies are still far from compliant with conventional wisdom. For example, India has registered fiscal deficits several times higher than Brazil's or Argentina's, with lower inflation and lower interest rates. While this fiscal trend is clearly unsustainable in the long run, and measures have been taken to correct it, it is clear that there is more to macroeconomic stability than a superficial reading of the size of the fiscal deficit. China has built extremely large contingent liabilities related to unfunded pensions and nonperforming loans in the banking system. While, again, this is not a sustainable situation, it suggests that economies do not operate in mechanical ways, and that dynamism in one sector can offset the cost of inefficiency in others. Similarly, India's and China's industries, though increasingly competitive in export markets, remain protected and state enterprises still play a large (though declining) role in these economies.

The mismatch between predictions and results, and the successes of China, India, and Vietnam

where there were substantial deviations from the full package of reforms, suggest several possible explanations. First, sufficient time may not have yet elapsed for results to emerge in all countries. Over time, market-oriented reforms may ultimately yield the results expected. Growth rates in African and other developing countries have rebounded since 1997; Argentina is experiencing its second year of rapid growth after the collapse of 2001–02; and growth rates in Eastern Europe have increased. Second, perhaps the reforms implemented in the 1990s were not sufficiently ambitious. Insufficient fiscal adjustment in Latin America, very partial privatization in Africa, and insufficient openness to international trade in the Middle East and Northern Africa may explain performance below expectations in these regions. A third possible explanation is that there were incoherencies in the implementation of policies. Argentina introduced a rigid exchange rate without the fiscal and financial conditions needed to sustain it. Fiscal adjustments in some African countries were achieved at the cost of reducing productive public spending. Open capital accounts encouraged pro-cyclical flows. Correction of these incoherencies may enable growth to resume.

Perhaps most important, while reforms in the 1990s focused on increasing the role of markets and decreasing the role of the state, they tended to neglect the role of institutions. Francisco Gil Diaz, Mexico's Minister of Finance (as quoted in Krueger 2004), recently suggested that

The policies that have been undertaken are not even a pale imitation of what market economics ought to be, if we understand market economics as the necessary institutional framework for a sound economy to operate and flourish. What has been implemented throughout our continent is a grotesque caricature of market economics.

State enterprises were privatized without much attention to the operation of the markets in which they would function. Financial liberalization swelled the resources, foreign and domestic, that ineffective

intermediaries channeled to state enterprises and related borrowers, contributing to the massive crises. In some cases, lack of competitive political forces and such institutions as a free press allowed those who were politically well connected to take advantage of privatizations and to take control of natural resources while enabling corruption to flourish.

These explanations are not mutually exclusive; one or more may apply to specific country circumstances. The experience also holds some deeper lessons. For example, while at one level Argentina's experience teaches that fixed exchange regimes require a very demanding set of conditions, a deeper lesson is that rigid rules are no substitute for credibility, and that government's discretion needs to be checked, not replaced with rules. Another deeper lesson is that the reforms of the 1990s did not focus on the binding constraints. For example, they reduced fiscal deficits when perhaps the binding constraints were lack of public capital and aggregate demand. Or they reduced tariffs on imports when perhaps the binding constraint was the workings of the financial sector. Or they focused on correcting government failures, when the binding constraints were market failures.

3. Lessons from the 1990s

Promote Growth, Not Just Efficiency

Reforms need to go beyond the generation of efficiency gains to promote growth. The policy focus of reforms in the 1990s enabled better use of existing capacity but did not provide sufficient incentives for expanding that capacity. While this emphasis on efficiency was warranted at a time of extremely large distortions and waste, it also explains the frequent instances of stabilization without growth or liberalization without growth. The experience highlights the importance of the investment climate, and of providing predictable conditions for investors and other economic agents.

It also highlights that growth entails more than the efficient use of resources. Growth entails struc-

tural transformation, diversification of production, change, risk taking by producers, correction of both government and market failures, and changes in policies and institutions. It is also a process of social transformation: people will change activities and live in different places. Social relations will change, and the informal networks of rural life will be lost as other more formal networks and organizations are established. Entrepreneurs will invest in new machinery to produce new products and adopt new organizational forms. Farmers will adopt new farming methods and change their product mix. The economy will produce and demand different goods and services. These changes take place over time, alongside changes in institutions that render them possible. Any growth strategy needs to include actions, both on the policy and the institutional front, that address and support this process of change.

Better policies can bring efficiency gains, and may increase incentives for investment, but without amounting to a growth strategy. They will not necessarily induce the behavior by private investors and the public sector that is needed to put an economy on a sustained growth path. For this, faster accumulation of physical and human capital by both the private and the public sector are essential, as are gains in productivity.

This may explain why the growth impact of the reforms of the 1990s was smaller than expected. The incentives needed to expand productive capacity (“expanding the frontier” in economists’ parlance) differ from those that are needed to use existing capacity better (“movements toward the frontier”). What matters for growth is less the degree to which policies approximate the ideal than “the extent to which a given development strategy is able to mobilize the creative forces of society and achieve ever-higher levels of productivity” (Alejandro Foxley, in World Bank 2005b). And, in Albert Hirschman’s words (1958):

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.

In retrospect, it is clear that in the 1990s we often mistook efficiency gains for growth. The “one-size fits all” policy reform approach to economic growth and the belief in “best practices” exaggerated the gains from improved resource allocation and their dynamic repercussions, and proved to be both theoretically incomplete and contradicted by the evidence. Expectations that gains in growth would be won entirely through policy improvements were unrealistic. Means were often mistaken for goals—that is, improvements in policies were mistaken for growth strategies, as if improvements in policies were an end in themselves. Going forward, the pursuit of policy reforms for reform’s sake should be replaced by a more comprehensive understanding of the forces underlying growth. Removing obstacles that make growth impossible may not be enough: growth-oriented action, for example on technological catch-up, or encouragement of risk taking for faster accumulation, may be needed.

Common Principles and Diverse Ways to Implement Them

Another mistake often made in the 1990s has been the translation of general policy principles into a unique set of actions. The principles of the 1991 *World Development Report*, “macroeconomic stability; domestic liberalization, and openness,” have been interpreted narrowly to mean “minimize fiscal deficits, minimize inflation, minimize tariffs, maximize privatization, maximize liberalization of finance,” with the assumption that the more of these changes the better, at all times and in all places—overlooking the fact that these expedients are just *some* of the ways in which these principles can be implemented.

