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Overview

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OVERVIEW

The past two decades have been shaped by a radical shift in development thinking and practice. In the wake of the debt and development crisis of the 1980s, a new policy approach looked to liberate enterprise from state intervention, deferring to the invisible touch of global market forces. The promise was for an end to macroeconomic chaos, stop-go development cycles and debilitating levels of debt, ushering in an era of sustained growth and poverty reduction. The collapse of the Berlin Wall gave this agenda global reach.

The agenda was embraced with particular enthusiasm in Latin America, and with the success of the Brady Plan the floodgates opened to foreign capital in the 1990s. The green light from international capital markets encouraged a quickening pace of reform, attracting foreign investment and making international competition the engine of renewed growth. But after some initial signs of success, familiar structural constraints have resurfaced. Most countries have failed to accelerate capital formation and technological progress, and diversify into more dynamic sectors. As spending outpaced the expansion of productive capacity and imports boomed, the growing reliance on external capital left many countries exposed to external policy shocks. Over the past five years, as global economic imbalances have generated such shocks with increasing frequency, Latin America has endured a "lost half decade", recalling the disappointing developments of the 1980s.

A passing familiarity with broader historical experience might have cautioned against advertising the originality of the new development agenda or encouraging exuberant expectations. Back in the 1920s, balanced budgets, independent central banks, flexible labour markets and a rapid opening to international competition also promised to get things back to normal. Instead, as unregulated financial flows spilled across the global economy, boom-bust cycles erupted on the periphery of Europe and in parts of the developing world, linked to instability in commodity export earnings and mounting levels of debt.

Fanaticism, according to the Spanish philosopher George Santayana, calls for a doubling of effort in the face of failure. Despite its pantheon of critical and creative minds, economics is also susceptible to such thinking. Indeed, as inflation has subsided and market forces enjoy an increasingly freer reign, the call for developing countries to pursue greater fiscal discipline, more deregulation and ever faster liberalization has intensified, even as growth prospects have dimmed in many places and poverty levels have risen.

In the 1920s, when the "market juggernaut" was rolling at full steam, John Maynard Keynes called for a "new wisdom for a new age" with "new policies and new instruments to adapt and control the workings of economic forces, so that they do not intolerably interfere with contemporary ideas as to what is fit and proper in the interests of social stability and social justice". Open-minded, tolerant and pragmatic approaches to the development challenge, consistent with today's increasingly interdependent world, are urgently needed to place economic policy once again at the service of social justice and stability.

Global trends and prospects

This is an anxious time for the global economy. The long anticipated rebound in the United States continues to be delayed, and there are concerns that the imbalances and excesses created during the high-tech boom of the 1990s could result in a long period of erratic and sluggish growth, with occasional surges and dips, accompanied by price deflation. With Europe undecided on, and Japan unable to find, the appropriate policy mix for sustained recovery, the world economy looks set to repeat the weak performance of the past two years and could still falter badly.

Adverse consequences for the developing economies, even the most resilient, are unavoidable. Brighter political conditions should help avoid a repetition of last year's recession in Latin America, but any recovery will be anaemic and fragile. Africa appears to be relatively insulated from global trends, but the continued weakness of many commodity prices means that it may not be able to repeat its performance of the past two years. Given the current level of development cooperation and the structural weaknesses across the region, there is now a growing consensus that it will be impossible to meet the Millennium Development Goals even under the most optimistic growth scenario for the world economy. Asia has until recently been able to maintain momentum based on domestic demand, exports to the United States and buoyant intraregional trade, but growth in the region is certain to slow.

The current downturn in the world economy was preceded, at the end of the 1990s, by widespread but misplaced optimism about the nature and sustainability of United States expansion as the single most important force driving global growth. This was noted in *TDR 2000,* at the time when the world economy was still moving at full steam and many observers thought that the United States economy had been liberated from the inexorable turn of the business cycle:

> Most forecasts of continued global expansion are based on the "Goldilocks" scenario in which the United States economy is neither too hot nor too cold, allowing Europe and Japan to grow and providing support for continued recovery in Latin America and Asia. In assessing the forecasts for accelerated global growth it is as well to remember that Goldilocks is a fairy tale.

