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Background paper for the 1991 World Development Report

Policies for Economic Development

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and
Vinod Thomas

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The economic policies developing countries should follow to sustain economic growth and development.

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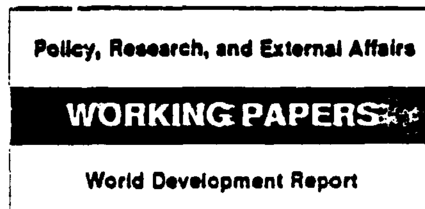

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Fischer and Thomas's explanation of the policy and institutional reforms needed to sustain economic growth and development is organized around several main points:

• The appropriate macroeconomic framework will ensure stability. Fischer and Thomas discuss the essentials of fiscal, monetary, and exchange-rate policy as well as investment and savings ratios and strategies.

• Sectoral pricing and development and regulatory environments must address key constraints on growth, while respecting the need for stability. The authors discuss economywide issues as well as issues related to agricultural, industrial, and human resource development, poverty alleviation, and sustainable development (observing environmental considerations).

• The domestic economy must be integrated with the global economy to increase competition and improve competitiveness. Fischer and Thomas discuss reforms of commercial and trade policy and the capital account.

• The government must create the proper enabling environment — an appropriate legal, regulatory, institutional, and policy framework. Fischer and Thomas discuss areas in which the quality and competence of governments need improving as well as the nature and appropriate extent of the government's role in providing social services, managing economic policy, and fostering development of the private sector.

The authors conclude with an analysis of the Bank's changing emphasis on types of lending, and with a discussion of major remaining uncertainties, including the role of external funding and international development agencies.

The PRE Working Paper Series disseminates the findings of work under way in the Bank's Policy, Research, and External Affairs Complex. An objective of the series is to get these findings out quickly, even if presentations are less than fully polished. The findings, interpretations, and conclusions in these papers do not necessarily represent official Bank policy.

Produced at the PRE Dissemination Center

Policies for Economic Development

by
Stanley Fischer
and
Vinod Thomas*

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POLICIES FOR ECONOMIC DEVELOPMENT

At the end of a decade in which many developing countries have experienced economic regress rather than progress, and in which the formerly socialist economies have turned away from central planning toward market-orientation, the policies needed for growth and economic development have emerged more clearly than at any time in the post-World War II period. Whether this moment is more than fleeting remains to be seen. But certainly the time is right to set out a mainstream, pragmatic view of what those policies are and of what uncertainties surround the market- and outward-oriented approach to development.

By economic development we mean equitable economic growth.[1] Economic growth at appreciable rates is a modern phenomenon -- a few centuries old, at most, in the more developed countries. The greatest known rate of increase in per capita income occurred in much of the world in the period following World War II, particularly up to 1973. (See table 1 for growth rates of per capita GDP for various groups of countries and time periods[2].) Until the early 1970s, the rate of economic growth accelerated in both the industrial countries and the middle-income countries. Then, signs of a slowdown appeared in many parts of the world. In the developing world, per capita GDP began to decline as early as the 1960s in some countries in Sub-Saharan Africa (Chad, Madagascar, Niger, Tanzania, Uganda, Zaire, and Zambia) and after 1980 in Latin America. These

[1]We thus sidestep difficult and important issues about the meaning of development, particularly questions about the relationship between economic well-being and human development, analyzed in Sen (1988), and economic development and the environment (discussed in section II below).

[2]Unfortunately we do not have data to measure changes in income distribution or poverty over those periods. For a recent comprehensive examination of the relationship between economic growth and the distribution of income, see Fields (1989).

downturns were cause for serious concern and for a reevaluation of the sources of growth and development.

Table 1: Growth Rates Of Per Capita GDP for Selected Countries and Country Groups, 1700-1988 (annual percentage change)

Country/ Group	1700-1950	1850-1950	1950-1960	1960-1970	1970-1980	1980-1988	1950-1988
Industrial countries			3.5	3.8	2.3	2.2	3.0
Western Europe[a]		1.3	3.5	3.4	2.4	1.9	2.8
France	0.8	1.1	3.6	4.5	2.7	1.4	3.0
U.K.	0.9	1.1	2.3	2.2	1.7	2.5	2.2
U.S.A.		1.7	1.4	2.5	1.7	2.1	1.9
Japan		1.1[b]	7.6	9.3	3.5	3.4	6.0
Developing countries			1.8	2.8	3.3	1.9	2.5
Sub-Saharan Africa			1.2	1.3	1.2	-2.5	0.3
Latin America			1.9	2.9	3.3	-0.8	1.8
Europe, Middle East & North Africa			1.8	4.1	5.0	0.4	2.1
Asia			2.3	2.4	3.1	5.8	3.4
South Asia			2.0	1.7	0.7	3.5	2.0
East Asia			2.7	3.0	4.3	6.8	4.2
Brazil			3.4	3.3	6.0	-0.1	3.2
Chile			1.3	2.0	1.2	0.6	1.3
Egypt			0.8	2.9	4.5	2.6	2.7
India			1.8	1.7	0.7	3.8	2.0
Kenya			0.7	1.4	4.0	0.4	1.6
Korea			2.8	5.4	6.6	8.4	5.8
Thailand			2.4	5.0	4.0	4.5	4.0

[a]Aggregated data for Belgium, Denmark, France, Federal Republic of Germany, and the United Kingdom, using simple averages.
[b]Estimate is for period 1870 to 1950
Sources: Data for years prior to 1950 are from Maddison (1970). Data for later years are from the World Bank data base. Data for aggregates are GDP weighted.

The expansion in growth following the end of World War II reflected not only the resumption of economic activity after the war, but also the spread of

modern economic growth worldwide. This long-term economic growth resulted both from increases in the quantities of productive resources -- the accumulation of capital, through saving, and increases in labor supply -- and, equally important, from improvements in the efficiency of resource use associated with technological advances and improvements in resource allocation and quality of physical and human resources. In addition, this growth was associated with structural transformation of the economy, with populations being drawn out of agriculture and into industry.[3] The economic success of the newly industrializing economies of East Asia provides more recent confirmation of the association between industrialization and growth.