There are many ways of achieving macroeconomic stability, openness, and domestic liberalization. As seen above, for example, the goal of achieving macroeconomic stability does not imply a need to minimize fiscal deficits at all times. A lower

fiscal deficit achieved today through off-budget contingent liabilities, or through cutting back public investments and thus reducing long-run growth and the future tax base, may mean a higher fiscal deficit in the future. A lower fiscal deficit does not even guarantee greater macro-stability if it is based on external borrowing in which interest rates are reduced at the cost of greater vulnerability to exchange rate fluctuations, or if it is based on building off-budget liabilities through the banking system, which eventually translate into an increase in public debt—as Latin American countries and Turkey found to their cost in the 1980s and 1990s. Similarly, trade integration can be achieved through various means that offset the effect of tariffs and reduce the implicit tax on exports. Duty rebate schemes, subsidized credit to exporters, and other forms of export promotion, export processing zones, infrastructure, and transport corridors have all helped China, India, Korea, and Mauritius to integrate into the world economy while keeping their tariffs relatively high in the initial phases of integration and reducing them gradually over time. Thailand's and Indonesia's foreign domestic investment regimes had few restrictions, whereas those of Korea and India had many until very recently—but both Korea and India found alternative instruments to access and adopt modern technologies. Financial intermediation can be increased by relaxing entry restrictions in the banking system, or by improving the workings of the legal system, particularly those parts that deal with the repossession of collateral.

To sum up, “getting the policies right” mistakes means for ends. Clearly not everything can be right at once, and not everything needs to be “right” for growth to take place—as witnessed in examples from Bangladesh, China, India, Indonesia, and many other countries.

Common Functions and Diverse Ways to Achieve Them

To sustain growth requires key functions to be fulfilled, but there is no unique combination of policies and institutions for fulfilling them. The

successful growth experiences in eight East Asian economies, reported in the World Bank's *East Asian Miracle* (World Bank 1993), resulted from diverse policy and institutional paths, but common functions were fulfilled along these paths.⁴ This perspective has several implications.

First, different policies can yield the same result, and the same policy can yield different results, depending on country institutional contexts and underlying growth strategies. This nonformulaic result holds not only for the eight East Asian economies featured in the 1993 study, but also for a larger set of countries 10 years later. Countries with remarkably different policy and institutional frameworks—Bangladesh, Botswana, Chile, China, Egypt, India, Lao PDR, Mauritius, Sri Lanka, Tunisia, and Vietnam—have all sustained growth in per capita income at rates above the U.S. long-term growth rate of close to 2 percent a year.

Second, common to all successes is that four functions have been fulfilled: rapid accumulation of capital, efficient resource allocation, technological progress, and sharing of the benefits of growth. Rates of progress in these four functions have not always been uniform, but successful countries have achieved a balance among them over time, and disruptions have ensued when the balance was not achieved. While there can be substitution temporarily, the balance will need to be reestablished at some point.

For example, Korea's policies in the 1960s and 1970s sought to encourage risk taking by the private sector. Import protection and priority lending contributed to higher levels of capital accumulation, at the cost of efficient allocation, which became a more important priority in the 1980s. The Soviet Union, well into the 1960s, grew rapidly on the basis of sacrificing consumption, accumulating capital, and maintaining a relatively equitable income distribution. But its considerable progress in science and technology was not effectively deployed in production and, more important, resource allocation was enormously wasteful. Eventually, the costs of this inefficiency and the political reforms of the late 1980s combined to bring growth to collapse. In India, a “big push” in capital forma-

tion in the decades following independence was complemented in the 1980s—when evidence of misallocation and low productivity growth began to emerge—by policies that gradually freed market forces and increased efficiency in resource allocation (Virmani 2004), thus ensuring not only the sustainability of growth but also its acceleration.

Factoring these four functions into analyses of growth makes it easier to understand why both policies and institutions play a role. For example, capital accumulation by the public sector requires sound tax policies and administration, sustainable macro policies, and a bureaucracy that is capable of formulating and managing public expenditure programs effectively and of choosing programs with high returns. Accumulation by the private sector requires at least reasonably secure private property rights, stable expectations about the future, a stable macroeconomy, and access to finance. One country might strengthen private investment by, say, improving expectations, whereas another country could achieve the same result by, say, reforming the financial sector.⁵ Similarly, efficiency in allocation requires not only reasonably sound policies—such as competitive exchange rates and an open trade regime—but also institutions that can enforce contracts and enable markets to function (World Bank, *World Development Report 2001*). Technological catch-up requires not only investment and trade policies that enable a country to attract foreign direct investment (FDI) and import equipment, but also institutions that, depending on the country's development stage, promote adaptive research or a patent regime. Indeed, in some instances, it is institutions and political realities that define the set of feasible policies, as testified by Russia's former Minister of Finance Yegor Gaidar (World Bank 2005b):

If I were the tsar of Russia, I would have done everything differently... But if I were deputy prime minister and finance minister, in a government without a parliamentary majority and under many pressures, I would have done more or less what we did.

Different policies can have the same effect, and the same policy can have different effects, depending on the context. In large economies, with access to foreign technology and equipment, competition and economies of scale lessen the efficiency cost of trade restrictions and markedly widen the scope for successful inward-oriented industrialization. Brazil, China, and India were able to develop manufacturing, many segments of which became internationally competitive, whereas in small countries such as Jamaica and Uruguay, or Sri Lanka in the 1960s and 1970s, the market was too small; the benefits of inward-looking industrialization were negligible and did not justify its costs. Sri Lanka became successful only after it began to liberalize imports in late 1977 and follow export-oriented policies. Thus, the same inward-industrialization policy produced different outcomes because country characteristics differed.

Conversely, a given policy can yield different results because of institutional variation. In Japan during the Meiji industrialization and, more recently, in Korea, public institutions were able to resist pressures from narrow interest groups. Public enterprises were run efficiently, and state ownership built capacity in sectors that the private sector had not entered because of perceived high risks. The same policy in Bolivia, however, where public enterprises were run for the benefit of narrow interest groups, did not play a strategic role in the industrialization process, and most of the enterprises were liquidated when Bolivia had to stabilize its economy in the 1980s. In the case of India, it has been shown that in the presence of poor institutions, liberalization can lead to less growth than expected (Virmani 2004).

Like that of policies, the effect of institutions depends on the context. Security of ownership rights has been achieved in different ways and to different extents in different country contexts. In Soeharto's Indonesia, securing returns depended on connections with the ruling elite. In contemporary China, the definition and enforcement of property rights depend on party and local government support—and only recently have initiatives been taken in this direction. And in India, success depends on

the functioning of a judiciary modeled after western legal systems.

