Chapter 3

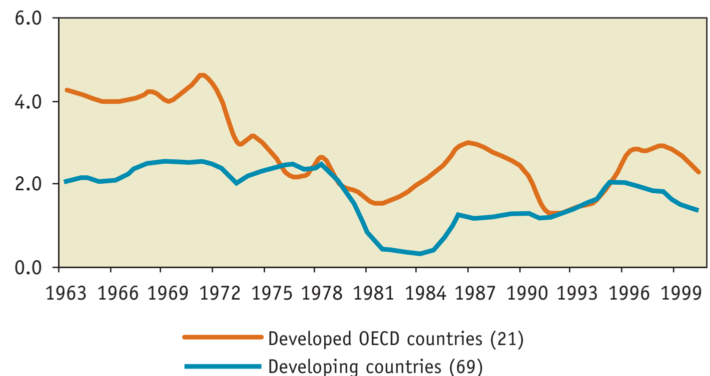
Something Special about the 1990s?

Developing countries' growth in the 1990s was higher than in the 1980s but lower than expected. Per capita income in the median developing country continued to grow more slowly than that in the median Organisation for Economic Co-operation and Development (OECD) country, and except in East and South Asia the growth of developing countries as a group continued to trail that of OECD (figure 3.1). This encouraged perceptions that the reforms of the 1990s had a disappointing payoff for growth.

Was developing countries' growth really disappointing during the decade? If so, could it be that an adverse external environment held them back? What about these countries' own policies? Did policies improve over the decade as much as commonly believed? Section 1 of this chapter reviews measures of growth performance over the 1990s, and section 2 examines global economic trends, finding that the external environment was not unfavorable for growth. Section 3 analyzes the extent of economic reforms during the decade, showing that they were extensive and significant.

FIGURE 3.1

Growth in Developed and Developing Countries, 1963–99



Source: World Bank, *World Development Indicators 2004*.

Note: Median of GDP per capita growth rates, five-year moving averages; 69 developing countries and 21 OECD countries for which complete series exist for 1961–2002. The Republic of Korea is included in the group of developing countries.

1. Developing Countries' Growth during the 1990s

While per capita income in the median developing country has grown more slowly than that in the median OECD country, the per capita income of the average citizen in the developing world has grown at least as fast as that of his or her counterpart in OECD countries (table 3.1).

This difference highlights the several possible ways in which developing countries' growth performance can be measured, and that the appropriate gauge to use depends on the purpose. One measure is the weighted average of per capita income growth, where the weights are developing countries' population or gross domestic product

TABLE 3.1
Growth in Developed and Developing Countries, 1960s–90s

	1960s	*1970s*	*1980s*	*1990s*	*1990s*
Median GDP per capita growth					
Developing countries (69)	2.0	1.8	−0.5	1.3	1.0
Developing countries (78)	...	1.9	−0.3	1.0	1.0
Developing countries (93)	...	...	−0.2	1.0	0.9
Developing countries (116)	...	...	...	0.6	0.8
Developed OECD countries (21)	3.8	2.7	2.0	1.9	1.8
Import demand growth					
High income	...	3.4	6.3	7.1	6.0
Developing countries	15.2	4.7	1.8	7.9	7.2
GDP per capita growth					
High-income countries	4.2	2.6	2.5	1.8	1.7
Developing countries	3.6	2.9	0.7	1.8	1.8
GDP growth					
High-income countries	5.4	3.8	3.1	2.5	2.3
Developing countries	5.8	5.1	2.6	3.5	3.4

Source: World Bank, *World Development Indicators 2004*.
Note: Average cumulative GDP per capita growth rates for the decade (for example, 1990s are 1991–2000 growth rates). Except for the median, all statistics refer to the sum of GDPs for the relevant group of countries, divided by the total population of that group.

(GDP). This approach provides an indicator of aggregate performance but does not capture variations across developing countries. For example, if China grows fast but Malawi does not, the aggregate measure will largely reflect China's performance simply because of China's size. Even if many smaller countries parallel Malawi's level of accomplishment, the weighted average will still not capture their growth performance.

An alternative, the unweighted average, corrects for this deficiency by treating each country as an observation, but it introduces another bias in that it may give an undue weight to outliers. For example, the discovery of oil in Equatorial Guinea enabled that country to grow at rates about 15 percent a year in the 1990s. Because of Equatorial Guinea's high growth rate, measuring Africa's performance through an unweighted average would give the impression that the continent grew faster than it did. Bosnia and Herzegovina is another example. Following the war, its per capita GDP grew by 80 percent. This observation alone would skew the estimate of the average for *all* developing countries upward by 0.5 percent. The higher the variance, the less representative the arithmetic average will be.

In the discussion in this chapter, the growth performance of a group of countries is measured using median statistics, a standard consistent with the focus of this report on policies and on country performance—for which the country is the most suitable unit of analysis.

Using the median as a summary statistic is not without its own problems, however. First, if the number of small countries is sufficiently large, the median will represent their performance. But it is not always proper to give the same weight in the analysis to China as to Uruguay, to India as to Estonia, and gauging developing countries' growth with medians might bias results in the "many small countries" picture just as using aggregate data biases them in the "China-India" direction. Thus in the analysis that follows we report aggregate data and medians together whenever possible.

A second problem with using medians as a summary statistic is that they can easily be regionally biased. Comparing developing countries' growth across decades using means requires us to follow a fixed sample of countries that have a complete GDP per capita series for the period in question. But out of the 69 countries that meet this criterion from the 1960s on, nearly three-fourths are from only two regions: Latin America and the Caribbean (21) and Sub-Saharan Africa (28). Extending the sample of countries and, of necessity, limiting the timeframe to the later decades, we find a smaller pick-up in the median country growth rate over the 1990s. The magnitude of the apparent growth contraction in the 1980s also shrinks depending on the number of countries included in the sample. Extending the 1990s to include 2001 and 2002 reduces median per capita growth significantly from 1.3 percent to 1 percent for the sample of 69 countries (mostly as a reflection of Latin America's performance), and reduces it marginally for the larger samples (table 3.1).

As noted above, estimating growth on the basis of the performance of developing countries as a group, where the per capita GDP is the aggregate GDP for all developing countries divided by the total population, shows a much higher per capita growth of 1.8 percent a year in the 1990s. This figure reflects the above average growth performance of China and India, two countries whose combined GDP increased during the 1990s from one-seventh of all developing countries' GDP to one-fourth. (China's GDP alone grew from 9 to 17 percent.) If one excludes China's contribution of 1.1 percent (13 percent of all developing countries' GDP in 1995, growing at 9 percent over the 1990s) the developing countries' growth rate drops to 0.7 percent. If one excludes India (7 percent, growing at 3.6 percent) it drops further to 0.6 percent. Because of the size of these two economies, and ignoring that the concept applies to economies, not to people, it has even been argued that these trends demonstrated absolute convergence (Fischer 2003).

A regional perspective on growth during the 1990s suggests that the change in performance during the decade is the result of changes in performance in three regions: The Middle East and North Africa and Latin America and the Caribbean, where performance improved, and Eastern Europe and Central Asia, where performance deteriorated (table 3.2).

