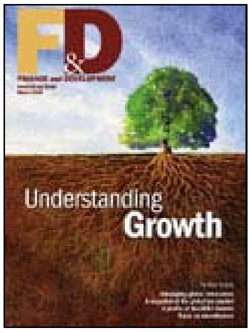

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FINANCE and DEVELOPMENT
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March 2006
Volume 43, Number 1

Understanding Growth

Rethinking Growth

Roberto Zagha, Gobind Nankani, and Indermit Gill

Economists are reconsidering what they really know about economic growth and how to go about formulating policies in the absence of reliable models. A recent growth study by the World Bank concludes that there is no unique, universal set of rules to guide policymakers. The answer lies instead in less reliance on simple formulas and the elusive search for "best practices," and greater reliance on deeper economic analysis to identify each country's one or two most binding constraints on growth.

Getting the Diagnosis Right

Ricardo Hausmann, Dani Rodrik, and Andrés Velasco

A look at a new growth diagnostics framework to help countries prioritize reforms. Once policymakers have identified the one or two most binding constraints holding back growth, they should focus on lifting those, setting aside for later other reforms that are desirable but not essential for growth.

Getting Out of the Rut

Danny Leipziger and Roberto Zagha

Results from a World Bank pilot study testing a new growth diagnostics framework suggests that the approach brings fresh insights to growth analysis but remains difficult to carry out.

The Quest Continues

Lant Pritchett

What exactly do economists know and not know about growth? And what direction should future research and policymaking take? Economists may have to abandon the quest for a single growth theory, focusing instead on developing a collection of growth and transition theories tailored to countries' particular circumstances.

Levers for Growth

Simon Johnson, Jonathan D. Ostry, and Arvind Subramanian

The quality of a country's institutions has long been recognized as key to achieving sustained economic growth. But improving such institutions is a slow and difficult process. Can other policy levers help kick-start growth when strong institutions are absent? New research suggests that macroeconomic stability, trade liberalization, and avoiding an overvalued exchange rate can sustain a self-reinforcing spiral of reform and growth.

Growing Pains

Catherine Pattillo, Sanjeev Gupta, and Kevin Carey

Africa's growth is finally picking up. But is the improvement sustainable? While some countries' growth accelerations have lasted for 10 years or more, they still need to do more to dramatically reduce poverty and avoid accumulating excessive debt.

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Examining Global Imbalances

Philip R. Lane and Gian Maria Milesi-Feretti

A new data set on external assets and liabilities reveals that U.S. investors have earned much higher returns on their assets than they pay on their liabilities. As a result, the United States has been able to run large current account deficits over the past four years without experiencing a major deterioration in its net external liabilities.

Going too Fast?

Paul Hilbers, Inci Otker-Robe, and Ceyla Pazarbaşıoğlu

Many countries in Central and Eastern Europe have experienced a rapid expansion of bank credit in recent years. While such credit growth is part

Straight Talk

Separate and Unequal

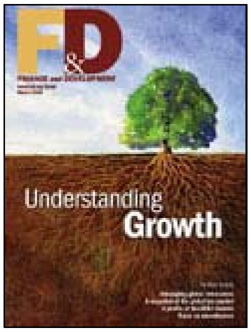
Raghuram Rajan

Microfinance is increasingly being touted as a miracle cure for poverty. But instead of focusing solely on microcredit for the poor, we should make financial services available for all, says the IMF's Economic Counsellor.

Country Focus

Mozambique

Since the end of its civil war in 1992, Mozambique has made impressive progress on growth and poverty reduction.



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Rethinking Growth

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For development economists of the 1950s and 1960s, growth was a complex process of economic, social, and political transformation. New economic concepts were created to capture some of its dimensions—for example, Lewis's "dual economy" and "surplus unemployment"; Schultz's "human capital"; Gerschenkron and Rostow's "stages of development" theory, "takeoff," and "catching up"; and Seer, Prebish, and Hirschmann's "structuralism."

In the late 1980s and early 1990s, however, economists working on development came around to the simpler view that growth was a matter of getting national policies right. Whether it was landlocked Uganda, unstable Argentina, or transitioning Ukraine, the right policies meant lower fiscal deficits; lower import tariffs; fewer restrictions on international trade and capital flows; and a greater role for markets in allocating resources, regardless of history, political economy, or local institutions.