Sharing the benefits of growth has been important in all sustained growth experiences, and particularly in countries with authoritarian forms of government, where it has helped to legitimize regimes that often were neither fully representative nor democratic. Various policies have been used to promote the sharing of the benefits of growth. They include land reform and redistribution of other assets; public expenditures on infrastructure (the 8-7 program in China); social spending (Tunisia); policies to increase opportunities to economically underprivileged groups (affirmative actions for *bumiputra* in Malaysia); and poverty-targeted programs (food stamps in Sri Lanka or employment programs in India and Bangladesh).

To sum up, diversity in the form of successful growth experiences should be no surprise. Each successful country was successful in its own way.

Government Discretion Needs to Be Managed and Checked, Not Replaced by Rules

Because developing countries' societies resolve agency, predation, and collective decision-making problems less effectively than do those of industrialized countries, much of the reform effort in the 1990s sought to introduce policies that would limit the discretion of national authorities in growth strategies and minimize demands on institutions. Privatization, financial liberalization, and removal of quantitative restrictions on imports are examples of policy reforms meant not only to improve incentives for more efficient allocation but also to reduce the need for government discretion. Dollarization, fiscal rules, or integration in larger economic unions are examples of institutional reforms meant to replace government discretion by rigid rules; they are consistent with the sense that, on balance, the costs of failures outweigh the benefits of discretion in the workings of an activist, developmental state.

However, government discretion cannot be dispensed with altogether, so it is important to find

ways in which it can be exerted effectively. What was learned in the 1990s is not only that sound policies do not necessarily engender the institutions of a modern economy—that institutions are not entirely endogenous—but also that institutions can prevent the adoption of growth-oriented policies or offset their impact. Experience showed how much institutions matter, and how hard it is to work around their absence or to improve their quality. Above all, the experience showed that government discretion cannot be bypassed. It is needed for a wide range of activities that are essential for sustaining growth, ranging from regulating utilities and supervising banks to providing infrastructure and social services. Improving institutions that support the implementation of policies, and strengthening checks on the use of discretion, are more promising guiding principles than seeking to eliminate government discretion.

Much of the complexity encountered in the realm of economic institutions is also found in the institutions governing political life. The formal institutions of democracy, for example, do not necessarily ensure appropriate checks on discretion, nor are those checks always absent in authoritarian regimes. Mechanisms and levels of accountability can take very different forms, rarely amenable to the simplicity of formal political institutions. Much of the growth success of East Asian countries can be attributed to these countries' ability to allow discretion by different government agencies, alongside checks on this discretion that made them accountable. The forms of these checks varied: an authoritarian development-oriented political leader in some cases (Soeharto's Indonesia, Korea in the first decades of its take-off), the checks and balances inherent in complex one-party systems (China), or the normal checks and balances of a democratic regime (India, Sri Lanka).

Prudent Macroeconomic Management Is at the Heart of Successful Growth Strategies

Avoidance of busts usually requires avoidance of booms. The costs of the crises of the 1990s in terms

of forgone growth, social distress, and public debt highlight once again the importance of prudent macroeconomic management. They also stress the importance of avoiding macroeconomic vulnerabilities, and the risks associated with indiscriminate opening of the capital account. Last but not least, they stress the importance of responding quickly to downturns. One difference between successful and less successful growth experiences is the frequency of downturns: virtually nonexistent for China, Korea, or Malaysia, but numerous for Argentina, Brazil, and Turkey.

In addition to dealing with crises effectively, it is also important to reduce financial fragilities and hence vulnerability to shocks. The financial crises of the 1990s differed from the many that preceded them because of their cost and their suddenness, and they were much harder to predict. The risks of financial integration had been underestimated and its gains overestimated. In the 1990s in emerging market economies, the opening of the capital account to financial inflows triggered large surges that lowered the costs of sovereign and private borrowing and helped reduce inflation. For those reasons, governments (with exceptions such as those of Chile, India, Korea in the early and mid-1990s, and Malaysia) encouraged these inflows. Of the 10 economies that received the largest inflows, however, 7 suffered severe crises that took the form of large output declines, higher incidence of poverty, and large exchange rate devaluations. The three exceptions were China, India, and Hong Kong (China).

Each crisis was preceded by a large surge in inflows that either led to appreciation of the real exchange rate and increased current account deficits or, as in some East Asian countries, created an external debt maturity profile excessively biased toward the short term, and exposed unhedged commercial banks to currency and maturity risks. In current account crises—many of which arose in the context of stabilization programs anchored on a nominal exchange rate—the sequence of events followed a remarkably similar pattern: a surge in capital inflows put pressure on the exchange rate to appreciate; the current account deficit of the bal-

ance of payments increased; private-sector and government debt exposures fed resistance to letting the exchange rate adjust; governments sought to sustain the rate by drawing down reserves, but the policy lacked credibility, or reserves were insufficient to sustain it; a large devaluation followed; and the tightening effect of the devaluation was amplified by the consequences of currency mismatches for the balance sheets of banks or those of their borrowers and of firms. In Indonesia and Korea, for example, where current account deficits were relatively small, the trigger was the need for a large debt rollover at a time when investors were retreating from emerging markets and when risk perceptions were on the rise. This was accentuated, in Indonesia, by the uncertainty of the political transition.

The booms and busts of the 1990s are reminiscent of some of the crises of the 1980s. They teach several important lessons. First, as with most liquidity surges, busts inevitably follow booms: avoiding the bust requires avoiding the boom and strengthening the fundamentals. Countries such as Chile, India, or Malaysia that managed inflows, including through the imposition of restrictions, were able to weather the crises much better than countries that took no such precautions. Can a boom be distinguished from a favorable lasting trend, *ex ante*? In most cases the distinguishing factors are the volume of the surge, the pressure it puts on the exchange rate, and its impact on bank credit. Second, the crises of the 1990s highlight the extent to which banks can amplify the consequences of a crisis, and the risks associated with currency mismatches, including mismatches on the borrowers' balance sheets. Third, sovereign borrowing in foreign currencies is risky. While sovereign borrowing should, in theory, help a country to access external resources on better terms, in practice it has encouraged governments and private firms to take excessive risks.

Move Away from Formulaic Policy Making and Focus on the Binding Constraint(s)

A vital lesson for policy formulation and policy advice is the need to be cognizant of the shadow

prices of constraints, and to address whatever is the *binding constraint* on growth, in the right manner and in the right sequence. This requires recognizing country specificities, and more economic analysis and rigor than does a formulaic approach to policy making. Policy makers face the practical problem that no scientific method permits *ex ante* identification of the most important constraint(s) binding growth in specific country circumstances, and hence the specific measures that are needed address it (them). During the 1980s and 1990s, China's approach was to "cross the stream by groping for the stones." Constraints were identified and dealt with as the growth process unfolded, through experimentation and trial and error (chapters by Lim and Huang, in World Bank 2005a).