TABLE 3.2

Developing Countries' Growth, 1990s: Regional Perspectives

(growth of GDP per capita for median country in each region)

	1960s	*1970s*	*1980s*	*1990s*
Sub-Saharan Africa (28†–41)	1.4	0.6† – 0.9	–1.0† – –0.9	–0.4† – –0.2
South Asia (5†-6)	1.7	0.7	3.1† – 3.3	3.0† – 3.1
Middle East and North Africa (6†–12)	2.4	3.6	–0.2 – 0.7†	0.5† – 1.0
Latin America and the Caribbean (21†)	1.8	2.6	-0.7	1.8
Europe and Central Asia (1†–24)	6.2‡	4.3	1.5	–1.8 – 1.0†
East Asia and Pacific (8†–12)	2.1	5.5	1.6† – 2.6	2.9

Source: World Bank, *World Development Indicators 2004*.

Note: This table gives a regional perspective on developing countries' growth. As indicated in the text, median estimates depend crucially on the choice of countries. † Denotes the estimate for the group of countries with complete GDP per capita data over four decades, 1960–2002. For example, for 1970 Sub-Saharan Africa, 0.6 percent is the median growth for the group of countries with complete GDP series over these four decades. If one includes in this group the countries for which GDP data are available starting in 1970 through the 1990s, the growth rate rises to 0.9 percent. Figures in parentheses represent the number of countries with complete GDP per capita series starting in 1960 "†" as well as the number of countries for which data are available for the 1990s. For example, ‡ in Europe and Central Asia only one country (Turkey) has a complete GDP per capita series that starts in the 1960s, but 24 countries have data available for the 1990s.

2. Global Economic Trends in the 1990s

During the decade a tremendous increase took place in global integration in goods, services, and investment flows (table 3.3).

Notwithstanding this improvement in integration, some empirical studies suggest that negative external shocks reduced developing countries' growth in the 1990s below their potential, offsetting the positive impact of economic reforms.

Analyzing policy reforms in developing countries, Loayza, Fajnzylber, and Calderon (2002) and Easterly (2001) find that countries that reformed their policies—improving macroeconomic management, opening the economy, liberalizing the financial sector and so on—grew faster in the 1990s than countries that did not take such steps. At the same time, both of these studies find that an unexplained negative shock affected all countries not only in the 1990s but also in the 1980s. In their studies, dummy variables for the 1980s and 1990s are large and statistically significant, implying that, other things held equal, developing countries grew nearly two percentage points more slowly in the 1980s and 1990s than in the 1960s or the 1970s.

Both of these studies have come under criticism. Loayza, Fajnzylber, and Calderon's study has been criticized because it uses outcome variables, such as a country's ratio of trade to GDP, or financial depth or inflation rates, to represent the extent of economic reforms, and thus is unable to attribute changes in economic growth to actual changes in policies, or to claim that Latin America's reforms added significantly to that region's economic growth (Rodrik 2003a).

Ignoring these specification problems, if period dummies truly capture the external environment over a period of time, the Loayza and Easterly studies provide an intuitively appealing explanation as to why the reforms of the 1990s did not generate the results expected: surely the reason must be a negative external shock.

Easterly (2001) finds that the slowdown in economic growth of developing countries' OECD trading partners provides a potential explanation for the decade shift dummies:

> In contrast, the effect of OECD trading partner growth on LDCs' home country growth is huge (if anything, implausibly large)… one less percentage point of OECD trading partner growth is associated with 2.1 less percentage points of home country growth.

Comparing the two 20-year periods 1960–70 and 1980–90, Easterly highlights that growth in high-income and developing countries moved closely together (figure 3.2), and that growth slowdowns in industrialized countries over the 1970s and 1980s mirrored and preceded those in develop-

TABLE 3.3
Global Integration, 1980–2000

	Exports and imports of goods and services as a share of GDP (in current US$)			*FDI flows as a share of GDP (in percent)*		
	1980–85 avg.	*1990*	*2000*	*1980*	*1990*	*2000*
Developing countries	41.0	39.2	55.3	0.3	0.8	2.6
Developed countries	40.7	39.1	46.4	0.6	1.0	5.1

Sources: Trade and FDI (foreign direct investment) flow figures from IMF *Balance of Payments Statistics*; GDP from the World Bank's *World Development Indicators*.

Note: A nominal measure is used here because of the difficulty in obtaining price deflators for services trade. Regardless of whether a real or a nominal measure is used, there was still a large increase in trade integration on the "goods" side in the 1990s. The analysis in the rest of this chapter regarding goods trade uses "real" measures, with nominal values deflated by the relevant price indexes.

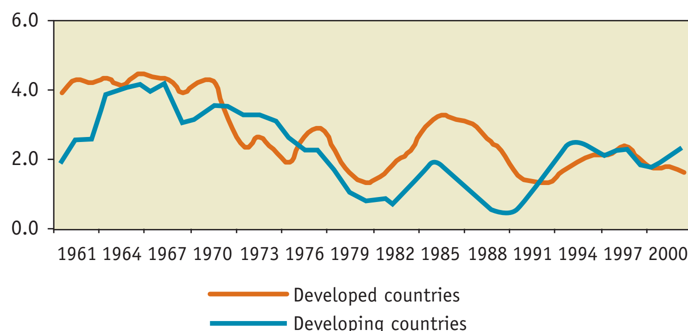
ing countries during the "lost decade" of the 1980s. But when he examines the 1990s separately, he finds that the relationship between developed and developing countries growth is not that strong.

There is little doubt that that the 1980s—the "lost" decade—had its share of negative shocks, including declines in primary commodity prices, a collapse in oil prices, a sharp hike in U.S. interest rates, debt crises, a sudden stop in capital flows to developing countries, and a collapse in import demand from developing countries.

But is harder to tell the same story about the 1990s. Certainly the financial shocks of the decade—notably in Asia, the Russian Federation, and Turkey—may suggest that the external environment was inimical to developing countries' growth. But trade and capital flows, which are two major channels whereby economic performance in industrialized countries affects developing countries, were both expanding dramatically during the 1990s. Analyzing indicator-by-indicator the variables underlying the external environment suggests indeed that the 1990s was not unfavorable to developing countries' growth.

FIGURE 3.2

Growth Slowdowns in Developed and Developing Countries



Source: World Bank, *World Development Indicators 2004*.

Note: GDP per capita growth rates (weighted averages), 1961–2002.

Unprecedented Expansion of International Trade

World trade boomed in the 1990s. The overall volume of trade grew 2.5 times faster than world GDP, compared to the average of 1.5 times over the period since World War II. Import demand expanded at an accelerating pace in industrialized countries and also recovered in developing countries (table 3.4).

The merchandise export growth of developing countries quadrupled in the 1990s, rising to an annual rate of 8.5 percent from less than 2 percent in the 1980s.

Increased Integration through Trade

Taking export shares in GDP as a measure of globalization shows that developing countries are now more integrated with the world economy than are high-income countries (figure 3.3). Between 1990 and 2000, developing countries' export revenues doubled as a share of GDP, rising from 12.5 to almost 25 percent.

The exports-to-GDP ratio for the median developing country rose during the 1990s from 24 to 27 percent (figure 3.4).