Much of this vision was reflected in the Washington Consensus. Articulated by John Williamson in 1990, the consensus synthesized the policies most economists in the World Bank, the IMF, the U.S. Treasury, and Washington's think tanks thought were necessary to rescue Latin American countries from cycles of high inflation and low growth. Williamson had emphasized that the consensus was to be applied judiciously, not mechanically, but it took on a life of its own, becoming the expression of what most economists inside and outside Washington thought most developing countries needed for growth.

As the 1990s unfolded, countries around the world implemented policies consistent with that consensus. In Eastern Europe and the former Soviet Union, market reforms followed the end of communism. In Latin America, countries stabilized their economies, defeated hyperinflation, further opened their markets to international trade and capital, and privatized public enterprises. In Asia, India abandoned central planning, embracing a wide range of reforms, and China continued its market-oriented reforms. In Africa, countries such as Ghana, Tanzania, and Uganda embarked on privatization, retrenched the public sector, and liberalized trade. And, in places as diverse as Bolivia, Brazil, India, and Russia, grossly overvalued exchange rates became more competitive; the devaluation of the CFA franc in 1994 was a particularly important change.

The scope, breadth, and depth of the reforms during the 1990s were unprecedented in recent economic history. The developing world emerged with more open and competitive economies, lower inflation, lower fiscal deficits, smaller governments, fewer restrictions on private sector activities, and more market-based financial sectors. The changes were not only economic. The number of democracies increased to 100 from 60 during the decade, and social indicators (particularly basic education and child health) improved steadily. In the early 1990s, most economists believed that these developments, combined with a favorable international environment—firm commodity prices, rapid growth of international trade, and abundant capital flows—would enable developing countries to overcome the "lost decade" of the 1980s and return to a path of sustained growth.

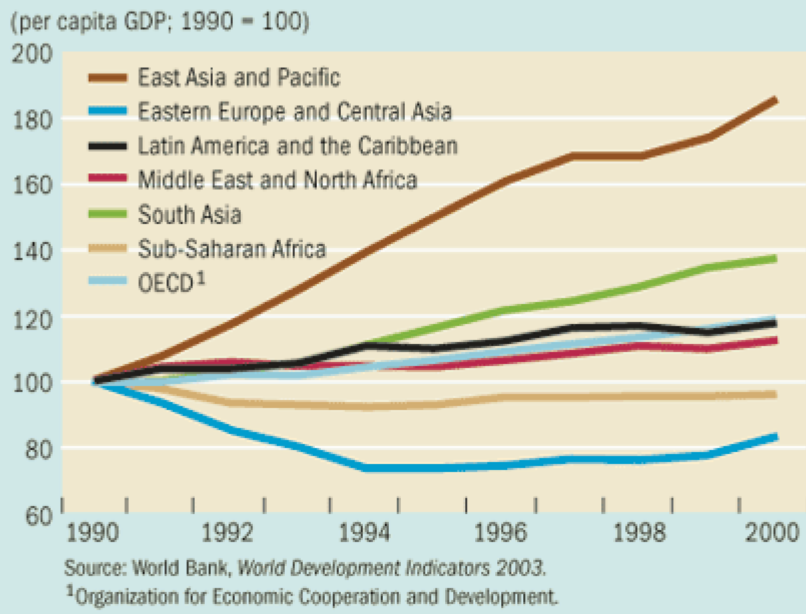
The results, however, were unexpected. They exceeded the most optimistic forecasts in some cases and fell well short of expectations in others. In East and South Asia, including China and India, which together account for 40 percent of the developing world's population, domestic liberalization and outward orientation were associated with spectacular growth, poverty reduction, and social progress. This was so even though reforms were implemented in a manner that departed from conventional wisdom—in terms of speed and design of reform, a large state presence, and, until well into the 1990s, high levels of import protection (with export orientation ensuring international competitiveness).