A number of studies show that enabling policy environments are positively associated with technological change and the productivity of resources.[4] The importance and characteristics of the enabling policy environment are also indicated in studies of the growth experience of countries.[5] Thus the economic policies that constitute a country's policy environment have a fundamental bearing on the rate of industrialization and growth. Behind this policy environment lie the quality and competence of the government and, more generally, the strength of a country's institutions.[6]

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[3]Typical shifts in the sectoral allocation of resources in the process of economic development are shown in Chenery and Syrquin (1975) and Chenery, Robinson, and Syrquin (1985).

[4]For example, Romer (1989) finds that increased openness to international trade increases the rate of technological change and the productivity of capital. See also Edwards (1989).

[5]See for example, World Development Report, various issues; and Chenery and Srinivasan (1988 and 1989). Evidence on country performance and policy during the 1980s is contained in World Bank (1988). No doubt the relationship among performance, policy and other factors is complex, as traced by Lewis (1984), Reynolds (1983) and Stern (1989).

[6]On the role of the government and institutions in explaining performance, see Morawetz (1977), North (1981), and Reynolds (1983).

In this paper we look at the economic policies and institutions needed to generate and sustain economic growth and development. The paper argues that policy and institutional reforms are needed in three broad areas (sections I through III). First, the need for a fiscal policy and overall macroeconomic framework that ensures stability is critical. Second, sectoral pricing and investments ought to address key constraints to growth while respecting the requirement for stability. Third, the domestic economy needs to be integrated with the global economy to increase competition and improve competitiveness. Policy and institutional reforms in these areas are necessary both for adjusting to exogenous changes and for ensuring long-term growth and development. To enable the appropriate policies to emerge in these areas, government must act competently in the spheres that are its proper concern (section IV). The paper concludes (in section V) with a brief discussion of some of the major remaining uncertainties.

I. Getting the Macroeconomic Framework Right

Economic development is more likely to take place if policies produce a stable macroeconomic environment. Stability is characterized by reasonably low inflation, an appropriately valued real exchange rate, sustainable fiscal and current account deficits, and the avoidance of foreign exchange and debt crises.

Fiscal and Monetary Policy

Fiscal policy is a key to successful macroeconomic policy both because of its direct macroeconomic effects on the current allocation of resources and because all methods of financing a budget deficit have potentially adverse

macroeconomic consequences when used to excess. Tax and expenditure policies, including the composition of government spending, are also the government's major microeconomic tools for affecting the allocation of resources.

For a given level of private saving, fiscal deficits displace private domestic investment or cause current account deficits. So unless private saving responds fully to public sector deficits -- and there is little reason to think that it does -- a reduction of the fiscal deficit is likely to improve the current account and, perhaps after a period of adjustment, to increase investment.

Fiscal deficits can be financed in four ways: by printing money, by running down foreign exchange reserves, and by borrowing at home or abroad (Fischer, 1989). Each method can be used benignly on a small scale (and in the case of running down foreign exchange reserves, on a transitory basis), but each is likely to cause additional problems if used on a major scale. Printing (high-powered) money faster than the real demand for it increases is inflationary; running down foreign exchange reserves will cause a foreign exchange crisis; domestic borrowing can boost real terest rates and destabilize the domestic fiscal situation as higher interest rates lead to a higher deficit and more borrowing; and excessive foreign borrowing can lead to an external debt crisis.

A contractionary <u>monetary policy</u> can, for a time, offset the inflationary effects of a fiscal deficit, but the monetary authorities in developing economies typically have only a limited ability to run an independent monetary policy. And even when such independence is possible, the combination of tight money and loose fiscal policy produces high real interest rates that reduce investment, slow growth, and contribute to harmful debt dynamics. Eventually, high and

persistent fiscal deficits spill over into pressure to use seigniorage and the inflation tax for government finance.

The temporary success of some economies, such as Israel and Brazil, in using indexation to live with inflation while growing fast appeared for a time to justify a relatively relaxed attitude to inflation. But since real factors also influence inflation, indexation tends to raise the inflation rate and may even make people worse off. In addition, an economy operating with a high rate of inflation is far more vulnerable to external shocks than one that maintains a stable macroeconomic environment.

On the whole, excesses in fiscal policy are central to the macroeconomic instability and poor performance of many developing countries.[7] The need for fiscal moderation does not mean, however, that a zero deficit is optimal. A country that is growing fast can afford to run a larger deficit than one that is growing slowly, and a country with a higher saving rate can run a given deficit for longer than a country with a lower saving rate. Fiscal moderation has to be judged by the projected path of the debt (internal and external) to GNP ratio and of the inflation rate and external balance.

The Exchange Rate

The second key to a sound macroeconomic framework is the exchange rate, which plays two policy roles -- one related to the real exchange rate, the other

[7] It is important to use the right measure of the deficit. The deficit has to include real interest payments: it is not sufficient that the primary (non-interest) budget be balanced, since the interest component of the deficit also has to be paid or rolled over. It is also necessary to include the quasi-fiscal deficit of the central bank, which often develops when subsidized credit is made available, either directly or through commercial banks, to particular sectors of the economy. Sometimes, high inflation takes place in an economy in which the finance ministry declares it has a balanced budget; typically, a quasi-fiscal deficit on the order of 5% of GNP or higher will be found.

to the nominal exchange rate. The level of the real exchange rate establishes market incentives to export and affects the level of protection for domestic import-competing industries. Overvaluation of the real exchange rate retarded development of the tradable sectors in many countries, contributing to the external sector crises of the early 1980s. Subsequently, many countries have achieved a substantial depreciation of the real exchange rate. Some analysts have argued that an emphasis on the market exchange rate is exaggerated, since a combination of tariffs and export subsidies can also be used to affect the real exchange rate relevant to domestic consumers and producers (the ratio of the price of traded to nontraded goods). But achieving a given real effective exchange rate through export subsidies and tariffs rather than through devaluation is equivalent to subsidizing capital exports -- not a policy likely to be chosen explicitly.[8] Export subsidies are also subject to retaliation under GATT in the form of countervailing measures.