The exports-to-GDP ratio alone is not a sufficient measure of trade integration, because changes in relative prices will alter it even if there are no changes in real flows. But given that the median developing country sustained a stable real exchange rate over the 1990s (figure 3.5), the rising ratio does

TABLE 3.4

Unprecedented Growth of World Trade, 1990s

(average annual cumulative growth rates, percent)

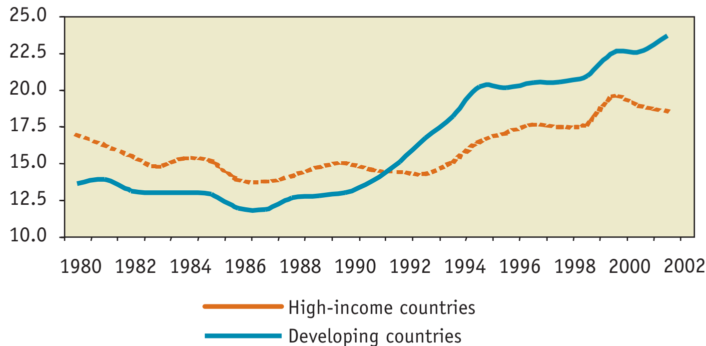
	1960s	*1970s*	*1980s*	*1990s*
World GDP growth	5.5	3.7	3.0	2.6
World trade growth	7.9	5.7	4.9	6.6
Developing countries				
Export growth	6.1	5.2	5.2	7.4
Import growth	6.4	7.7	1.6	5.3
High-income countries				
Export growth	8.3	6.3	5.0	6.6
Import growth	8.7	4.9	5.3	6.8

Source: World Bank, *Global Economic Prospects*.
Note: Imports and exports are of goods and nonfactor services.

FIGURE 3.3

Export Shares of GDP, 1980–2002

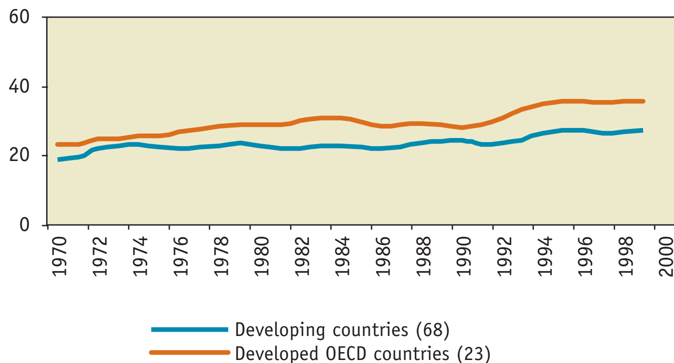
(percent)



Source: World Bank, *Global Economic Prospects 2003*.

FIGURE 3.4

Faster Integration into World Trade during the 1990s



Source: World Bank, *World Development Indicators 2004*.

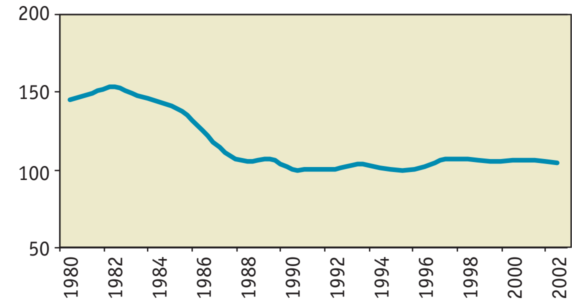
Note: Median exports of goods and services as a percentage of GDP; 68 developing and 23 OECD countries, 1970–2000. Balancing the sample of developing countries over different decades—that is, including all countries for which data are available—does not significantly alter these results.

suggest increasing integration into world trade over the decade.

Services trade rose during the decade, though goods trade integration dominated the globalization scene (table 3.5).

FIGURE 3.5

More Competitive Real Exchange Rates



Source: World Bank, *World Development Indicators 2004*.

Note: Median real effective exchange rate index. Sample of 52 developing countries, 1995=100.

Diversification into Higher-Value Products

The composition of developing countries' exports shifted dramatically from agricultural and resource exports into manufactures, which now constitute nearly 80 percent of exports from all developing countries (figure 3.6 and table 3.6). Many countries successfully diversified into medium- and high-technology products.

Countries whose incomes were low in 1980 managed to raise their exports of manufactures from roughly 20 percent of their total exports to more than 80 percent (figure 3.7). As a result, many grew quickly and entered the ranks of today's middle-income countries. The middle-income group of 1980 also raised the share of manufactures in their exports, but somewhat less rapidly, to nearly 70 percent.[1]

Not All Developing Countries Benefited

The rising tide of exports did not lift all boats, however. Forty-three countries achieved no increase, on average, in their merchandise exports between 1980 and 2000 (World Bank 2003b), and their share in world exports declined. A group of least-developed and Sub-Saharan countries remained highly dependent on primary commodity trade, and often on just one or two commodities. Many in this group

TABLE 3.5

Exports and Imports of Goods and Services as Shares of GDP, 1980–2000

(current US$)

Export and import shares of GDP	*Developed countries*			*Developing countries*		
	1980	*1990*	*2000*	*1980*	*1990*	*2000*
Goods	34.2	31.0	36.8	37.1	31.6	45.9
Services	7.7	8.1	9.6	7.9	7.6	9.4
Goods and services	41.8	39.2	46.4	45.1	39.2	55.3

Sources: Trade figures from IMF *Balance of Payments Statistics*; GDP from the World Bank's *World Development Indicators*.

were plagued by civil conflict and engaged in politically motivated trade embargoes. Both of these factors were often complicated by inept governance.

International Terms of Trade: No Clear Trend

Developing countries suffered no large terms-of-trade shocks during the decade (figure 3.8).

Although primary commodity prices had declined in the 1980s relative to those of manufactures, they were stable over the 1990s, fluctuating without a clear trend (figure 3.9). Analyzing the impact of commodity-price cycles during the 1990s, a number of studies have concluded that overall these cycles were more effectively managed than in previous decades and should not have adversely affected the prospects for developing countries' growth (World Bank, *Global Economic Prospects 2001*). Even for non-oil-exporting Sub-Saharan countries, changes in real incomes were generally small and the policy environment was much better than in the previous decades.

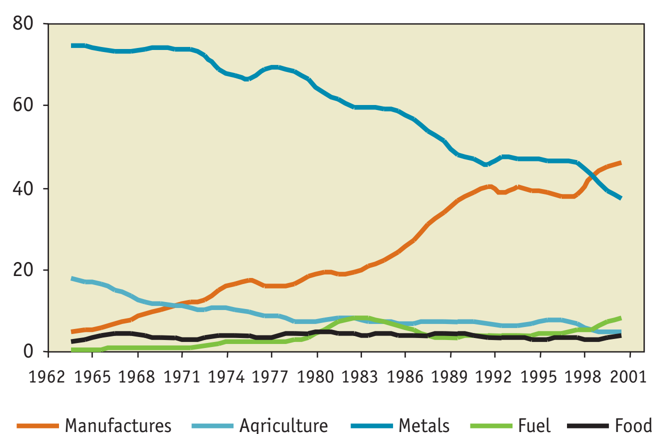
Oil prices were generally lower in the 1990s than in the 1970s and 1980s, and since most developing countries are oil importers rather than oil producers, this drop has meant a generally favorable trend (figure 3.10).

Expansion of International Capital Flows

The largest increase in integration in the 1990s was in investment flows. Globally, FDI as a share of GDP more than quadrupled between 1990 and 2000.

FIGURE 3.6

Developing Countries Diversified into Manufactures, 1960s–1990s



Source: World Bank, *World Development Indicators 2004*.

Note: Median merchandise export shares, three-year moving average; 60 developing countries with complete data, 1962–2002. For some countries a few missing observations were filled in by simple linear interpolation. Technically, because the median could be a different country in each year, the sum of the shares is generally smaller than 100. Thus, they have been renormalized.

After reaching a nadir in the late 1980s, capital flows to developing countries expanded rapidly during the 1990s (figures 3.11 and 3.12). Capital flows to all regions were unambiguously stronger on average than in the 1970s and in the 1980s.