Indeed, the factors that helped the United States economy to surge ahead have also increased financial fragility and global imbalances. Accordingly, and as anticipated in *TDR 2001* in the wake of the current downturn, the unwinding of the legacy of the 1990s is proving a good deal more difficult than many had expected:

> Expectations remain quite high that a short Keynesian downturn in the United States can be corrected by appropriate monetary and fiscal action. ... But, even if the steady hand of recent years is maintained, there are doubts that traditional macroeconomic policies will carry the day, given the high level of private indebtedness, the surfeit of investment during the technology boom, and the uncertainties surrounding the dollar. ... The fact that such a long period of expansion has no recent precedent should make for cautious assessment of the current slowdown. However, on balance, the various conflicting pressures point to an uncertain future.

Thus, in spite of aggressive interest rate cuts by the Federal Reserve, investment has failed to recover as capacity utilization remains low despite the scrapping of excess equipment. The economy has so far avoided a more prolonged period of recession thanks to continued growth in consumer spending, which now appears to be losing momentum. Europe's ability to respond vigorously to the current downturn has continued to be compromised by the restrictions on fiscal policy imposed by the Stability and Growth Pact, and the monetary policy stance of the European Central Bank. Japan appears to have given up fighting deflation with macroeconomic tools, emphasizing instead international competitiveness and exports as a basis for growth. Consequently, even though growth rates have fallen everywhere, disparities in the strength of demand among the major industrial countries have persisted, with the United States economy still outperforming Japan and the European Union.

With weak policy responses to sluggish and uneven growth, there is increased reliance on currency adjustments to reduce trade imbalances and revive growth. The combination of the reduced attractiveness of United States assets to foreign investors and the continued increase in its current account deficit has created downward pressures on the dollar. However, this has so far been reflected primarily in a rapid depreciation of the dollar against the euro and some reversal of prior depreciation of Latin American currencies: East Asian economies, including Japan, have resisted the appreciation of their currencies by intervening in the foreign exchange markets and accumulating large reserves.

Since the bulk of the United States trade deficit is with East Asia, it is not clear if recent currency movements will reduce rather than aggravate trade imbalances between Asia and the rest of the world. Indeed, the events of recent months evoke memories of the competitive devaluations of the inter-war period. Certainly, it would be unrealistic to expect the international trading system to evolve in the right direction or international monetary stability to be maintained in the face of slow growth and mounting unemployment. A reversion to the pattern of unruly competition and conflict characteristic of the 1930s could derail the process completely.

Different developing countries are unequally prepared to deal with these increasingly volatile conditions. The weakness of global demand in the past two years has only had a limited impact on East Asia despite its dependence on exports, largely because the strong macroeconomic and balance-of-payments positions of countries in the region have allowed considerable room for domestic demand expansion to support growth, reinforced by strong intraregional trade linkages.

Such policy space was not available to most economies in Latin America facing stringent payments positions. In these countries the global downturn aggravated external financial difficulties, and macroeconomic policy has focussed on reducing current-account deficits and reassuring financial markets. While Asian economies generated large current-account surpluses through a rapid expansion of exports, the situation in Latin America in 2002 was reminiscent of the conditions prevailing during the debt crisis of the 1980s. The region received virtually no net inflows of private capital in 2002 after being the largest recipient in 2001, and it has had to combine a fall in output with a trade surplus and net transfers abroad, generated entirely by cuts in imports.

While prospects for East Asia and, to a lesser extent, Africa, depend on the evolution of their external trading environment, for Latin America financial conditions are equally important. In recent months extremely high yields and improved political conditions in some countries in the latter region, combined with sharp declines in equity and bond yields in industrial countries, have been attracting short-term, speculative capital, leading to the appreciation of currencies at a time when global prospects are deteriorating and long-term capital inflows to the region declining. It is unlikely that such short-term inflows mark the beginning of another cyclical upturn in private capital flows to the region, as happened during the 1970s after a long period of stagnation or in the 1990s after the debt crisis. These post-war surges in private capital flows to Latin America were idiosyncratic, driven by ad hoc responses to specific global circumstances rather than being parts of a recurrent cyclical pattern. The

first was made possible by the end of the Bretton Woods system and the accompanying financial deregulation in industrial countries and the recycling of petrodollars. In the second, the Brady Plan, designed to relieve United States banks of non-performing loans, laid the ground for a surge in portfolio and investment flows which were further encouraged by progressive liberalization and privatization in the region. There is no guarantee of a renewed surge in capital inflows, and certainly not to the peaks reached during the 1990s.