The real exchange rate is affected by fiscal and monetary policy, by foreign borrowing and foreign aid, by terms of trade shocks, and by foreign exchange controls. (We discuss the desirability of foreign exchange controls below.) Foreign aid, if it substitutes for domestic savings, causes the Dutch disease, which slows the development of export potential (and stimulates production for the domestic market) by tending to appreciate the real exchange rate. This cost has to be set against the direct benefits of external assistance.

[8]The political preference for tariffs and export subsidies may result from the ability to set such rates on a commodity-by-commodity basis. But so doing is undesirable because it introduces distortions in resource allocation whereas the exchange rate leaves the choice of activities to the market.

The second policy role relates to the use of a stable nominal exchange rate as a monetary anchor and a powerful anti-inflationary tool. When an economy operates with a fixed nominal exchange rate, the quantity of money becomes endogenous. This has the advantage of simplifying the job of the monetary authority, but as experience shows, the authority frequently attempts to control the quantity of money through foreign exchange controls.

The two roles of the exchange rate sometimes clash: governments afraid of inflation hold the nominal exchange rate constant or devalue it too slowly, and so the domestic currency appreciates and -- with a lag -- the current account goes into crisis. In the Southern Cone countries of Latin America, the use of the nominal exchange rate as a monetary anchor led to an increasing overvaluation of the currency. When the monetary anchor and trade incentive roles of the exchange rate conflict, the monetary anchor should be pulled up first, and attention turned to the underlying source of inflationary pressure, typically the budget. There are intermediate steps, such as a crawling peg, that together with appropriate fiscal policy can provide some monetary stability without tending to produce an overvalued currency.

Investment, Saving, and Growth

Investment and saving ratios in rapidly growing economies typically exceed those in stagnating economies (see table 2).[9] It is further clear that sustained growth will not resume in Sub-Saharan African and Latin American countries until their investment ratios rise significantly.

[9] Though, to be sure, there is no mechanical relationship between the investment rate and economic growth.

Table 2: Saving and Investment Shares in GDP and GDP Growth for Selected Country Groups: 1982 - 1988

Country Group	Saving Share	Investment Share	GDP Growth Rate
Developing countries	23.5	23.6	4.2
Low-income countries	23.3	25.7	6.9
Low-income countries (excluding China and India)	13.6	17.3	2.6
Middle-income countries	23.5	22.5	2.4
Sub-Saharan Africa	11.4	14.5	0.9
Latin America	21.7	18.7	1.3
Europe, Middle East & North Africa	22.2	26.0	2.9
Asia	27.5	28.3	8.0
South Asia	19.2	22.8	5.6
East Asia	31.0	30.6	8.8
Highly indebted countries	21.7	18.9	1.3
Oil-exporting countries	23.4	21.8	1.3
Manufacturing exporters	25.[illegible]	26.1	6.3
Industrial countries	20.0	20.0	3.0

Note: Growth rates are averages for the period 1982-88. Data for aggregates are GDP weighted. The shares refer to nominal shares.
Source: World Bank data.

The rise in the real interest rate in the eighties and the unwillingness of international commercial lenders to take on new debt in many countries reduced the possibilities of financing investment from abroad. Economic growth in the nineties will have to be financed largely from domestic savings, and the surest way to increase domestic saving is to increase government saving.

Much of the attention to saving during the eighties emphasized the importance of positive real interest rates for development. Negative real interest rates can reduce saving and impair the efficiency of the financial system by reducing the share of saving intermediated through financial

institutions. Thus the emphasis on the real interest rate is appropriate when that rate is significantly negative, as is frequently the case in high inflation economies with interest rate controls. But once the real interest rate is positive, or close to that level, neither theory nor experience offers any reason to believe that further increases will increase saving.

Public policy also affects the demand for investment, particularly by providing investment incentives and by safeguarding productive public investment. Efficient public and private investment are probably complements, so the tendency of governments to reduce efficient public investment in times of fiscal stringency probably reduces the demand for private investment as well.[10] The stability of macroeconomic policy also affects the demand for investment. Recent theoretical and empirical developments emphasize the dampening effects of uncertainty on the demand for investment: the investor always has the option of waiting for conditions to change before committing to an illiquid investment.

Increasing the demand for investment does not lead to increased investment, however, unless domestic or foreign saving responds. In an economy with some slack, higher investment demand generates higher saving as a result of the increase in income; in such economies, increased investment is partly self-financing. In economies at full employment, an increase in investment demand generates higher investment only by increasing saving (conventionally, by increasing the real interest rate, although the evidence does not favor a powerful saving response in this regard) or by drawing in foreign saving, perhaps from official agencies willing to support an adjusting government. Some evidence

[10]This is not to deny that some public investment, especially in public enterprises, is wasteful; rather, it is to make the point that cutting productive public investment is likely to affect the rate of private investment.

also shows that saving increases as the growth rate rises, so a virtuous circle of investment, growth, and saving may function to some extent.

Response to Shocks

Fiscal and monetary policy, the exchange rate, and borrowing strategy may have to adjust rapidly when external conditions change; the more successful governments recognize change and respond appropriately. Flexibility is particularly important for economies with widely fluctuating external earnings, typically because of a dependence on earnings from one or a few primary commodities. In such economies, governments must avoid committing themselves to irreversible new expenditures when revenues increase temporarily, such as during a commodity boom. Failure to observe this principle led to debt crises in countries such as Cote d'Ivoire, Mexico, Nigeria and Senegal.

That countries should save when income is temporarily high and draw down savings when income is temporarily low is well known. But predicting whether a change in external earnings is going to be temporary or permanent is difficult, and the temptation is strong to believe that increases in external earnings are permanent. For governments facing unstable external earnings, formal stabilization mechanisms such as the Chilean copper fund may help smooth absorption. New financial instruments such as commodity bonds can also help achieve this goal. Adjustment to other external shocks is less likely to be amenable to the application of such automatic mechanisms, but rapid adjustment is nonetheless needed if crises are to be avoided.