At the same time, booms and busts continued in Latin America, extending to other regions. For most former Soviet Union countries, the 1990s will be remembered as a costly and traumatic decade. While everyone knew that the transition to a market economy would be tumultuous and difficult, the output loss was longer and deeper than expected. It took more than a decade for the best-performing economies to return to the per capita income levels prevailing at the beginning of the transition, and some of the worst cases are still below the starting point. Africa did not see the takeoff that was expected, although many countries showed signs of recovery in the late 1990s. Costly financial crises rocked Mexico (1994), East Asia (1997), the Russian Federation (1998), Brazil (1999, 2002), Turkey (2000), and Argentina (2001). Some countries managed to sustain rapid growth with just modest reforms, while others could not grow even after implementing a wide range of reforms. Moreover, similar economic reforms yielded vastly different responses (see Chart 1).

Chart 1

Widely varying results

Economic regions grew at vastly different paces during the 1990s despite undertaking broadly similar reform policies.



Interpreting the reasons for this wide variation and drawing lessons for the future was the central task for the 2005 World Bank study, *Economic Growth in the 1990s: Learning from a Decade of Reform*. The study focused on the main areas of policy and institutional change during the 1990s: macroeconomic stabilization, trade liberalization, financial sector reform, privatization and deregulation, public sector reform, and democratization. And it combined an analytical review of growth episodes with the views of practitioners—policymakers who had been in charge of implementing significant policy and institutional reforms during the 1990s and former World Bank country directors.

Lessons of the 1990s

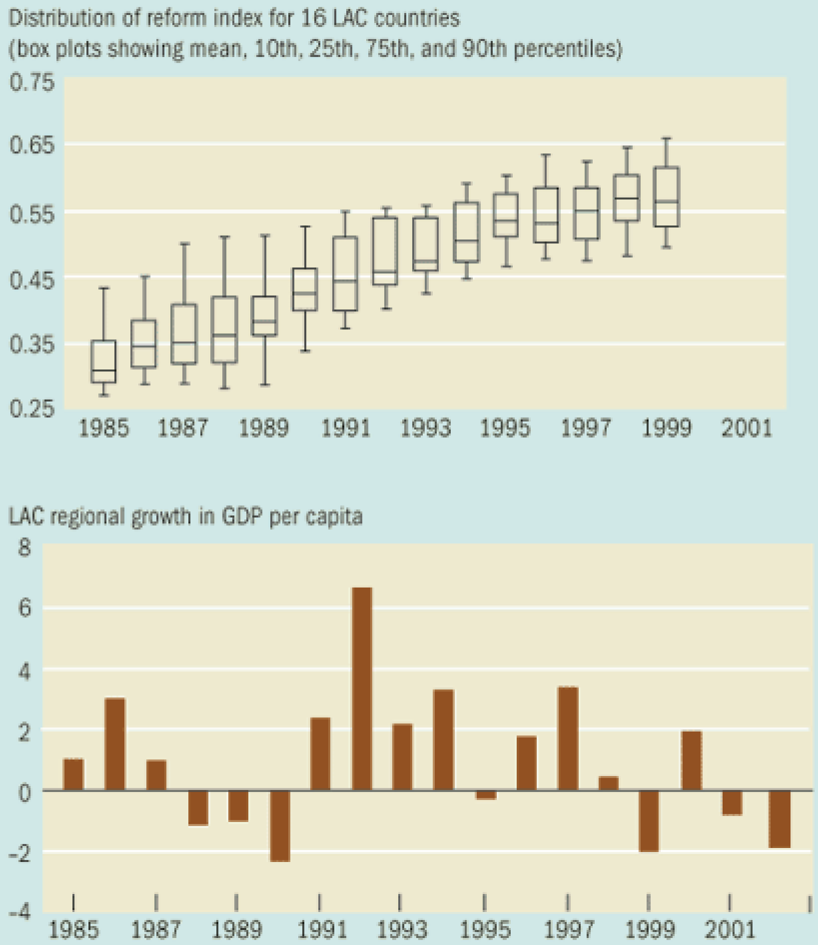
The central result of the exercise was rediscovering the complexity of economic growth, recognizing that it is not amenable to simple formulas. Another result was the degree of convergence of views. Even though the practitioners, senior Bank operational staff, and economists started from different perspectives, they all came up with remarkably similar lessons.