Hopes are also being pinned on a successful Doha round of trade negotiations to bolster confidence and kick-start the global economy putting trade ahead of growth. Certainly, international trade surged from the late 1980s, growing considerably faster than output until the beginning of the new millennium when it fell not only behind growth of world output but also in absolute terms. While trade is expected to recover in 2003, again there is a danger of optimistic extrapolations. The growth of world trade during the 1990s was driven by a number of structural and institutional changes, which are unlikely to be repeated, at least with the same intensity. These changes included the rapid liberalization of imports in developing countries; the spread of international production networks for some of the most dynamic products in world trade, resulting in a rapid expansion of intra-industry trade with a prominent North-South component and the round-tripping and double-counting of goods in the measurement of world trade; and a surge in capital inflows which helped to boost trade by allowing imports to expand faster than exports in many developing countries. While similar forces could still propel an independent recovery in trade, they are unlikely to match the earlier rise, if only because they will lack the same first-mover boost. Under current conditions, a rapid expansion of trade and further trade liberalization will depend crucially on a rapid recovery of demand and production in the world economy rather than the other way round.

The world economy is now facing a widening deflationary gap created by deficient global demand. There is a global glut in both labour and product markets, with too many goods chasing too few buyers and too many workers chasing too few jobs. Intense price and exchange-rate competition among major exporters have been adding to instability and deflationary pressures, while many developing countries facing tight payments positions are being forced to curtail imports. These difficulties are similar to those that the Bretton Woods Institutions were created to resolve. If decisive action is not taken to restore stability in financial and currency markets, to start a global recovery and reverse the rapid rise in unemployment, there is a real threat that trade imbalances and the coexistence of continued rapid growth in some parts of the world with stagnation, decline and job losses elsewhere could deepen the existing discontent with globalization among a wide section of the world's population, triggering a political backlash and a loss of faith in markets and openness, and leading to international economic disintegration with the burden falling disproportionately on the poor and underprivileged. This is perhaps the first real test for economic policy in a post-Bretton Woods globalized world.

Guided by fiscal and monetary orthodoxy, the measures so far applied in some leading economies have been inadequate for striking a better balance, even as inflationary pressures have dissipated and unemployment is rising again. Indeed, with prices already declining in some larger developed and developing economies, the risk of a deflationary spiral is an increasing worry to policy makers everywhere. Although the likelihood of such a spiral is still controversial, it is nevertheless clear that there is now a real danger of a "liquidity trap" emerging, where monetary policy becomes incapable of checking and reversing the falls in output and employment. This is precisely the context in which it is most apt to adopt Keynesian policies to expand liquidity and effective demand, both at the national and global level. An effective policy response should include a fiscal stimulus over and above that provided by automatic stabilizers: an increasingly interdependent global financial and trading system can scarcely function efficiently with only one policy tool, monetary policy, especially without an appropriate degree of policy coordination and agreement on its objectives. Policy should also address the liquidity needs and the debt burden of developing countries facing stringent external financial conditions. For all countries, therefore, the prospects for prosperity hinge on international cooperation as well as on the intensity of their own efforts.

Capital accumulation, economic growth and structural change

The increased diversity in economic performance of developing countries in the current global downturn reflects differences in their domestic conditions. In this respect the contrast between East Asia and Latin America is particularly striking. The poor economic performance of most middle-income Latin American countries in comparison with East Asia suggests that their productive structures, institutions and policies do not have the flexibility and resilience needed to respond to external shocks with the same vigour and effectiveness as in East Asia. In this respect, the current economic landscape in the developing world has an uncanny resemblance to conditions prevailing in the early 1980s, when external shocks, including widespread recession in the industrial world and tightened financial conditions, pushed Latin America into a deep crisis while most East Asian economies were able to swiftly adjust and continue, after a brief pause, on their high growth paths.

What is perhaps more unsettling is that current difficulties in Latin America follow many years of intensive market-based reforms adopted in response to the debt crisis of the 1980s with the support of the international financial institutions. These reforms, collectively referred to as the "Washington Consensus", aimed to remove structural and institutional impediments to growth, improve productive capacity and trade performance, and put an end to stop-go development associated with excessive indebtedness and periodic balance-of-payments crises. While claiming success in controlling inflation and bringing monetary and fiscal discipline, the evidence examined in Part II of this year's *Report* shows that the reforms have failed in exactly the same areas in which previous policies of import substitution had also failed. Just as significantly, the problem lies as much with what has been included in the reform packages as with what has been left out.