II. Sectoral Policies and Investments for Development

Macroeconomic policies for stability and growth are necessary but far from sufficient for development. They need to be supported by appropriate sectoral pricing and regulatory policies and sectoral investments. In addition, poverty alleviation and natural resource management require special attention -- both in their own right and because of their influence on the sustainability of development.

Investments in agriculture, industry, human resources, and other sectors have long formed the core of development efforts. In addition, countries use subsidies, taxes, price controls, and quantitative regulations to influence the development of particular sectors. At the microeconomic level, traditional analysis of the economic benefits and costs of projects can go a long way in guiding the selection of particular investments. Proper assessments of the economic benefits and costs of investments take into account the effects of price distortions on the returns to investment (Harberger, 1983, Little and Mirrlees, 1974). Ultimately, the effectiveness of the investments depends on the macroeconomic policy environment affecting the sector and on the consistency among po. cies being pursued in various sectors.

We turn below to economy-wide and cross sectoral considerations relevant to sectoral development, and then consider issues important to the development of particular sectors -- focusing on agriculture and industry and human resource development. We then examine special concerns of poverty alleviation and implications for sustainable development.

Economy-wide and Inter-sectoral Considerations

Traditionally, sectoral analysis has focused on the incentive effects of sectoral price policies on sectoral growth. But often, macroeconomic policies have a stronger impact on a sector than do explicit sectoral policies. An overvalued exchange rate usually has a greater (negative) effect on agricultural incentives and performance than do agricultural price policies themselves. A study of the impact of sector-specific (direct) and economy-wide (indirect) policies on agricultural incentives in eighteen developing countries for 1975-84 found that the indirect (macroeconomic) effect taxed agriculture and dominated the direct (sector pricing) effect, whether the direct effect was positive or negative (Krueger et al., 1988).

Also important in their welfare effects are conflicts among policies followed in different sectors and aress. These conflicts are not often assessed in policy formulation when sectoral policies are considered in isolation. Policy change in one area can have unintended and indirect effects on outcomes in another area. For example, increasing the level of agricultural procurement prices benefits farm production but harms the government budget. Increasing agricultural output prices or lowering the controlled prices of agricultural inputs hurts the industrial enterprises that process agricultural goods; lowering input prices has the same effect on the manufacturers of the inputs. Sometimes, a (partial) reform can be ineffective or counterproductive unless accompanied by complementary actions. For example, a devaluation or import liberalization will not induce a favorable production response if entry and exit regulations are not relaxed in the domestic market.

A related issue in sectoral policy is the effort by each sector (or subsector) to augment its own production incentives without considering their

economy-wide impact. Increased incentives in one sector -- permitted by subsidies -- have offsetting effects on other sectors as well as overall budgetary consequences. Experience suggests that pricing and regulatory policies should strive for neutrality across sectors. Neutral incentives can, of course, be achieved through offsetting interventions (see section III also), but the evidence argues against interventions designed to favor particular industries, regions, or factors of production at the expense of others. However, in moving toward neutrality, governments may need to pursue active transitional policies, for instance, to restructure public enterprises, the financial system, or the trade regime.

Historically, sectoral policies have favored industry over agriculture. Economic development requires a rise in agricultural productivity that permits an increasing share of the labor force to contribute to industrial production. Accordingly, development is usually accompanied by a declining share of agriculture in total output and an increasing share of industry. This pattern, however, should not be misinterpreted as denigrating the importance of agriculture to development or as an argument for accelerating development by taxing agriculture. To the contrary, a squeeze on agricultural incentives leads to agricultural and overall economic stagnation, in turn slowing the process of industrialization.[11] A shift to greater neutrality in policy-induced incentives between agriculture and industry has been found beneficial in many countries.

[11] See, for example, Denison (1962), Kuznets (1966), Hayami and Ruttan (1985), T.W. Schultz (1964), and Timmer (1988).

Sector-specific Policies

A two-part approach to agricultural development has proven successful, based on the avoidance of government interventions that produce agricultural disincentives and on active measures for the development and dissemination of technical innovations beneficial to farmers. On the avoidance side, governments need to be wary of heavy taxation or neglect of agriculture. Faced with adequate incentives, farmers respond rationally to profit opportunities -- contrary to previous beliefs that traditional farmers respond poorly to incentives, if at all. On the active side, government and private investments both in agricultural research and extension and in rural infrastructure are essential. The Green Revolution is an example of a successful outcome of an approach that reversed agricultural disincentives and actively attended to local research capabilities.

Developing countries have made special efforts to industrialize rapidly and catch up with the rest of the world. Some aspects of an industrial policy have worked (see below), but others have not. In some countries industrial policies meant large investments in heavy and chemical industries, which subsequently led to excess capacity and macroeconomic crises.[12] In others it meant the establishment of public enterprises or the introduction of incentive systems that fostered industrialization through heavy protection, subsidized credit, and other interventions and regulations. For some countries, the strategy worked in some areas, at least for a time, because they happened to select the right industries (Japan, Korea, Taiwan). Generally, the industries survived because of continued subsidies, protection, or other interventions.

[12]During the 1960s and 1970s, this was the case even in Korea, which on the whole, was successful in its industrialization strategy. See World Bank, 1986.

To develop a more efficient and sustainable industrial structure, industrial policy required adjustments in the sector to reduce losses, protection, and regulation (see World Bank, 1988, Meier and Steel, 1989). In addition, attention to key nonprice factors -- infrastructure, telecommunication, marketing, quality control, research and development -- can have handsome payoffs (see section III also).