Private capital flows boomed, rising from 1 percent of developing countries' GDP in the 1980s to more than 4 percent in the 1990s, and displacing official flows as the principal source of finance. Offi-

TABLE 3.6

Diversification Took Place before the 1990s

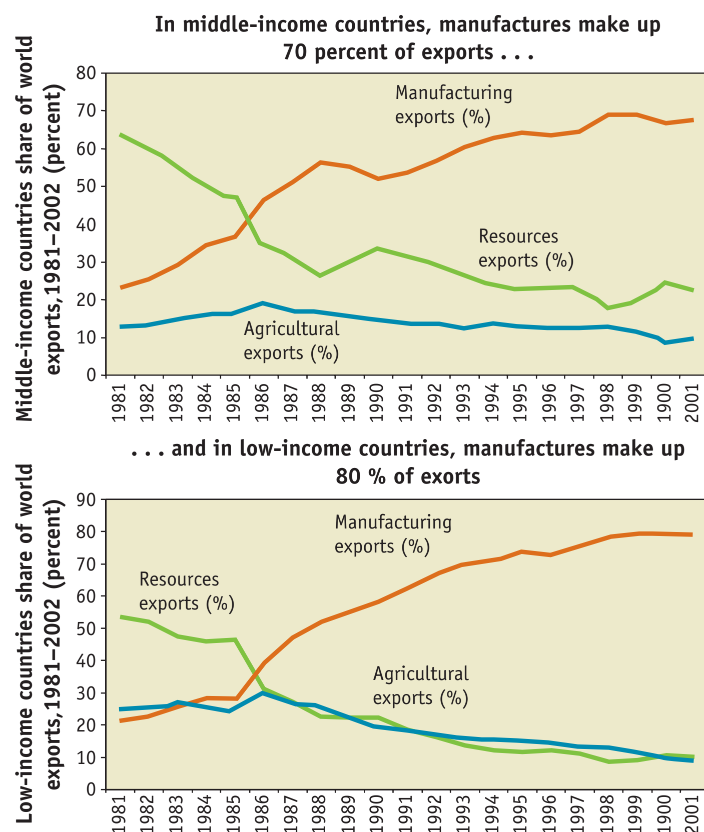
Regions ()	Manufactured export shares 1970	1980	1990	2000
Sub-Saharan Africa (24)	7.0	8.1	18.5	15.9
South Asia (5)	—	53.2	76.1	77.3
Middle East and North Africa (12)	9.6	13.2	26.9	26.5
Latin America and the Caribbean (21)	15.4	25.8	36.1	46.6
Europe and Central Asia (4)	—	60.7	64.3	79.2
East Asia and Pacific (6)	—	3.5	39.2	58.2

Source: World Bank, *World Development Indicators 2004*.

Note: Median share of manufactures in overall merchandise exports; sample of 72 developing countries. Number of sample countries are shown in parentheses. For some countries, a few missing observations were filled in by simple linear interpolation. Average for given and two preceding years used—for instance, "1970" is an average of 1968–70 export shares.
—. Not available.

FIGURE 3.7

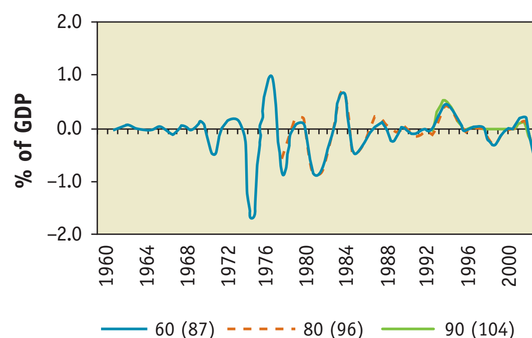
Developing Countries' Exports of Manufactures, 1981–2001



Source: World Bank, *Global Economic Prospects 2004*.

FIGURE 3.8

No Large Terms-of-Trade Shocks for Developing Countries, 1990s



Source: World Bank, *World Development Indicators 2004*.

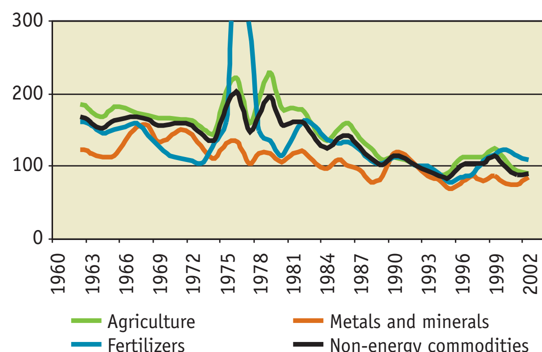
Note: Median terms-of-trade shocks as a percentage of GDP, 1970–2000. Numbers of developing countries in the sample in parentheses.

cial flows declined slightly, to less than half a percent of developing-country GDP by the end of the decade.

A combination of pull factors (liberalization of capital accounts and domestic financial markets) along with a range of push factors (regulatory changes in mature market economies) resulted in an explosion of international investment in all countries, mature and developing. A growing consensus holds that push factors explain much of the

FIGURE 3.9

Decline in Nonenergy Commodity Prices

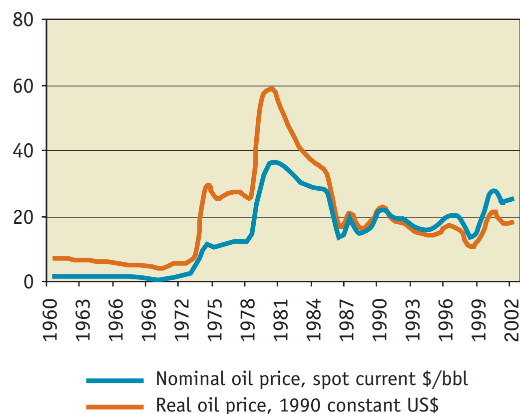


Source: World Bank staff calculations.

Note: Constant dollar indexes deflated by manufactures unit value (MUV) index with 1990=100, 1960–2003.

FIGURE 3.10

Oil Prices Were Lower in the 1990s than in the 1970s and 1980s

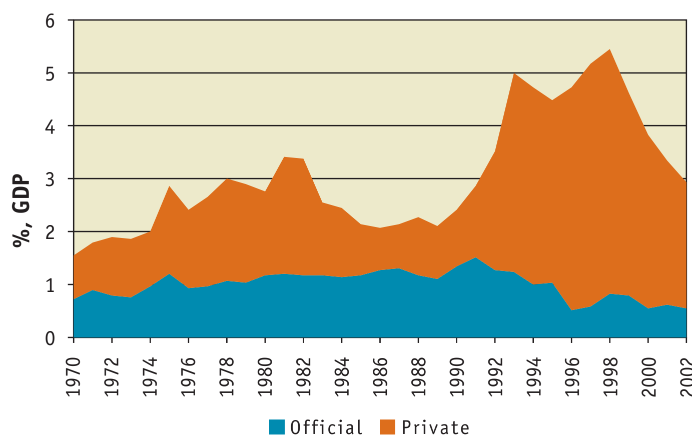


Source: The Economist, Intelligence Unit.

acceleration. Servén, Albuquerque, and Loayza (2003) find that global factors became progressively more important in FDI flows over the 1990s, and by the end of the decade could explain (in a statistical sense) nearly half of these flows. The flood of credit was facilitated by advances in financial technology, such vehicles for risk pooling (mutual funds), the development of new financial instruments (derivatives and securitization), and a decline in nominal and real interest rates. The London interbank offered rate (LIBOR, both nominal and real) was much lower in the 1990s (figure 3.13), and one result was an energetic search for yield.

FIGURE 3.11

Capital Flows to Developing Countries Expanded in the 1990s



Source: World Bank, *Global Development Finance 2004*.