First, *expectations about the impact of reforms on growth were unrealistic* (see Chart 2). Take trade. Rising trade volumes are unambiguously related to growth, but the direction of causation is unclear. As an economy grows and develops and expands its stock of physical and human capital, its opportunities for trading will inevitably increase, even if tariffs remain the same. Also, some countries increased exports by reducing import tariffs, while others did so by creating export processing zones; or offering exporters incentives, including duty rebates; or making the exchange rate more competitive; or improving trade-related infrastructure—with export liberalization preceding import liberalization. In some cases, trade liberalization coincided with deteriorating export incentives (for example, exchange rate appreciation, as was the case in several South American countries), while in others export incentives strengthened. Not surprisingly, trade reforms stimulated growth and helped reduce poverty when export incentives improved, but not when they deteriorated. The lessons are that trade is an opportunity, not a guarantee, and that it was overly naïve to expect that simply reducing tariffs would automatically increase growth.

Chart 2

A decade of disappointment

Although nearly every country in Latin America and the Caribbean (LAC) has pursued economic reform, growth has been slow.



Sources: Reform data: Eduardo Lora, 2001, "Structural Reforms in Latin America: What Has Been Reformed and How to Measure It," Inter-American Development Bank. Growth data: World Bank, *World Development Indicators 2003*.

Similar conclusions about expectations hold true throughout the whole range of policy areas on which reforms focused in the 1990s, including financial sector liberalization (see box) and, somewhat surprisingly, political reforms. The rise in the number of democracies was expected to bring better leaders to power and improve decision making and economic performance. Again, expectations proved overoptimistic. Democracy is not a shield against predation by the powerful or against governments exerting their authority to the benefit of elites. Informed citizens, low social polarization, and political competition are needed.

Second, *reforms should promote growth, not just efficiency*. The reforms of the 1990s focused on the efficient use of resources, not on the expansion of capacity and growth. They enabled better use of existing capacity, thereby establishing the basis for sustained long-run growth, but did not provide sufficient incentives for expanding that capacity. In the early 1990s in Brazil, trade reforms were designed to strengthen competition and improve the efficiency of resource use rather than to expand domestic capacity or exports. As a result, they were introduced rapidly, without much concern for the competitiveness of the exchange rate and the response of the manufacturing sector. In contrast, during the same period in India, trade reforms were designed to enable domestic firms to restructure and spread the costs of adjustment over time. As a result, they were introduced at a gradual (some would say glacial) pace, and the exchange rate was kept competitive to ensure export growth. Similarly, anti-inflationary policies in China during the 1990s were introduced in a manner that minimized output losses. Thus, whereas reforms can help achieve efficiency gains, they will not put the economy on a sustained growth path unless they also strengthen production incentives and address market or government failures that undercut efforts to accumulate capital and boost productivity.

Financial liberalization: the good and the bad

The financial liberalization that took place in developing countries in the late 1980s and the 1990s was part of a general move toward giving markets a greater role in development. It was also sparked by a number of financial factors, including the high cost of using finance as an instrument of populist, state-led development; a desire for cheaper and better finance; and the growing difficulties of using capital controls in a world of increased trade, travel, migration, and communications. It differed in timing, speed, and content across countries. But it always involved freeing interest rates and credit allocations. And it often involved giving central banks more independence, opening up capital accounts, privatizing state banks and pension systems, developing financial markets, and encouraging competition between banks (and sometimes nonbanks). However, improving bank regulation and supervision lagged behind in many cases.

Did financial liberalization deliver? On the plus side, most major countries did see a rise in deposit growth, and the private sector gained access to more financing, from both domestic and international sources. But capital markets became important only in a few, large countries. And, by the end of the 1990s, government and central bank debt had absorbed much of the deposit growth, partly because of financial crises—which also fed into a smaller-than-expected impact of financial liberalization on growth.

Several factors were behind the "boom and bust" cycles of the 1990s.

- *Traditional macroeconomic problems—including unsustainable fiscal policy, unsustainable exchange rates, and high government debt—continued to plague many developing countries*. Financial liberalization often allowed the countries to prolong such policies by providing more resources, but ultimately this tactic raised the policies' cost.
- *Financial liberalization itself was a problem*. Timing and sequencing left a lot to be desired. The quality of credit allocation was weakened by implicit and explicit government guarantees that limited market discipline and by weak regulation and supervision. And sudden shifts in market views about countries' ability to service debt contributed to "sudden stops" in net capital inflows.
- *Weak loans (both old and new) incurred by state banks and powerful financial-industrial conglomerates were allowed to accumulate*. The standard postcrisis policy was to bail out depositors by replacing the banks' bad loans with government debt, generating a debt overhang that may limit growth in this decade.
- *Some policy responses were bad*. In some cases, excessive liquidity support was given to banks that were being looted by their owners, while in others, not enough liquidity was provided, thereby forcing solvent banks into bankruptcy. Runs on banks became runs on the currency, especially in countries with more open capital accounts, ineffective capital controls, and exchange rate support.