Human resource development is both an independent goal of development and an essential instrument of economic progress. The sources of economic growth comprise not only the expansion of physical capital and labor but, even more important, the improvement of their quality. Various studies indicate the positive link between investment in the human capital of the population and increases in productivity and economic performance (see T. P. Schultz 1988). While human resource development depends on a favorable policy environment, determining an efficient allocation of government resources across and within sectors requires specific analysis in each case -- for instance, on the appropriate distribution among primary, secondary, and university education or between technical and more general education. Like the education level, the health and nutritional status of the population is both an indicator of welfare and a determinant of productivity. So decisions on public expenditures on education or health and nutrition have a bearing both on welfare directly and on the productivity of the population.

Reducing the rate of population growth remains a priority of development policy in many developing countries. Unprecedented rates of population growth have meant low or negative per capita income growth in much of Africa and Asia in the post-World War II period and for an even longer time in China and India. Despite political opposition in the United States, international agencies have

sought to assist governments to reduce population growth. Historical evidence suggests that overall economic growth contributes to lowering population growth. The response to family planning programs has been mixed: it has been good in a number of East Asian countries (Indonesia, Thailand), is becoming evident in South Asia, but has remained weak in Africa -- although lately, even in Africa, population growth rates seem to be turning down in some countries.

Growth and Poverty Alleviation

Rapid growth of the economy reduces the incidence of poverty, but experience shows that the type of growth also has a bearing on its impact on poverty. Growth based on improvements in agricultural technology will usually reduce poverty, as was the case with new rice technologies in Indonesia. Land redistribution too has benefited the poor, in some cases also augmenting productivity.[13] Labor-intensive growth reduces poverty. Because export production is typically labor intensive, export-led growth has had a salutary effect on poverty, except in cases where exports comprised mainly the output of large plantations or mines (OECD 1989).

Although the process of economic development is expected to reduce poverty, poverty alleviation is a goal of policy in its own right -- in developing as well as in industrial economies. In the 1980s, attention focused on the immediate victims of government programs of stabilization and structural adjustment.[14] Examples are civil servants or private employees who are laid off because of austerity measures or shifts in production, and low-income and vulnerable groups

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[13]For a discussion see World Development Report (forthcoming) and OECD (1989).

[14]See for example, Cornia, Jolly, and Stewart (1987) and Demery and Addison (1987).

(the old, infants, lactating and pregnant women, and landless and poor farmers) who are hurt by cutbacks in social programs or by changes in relative prices.

The extreme poor in rural areas -- where the bulk of the poor lives in most developing countries -- may not be particularly affected by stabilization and structural adjustment to the extent that changes in incentives, production and public spending do not touch them. The urban poor, however, may suffer because of the food price increases and social program cuts that are often a part of adjustment programs. Indeed, the removal of food price controls generally benefits the rural sector as a whole relative to the urban sector and, on balance, the poor relative to the middle class. Such adjustment, together with urban food price subsidies directed specifically to poor groups, is likely to reduce poverty.

Specific policies, such as directed food subsidy and health programs, can be used to protect the poor and reduce poverty during adjustment. Bolivia, for example, has introduced its Emergency Social Fund and Ghana has the Program of Actions to mitigate the Social Cost of Adjustment. These are temporary measures (three years in Bolivia and two in Ghana) designed to ease the effects of adjustment on vulnerable groups during the more difficult transition period. In many countries, however, social spending helps mainly the middle and upper classes. Countries need to improve the effectiveness and targeting of their public expenditures so that they reach the poor. The mistargeting of public social expenditures can be redressed, for example, by reducing or recouping (through user fees) public funding of higher education and some curative health care expenditures. In addition, education, health services, and other social programs can be designed to reduce poverty (as in Chile).

Growth, Adjustment and Sustainable Development

Sustainable development relates both to the interactions between economic growth and the environment and to the social, political, and economic sustainability of adjustment programs (World Bank, 1989). Environmental sustainability has aspects that relate to individual sectors and countries, and aspects with global consequences. One concern is that growth in many sectors and countries is not sustainable because it rests on misuse and destruction of a country's natural resource base. Two-way links exist between growth and the environment: certain growth policies are consistent with environmental protection, and environmental care contributes to sustained growth. But much more needs to be learned about the tradeoffs between measured growth and environmental protection. In the meantime, however, simple steps are already being implemented to prevent environmental damage, such as environmental assessments for World-Bank funded projects.

Global environmental issues pose more difficult problems. Global warming exemplifies some of the complexities involved. If global warming is taking place, responsibility lies largely with the current and past economic activities of the now industriali ed countries. Putting measures in place to reduce global environmental damage will pose major political challenges, among them the issue of burden-sharing between developing and industrialized countries -- and among all countries.

The second area of concern is whether current adjustment programs are socially, politically, and economically sustainable. Adjustment is more likely to be socially sustainable if the poor are protected during the process of adjustment. Political sustainability may depend on how adjustment affects those elements of the population that have political influence. Finally, adjustment

is more likely to be sustainable if beneficial economic results emerge early. All these aspects of sustainability can be improved by external financing -- in the form of adjustment lending, for example (section IV) -- during the adjustment process, which temporarily enables a country to make less drastic cuts in expenditures and in imports than it would otherwise have had to make.

III. Integrating with the World Economy

The most successful economic performers of recent decades have been the newly industrializing economies and, in general, the exporters of manufactured goods. What notably differentiates these countries from many other developing countries is their relative openness and strong links with the world economy. To maintain the global links, the more open economies have had to remain competitive in a rapidly changing world environment. Common to their successful competition strategies is the reduction or elimination of discrimination against tradables, in particular, exportables -- permitting production of exports, as well as efficient import substitutes, on an equal footing with nontradables. The result is a more rapid expansion of exports and imports as well as overall GDP compared to other countries. Superior trade performance among various country groupings is positively associated with economic growth, as suggested in table 3.