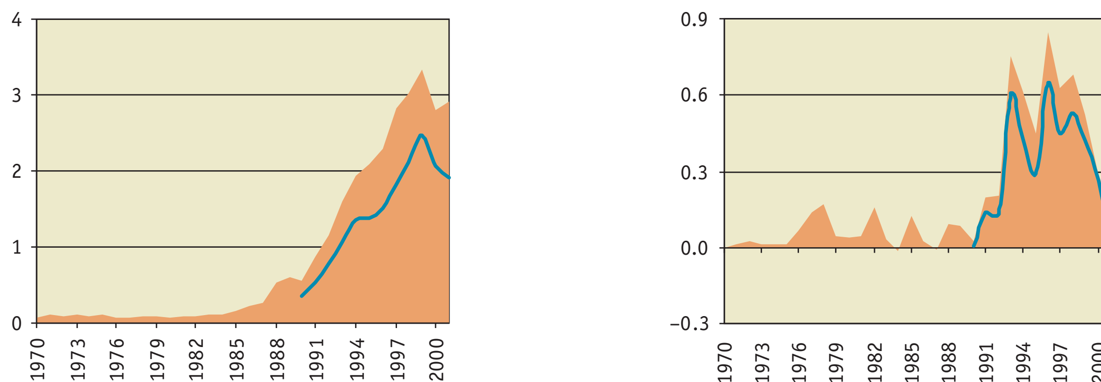
Note: Aggregate net resource flows to developing countries as a percentage of GDP.

Conditions in developing and emerging market countries clearly influenced the geographical destination of capital flows. Growth in many developing countries accelerated in the 1990s; many had completed external debt restructurings, successfully stabilized their economies, embarked on substantial liberalization of their financial sectors, and, as discussed in section 3 below on policy reforms, had undertaken significant privatization.

Underlying the expansion in capital flows to developing countries were two important shifts in the structure of these flows: first, from bank lending to bonds and portfolio financing and, second, a shift from debt to equity. Up to the time of the Brady plan in 1989, the developing countries' main creditors were not bondholders but commercial banks. In the 1970s and 1980s, as commercial banks recycled oil surpluses from oil producers to other developing countries' banks, banks accounted for about 90 per-

FIGURE 3.12

Capital Flows Were Driven by a Surge in FDI and Portfolio Equity Flows



Source: World Bank, *Global Development Finance 2004*.

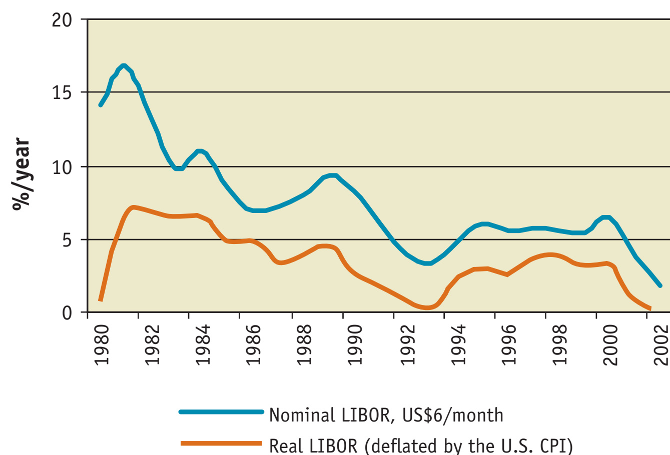
Left: Net FDI flows to developing economies as a percentage of GDP. Solid line is the flows to the top 10 recipients (in descending order): China, Brazil, Mexico, Argentina, Poland, Chile, Malaysia, Thailand, Czech Republic, and R. B. de Venezuela.

Right: Portfolio flows to developing economies as a percentage of GDP. Solid line is the flows to the top 10 recipients (in descending order): Argentina, Mexico, Brazil, Turkey, Russian Federation, Philippines, India, China, Colombia, and Malaysia.

FIGURE 3.13

Nominal and Real Interest Rate, 1980–2002

(London interbank offer rate)



Source: Bloomberg.

cent of developing countries' public external debt to private creditors. Developing countries' debt expanded at double-digit annual rates in the 1970s. The debt crises of the 1980s slowed the growth of bank financing, and by the end of the 1980s, the banks' share had declined to nearly 30 percent. The Brady plan restored market confidence in international lending to developing countries, and debt flows increased again in the 1990s. Successful macrostabilization in many emerging economies, the opening of their capital markets, and technological innovation contributed to the rapid growth of bond finance (see figure 3.12, right side).

In the shift from debt to equity, FDI played an important role, as nonfinancial corporations increased their exposure to developing countries. Developing countries accounted for about 30 percent of global FDI flows—a share that remained stable over the decade. While North-South FDI flows declined, South-South FDI increased substantially over the 1990s, from less than 10 percent of the total at the beginning of the decade to nearly 40 percent at the end.

Empirical studies suggest that FDI flows to developing countries were largely *horizontal* in the past, as when multiplant firms chose to replicate roughly the same activities in many countries to serve the local markets in those countries. Such

investment choices were usually motivated by trade costs, such as for transport and tariffs, though in the 1990s they were also related to the privatization of utilities and the entry of foreign banks (Shatz and Venables 2000).

What distinguished the 1990s was the rapid growth in international *vertical* FDI, that is, investment by firms that break up the production of final goods geographically into discrete stages, typically choosing the location for each stage on the basis of factor abundance. Along with technological progress and policy reforms that liberalized trade and finance, this investment led to the creation of global production networks that locate each stage of production in the country where it can be accomplished at the least cost. In developing countries as a group, parts and components exports (a proxy for participation in global networks) grew faster during the 1990s than in the 1980s, and much faster than in industrial countries (figure 3.14). As a result, developing countries' share of global parts and components exports increased from a mere 7 percent in the early 1990s to 21 percent in 2000.

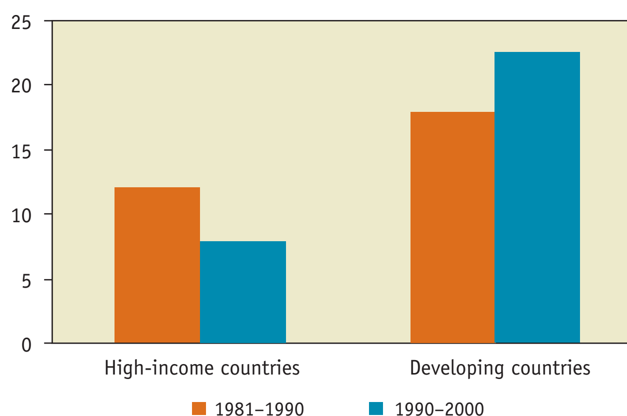
The possibilities for participating in international trade expanded during the 1990s as the global division of labor changed and more resources were shifted into labor-intensive activities, in which developing countries have a comparative advantage (World Bank 2002b).[2] At the same time, however, global production networks were concentrated in just a few countries: the top five emerging-market exporters of parts and components (China, Mexico, Korea, Malaysia, and Thailand) accounted for 78 percent of the total.

Such concentration on just a few large developing countries was the defining feature of private capital flows over the 1990s. At the end of the decade, the top 10 recipients of FDI received more than 70 percent of all net inflows, and for the top 10 portfolio equity recipients, the proportion was even higher. While it is true that the largest recipients are also the largest emerging economies, the amounts of financing that they attracted accounted for a large share of their GDP and exports (World Bank 2002b).