Which policy should be introduced, and when, varies considerably from case to case depending on initial conditions and institutional endowments. For example, one can generally assume that 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 utilization of existing capacity, as in many countries of the Middle East and North Africa, reducing them will be essential. Where there is uncertainty regarding the future course of economic policies, 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 is still the case in some Central Asian and some African countries, trade liberalization will be of little effect.

Experimentation and learning is hence an important part of the growth process. The *East Asia Miracle* study highlighted that behind the miracle was the East Asian countries' willingness to experiment, and ability to learn from, not to persist in, their mistakes. This approach helped them identify,

at any point in time, the constraint that most severely limited growth, and the right sequence of policies needed in each situation. There may be situations in which a country needs to address many constraints at once, as during the transition of Eastern European countries. These situations are rare, however. In most cases, countries can deal with constraints sequentially, a few at a time. Success in addressing one or a set of constraints makes it easier to deal with the others, and may help establish virtuous circles.

4. Lessons from Policy and Institutional Reform Experiences in the 1990s

The economic policy reforms of the 1990s focused on improving efficiency in the allocation of resources through macroeconomic stabilization, liberalization of trade and the financial sector, privatization, and deregulation. Deregulation and reduction in the role of government were expected to improve the governance of the public sector through improvements in incentives for performance, more transparency, and fewer opportunities for rent seeking. Institutional reforms focused on improving collective decision making and solving agency problems through democratization, decentralization, and public sector reforms aimed at enhancing the efficiency, transparency, and accountability of government activities. From 60 countries choosing their leaders through competitive elections in 1989, the number rose to 100 by 2000. Delegation to subnational levels of government of political, administrative, and financial powers has taken place not only in federated states such as India, Brazil, and Russia but also in smaller states and centralized states such as Bolivia and the Czech Republic. Deregulation and privatization have been trends virtually everywhere, even though the intensity of the reforms has varied significantly from region to region.

What have we learned from a decade of reforms in these areas?

Macro-stability Needs to Be Achieved in a Manner That Is Sustainable and Pro-Growth

The rise in real interest rates in the late 1970s and early 1980s, combined with a variety of commodity price shocks, had rendered unsustainable the fiscal stances, debt levels, and exchange rate regimes of most countries in Latin America, East and South Asia, Africa, and the Middle East. Performance differed sharply between countries that rapidly adjusted to these shocks (Korea and East Asian countries in general) and those that did not (Brazil, Nigeria, and many other countries in Latin America and Africa).

As a result, the Structuralist view that inflation and macro instability were inevitable companions of structural transformation and growth was replaced in the 1990s by the strong belief that macroeconomic stability was needed for growth. The 1990s indeed saw considerable progress in this area: fiscal deficits declined in most countries, exchange rates were adjusted to reflect market realities, black markets for foreign exchange disappeared, and inflation declined virtually everywhere. However, while macroeconomic policies as conventionally measured improved in a majority of countries, the growth benefits failed to materialize. In addition, financial crises were numerous, with severe adverse effects on economic growth and poverty.

The openness of the capital account was a key source of fragility which, combined with unsound policies in the financial sector (such as currency mismatches on banks' or final borrowers' balance sheets in the absence of hedging instruments) and appreciation of the real exchange rate, helps to explain many of the crises of the 1990s. Countries such as India have avoided appreciation of the real exchange rate, and made the opening of the capital account a medium-term goal, to be realized contingent on strengthened economic performance (including fiscal adjustment), export diversification, and achievement of a sound banking system. Chile and Malaysia, among others, did not hesitate to tax capital inflows when excessive liquidity threatened

to destabilize the economy, and they maintained the competitiveness of the real exchange rate. These countries fared much better than those that opened themselves to external liquidity surges. Notwithstanding the theoretical arguments in favor of capital account openness, the evidence on growth is inconclusive and volatility clearly increased. A major lesson of the decade is that restrictions should be placed not so much on outflows as on inflows. Obviously, differentiating an unsustainable boom from a positive sustainable trend can be difficult, but standard indicators of vulnerability such as indebtedness, evolution of the real exchange rate, and current account deficits have proven to be reliable, if imprecise, tools.

Macroeconomic stabilization programs often suffered from other design flaws, which created serious macroeconomic fragilities. While primary deficits did decline over the 1990s, public debt increased in most countries, whether because of the bank recapitalization costs of financial crises (as in Indonesia, Turkey), or because of the cost of contingent liabilities being shifted to the public sector (pensions in Argentina), or because of high real interest rates on the public debt (as in Brazil and Jamaica). Other design flaws help explain why the search for macro-stability may in some cases have actually been inimical to growth. A preoccupation with reducing inflation led some countries to adopt exchange rate regimes that ultimately proved destabilizing—price stabilization was achieved at the cost of appreciating exchange rates. Fiscal adjustment was often based on highly distortionary taxes (for example on external trade or on domestic financial transactions); or on cuts in spending on productive infrastructure or human capital that proved detrimental to sustained growth; or on borrowing abroad where interest rates were lower but currency exposure increased risks. Hence a single-minded pursuit of macro-stability sometimes came at the cost of public spending that might have both increased growth and made stability more durable.

There are two lessons to draw from this experience. First, even with macroeconomic stability, macroeconomic vulnerabilities induced by policy

flaws can be serious, and these can have tremendous costs. However, indicators of *sustainable* macro-stability are less self-evident than common indicators of fiscal and external stance suggest. The inability of financial markets (as measured by country risk premia) to predict most of the financial crises of the 1990s provides further evidence that unambiguous indicators of risk are difficult to find.

Second, the institutions underlying macroeconomic outcomes and stability matter as much as stability itself. There is ample evidence that budgetary processes influence fiscal outcomes and that countercyclical fiscal policy rules strengthen macroeconomic stability. Centralized budget processes lead to better balanced fiscal outcomes over time, and countercyclical fiscal policies shorten cycles and narrow their amplitude. Few governments find it politically appealing to run fiscal surpluses during good times, however. Transparent fiscal rules, with stipulated penalties for noncompliance, may be effective in some contexts. In others, the creation of institutions such as oil stabilization funds may be needed to save windfalls. One promising example is Chile's Structural Surplus rule, which establishes fiscal policy targets adjusted for the variation in growth over the cycle. Other proposals, yet to be adopted, have focused on creating an independent fiscal policy council, modeled along lines similar to an independent central bank, that would set annual deficit limits. Another institutional dimension of fiscal policy is transparency. Uncertainty about the state of the fiscal accounts probably played a large role in generating the volatility of the risk premiums that developing-country borrowers faced during the 1990s. There is also evidence that more transparent budgetary processes brought down deficits and debt.