Table 3: Growth in Real GDP, Exports and Imports
(weighted averages)

	Average annual % growth rates					
	1965-81			1982-88		
	GDP[a]	Export[b]	Import[c]	GDP[a]	Export	Impor
Developing Countries	5.6	6.6	8.1	4.2	8.2	3.6
Low export growth[d] (<5.0%)	4.2	2.0	4.8	1.7	0.0	-1.1
Moderate export growth (5.1-7.5%)	4.9	6.6	7.5	2.7	6.5	2.
High export growth (7.5-10.0%)	5.5	8.8	8.4	5.6	8.4	3.
Very high export growth (>10.0%)	7.1	16.3	11.9	5.6	14.9	8.
Low-income countries	4.9	4.5	6.3	6.9	13.1	8.
Low-income countries (excluding China & India)	4.4	4.1	6.9	2.6	0.2	-6.
Middle-income countries	6.0	7.6	8.9	2.4	6.4	1.
Sub-Saharan Africa	3.6	3.8	6.8	0.9	-0.4	-7.
Europe, Middle East & North Africa	6.7	7.2	8.7	2.9	6.3	2.
Latin America	5.9	8.6	8.9	1.3	4.8	-2.
Asia	5.8	7.7	3.4	8.0	14.6	11.
South Asia	3.7	4.6	3.2	5.6	4.4	5.
East Asia	6.9	8.2	10.9	8.8	15.7	12.
Highly indebted countries	5.4	7.1	9.1	1.3	4.8	-2.5
Oil-exporting countries	5.6	6.9	12.4	1.3	2.9	-5.9
Manufacturing exporters	6.2	8.8	8.2	6.3	12.8	9.3
Industrial countries	3.5	7.1	6.2	3.0	4.3	5.8

[a]GDP at 1980 constant prices.
[b]Export volume of goods and nonfactor services.
[c]Import volume of goods and nonfactor services.
[d]Countries in each of the four growth-based groups are different in the two peri
1965-81 and 1982-88.
Source: World Bank data.

Countries have moved toward neutrality of incentives along different paths.[15] Some successful reformers substantially liberalized their trade restrictions (Chile in the second half of the 1970s, Mexico in the mid-1980s), others intervened to offset existing biases against exports (Korea and Taiwan in the 1960s and 1970s), and some did both (Indonesia, Turkey in the 1980s). In view of the substantial trade restrictions prevalent in most countries, the shift to greater neutrality in incentives in these countries should come mostly through liberalization. But a role exists for additional government measures to support export development, for example through government measures to access or subsidize new technologies -- an approach which have paid off in some countries (see section IV).

Commercial Policy Reform

Developing countries today are more open and their trade regimes are more efficient than they were a decade ago. Many have substantially reformed their exchange rate and export policies and have increased the efficiency of their import regimes by switching from quantitative restrictions to tariffs. But much still remains to be done in reducing levels of nominal and effective protection.

Most countries that have implemented trade policy reforms have won long-term economic gains. Both policy changes and additional financing under adjustment programs have been associated with moderate improvements in output and export growth.[16] The supply response to the changes in relative prices associated with the trade reforms has remained sluggish in many countries, however. The primary contributing factors have been restrictive domestic

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[15]For discussions see Bradford and Branson (1987), and Balassa (1982).

[16]We draw here on the results of Thomas and Nash (1990). See also UNCTAD (1989).

regulations and inefficient public enterprises, growing protectionism in industrial countries, investor doubts about the permanence of the reforms, and inadequate institutional, infrastructure, entrepreneurial, and managerial capacity in the reforming country.

The Capital Account

Integration into the world economy requires not only commercial policy reforms, but also the eventual opening of the capital account. Some developing countries, such as Indonesia, Malaysia, and Mexico, long ago opened their capital account. But most developing countries still have substantial capital controls. Despite the benefits of free capital mobility, however, capital account liberalization should typically come relatively late in the adjustment process because unrestricted capital flows can sometimes jeopardize macroeconomic stabilization programs.

Opening the capital account has a particularly strong influence on foreign direct investment, which is likely to be an increasingly important source of foreign capital for developing countries. Its importance lies as much in the access it gives the recipient country to improved technology, management, and export markets as in the amount of financing it brings. Although the opening of the capital account makes a country more attractive to foreign investors, even countries that need to maintain some capital controls can attract foreign direct investment by making special provisions for profit remittances.

Priorities in Trade Reforms

Trade policy reforms, because of their economy-wide effects on relative prices and efficiency, have been a key component of the first phase of adjustment. Experience shows the importance of paying attention to conflicts that are likely to emerge in the process of trade reform. Most commonly, the reforming country needs both to stabilize its economy and to reform its trade regime. Successful reformers have succeeded in combining stabilization with trade reform by simultaneously reducing the fiscal deficit and depreciating the real exchange rate: the depreciation offsets the potential destabilizing effects of the liberalization of imports. Some trade reforms (such as switching from quotas to tariffs) will themselves improve the fiscal situation and so contribute to the stabilization effort. But when tariff revenue falls because of trade reform, governments need to find an alternative source of revenue to prevent a worsening of the deficit. While stabilization and trade reform can generally proceed in tandem, trade reforms have seldom been effective when inflation is very high and variable, especially when stabilization efforts have led to a real appreciation of the exchange rate. Under these conditions, countries need to bring their fiscal deficit and inflation rate under control before they can implement effective trade policy reforms.

In most practical situations, trade and domestic economic reforms (including financial sector reform, deregulation and labor market reform) reinforce each other and should be carried out together. Thus, for example, an important benefit of import liberalization is the introduction of competition into noncompetitive domestic markets. But where market rigidities and controls exist, they can render trade reforms ineffective or even counterproductive by impeding the reallocation of unemployed or inefficiently employed resources.

Examples of such controls, which need to be relaxed along with import controls, are excessively restrictive labor laws, price controls, transport regulations, central planning mechanisms, and financial market regulations. Similarly, introducing internal reforms without liberalizing import policy can also be ineffective or counterproductive if it leads to investments in highly protected sectors.