FIGURE 3.14

Developing Countries' Parts and Components Exports Grew Faster in the 1990s

(percent per year)



Sources: UN Comtrade and World Bank.

For the median developing country, by contrast, portfolio capital flows were effectively zero throughout the 1970–90 period. Further, the spreads at which economies borrowed were high during the decade, reflecting creditors' focus on risk, not just returns. Moreover, many countries experienced sudden stops—abrupt and extremely disruptive reversals in the flow of capital—and quite a few were struck by financial crises.

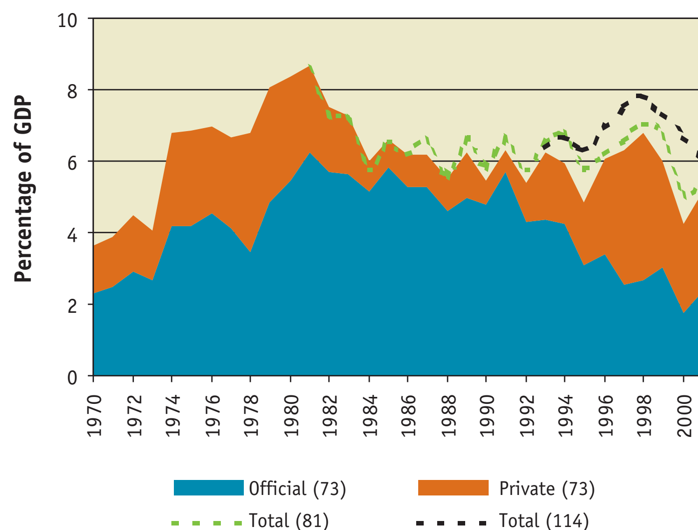
Should one then conclude that the external financial environment for developing countries in the 1990s was largely negative? The answer is no.

First, the supply of funds available to the developing countries was far greater in the 1990s than in any previous decade. Figure 3.15 suggests that capital flows to the median country at least did not decline, and those to a few large economies rose sharply.

Second, significant deregulation and liberalization, as well as financial innovations, greatly expanded the choice of investment vehicles. Third, the group of investors was growing, to include banks, nonfinancial institutions, mutual and pension funds, and individual investors. Fourth, considerable progress was made over the decade in improving

FIGURE 3.15

Capital Flows to a "Median" Developing Country as a Percentage of GDP, 1970–2002



Source: Global Development Finance 2003.

the transparency, data sharing, and circulation of information between investors and emerging markets. By the end of the 1990s, many more countries were rated (a prerequisite for borrowing internationally), even after adjusting for the emergence of former Soviet Union republics as new sovereign borrowers. The result of such diversity of investors and instruments, as well as much better understanding of emerging markets as an "investment class," was that international capital flows became a much more resilient and viable form of development financing. This coming of age could be seen at the end of the 1990s: when debt flows dried up, equity flows remained significant—unlike in the 1980s, when the drying-up of bank lending led to a protracted debt crisis.

Fifth, though the spreads at which economies borrowed were high during the decade, reflecting creditors' concern with risk, they cannot be compared with those of previous decades; as noted above, bond financing emerged only in the early 1990s after the completion of Brady restructuring.

Sixth, the financial and banking crises that rocked the 1990s were not a new phenomenon (see chapter 2 and Kindleberger 1984, 2000), and their severity was largely a reflection of the underlying fragility of the economies affected (Reinhart and Kaminsky 1999), rather than of adversity in the international environment.

Seventh, developing countries' interest payments on external debt were lower in the 1990s (figure 3.16). Throughout the decade, heavily indebted poor countries continued to receive an unprecedented amount of debt relief. The Highly Indebted Poor Countries' debt relief initiative of the International Monetary Fund (IMF), the World Bank, and other multilateral and bilateral creditors had committed US$40 billion for debt relief to 26 countries by the end of the decade. Moreover, large positive net transfers from the International Development Association (IDA) and bilateral concessional sources offset negative net transfers for the International Bank for Reconstruction and Development (IBRD), IMF, and private sources—in effect becoming another form of debt relief by replacing concessional debt with nonconcessional lending containing a large grant element.

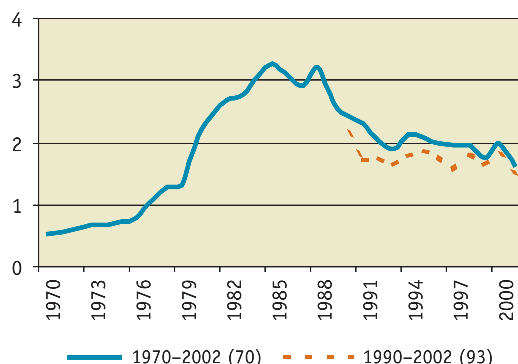
Conclusion: No Unusual Adversities in the External Environment

From this brief review of the features that are most commonly thought to represent the external environment, it is difficult to conclude that adverse external conditions explain why developing countries' growth was below expectations in the 1990s. International trade expanded rapidly and so did capital flows to developing countries in the 1990s. The context was one of relatively stable terms of trade, reasonably low oil prices, and lower interest payments on developing country debt.

True, the averages mask vast divergences in experiences and growth outcomes: some countries indeed suffered from real exchange rate appreciation; some were adversely affected by a decline in their terms of trade; while for others the prospects of growth were frustrated by the continued import pro-

FIGURE 3.16

Developing Countries Paid Less Interest On External Debt in the 1990s



Source: World Bank, *Global Development Finance 2004*.

Note: Median interest payments on the external debt as a percentage of gross national income; sample sizes in parentheses.

tection in developed countries; and so on. Yet overall it is still difficult to argue for negative shocks in the external environment that could account for the negative common shocks postulated in Loayza, Fajnzylber, and Calderon (2002) and Easterly (2001).

Econometrically, lower OECD growth explains away the negative dummies for the 1990s, as in Easterly (2002).[3] Yet the channels through which OECD countries influenced developing countries' performance are unclear. Easterly himself indicates that

> The OECD slowdown *may have* caused the LDC slowdown… However, I am not able to demonstrate a clear mechanism by which these external shocks translated into lower growth for the developing world. A variable that interacts OECD growth with the share of OECD trade in the economy is insignificant, for example [emphasis added].

It is always possible to find *some* adverse external shock affecting *some* countries. But econometric testing is always a joint hypothesis test of the economic theory and the empirical model. Unable to determine precisely what aspects of the external environment produced such an adverse shock, or what are the exact channels through which slower OECD growth affected developing countries performance, Easterly (2001) suggests a possibility that the type of growth regressions used in the empirical analysis might be mis-specified, given that stationary economic growth is regressed on nonstationary, upward-trending, indicators of policy performance:

> Alternatively, I have shown that the significance of the 1980s and 1990s decade dummies in regressions omitting OECD growth reflects *in part mis-specification rather than shocks* [emphasis added].

In short, it is difficult to conclude that adverse external conditions explain why growth was below expectations in developing countries over the 1990s, and Easterly's suggestion that the dummies result from econometric mis-specification needs to be taken seriously.