For monetary policy, institutional arrangements are equally important to ensure that low and stable rates of inflation are achieved and maintained, and that they last. However, there are no magic institutional shortcuts to monetary credibility, which has to be earned through anti-inflationary performance. The institution of an independent central bank—with a commitment to price stability that

takes the form of a publicly announced inflation target—has succeeded among emerging market economies during the past decade (Brazil, Chile, Colombia, Korea, Mexico, Peru, South Africa, and Thailand). This institutional arrangement has the important advantages of flexibility (since the central bank is not constrained in *how* it attains its inflation target) and commitment (since the central bank's prestige is publicly put on the line).

Trade Openness, a Key Element of Successful Growth Strategies, Can Be Achieved in Many Ways

During the 1980s, the performance of countries that responded to shocks by increasing their outward orientation (East Asian countries) contrasted sharply with that of countries that did not (Latin America, Africa, most countries of the Middle East and North Africa). Most policy makers concluded that openness mattered for growth and, as a result, during the 1990s, most developing countries significantly reduced tariffs on imports and dismantled other forms of trade restrictions. As in the case of macroeconomic reforms, however, the results varied and, in general, fell short of expectations. Whereas openness helped efficiency and growth in many cases (East and South Asian countries, Botswana, Chile, Mauritius, Tunisia), it failed to do so in many others. Several lessons emerge.

First, openness to trade has been a central element of successful growth strategies. Although the paths taken toward greater integration with the world economy were far from uniform during the 1990s, the most successful developing countries reduced barriers to international trade and foreign investment during the decade.

Second, trade is an opportunity, not a guarantee. Trade reforms in some countries yielded few gains in terms of export expansion or increased economic growth, while creating social and economic adjustment costs. Liberalization of trade in Argentina in the 1980s and 1990s, and in Chile in the early 1980s, for example, was accompanied by an appreciation of the real exchange rate that

reduced the competitiveness of domestic industries, and incentives to exports—with adverse consequences for the balance of payments and the real economy. In some countries of Eastern Europe in the 1990s, trade was liberalized while property rights were not well defined, and the institutional base for a market economy was not well developed. These, and other institutional issues preventing the free movement of resources, often meant that trade reforms did not expand economic opportunities but restricted them instead (Bolaky and Freund 2004). Such experiences do not imply that less trade reform would have been desirable, but that trade reform must be done sensibly, as part of an effective growth strategy.

Third, countries that have successfully opened their economies have done so following a striking variety of policy approaches. They have opened up different sectors at different speeds (for example Bangladesh and India). Some, such as China and Mauritius, have achieved partial liberalization through the establishment of export processing zones, and some have combined unilateral trade reforms with participation in regional trade agreements (Mexico and countries in Central and Eastern Europe that have now joined the European Union). These differences, and differences in the range of complementary policies adopted, make it difficult to pin down the statistical relationship between trade integration and growth. The academic debates on whether openness to trade causes higher growth are riddled with problems of measurement, reverse causation (faster-growing countries tend to open their markets more quickly), and omitted variable bias (countries that successfully lower tariffs and increase growth also adopt other complementary policies).

Fourth, the distributive effects of trade liberalization are diverse, and not always pro-poor. Trade reforms were expected to be pro-poor because in most societies the relatively wealthy and urban classes have been more successful at using protection for their own benefit. The expectation was that trade reform would increase the incomes of the unskilled. Yet evidence from the 1990s on the rela-

tionship between trade reforms and poverty is to date mostly indirect. Even where trade policy has reduced poverty, there are still distributive issues. An important policy lesson is that countries need to help the affected workers move out of shrinking (import-competing) sectors into expanding (exporting) sectors.

Fifth, the preservation and expansion of the world trade system hinges on its ability to strike a better balance between the interests of industrialized and developing nations. Though more supportive of development than at the beginning of the 1990s, the world trade system is still biased against the poor. Notwithstanding a decade of significant expansion of international trade, global markets are most hostile to the products the world's poor produce—agricultural products, textiles, and labor-intensive manufactures—and problems of escalating tariffs, tariff peaks, and quota arrangements systematically deny the poor market access and skew incentives against adding value in poor countries. These problems are embedded in the remaining structure of protection in both industrial countries and developing countries (the latter owing to their own anti-export biases and also to higher barriers to trade in developing-country markets), and they can be addressed through collective actions. Those actions are best achieved through the Doha Round and the World Trade Organization (WTO). Although there is a role for nonreciprocal preferences and for reciprocal regional approaches, such preferential arrangements are economically arbitrary; they come at a cost to excluded countries and are not the best way to generate the right incentives for investment.

Design Privatization and Deregulation with regard to Institutional Strengths and Weaknesses

Privatization and deregulation have a potentially large efficiency impact and can benefit the population at large, including the poor. But there is a need to keep expectations realistic as to what they can achieve, to establish the institutions that are key to

success, and to design privatization strategies taking into account institutional strengths and weaknesses.

Privatization and deregulation were key areas of reform in the 1990s. Commercial public enterprises, development banks, and other forms of public interventions in the economy, even when meant to address market failures, had become discredited because in many instances they had failed to work well in practice. State activist policies using discretion, combined with weak accountability in public sector organizations and weak political accountability of states to citizens, were producing costs that were just too high. The end of communism, and the deregulation revolution in the United States and the United Kingdom, added further impetus for the wave of privatization that swept across the industrialized and developing world in the 1990s.

The results varied. In most countries, privatization brought unambiguous gains in terms of more efficient use of resources, more investment, and enhanced welfare for consumers. At the same time, however, privatization itself failed to bring about all the gains for investment and growth that were expected of it. It is also clear that too much was expected from privatization, particularly in some areas of infrastructure, but also in terms of the governance improvements it would bring. In cases where the overall package of reform failed to bring about the expected growth, even the efficiency gains of privatization were put in question—a problem that is particularly serious in Latin America and Africa, where it has in some cases derailed the privatization process.

In addition, the process of privatization has often been less than fully transparent and competitive, and this has left sequels that in some cases can be costly to repair—particularly where privatization has led to concentration of economic power, as it has in many parts of Africa and Eastern Europe.

Privatization is not just finding “better owners” than the government but about changing governance to separate the commercial from the political. As is now widely accepted, government ownership of a commercial firm makes this separation difficult. But privatization does not automati-

cally ensure this separation. The well-publicized difficulties of doing business in countries such as Russia show that a government can use a wide range of laws to influence a firm’s decisions without ownership. Separating the commercial from the political requires institutions that define and limit government powers. Notwithstanding the claims of some privatization advocates, institutions to support a well-functioning market economy will not spring up quickly in response to demand. The lack of effective institutions permits predation through several avenues, not just the government: in extractive industries, for example, the mining or petroleum firm and the government are beholden to each other, and either could act or collude at public expense. Vested interests could act through either the public or private sector, and poor shareholder oversight over a firm, as well as poor public oversight over governments, permits misappropriation.