The emphasis on trade policy reform in adjustment programs is well placed and should continue. For better effectiveness, however, countries need to consider two issues related to the pace and sequencing of trade reform. First, countries that are experiencing critical problems with indebtedness, the fiscal deficit, and very high inflation need to introduce macroeconomic stabilization measures before undertaking trade reforms. The disappointing experience of Southern cone countries with trade liberalization illustrates this consideration. Second, trade reforms alone may be insufficient to generate a supply response, especially in low-income countries with severe domestic distortions and institutional and infrastructural deficiencies. These countries would profit from stronger actions to improve domestic competition, technology policies, and institutional development in order to get the most from trade policies.

IV. Managing Economic Development

Development policy today places greater stress than before on the central role of markets, and on the private sector -- in some countries, the informal private sector -- as the engine of growth. But to enable economic agents to function effectively to stimulate rapid development, countries need to ensure a favorable environment for economic activity -- that is, an appropriate legal,

institutional, and policy framework. Governments and external agencies such as the World Bank have important roles to play in the creation and maintenance of such an environment.

The Size and Quality of the Government

The Government needs to ensure the provision of social services including infrastructure (such as roads, water supply, sewerage), anti-poverty programs, basic education, access to health care, environmental protection, and public security. The government does not have to produce all these services itself to enable their provision. In some cases, such as education or health care, it may be more appropriate -- on efficiency grounds -- for the government to foster private sector production and competition to enhance the efficiency of supply.

The government's role is critical in managing economic policy, anticipating and adjusting to external and domestic shocks, facilitating transitions in economic policy, and in general, designing and implementing policy reform. Its role is central in ensuring a stable macroeconomic framework, in particular, in establishing and maintaining an efficient fiscal system. Equally important are a suitable regulatory environment and a stable legal system. Government intervention is also desirable for addressing market failures, such as those posed by the presence of externalities (such as pollution and congestion).

Governments in developing countries, in addition to their well-justified involvement in the abovementioned areas, also engage directly in many other economic activities -- for example, the production of basic materials such as cement and steel, and the procurement and distribution of agricultural products and inputs. Some government policy interventions exceed those warranted by reasons of market failure; they include price controls, credit subsidies, export

and import quotas, control of firm entry and exit, and other distorting interventions.[17] Experience shows that such government involvement in economic activity is excessive both on efficiency and redistribution grounds and constitutes an obstacle to economic development. The appropriate purview of government is narrower than the typical range of government activities in the developing world.

The most difficult question to answer is whether the Government should actively promote particular industries -- in brief, whether it should pursue a proactive industrial policy. Some elements of an active industrial policy evoke little controversy: export development through assistance in export marketing, information, technology, and know-how. Japan, Korea, and Taiwan have paid attention to these and other nonprice requirements of export development. But they also at one time pursued export development while maintaining a degree of import protection, supporting this approach through macroeconomic and export policies that helped them counteract the anti-export bias of import protection. Some aspects of this active approach are unlikely to be practical or efficient today, especially the targeting of specific industries for special treatment.[18] But other policies that relate to the stability of the macroeconomy, neutrality of the trade regime, and nonprice support for exports can and should be emulated.

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[17]Available data on government spending do not capture the activities of state owned enterprises, or the extent of interventions and regulations. Therefore, they give an incomplete picture of the role and influence of the government in most developing economies.

[18]Protection to specific industries is often provided on grounds that they are infant industries requiring special protection to enable them to reach a competitive position. Such protection has often not yielded the expected results because it was guided more by political interests than by criteria of economic benefits. The few successful cases recognized that the initial economic costs of protection must be offset by the learning-by-doing benefits within a reasonable period of time.

In creating an efficient enabling environment for development, a clear need is for institutional development to improve the quality and competence of governments, especially in low-income countries. While the need is wide-ranging, it is most apparent in public sector management and is particularly urgent in four areas (World Bank, 1988, 1989). The first is the need to strengthen the core agencies that formulate and implement a country's economic policies. The success of reform programs depends on the public sector's ability to manage them efficiently and credibly. The second need is to rationalize or scrap public enterprises, whose inefficiencies and losses are at the core of fiscal problems in many countries. The third is to restructure the mechanisms for policy making, public expenditures, and financial management. Improving the way public expenditure priorities are established, reviewed, and implemented can greatly improve the quality of adjustment programs. The fourth need is to revamp personnel and incentive policies in the public sector, where inefficiency is related not only to the bloated size of the sector but also to the quality of its personnel, which is linked to incentive policies.

Just as important as improvements in public sector management are efforts to foster the private sector. These include reform of the financial system, privatization of public enterprises and improvement of the efficiency of government monopolies, relaxation of licensing and price controls, and removal of impediments to domestic and foreign investment. In countries with an enduring legacy of policies inimical to the private sector, more active measures may also be needed to promote entrepreneurship and private sector initiative.

The World Bank's Participation

Since the start of its operations in 1946, the World Bank's activities have shifted from reconstruction efforts in post-World War II Europe, to physical infrastructure construction in the developing world, to financing development projects, to the design and implementation of policy-based lending programs in support of structural reform (Mason and Asher, 1973, World Bank, 1988). This evolution reflects the parallel shift in the economics of development. Under the weight of four decades of experience, the professional view of development has shifted from a focus on critical mass and the role of the central economic planner to a concern with establishing an enabling policy environment, a properly functioning incentives structure, and integration with the world economy.

The way governments are viewed has also changed. That view is now more realistic about the goals and operations of government and more complex than the view implied by the simple notion of government as an altruistic entity with more efficient planning capabilities than private markets. Along with this increasingly complex view has come the belief that significant and lasting changes cannot be instituted if they are not owned by the policy makers and administrators and supported by strong and efficient institutional frameworks. A substantial effort in human resource development is required in support of such frameworks.

From 1950 to 1980, the World Bank's role -- almost exclusively -- was to provide financing and technical assistance in the development of investments. And even since the advent of adjustment lending in 1980, about 75 percent of Bank lending continues to be for investment projects. The technical assistance components of such projects have been as important as the financing, encouraging the transfer of know-how and productivity enhancements. World Bank financing

for human resource development has been an important tool in speeding up development and a vital channel for affecting sectoral development.