3. Policy Reforms in the 1990s

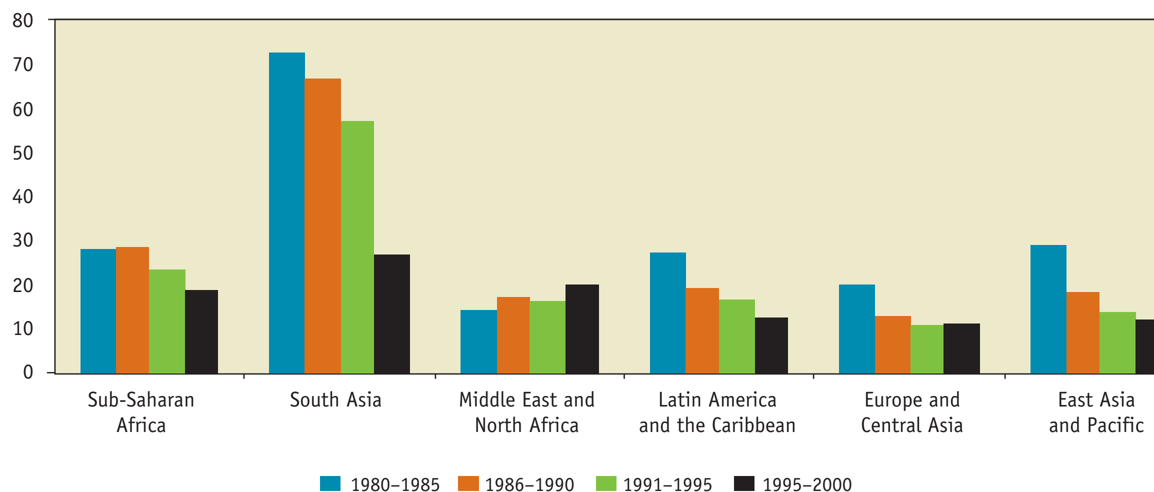
Developing countries made significant policy changes during the 1990s.

The reform agenda of the 1990s ranged from financial deregulation and privatization to upgrading labor codes and mounting anticorruption campaigns, but the most impressive results during the decade came from opening up, or further opening up, economies to international trade and capital flows. Tariffs were cut, the coverage of nontariff barriers shrank, black market premiums disappeared, and real exchange rates became more competitive.

Trade Liberalization

On balance, developing countries made convincing progress in opening their economies to international competition. Since the mid-1980s, they have nearly halved their average tariff rates from 28 percent (1980–85) to 15 percent (1995–2000). (See figure 3.17.)

FIGURE 3.17
Reduction in Tariffs in Developing Countries, 1980–2000



Sources: World Trade Organization, World Bank, UNCTAD.

Note: Median average tariff in percent, based on unweighted averages for all goods in ad valorem rates, or applied rates, or most-favored-nation rates, whichever data are available for a longer period.

Further, all of the developing regions have at least halved the incidence of nontariff barriers (table 3.7), and in most countries tariff-rate dispersion has declined significantly.

Progress has varied by regions, countries, and policy instruments. Countries in South Asia, Latin America, and East Asia achieved the most impressive gains in opening their economies, but there was little progress in the Middle East and North Africa and only moderate successes in Africa. Over the span of a few years, Latin American countries became more open to international trade and capital than East Asian countries did over decades. South Asia remained the most protectionist region with the highest tariff rates, even after a decade of reforms involving the deepest tariff cuts and a sharp reduction in tariff dispersion. Africa's moderate reduction of tariffs masks drastic reforms in a number of individual countries. Kenya reduced its import tariffs from 41 percent in the late 1980s to 14 percent in 1999. Guinea did the same, from 76.4 percent to 10.8 percent. In some Middle Eastern and North African countries, the signing of trade agreements with the European Union in the late 1990s eventually started a gradual process of opening up (World Bank 2003j).

TABLE 3.7
Reduction in Nontariff Barriers in Developing Countries, 1990s

Country	*1989–94*	*1995–98*
Sub-Saharan Africa (12)	26.0	10.4
South Asia (4)	57.0	58.3
Middle East and North Africa (4)	43.8	16.6
Latin America and the Caribbean (13)	18.3	8.0
East Asia and Pacific (7)	30.1	16.3

Source: Michalopoulos 1999.

Note: Average number of commodities subject to non-tariff measures as a percentage of total. Figures in parentheses are the number of countries in each region for which data are available. In the case of South Asia, significant reductions have taken place since.

Financial Sector Liberalization

The liberalization of finance has been at least as impressive as that of trade (figure 3.18). The main

[[AU: callout needed for table 3.8]]

TABLE 3.8

Tariff Dispersion Decline in the 1990s

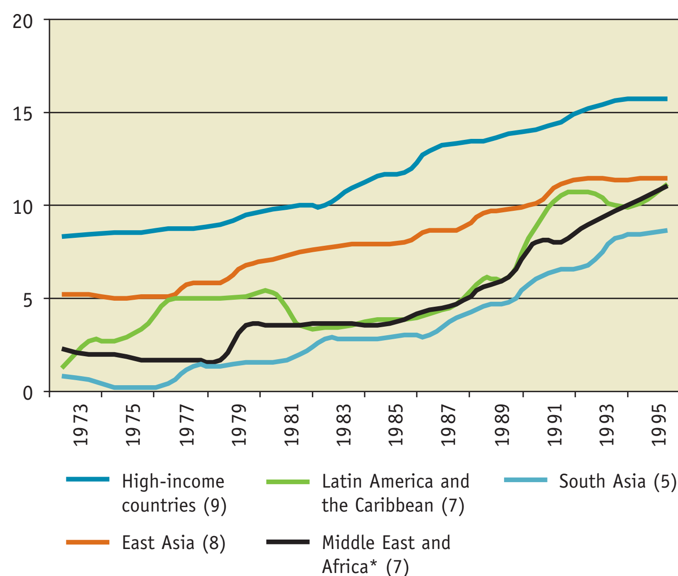
Region	1990–1994	1995–1998	1999–2002
South Asia			
Bangladesh	114.0	14.6	13.6
India	39.4	12.7	12.4
Sri Lanka	18.1	15.4	9.3
Africa			
South Africa	11.3	7.2	11.7
Malawi	15.5	11.6	10.5
Zimbabwe	6.4	17.8	18.6
East Asia			
Philippines	28.2	10.2	7.3
Thailand	25.0	8.9	14.3
Indonesia	16.1	16.6	10.8
China	29.9	13.0	10
Latin America			
Argentina	5.0	6.9	7.2
Brazil	17.3	7.3	12.9
Colombia	8.3	6.2	6.2
Mexico	4.4	13.5	9.3

Source: World Bank, *World Development Indicators* 1998, 2000, 2003; WTO Trade Policy Reviews, various issues.

Note: Country observations are for one year within the time periods noted above.

FIGURE 3.18

Financial Sector Liberalization, 1973–96



<Q? Is the y-axix unit "per-cent"?>

Source: Abiad and Mody 2003. The database covers financial sector policy changes in 35 countries over the 24 years from 1973 to 1996.

Note: The Middle East and Africa region also includes Turkey. Figures in parentheses are the number of countries in each region for which the index has been calculated.

goal of financial reform was to grant greater operating freedom to market intermediaries and at the same time to strengthen prudential regulation and oversight. As a result, at the end of the decade only South Asia's financial systems remained "partly repressed" according to the Abiad-Mody measure, and economies in Latin America, Sub-Saharan Africa had moved to "partly liberalized" status.[4] The Abiad-Mody measure is complete only up to 1996, but significant reforms had already been instituted by then.

Although financial reforms were largely implemented in packages, they tended to focus most closely on steps to eliminate interest controls and credit controls, such as directed credit schemes, sectoral credit ceilings, and high reserve requirements. Less rapid successes were achieved in privatization and the liberalization of entry barriers such as licensing requirements and limits on the participation of foreign banks.