Turning to utilities, the second major area of privatization during the 1990s, there are three main lessons. First, expectations of private investment in infrastructure have been overly optimistic—because (1) underpricing continued to be a problem that governments did not fully address, (2) the risks of infrastructure investment were not appreciated, and (3) governments could not credibly commit to a policy and regulatory regime. At the beginning of the 1990s, the private sector was expected to enter virtually all areas of infrastructure, including roads, but experience has since shown that the risks involved in infrastructure investment are often too large to be taken up by the private sector.

Second, if privatization is overstated as a means of severing the link between economics and politics, regulation as a means of restoring the link is underappreciated. The clearer the separation between economics and politics, the better it is for each: commerce will be more efficient and politics less corrupt. But the more complex the regulatory issue, the more likely are mistakes, and the less likely that bad regulation (and capture of the regulators by vested interests) will be detected. Even if detected, the poorer the institutions, the less likely it is that bad regulation will be corrected.

Third, the reform experiences of network utilities clearly show that there is no universally appropriate reform model, and that privatization is not necessary or indispensable for every country. Every restructuring and privatization program needs to explicitly consider the specific features of each sector (its economic attributes and technology) as well as the country's institutional, social, and political characteristics. Important lessons in this respect are as follows:

- Regulatory reform should promote competition, not control; competition is the most effective regulator.
- Getting the economics right is key. Understanding the source of benefits helps in structuring the reform. A pricing policy that does not allow adequate revenue cannot improve the situation even if a utility is privatized or an independent regulator is established. For example, as of 2000, in almost all Commonwealth of Independent States (CIS) countries, household electricity prices covered less than 50 percent and industrial prices were less than 70 percent of the long-run marginal costs of supply.
- Institutions differ, and hence regulatory agencies cannot be easily transplanted. Countries differ greatly in their economic structures and in their institutions: the whole chain that includes courts (where appeals are made), legislatures (where laws are passed), the press (which informs the electorate), an engaged public (which demands more from governments), and academia (which trains regulators and encourages studies of problems). These institutional differences across countries determine why what is sound regulation in one country is ineffectual in another. They are analogous to the differences in performance of state-owned firms: they are disappointing in some countries (India, Mexico) but not in others (Sweden or France).

Pensions are an area in which the private sector's contribution has most clearly fallen short of expectations. Eastern European countries with

almost universal pension coverage trimmed the benefits of their defined benefit schemes, out of fiscal necessity. Many Latin American countries sought to phase out their defined benefit schemes and replace them with mandatory coverage by private providers through defined contribution schemes. Few of these schemes have lived up to their billing: despite favorable demography their coverage remains low because of the small size of the private formal labor market; their administrative costs have been high, partly because insurance costs are included and partly because of start-up costs, and they remain dependent on government finances because there are few securities besides government paper to invest in. There was really no way to isolate these countries' social security and pension schemes from their governments without allowing them a greater range of investment in external markets.

The Impact of Financial Liberalization on Growth Depends on Underlying Institutions and on Macroeconomic Management

Over the 1980s and 1990s, as part of the general shift to a more market-oriented economy, the approach to finance shifted away from holding down interest rates, limiting competition, and relying on governments to allocate credit and toward more market-based, internationally open systems. Financial liberalization reflected the reaction to the costs, corruption, and inefficiencies of financial repression; the demands of government and the public for more financial resources and services; and the pressures from greater trade, travel, and migration, and better telecommunications.

Contrary to expectations, financial liberalization did not add much to growth, and it appears to have augmented the number of crises. As expected, deposits and capital inflows rose sharply as a result of liberalization. But, other than in a few East Asian and South Asian countries, capital markets did not provide resources for new firms. Numbers of stock market listings declined, even in the newly created markets in the transition countries that were some-

times used for privatizations. Also, although relevant time-series data on access are weak, and contrary to expectations, it appears that access to financial services did not improve substantially after liberalization.

The explanation for these disappointing outcomes lies largely in weak institutions, concentrated economic and political power, and macroeconomic shocks. The implicit and explicit guarantees that were extended to depositors and investors weakened the market discipline that might have limited the activities of weak lenders. By the end of the 1990s, much of the deposit growth had been absorbed by central bank debt and government deficits. The state banks, which remained important during the 1990s, and financial industrial conglomerates used their increased deposits to expand lending to state enterprises, well-connected borrowers, and other parts of financial-industrial conglomerates. Regulation and supervision were weak, reflecting not just technical problems but also political pressures for leniency. Eventually the poor quality of lending was exposed in crises, as were the weaknesses of the bank privatizations in the context of the weak institutional environment and the exclusion, in many cases, of international banks.

The lack of improved credit access reflected not only the preemptive borrowing by the public sector and central banks but also weak informational and legal frameworks. Lack of information on borrowers hindered lenders and gave borrowers no incentive to maintain a good credit record. Weak legal and judicial frameworks (designed to protect borrowers and often responsive to economic and political elites) reduced the incentives to service debts; they made it difficult for new borrowers to gain access to finance by pledging collateral effectively and made it difficult for lenders to execute collateral.

The 1990s reinforced the old lesson that successful financial liberalization depends on macroeconomic management. No banking system, however sound in principle, can withstand a serious macroeconomic crisis. Dealing with a banking crisis is quite complex, involving highly political issues of liquidity support to banks (which can easily con-

tribute to capital flight and devaluation), bank closure, and handling of explicit and implicit guarantees to depositors; experience in the 1990s suggests that it is difficult to avoid socializing the losses and a fall in output. Further, open capital accounts and volatile international capital flows place a large premium on sound macroeconomic management. Internationally, few attempts have been made to reduce the volatility of capital inflows (reducing volatility depends on limiting the upside, not just trying to stop outflows when a crisis develops). Chile's implicit taxes on short-term inflows appear to have had some success in extending maturities, reducing inflows, and limiting volatility against small shocks, albeit at the cost of reducing credit availability to the private sector (Edwards 1999; Forbes 2003). Part of India's success in avoiding a 1997 crisis stemmed from its limits on banks' (and firms') offshore borrowing, even as it allowed inflows into the stock market and eased direct foreign investment. Indonesia's limits on state banks' external borrowing did reduce their growth, but excessive inflows to private banks and corporations were a major factor in the 1997 crisis. Except for Chile's taxes on short-term flows and some attempts to hold down interest rates, countries have made few attempts to remove the incentives to banks for increasing their offshore borrowings. All attempts at limiting excessive inflows depend on political will to restrict them during a boom. In practice, countries often have eased restrictions on capital inflows to prolong a boom with negative consequences when the flows necessarily slowed.

