Economic Growth in the 1990s

Learning from a Decade of Reform

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Foreword

When you get right down to business, there aren't too many policies that we can say with certainty deeply and positively affect growth.
—Arnold Harberger, July 2003
(*IMF Survey*, 216)

Therefore, the real lesson for the architects of growth strategies is to take economics more seriously.
—Dani Rodrik, September 2003
(*Growth Strategies*, 30)

At the start of the 1990s, economists thought the road ahead was clear. What for many countries had been the "lost decade" of the 1980s made it evident that government interference in the economy—through price controls, foreign exchange rationing, distorted trade regimes, repressed financial markets, and state ownership of commercial enterprises—wasted resources and impeded growth. Hence, the logic went, rolling back the state would lead developing countries to sustained growth.

Much of this vision was reflected in the "Washington Consensus." Articulated by John Williamson in 1990, the Consensus was meant to synthesize the reforms that most economists in the World Bank, the International Monetary Fund, the U.S. Treasury, and some of Washington's think tanks believed were needed to rescue Latin American countries from cycles of high inflation and low growth.

When the Consensus was formulated, the current of opinion was already shifting toward a smaller role for governments more generally. Privatization and deregulation were taking hold in the United Kingdom, in the United States, and in Eastern Europe and the former Soviet Union. Williamson had emphasized that the Consensus was to be applied judiciously, not mechanistically, but it quickly took on a life of its own, becoming the expression of what economists both inside and outside Washington thought developing countries needed for growth and development. This thinking guided much of the advice by the World Bank and was reflected in the conditionality associated with adjustment loans. Some of its key aspects were reflected in the World Bank's *1991 World Development Report*, although that report stressed the importance of achieving the right balance between government and market, rather than choosing between them, and was generally more nuanced on the impact of specific reforms. The Washington Consensus was not the only point of view among economists. But it was the dominant view, making it difficult for others to be heard, and it provided the framework for many of the reforms

implemented during the 1990s by a wide spectrum of countries around the world.

The results of these reforms were unexpected. They exceeded the most optimistic forecasts in some cases and fell well short of expectations in others. Although implemented in a manner that departed from conventional wisdom—in terms of speed and design of reform, large presence of the state and, until very recently, high levels of import protection—domestic liberalization and outward orientation were associated with spectacular growth, poverty reduction, and social progress in East and South Asia. At the same time, booms and busts continued in Latin America and extended to East Asia and other regions as well. For most countries emerging from the former Soviet Union, the 1990s will be remembered as a costly and traumatic decade. Sharp declines were followed by a prolonged and as yet incomplete recovery, with results varying from relative success in the Czech Republic, Hungary, and Poland to costly transitions in most other countries. Africa did not see the take-off that was expected at the beginning of the decade, although many countries showed signs of recovery in the late 1990s. Costly financial crises rocked Mexico (1994), East Asia (1997), Brazil (1998), the Russian Federation (1998), Turkey (2000), and Argentina (2002). Some countries managed to sustain rapid growth with just modest reforms, and others could not grow even after implementing a wide range of reforms.

Interpreting the reasons for this wide variation is the central task of this report. A common interpretation has been that countries that grow have reformed enough, and countries that have not achieved sustained growth have not reformed enough. But for many economists and, perhaps more important, the policy makers they advise, this interpretation is not entirely satisfactory. Unquestionably, macroeconomic stability, domestic liberalization, and openness lie at the heart of any sustained growth process. But the options for achieving these goals vary widely. Which options should be chosen depends on initial conditions, the quality of existing institutions, the history of policies, political economy factors, the external environment, and last but not least, the art of economic policy making. The range of options puts the onus on economic analysis to guide policy making effectively. In dealing with growth processes, economists have no formula. They have broad principles and tools—in the same way that principles and tools can be used to build an airplane. If those are not appropriately put to use, the airplane may not fly, or may not weather storms well. The manner and sequence in which economic principles and tools are used will determine whether specific growth country strategies will succeed or not.