Although there are exceptions within each region, countries within regions tended to liberalize their financial sectors at roughly the same time and in roughly the same way. Latin American countries carried out drastic and rapid reforms in the late 1980s and early 1990s. By contrast, East Asian countries implemented financial liberalization gradually, starting in the early 1980s, opening up in small policy steps with the whole process stretching over the 1990s. South Asian countries reformed only in the early to mid-1990s. South Africa in 1980 and the Arab Republic of Egypt in 1987 followed a "big bang" approach to financial liberalization, while others including Ghana, Morocco, and Zimbabwe followed a rather gradual approach (Abiad and Mody 2002).

Liberalization of the International Financial System

Equally significant were the measures taken to lift restrictions on the international movement of capital. The numbers of countries using multiple exchange rates and requiring compulsory surrender of export receipts declined, and several countries moved slowly to liberalize their current and capital account transactions (table 3.9 and figure 3.19). However, financial crises in the late 1990s, in East Asia in particular, forced policy makers to reevaluate the conventional wisdom that opening the capital account as soon as possible is the right policy to follow (see chapter 3).

Tax Reforms

Although not as extensive as trade and financial liberalization, tax reforms were a significant area of

TABLE 3.9

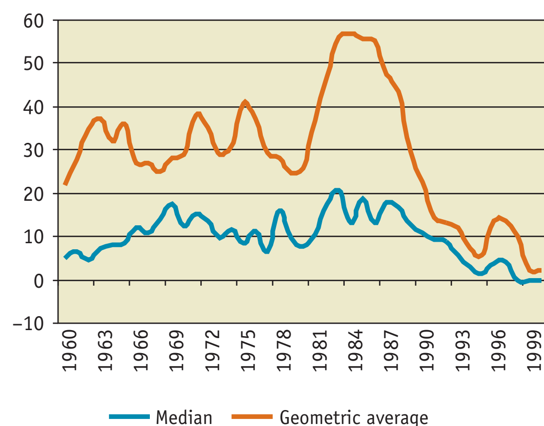
Capital Account Restrictions Were Progressively Dismantled, 1970–97

	1970	*1980*	*1990*	*1997*
Multiple exchange rate practices				
Sub-Saharan Africa (46)	20	19	18	14
South Asia (7)	50	16	14	0
Middle East and North Africa (16)	33	33	18	23
Latin America and the Caribbean (31)	24	39	42	19
East Asia and Pacific (16)	11	2	13	3
High-income countries (21)	17	10	0	0
Current account restrictions				
Sub-Saharan Africa (46)	88	73	73	82
South Asia (7)	100	79	86	86
Middle East and North Africa (16)	70	43	52	47
Latin America and the Caribbean (31)	48	44	58	48
East Asia and Pacific (16)	45	28	31	62
High-income countries (21)	38	26	20	10
Capital account restrictions				
Sub-Saharan Africa (46)	97	95	97	85
South Asia (7)	100	84	86	86
Middle East and North Africa (16)	70	50	52	47
Latin America and the Caribbean (31)	66	71	84	53
East Asia and Pacific (16)	79	64	63	68
High-income countries (21)	85	70	52	0
Surrender of export proceeds				
Sub-Saharan Africa (46)	97	95	96	77
South Asia (7)	100	100	100	57
Middle East and North Africa (16)	68	50	52	38
Latin America and the Caribbean (31)	79	85	97	50
East Asia and Pacific (16)	93	82	63	56
High-income countries (21)	68	55	40	0

Source: International Monetary Fund.

Note: The data show percentage of the countries imposing restrictions according to IMF methodology. Years are three-year averages, except for 1997, which is the 1996–97 average. Figures in parentheses are the number of countries in each region for which the index has been calculated.

FIGURE 3.19
Effects of Liberalizing the Financial Sector, Developing Countries



Sources: Levine and Renelt 1995; World Currency Yearbook; Wood 1997; World Bank.

Note: Median black market premium and its geometric average, 1960–2000; 103 developing countries.

[no exact match]; [no match; Refs list has 1988]

[AU: What is the unit? Percent?]

reform during the 1990s (Lora 2001a; IDB 1997). To increase revenue and to reduce the efficiency cost of taxation, many developing countries lowered their marginal tax rates, simplified and rationalized their tax systems, introduced value added taxes, and strengthened tax collection. Countries of Central and Eastern Europe and the former Soviet Union designed new tax codes. Liberalization of trade altered tax structures by sharply reducing the share of trade taxes in total tax revenues.

The fiscal reforms were implemented in a much more stable macroeconomic environment than that of the 1980s. Fiscal balances improved in most regions and inflation declined. Real exchange rates that had been overvalued in the 1960s and 1970s were devalued.

4. Conclusions

The economic environment of the 1990s has often been seen as unstable, volatile, and unforgiving for economic growth. In reality, however, it was quite favorable for developing countries. During the decade, practically all developing countries embarked on ambitious market-oriented reforms. Since the mid-1980s most of these countries have succeeded in reducing tariffs, liberalizing their financial sectors, privatizing their public enterprises, and reducing their deficits. Driven by exports of manufactures, world trade grew much faster in the 1990s than in any previous decade. Aggregate financial flows recovered rapidly in the 1990s after reaching a nadir in the late 1980s, and an average developing country experienced no significant decline in capital inflows. For the median country, capital flows regained their average level of the 1970s in 1997, with portfolio and FDI flows growing particularly fast. Real interest rates, high in the 1980s, came down in the 1990s, and so did oil prices. Large numbers of poor countries received unprecedented amounts of debt relief. By most common indicators of macro instability, the 1990s were less volatile than previous decades. On the macroeconomic front, inflation declined, real exchange rates significantly depreciated, and black market premiums disappeared. From any perspective, the positive changes witnessed during the decade were quite remarkable and created a reasonable expectation of higher growth.

Notes

1. Notwithstanding the rising U.S. growth rate in the 1990s, high-income countries as a group grew more slowly than in previous decades first and foremost because of the slowdown in Japan, which accounts for 20 percent of industrialized countries' GDP. Japan grew at just 1.4 percent in the 1990s, far below its historic average of 6.3 percent over the previous two decades. The United States (32 percent of industrialized countries' GDP) grew only slightly faster during the roaring 1990s than in the 1980s: 3.3. versus 3.2 percent annually.
2. These changes were not just due to declines in the prices of agricultural and resource commodities relative to manufactures—the strong shift in the composition of exports shows up even when price changes are removed. Further, it was not just due to a few, large high-growth exporters such as China and India. Excluding China and India, the share of manufactures in developing-country exports grew from one-tenth in

1980 to almost two-thirds in 2001. It increased sharply, but not equally, in all regions. The laggards included Sub-Saharan Africa and the Middle East and North Africa, which have yet to reach 30 percent. Many countries, particularly the poorest, remain dependent on exports of agricultural and resource commodities.

3. For instance, only 4 percent of U.S. affiliates' production in the European Union is sold back to the United States, whereas for developing countries the figure is 18 percent and for Mexico it is more than 40 percent (Shatz and Venables 2000).
4. It should be kept in mind that there are questions as to whether participation in global production-sharing actually leads to higher productivity, to faster growth in value added or employment, or to any other positive spillovers.
5. The slowdown in developed countries' growth over the 1990s was a mixed experience—neither universal nor particularly sharp. Three-fourths of the slowdown was a result of the prolonged recession in Japan; the United States grew no more slowly, and the European Union only moderately more slowly.
6. The Abiad-Mody index of financial liberalization is an aggregate of six components of financial sector policy: credit controls, interest rate controls, entry barriers, regulations and securities markets, privatization in the financial sector, and international financial transactions.

Part 2

Development Controversies of the 1990s