A onetime cleanup

Despite these problems, most countries have maintained a relatively liberalized financial system. To some extent, the crises of the 1990s can be seen as onetime cleanups, laying the groundwork for a better financial system. They also provide at least two important lessons for making financial systems work better and reducing the risk of future crises:

Successful finance depends on macroeconomic stability. Even a strong financial system cannot protect itself against high inflation, inappropriate exchange rates, the threat of default by overindebted governments, or severe real economy downturns. Moreover, financial liberalization, especially the opening up of the capital account, puts a greater premium on good macroeconomic policy and quick action to limit unsustainable booms and deal with weak banks, not least by putting a stop to the popular policy of socializing bank losses.

Good financial systems depend on good institutions—which include intermediaries; markets; and the informational, regulatory, legal, and judicial framework. But building up these institutions is not easy: it takes time and requires political support.

James Hanson

Third, *the necessary conditions for economic growth can be created in numerous ways—not all of them equally conducive to growth*. Any sustained growth process is based on accumulation of capital, efficient use of resources, technological progress, and a socially acceptable distribution of income. The World Bank's *World Development Report 1991* had proposed that these functions of growth were best achieved in economies with macroeconomic stability, market allocation of resources, and openness to international trade. One can readily agree with this proposition and still realize that this trio does not translate into a unique set of policies. A frequent mistake in the 1990s was to translate these principles into "minimize fiscal deficits, minimize inflation, minimize tariffs, maximize privatization, maximize liberalization of finance," with the assumption that the more of these changes that were made, the better. In short, the lesson is that "getting the policies right" does not translate into a rigid set of policies and that any reform, however beneficial for efficient resource allocation, is not necessarily growth-inducing.

Fourth, *stabilization and macroeconomic management need to be growth-oriented*. The 1990s made us realize that how macroeconomic stability is achieved matters for growth. Lowering inflation on the basis of appreciating nominal exchange rates stunts exports and thus GDP growth. So does reducing fiscal deficits through declines in high-return public spending or lowering domestic interest rates through excessive (often short-term) external borrowing. The decade also shows that the gains expected from capital account liberalization were unrealistically high and the risks underestimated—the danger was not so much financial flows moving out during normal times, but inflows that eventually destabilized the economy. Indicative of this, most of the major recipients of private capital flows during the 1990s suffered a financial crisis (see Table 1). The exceptions are Chile, China, and India, all of which had introduced restrictions on financial inflows and had not completely opened their capital account.

Table 1
A Mixed Blessing
Most of the major recipients of capital inflows succumbed to financial crises.

Financial crises (country, year)	Rank of recipients, by absolute volume of private flows 1990-96	Private capital flows 1990-96 percent GDP (in 1996)	FDI flows 1990-96 percent private capital flows
Mexico 1994-95	2		42.8
Thailand 1997	6	33.0	22.7
Indonesia 1997	7	27.1	22.7
Korea 1997	...	17.7	...

Malaysia 1997	5	...	47.2
Russian Federation	11	62.7	18.7
1998		4.8	
Brazil 1999, 2002	3		20.7
Turkey 2000-01	10	12.6	22.1
Argentina 2001-02	4	12.1	33.4
		23.9	
China	1		68.2
India	8	25.2	20.6
Chile	9	7.6	37.2
		39.4	

Sources: IMF and World Bank staff estimates.
... Data not available.

If anything, the decade shows that sustaining long-term growth requires macroeconomic policies that reduce the risk and frequency of financial crises. Table 2 shows that what differentiates successful countries (that is, those that reduce their per capita GDP gap with industrial economies) from unsuccessful ones (those that do not) is the ability to reduce the volatility of growth—which, in turn, reflects decisive responses to shocks and macroeconomic policies that reduced vulnerabilities and, hence, the costs of shocks. Developing countries experience a year of negative per capita growth roughly once every three years—whereas in East Asia, the average is one-half that rate and, in OECD countries, one-third that rate. Korea has had only three years of negative per capita growth since 1961. The region's ability to avoid downturns and periods of low growth—partly resulting from macroeconomic policies that reduced the probability of shocks—explains much of the East Asian "miracle."