The Bank has responded to changes both in the real environment for development and in the analytic constructs used to assess the prospects for development. It has come to recognize that sectoral and macroeconomic policies are part and parcel of project design and integral to the analysis of project benefit-cost profiles. This might mean that project design for an export development project, for example, would include an analysis of the macroeconomic policies affecting the exchange rate, since the exchange rate will influence the gains from the project. The Bank's use of policy-based lending is an acknowledgement of the importance of the policy environment.

The Bank introduced adjustment lending in the 1980s as a complement to investment lending, as developing countries received several blows in rapid succession, from which many of them were unable to recover on their own: large terms of trade and interest shocks, debt crisis, and severely curtailed lending from commercial banks for general balance of payments support.[19] As the debt crisis deepened, it became clear that the Bank could help many of the indebted countries smooth their adjustment to the sharp reduction in external financing by providing rapidly disbursing loans. Loan conditionality was tied to policy changes in the borrowing country. While adjustment lending has evolved as a rapidly disbursing and policy-based loan instrument, these characteristics are not inseparable; slowly disbursing policy lending is also possible.

[19]The emphasis on adjustment lending also coincided with the recognition that the overall quality of economic policy management is a key to economic development and -- its practical corollary -- that a good economic environment is essential to project development.

Adjustment lending was provided to a remarkably diverse group of countries.[20] The experience gained from adjustment lending helped to identify the appropriate economic policy issues (many of them discussed above) with which adjustment programs should be concerned. In fiscal policy, this includes reduction of deficits to sustainable levels, rationalization of public expenditures (especially investments), and reform of tax systems. In trade policy, the chief concerns are replacement of quantitative restrictions with tariffs, reform of the tariff structure, and the maintenance of an appropriate exchange rate. In the public sector, adjustment programs generally seek to reform and reduce the losses of state enterprises (liquidating them in some cases) and to privatize enterprises where economically feasible. Agricultural sector policy normally addresses pricing policies and incentive mechanisms. Reform in the financial sector has also become an increasingly common aspect of adjustment lending programs, but it remains a complex and difficult issue.

As suggested by this broad array of policy areas appropriate to adjustment programs, it is also important to minimize policy conflicts. For example, introducing trade liberalization without financial sector reform can exacerbate the debt and solvency problems of key enterprises; and depreciating the exchange rate without liberalizing domestic prices can increase the production costs of enterprises that rely on imported inputs while their output prices remain controlled. The experience with adjustment programs over the past decade has also suggested the need for a slight shift in emphasis from general macroeconomic reform to sector-oriented programs, and thus for a move toward more sectoral adjustment loans. Sectoral adjustment loans typically support significant policy

[20]Initially, the group included Jamaica, Korea, Malawi, Pakistan, the Philippines, Senegal, and Turkey. During the 1980s more than fifty countries received such loans.

changes in particular sectors, with disbursement depending on both the sectoral policy measures and the maintenance of an appropriate macroeconomic framework.

Initially, the design of policy-lending programs aroused controversy among borrowing members, international organizations, and Bank staff and management alike. The heat of the controversy was, in large measure, fueled by the context in which the loans were introduced -- the international debt crisis. Borrowers, who were under the pressure of debt-service requirements and domestic resistance, protested at the hardships coincident with the undertaking of such programs. Some observers in donor countries objected to the social burdens associated with the implementation of loan conditionality provisions, while others argued that adjustment loans enabled borrowers to postpone making difficult but necessary policy changes.

The controversy over adjustment lending has abated, as both industrial and developing countries have come increasingly to recognize the continuing need for adjustment and to agree that its proper direction is toward market-based policies that integrate the individual economy into the world economy. Some evidence of the improved performance of economies that have undertaken adjustment programs has increased acceptance of the need for structural adjustments as complements to investments.[21] Controversy remains, however, about the extent and direction of the adjustments that need to be pursued in individual countries, and about the degree of state intervention that is desirable.[22]

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[21] Recent work at the World Bank found that countries adopting adjustments have improved their economic performance modestly relative to others. This improvement is stronger when the focus is on early and intensive adjusters. See World Bank (1988, 1990).

[22] See, for example, UNCTAD (1989), UN ECA (1989).

V. Outstanding Issues

By intention, we have concentrated in this paper on the economic policies that developing countries should follow. Nonetheless the economic success that developing countries can achieve is greatly affected by the external environment. The openness of the world trading system, the level of real interest rates, the level of resource transfers to or from developing countries, will all play a major role in determining the rate of growth that developing countries can achieve in the coming decade. Developing countries thus have a major stake in the success or failure of the Uruguay Round and in the macroeconomic policies pursued by the industrialized countries, as well as in further progress in resolving the debt crisis. But while the external environment will help determine the success of the policies followed by the developing countries, the nature of the policies they should follow is less affected by external conditions.

The ultimate test of the appropriateness of the policies increasingly being proposed to stimulate growth and economic development is whether they actually produce growth and development. Seen in that light, the challenges, particularly in Africa, in Latin America, and, most recently, in the reforming socialist economies, are formidable. In many cases -- and especially for these formerly socialist economies -- the problems are analytic, involving the appropriate sequencing of the adjustment of a heavily distorted economy, with macroeconomic and external imbalances, to the market-oriented structure that its policymakers seek. In other cases, the problems are political: countries with the necessary infrastructure and analytic capacity lack the political ability to implement changes that are recognized to be desirable -- and this is a problem for the

industrialized as well as the developing countries. In some countries, inadequate human capital and institutional frameworks constrain development. The problems of development are not the same everywhere, and each country's policies must fit its own structure while taking into account the realities of the world economy in which it operates. The challenge is not only one for the developing countries to adopt the right policies, but also for the industrialized countries to provide a supportive external environment.

Important questions also remain about the role of external funding and of international development agencies. Some people have argued that countries would have done better if left to their own devices and forced to confront their budget constraints earlier and harder. For some countries, this judgment may be accurate; for most, it is not. Nonetheless, it is essential to recognize that an important goal of development is for countries to reach the stage at which they can manage their own affairs.

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