

The Growth Experience

What Have We Learned From The 1990s?

A Background Note
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The Bank is just completing a major review of the Lessons from the Growth Experience of the 1990s, including the growth impact of the main policy and institutional reforms introduced in the 90s. The review takes a broad perspective on the events, country experiences, academic research and controversies of the 90s, to reflect on how they alter our thinking about economic growth. Its conclusions benefit from contributions by Bank and non-Bank “Practitioners in Development”—a revival of the lectures by “Pioneers in Development” in the early 80s. Twelve policy makers, who were at the forefront of policy implementation in the 90s, have used their experience to draw lessons about economic growth during a one-year cycle of lectures at the Bank. Twelve former Bank country directors have similarly shared the lessons they drew from their work at the Bank in a series of papers to be published separately. The report also benefited from the outcomes of the May 2004 Shanghai Conference. The following describes briefly the scope and findings of this work which has relevance for the discussions on the approach to and content of conditionality.

An institution whose primary business is finance and advice for poverty reduction needs to have a good understanding of what causes growth, and what sustains it. Poverty declines rapidly where growth is rapid and sustained. Poverty stagnates where growth is tepid. A few exceptions notwithstanding, the unambiguous impact of rapid growth on poverty reduction has been confirmed again in the 90s, and was a central theme of the May 2004 Shanghai Conference.

Economics is an imprecise science and the nature of economic growth has changed over the course of history. It is hence no surprise that our understanding of growth is partial and incomplete. The growth experience of the last fifty years has abundant examples of economists’ inability to anticipate *successes*, such as Botswana, China, India, Indonesia, Korea, Mauritius, Singapore, Thailand,; economists’ and markets’ inability to predict *crises*, such as the financial crises of the 90s; and *disappointments*, such as Latin American and African countries unfulfilled growth potential in the last two decades. Growth is difficult to predict because it implies transformation of society, a break with past trends, behaviors, and institutions which reflect deep forces in societies and how they organize themselves.

Absent definitive theories, our views on growth have been influenced by facts and changed pragmatically in the face of experience. The successful reconstruction of Europe and Japan, and the financial turmoil that preceded World War II, gave reason to believe in the 60s and 70s that governments could address market failures effectively, be a positive force for growth, and accelerate capital accumulation, as the main force driving economic growth. However, starting in the 80s, the costs of industrialization policies based on import substitution and extensive state interventions in the economy, led to greater recognition that the costs of government failures could be larger than those of market failures. The focus of growth strategies hence shifted from policies aimed at expanding productive capacity and accelerating the accumulation of capital, to policies improving the efficiency in the use of existing capacity.

We approached the 90s with the shared conviction that economic reforms would not only reverse what for many developing countries had been the “lost decade” of the 1980s, but would also bring about the conditions for sustained growth. Best captured in the “Washington

Consensus” and the 1991 World Development Report, macroeconomic stability, domestic liberalization, openness to international trade, and reducing the role of the state became the principles that guided economic policies in the 90s in former communist countries in Eastern Europe and Central Asia, in Latin America, in South and East Asia, in Africa and, although to a much lesser extent, in the Middle East and Northern Africa. In parallel, democratization of former communist countries, and the consolidation of democracy in Latin America, Africa, and some East Asian countries gave ground to optimism that free markets and free societies provided the basis for rapid and sustained growth.

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

The report confirms and builds on the conclusions of an earlier Bank report: the 1993 East Asia Miracle, which reviewed experiences of highly successful East Asian economies. It confirms the importance for growth of fundamental principles: macro-stability, market forces in the allocation of resources, and openness. At the same time, it echoes the finding that these principles translate into diverse policy and institutional paths, implying that economic policies and policy advice must be country-specific if they are to be effective. Valid general principles do not imply generic “best practice” policy or institutional solutions. It also echoes the finding that selective government interventions can contribute to growth when they address market failures, are carried out effectively, and are subject to institutional checks.

More specifically, the report examines the impact on growth of key policy and institutional reforms: macroeconomic stabilization, trade liberalization, deregulation of finance, privatization, deregulation of utilities, modernization of the public sector with a view to increasing its effectiveness and accountability, and the spread of democracy and decentralization. It draws lessons both from a policy and institutional perspective and from the perspective of country experiences about how reforms in each policy and institutional area have affected growth. Regarding macro economic policies, for example, the report stresses the importance of the institutions underlying macro economic stabilization, the risks associated with external financial liberalization, the disruptions associated with episodes of exchange rate appreciation, and the sometimes excessive focus on minimizing inflation in the short term, which then came at the cost of growth enhancing public spending that might have both increased growth and made stability more durable. Regarding trade, it highlights that the fact that countries which have successfully integrated into the world economy have followed different approaches and also adopted a range of complementary policies which makes it difficult to pin down the exact relationship between trade integration and growth—but establishes a strong positive relationship while not making it clear whether openness is the cause of or result from rising incomes still is an open question. Unambiguously, however, all successful countries e.g. India and China benefited considerably from integration in the world economy and access to external markets. Across policy reform experiences in different areas also emerge common themes regarding the importance of institutions, to which for example the chapter on finance attributes the main reason for results

below expectations, and for effective checks on predatory behavior by the state, and by the private sector—all important in explaining the outcomes of privatization, the performance of the public sector in the delivery of services, and the quality of the investment climate.

In addition to the impact of specific policies on growth, the report also draws lessons about growth considering the entire spectrum of policies and institutional reforms. It concludes that the emphasis of the 90s on reforms improving efficiency in the use of existing capacity, while warranted at a time of extremely large distortions, did not balance it with sufficient focus on the forces driving expansion of that capacity. Whereas efficiency gains can bring about short term growth, sustained long term growth can only be achieved through expansion of capacity: accumulation of physical and human capital, and technology improvements. This highlights the importance of the investment climate, and of the confidence with which economic agents can forecast returns in the future.

More importantly, perhaps the lesson of lessons of the 1990s, is that we need to *get away from formulae* and realize that economic policies need to address the *binding constraint* to growth, instead of any constraint, at the right time, and in the right manner. This requires recognizing *country specificities*, and also requires more *economic and social analysis and rigor* than a formula-based approach to policy making. So, while recognition that there is no unique path to growth that can be known in advance introduces more flexibility and options, it also demands more rigor in the evaluation of these options than is the case in the application of formulae.

While they confirm the importance of market incentives for resource allocation, of openness, and of macro-stability, the lessons drawn in this report highlight the diverse ways in which these principles can translate into concrete policy choices. They also echo Albert Hirschman's view that: "*development depends not so much on finding optimal combinations for given resources and factors of production as on calling forth and enlisting for development purposes resources and abilities that are hidden, scattered, or badly utilized.*" The lessons have implications for the understanding and practice of economic policies and advice and, in particular, for the Bank's analytical, strategic and operational work, including for the formulation of growth strategies focused on relaxing the most binding constraints instead of making all policies "*best practice*". They also imply the need to temper technical expertise with humility and flexibility. And last but not least the lessons highlight the need for a better understanding of non-economic factors in growth processes such as history, culture and politics.