Table 2
Recipe for success

Successful growers avoided downturns and kept growth steady..

	Years in which growth rate from 1960-2002 was			
	negative	below 1 percent	below 2 percent	above 2 percent
All developing	14	19	24	18
countries	18	22	27	15
Sub-Saharan				
Africa (28)	2	3	4	38
Botswana	10	15	16	26
Lesotho	8	11	!7	25
South Asia (5)	11	15	21	21
Bangladesh	8	10	14	28
India	10	18	22	20
Nepal	4	6	14	28
Sri Lanka	15	18	22	21
Middle East and				
North Africa (6)	4	10	15	27
Egypt, Arab				
Republic of	12	19	25	17
Latin America and				
Carribean (21)	7	11	18	24
Chile	7	8	10	32
East Asia and				

Pacific (7)	5	6	7	35
China	7	8	10	32
Indonesia	5	5	7	35
Malaysia	2	2	6	36
Thailand	5	8	16	27
High-Income OECD (22)	3	3	4	38
Korea				

Source: World Bank, *World Development Indicators 2003*.
Note: The table shows evidence for the 89 countries for which growth data are available for the four decades since 1961. Regional aggregates are medians. The Republic of Korea "graduated" into a high-income category in the early 1990s and thus is classified here in the high-income OECD group rather than in East Asia and Pacific.

Fifth, *governments need to be made accountable, not bypassed*. Because, in general, developing countries resolve agency, predation, and collective decision-making problems less efficiently than industrial countries, many of the 1990s reforms sought to introduce policies (such as dollarization and fiscal rules) that reduced government discretion and minimized demands on institutions. But these policies did not turn out to be sustainable solutions. Government discretion is needed for a wide range of activities essential for sustaining growth, from regulating utilities and supervising banks to providing infrastructure and social services. For that reason, reducing government discretion should not be the guiding principle of national development policies. Instead, the focus should be on improving checks and balances on government discretion and putting in place conditions that lead to better decision making.

Sixth, *governments should abandon formulaic policymaking in which "any reform goes" and concentrate on supporting growth*. To do so, they must identify the binding constraints to growth, which, in turn, necessitates recognizing country-specific characteristics and undertaking more economic analysis and rigor than a formulaic approach would call for. For example, during the 1980s and 1990s, China's approach was "crossing the stream by groping for the stones"; constraints were identified and dealt with as the growth process unfolded through experimentation and trial and error. It will not be easy for governments to identify the binding constraints at a given point in time and stage of development—indeed, the process is more an art than a science—but some recent proposals on new methodologies look promising (see "Getting the Diagnosis Right" on page 12 of this issue).

A great deal to learn

The 1990s yielded many lessons. The most important perhaps is that our knowledge of economic growth is extremely incomplete. This calls for more humility in the manner in which economic policy advice is given, more recognition that an economic system may not always respond as predicted, and more economic rigor in the formulation of economic policy advice. This view is increasingly shared. In September 2004, 16 well-known economists—Olivier Blanchard, Guillermo Calvo, Daniel Cohen, Stanley Fischer, Jeffrey Frankel, Jordi Galí, Ricardo Hausmann, Paul Krugman, Deepak Nayyar, José-Antonio Ocampo, Dani Rodrik, Jeffrey Sachs, Joseph Stiglitz, Andrés Velasco, Jaime Ventura, and John Williamson—

gathered in Barcelona and issued a new consensus on growth and development. The "Barcelona Consensus" echoes many of the findings of the World Bank's work, which, in turn, reflects recent academic research by several of the signatories.

Roberto Zagha led the World Bank's 2005 report, *Economic Growth in the 1990s: Learning from a Decade of Reform*, under the direction of **Gobind Nankani**. The team consisted of **J. Edgardo Campos, James Hanson, Ann Harrison, Philip Keefer, Ioannis Kessides, Sarwar Lateef, Peter Montiel, Lant Pritchett, S. Ramachandran, Luis Serven, Oleksiy Shvets**, and **Helena Tang. Indermit Gill** was an active advisor.