Improvements are being made in regulation and supervision in an attempt to limit financial crises, but experience in the industrial countries, where political and economic power is more diffuse than developing countries, suggests that this will not be easy. In the United States, for example, financial economists have raised concerns about some U.S. banks being too big to fail. Also in the United States, political forces and regulatory forbearance are often cited as contributory factors in the savings and loan crisis. In many developing countries a few large banks, often state-owned, dominate the sys-

tem. Bankers and major borrowers are often one and the same. Limits on connected lending are a problem because the industrial-financial groups are also the main entrepreneurs in many countries, even large ones. If problems of loan quality develop, the political strength of the economic and political elite will likely lead to regulatory forbearance in loan classification and provisioning standards. These kinds of problems suggest that attempts to improve the regulatory and supervisory framework need to include a substantial effort to improve market discipline, through better information on the banks and credible limits on deposit guarantees. Increased entry of well-known foreign banks, which have a reputation to protect, can also improve the functioning of the system.

Thus, in finance, the 1990s may best be regarded as a transition period. The high expectations for liberalization were met only in resource mobilization. Resource allocation, which makes a key contribution to development, did not generally improve. However, much of the debris of the old financial system was removed by the crises, albeit by government recapitalization bonds that now represent much of the system's assets.

As the connecting link between savers and investors, the contribution of finance to growth depends not only on macroeconomic stability and reasonable interest rates, but also on the quality of financial intermediaries and information and of the legal and regulatory framework. Improving the contribution of finance to development will depend not only on market-based finance but also on sound institutions, appropriate incentives for lenders, further improvements in informational and legal frameworks and, ultimately, on a more competitive political system that is able to reduce the power of political-economic elites and their ability to tap the financial system.

Pragmatic, Incremental Approaches to Public Sector Governance Are More Effective

Economic performance depends partly on governance, which in turn is shaped by underlying insti-

tutions, defined broadly as the “rules of the game” that shape the behavior of organizations and individuals in a society (North 1990, 3).⁶ A crisis of governance of varying intensity pervades much of the developing world, with the poor paying the heaviest price for it.

Public sector reforms in the 1990s sought to change the structure of organs of the state, and incentives within them, in the hope of improving government efficiency and responsiveness. From mega-reforms such as decentralization to less sweeping reforms in budget or personnel management, the aim was to find a balance between the discretion of politicians and bureaucrats over policy making and policy implementation and their accountability for decisions and actions. The fall of authoritarian regimes and the consequent spread of democratic processes constrained the previously wide discretion of many governments. Decentralization sought to further limit central government discretion while granting local governments more managerial autonomy. Legal, judicial, and legislative reforms were initiated to establish institutional checks on executive power. Public management reforms sought to give public managers more flexibility in decision making while demanding greater accountability from them for their decisions. Perhaps partly because of the immense difficulty of addressing problems in political institutions, many countries and donors in the 1990s focused largely on reforming legal and judicial systems—a channel of political accountability that seemed more amenable to technocratic solutions, often using models directly transplanted from industrialized countries.

Most of the reforms had little effect on behavior. The ills that they sought to treat—nonmeritocratic civil services, weak financial controls, opaque or incoherent budget processes—are deeply rooted in local political and institutional arrangements that favor the status quo.

The decade was not all discouraging, however. Homegrown initiatives gave hope for improving government performance. In some instances, civil society engagement and participation and innova-

tive applications of information technology led to improvements in transparency and accountability in public decision making and consequently to some increase in government responsiveness, efficiency, and effectiveness. The challenge is scaling up these initiatives, given political constraints and historical inertia.

The designs of governance reform strategies in the 1990s typically fell into two broad types: “big bang” or ad hoc incrementalism. Big bang approaches proved to be largely inconsistent with capacity constraints and political realities. Their main results were major changes in formal rules: new or amended constitutions, new legislation, ostensibly independent courts and audit institutions, and so forth. Meanwhile, the informal rules shaping the incentives that face politicians, bureaucrats, and citizens remained in place.

Ad hoc incrementalism has also been problematic. Many of the ad hoc reforms were symbolic, intended to preserve the old informal rules while pretending to reform. Some represented well-motivated attempts of individual or small groups of reformers who, for lack of support, were undermined by jealousy, intrigue, or fatigue. More important, they tended to be unrelated to a more coherent reform strategy and thus over time many lost their steam.

An important general lesson is that technocratic responses to the governance crisis work only in very auspicious settings—where there is committed leadership, a broad-based coalition in support of reform, and sufficient capacity to carry the reform process forward. Clearly, these conditions exist in only a few developing countries, and rarely in those that most need governance reform.

State building is a complex process that requires time, leadership, and social capital. Governance reforms have to find a delicate balance consistent with the country’s politics, history, and culture. What may be needed are highly focused, pragmatic interventions that may be termed “strategic incrementalism.” These interventions are opportunistic because they exploit the willingness to reform, but they are grounded in political realities and consistent with the capacity constraints of the country concerned.

Politics: Checks and Balances Are Central to Accountability and Results, but There Is No Single Way to Achieve Them

Institutions resolve a number of problems in society, of which two are particularly important: collective decision-making processes, and principal-agent problems.⁷ Not all preferences can be represented in collective decision making, and principal-agent problems can be reduced but never resolved.

Both theory and evidence suggest that the formal rules of democracy do not ensure efficient, accountable, and credible government, and conversely that nonelected governments are not incapable of responding to citizens or of acting accountably. Though the number of elected governments grew significantly in the 1990s, the decade produced no clear evidence that elected governments perform better in delivering policies benefiting average citizens than do nonelected ones. The experience did confirm, however, that relative to the situation in richer democracies, private investors in most developing-country democracies receive less enforcement of their contractual and property rights, and average citizens are not as well treated by the state as special interests.

By the close of the 1990s, we had begun to understand the complicated interaction of formal political institutions with informal rules and norms. Elected governments are most likely to make policies at the expense of the majority and in favor of narrow segments of the population when citizens are badly informed about what government does, when political competitors cannot make credible promises to voters, and when society is polarized. Evidence shows that uninformed or polarized citizens and noncredible politicians undermine the connection between voters and politicians in democracies. Long-run economic growth and the provision of public goods are significantly higher in democracies with more credible politicians, better informed citizens, and less social polarization. Non-democracies vary substantially as well: those that have internal checks on the exercise of discretion by the executive seem to perform better, both in

terms of growth and public policy performance, than others. The lesson here is that governments of all kinds, elected or not, are most credible and most likely to respect property rights when they face checks and balances on their decision making.