This volume is part of a three-pronged exercise the World Bank undertook to learn from the experience of the 1990s from three perspectives: (1) analytical (this book); (2) policy (13 policy makers who were at the forefront of policy implementation in the 1990s drew lessons from their experience during a one-year cycle of lectures at the Bank); and (3) operational (13 former Bank country directors drew lessons from their work at the Bank in a series of papers, to be published separately). From all three perspectives, growth was at the center of the discussion. An institution whose primary business is finance and advice for poverty reduction needs to understand what causes growth and what sustains it. Poverty declines rapidly where growth is rapid and sustained. Poverty stagnates where growth is tepid. A few exceptions notwithstanding, the unambiguous impact of rapid growth on poverty reduction was confirmed again in the 1990s. However, growth is difficult to predict because it implies social transformation: a break with past trends, behaviors, and institutions that reflect deep forces in societies and how they organize themselves.

The findings of the analysis confirm and build on the conclusions of an earlier World Bank report, *The East Asian Miracle* (1993), which reviewed experiences of highly successful East Asian economies. They confirm the importance for growth of macro-stability, of market forces governing the allocation of resources, and openness. But they also emphasize that these general principles translate into diverse policy and institutional paths, implying that economic policies and policy advice must be country-specific and institution-sensitive if they are to be effective.

The central message of this volume is then that there is no unique universal set of rules. Sustained growth depends on key functions that need to be fulfilled overtime: accumulation of physical and human capital, efficiency in the allocation of resources, adoption of technology, and the sharing of the benefits of growth. Which of these functions is the most critical at any given point in time, and hence which policies will need to introduced, which institutions will need to be created for these functions to be fulfilled, and in which sequence, varies depending on initial conditions and the legacy of history. Thus we need to get away from formulae and the search for elusive "best practices," and rely on deeper economic analysis to identify the binding constraints on growth. The choice of specific policy and institutional reforms should flow from these growth diagnostics. This much more targeted approach requires recognizing country specificities, and calls for more economic, institutional, and social analysis and rigor rather than a formulaic approach to policy making.

The messages in this book were well received during the extensive consultations that we held during its preparation. While there is a sense of discomfort associated with the ending of a conviction, there was a strong sense that the findings of the report spoke to the experience of the 1990s and helped its understanding. There was also appreciation and recognition that the complexity and diversity of growth experiences are not amenable to simplistic policy prescriptions. They require more refined and rigorous economic analysis. There was general acceptance for the realization of the multiple ways in which policies and institutions can fulfill the functions of growth. At the same time there was concern that these degrees of freedom could be misused by policy makers and interpreted as "anything goes." It was recognized, however, that rigid formulas were not an appropriate response to this challenge, and that while economic policy advice should be cognizant of the strengths and weaknesses of institutions and downside risks, it should not be influenced by mistrust. In September 2004, 16 well-known economists gathered in Barcelona and issued a new consensus that reflects their views on growth and development.[1] The Barcelona Consensus echoes much of the findings of the World Bank's work, which in turn reflects recent academic research by several of the signatories.

We expect this change in thinking to influence operational decision making in the World Bank and aid agencies in general. In the Bank in the last few years, these perspectives have been translated into new analytical and operational instruments such as poverty and social impact analysis and country-driven poverty reduction strategies, which seek to bring analytical rigor and empirical accuracy to the evaluation of policy reforms, and country specificity into growth strategies. To mainstream this approach to the formulation of growth strategies needs persistent efforts and willingness to experiment. The new perspectives also have implications for behavior—in particular the need for more humility. And, last but not least, they highlight the need for a better understanding of noneconomic factors—history, culture, and politics—in economic growth processes. The operational implications of these perspectives will be explored separately.

Gobind Nankani
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Poverty Reduction and Economic Management
now Vice President for Africa
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1. Olivier Blanchard, Guillermo Calvo, Daniel Cohen, Stanley Fischer, Jeffrey Frankel, Jordi Galí, Ricardo Hausmann, Paul Krugman, Deepak Nayyar, José Antonio Ocampo, Dani Rodrik, Jeffrey D. Sachs, Joseph E. Stiglitz, Andrés Velasco, Jaime Ventura, and John Williamson. The Barcelona Consensus is online at http://www.barcelona2004.org/eng/eventos/dialogos/docs/agenda_eng.pdf

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