Another lesson of the 1990s is that policies fail when citizens cannot hold politicians accountable for poor performance and when governments cannot make credible commitments. Credible, sustainable reform depends on the checks and balances provided through political institutions. In democracies, checks and balances and elections prevent arbitrary policy reversals by governments. But they are not the only means to hold governments accountable: broad-based political parties can in some circumstances substitute for democratic checks and balances in one-party states.

5. Operational Implications

The complete operational implications of this study still need to be fully developed. Some preliminary ideas are outlined below.

For Analysis

On the analytical front, the first implication is the need to redress the balance between analysis of *policy instruments* and analysis of *strategies*—understanding strategies as coherent sets of actions that are intended to initiate and sustain growth. Over the years, in institutions such as the World Bank, the focus of research gradually has shifted away from country-specific growth experiences to focus increasingly on policies—trade, finance, macro, privatization to name a few—with secondary importance given to country contexts.⁸ At the same time, outside the World Bank there has been increasing emphasis on individual country experiences (for example, Rodrik 2003b, and the research programs sponsored by the Global Development Network).

The second implication is the need to recognize country specificities in country economic analysis, acknowledging that policies are conceived and

implemented within a specific institutional, social, and historic context. Recent economic and sector work at the World Bank already seeks to achieve a better balance between country specificities and the lessons from country experiences, but more is needed fully to recognize that country-specific market structures and institutions have a strong influence on policy outcomes. In particular, this recognition calls for harder and more rigorous economic, institutional, and social analysis.

Third, analytical work needs to change its orientation, away from seeking to assess how far policies diverge from optimality, to seeking to assess what policy and institutional conditions—for capital accumulation, shared growth, productivity growth, and risk taking in a country-specific context—are needed to set the growth process in motion.

For Strategy

There is a need to rethink the focus of growth strategies and of development assistance. Up to now, that focus has been on the nation state with the implicit assumptions that (1) development outcomes within the boundaries of a nation state are homogeneous, and (2) all developing countries' per capita incomes could and should converge with those of industrialized countries. There is now greater evidence and acknowledgment that these two assumptions do not always hold. Convergence is much less a force now than anticipated a decade or more ago. Within countries such as Brazil, China, and India, income differences across regions are as large as income differences across countries, and even in relatively small Bolivia, income differences between the lowlands and the highlands are large. This recognition implies a need to pay much greater attention to the forces driving agglomeration and migration, both within and across countries.

For Research

On the research front, two issues in particular warrant further examination. The first relates to devel-

opment agencies' role in aid-dependent countries. The agencies' large role in financing the budget has forced them to be involved in budget processes, weakening national decision making and rendering the concept of "ownership elusive in practice" (Kwesi Botchwey, World Bank 2005a), particularly in aid-dependent Africa. Clearly, forms of engagement developed for project finance do not apply to budget finance. There may be a need to explore new approaches to the transfer of resources to these countries, rooted in public finance, such as those typically used in federated nations that have chosen rule-based, arms-length systems of transfers.

Second, the unit of analysis for economic and social development has traditionally been the nation state, reflecting the assumptions (outlined above) that nations are homogeneous and that all nations would be able to catch up to the income levels of industrialized countries. There is a rich research agenda on these assumptions that needs to be articulated. All nations may not succeed in reaching industrialized countries' income levels within a reasonable time frame—partly because institutions can take such a long time to develop, but also because the economics of agglomeration and poles of development do not necessarily follow national boundaries. Research in this area may yield important implications for the role of nations and migration, and also for the optimal degree of discretion regarding national policies.

For Operations

On the operational front, the recognition that not everything needs to be right for growth to succeed, and that partial success may sometimes be a more pragmatic goal than optimal policies, has obvious consequences for the type and extent of conditionality associated with development lending. Again in this case, more rigorous economic analysis should help to distinguish what are binding constraints, and thus to inform decisions. The record suggests that forecasts need to be realistic and mindful of the forces driving growth.

For Behavior

On the behavioral front, if solutions must be found in specific-country contexts, rather than applied from blueprints, those who advise or finance developing countries will need more humility in their approaches, implying more openness on the range of solutions possible, more empathy with the country's perspectives, and more inquisitiveness in assessing the costs and benefits of different possible solutions.

Notes

1. See Country Note 3, "Poverty and Inequality: What Have We Learned from the 1990s?"
2. Countries successful at "converging" include most South Asian countries (Bangladesh, Bhutan, India, Nepal, Sri Lanka); many East Asian countries (China, Indonesia, the Republic of Korea, Lao PDR, Malaysia, Thailand, Vietnam); and Botswana, Chile, the Arab Republic of Egypt, Lesotho, Mauritius, and Tunisia. See Country Note 2, "Lessons from Countries That Have Sustained Their Growth."
3. This point of view was reinforced by the fiasco of the collapse of the Southern Cone stabilization programs of the late 1970s, in which strong currency appreciations combined with rapid reductions in tariffs to create an adverse shock to industry, ultimately derailing the stabilization programs. Most analysts soon blamed the collapse on excessive speed, leading to faulty sequencing of the reform program: they argued that capital accounts had been liberalized too soon, without waiting until fiscal probity had been established and both trade and the domestic financial system had been successfully liberalized.
4. This study reviewed the growth experience of eight economies: China, Hong Kong (China), Indonesia, Japan, Korea, Malaysia, Taiwan, Thailand, and Singapore. The report highlighted the variations in policy and institutional environments under which these economies reached unprecedented rates of growth. It emphasized that, with few exceptions, the state in the economies studied had taken an activist role to stimulate risk taking in both the private and the public sector. It concluded that while highly successful in East Asia, the institutions needed for replicating this activist role may not be present in other contexts.
5. It has been argued, for example, that the increase in India's growth rate in the early 1980s was less the result

of the reforms introduced at that time than of the private sector's changing expectations regarding the future—where the government was credible in ensuring reduced expropriation risks and a more welcoming environment (Rodrik and Subramanian 2004).

6. Public sector governance refers to how the state acquires and exercises the authority to provide and manage public goods and services. Corruption, which refers to the use of public office for private gain, is the

mirror image of governance: bad governance invariably leads to corruption; but corruption can likewise perpetrate bad governance.

7. The principal delegates the implementation of a task to an agent but must monitor the agent efficiently to ensure that the task is accomplished.
8. A recent World Bank research project focusing on individual country experiences is *Aid and Reform in Africa* (2001).

Part 1

Facts of the 1990s