Investment and growth: the record

Between 1960 and 1973 Latin America and East Asia grew at much the same rate, and average per capita income in 1973 in the four first-tier NIEs was lower than that in the five largest countries in Latin America by $850. Thereafter, performance started to diverge sharply, with East Asia growing at more than double the average rate in Latin America between 1974 and 2000. Furthermore, the slowdown in Latin America was accompanied by increasing instability: in most countries of the region, growth in the period 1980–2000 was slower and less stable than in the previous two decades. Only Chile enjoyed a more rapid and sustained growth rate accompanied by greater stability.

Why growth rates differ between countries and regions has generated a myriad of explanations. Nevertheless, there is general agreement that growth cannot be sustained without an adequate level of

investment. Certainly, as discussed in past *TDRs*, a strong and sustained investment drive by national elites, often from very low levels, has been a defining feature of successful development episodes in the post-war period. The minimum level needed for a satisfactory growth performance will be influenced by country-specific factors, but a 20 per cent share of fixed investment in GDP has been suggested as a target threshold in poorer countries, rising towards 25 per cent as countries climb the income ladder.

In the first half of the 1980s, there was a drop in the share of investment in almost all developing countries, often below these thresholds, and in some cases below the level needed to replace depreciated capital. Drastic policy changes introduced in response to the debt crisis to restore macroeconomic stability, correct price distortions and free market forces were expected to improve the investment climate and prepare the ground for a recovery led by private investment. However, the strategies adopted for activating a dynamic process of capital accumulation and growth, based on a combination of increased FDI and reduced public investment and policy intervention, have not produced the expected results.

In Latin America where such reforms have gone furthest, there has been a steady and persistent fall in the share of public investment, along with increased FDI, often through the sale of public assets. There was only a weak recovery of total investment from the second half of the 1980s, often led by less productive categories such as housing construction, before hovering around 20 per cent of GDP in the 1990s, well below previous peaks. In many cases, investment in machinery and equipment during the 1980s stagnated or declined sharply, before posting modest recoveries in the 1990s. This shift in the structure of investment towards less productive activities appears to have contributed to the weakening of the link between capital formation, technological upgrading and output growth. Furthermore, the conditions that attracted foreign enterprises to Latin America have not been conducive to faster capital formation: FDI as a proportion of GDP was higher by some 1.7 percentage points in the 1990s compared with the 1980s, but the share of gross fixed capital formation was lower by 0.6 percentage points. This trend characterized all the major economies, except Chile, and is equally apparent when the contrast is with domestic private investment.

In the East Asian economies a very different investment regime has been established. The rising share of investment in GDP throughout the 1970s was only briefly interrupted by the turmoil of the early 1980s and it recovered strongly during the second half of the decade as moderate devaluations and temporary wage restraints allowed countries to build a dynamic investment-export nexus, before accelerating rapidly in the first half of the 1990s. The regional peak of 30 per cent of GDP was surpassed in a number of countries, in some cases by a considerable margin. Investment in machinery and equipment along with expanding construction in physical infrastructure were important features of East Asian investment. This improvement in overall investment was in most cases associated with a stable or rising share of public investment with strong crowding-in effects. For some countries, such as Malaysia, the surge was closely associated with increasing FDI, but this was not a common feature in the region.

It is not just the level or composition of investment that matters. A comparison of investment cycles over the past four decades suggests that the cycle is a good deal more volatile in Latin America than in East Asia. Furthermore, investment has played a much more significant role in the recovery phase of a typical cycle in the latter region than in the former. Thus, in Latin America, in a typical cycle, the investment recovery has been much shorter and the slowdown, when it came, has been much more pronounced. This implies that counter-cyclical policies gain added importance in Latin America, but their scope is limited due to greater fiscal and monetary fragility.

Industrialization, deindustrialization

The historical experience of advanced economies shows that establishing a broad and robust domestic industrial base holds the key to successful development because of its potential for strong productivity and income growth. This process is associated with a strong investment drive in industry, rapidly rising productivity and a growing share of the sector in total output and employment. As the economy matures, growth in demand for manufactures slows down relative to productivity growth, and the share of the sector in the economy levels off and eventually starts to decline. In today's advanced economies, such a process of "deindustrialization" occurred at very high levels of industrial productivity and income, and under relatively rapid overall rates of economic growth, accompanied by a persistent rise in the share of services, many of them closely related to the needs of industry.

Industrialization still matters for developing countries lower down the income ladder. The presence of scale economies, gains from specialization and learning, as well as favourable global market conditions, implies that the creation of leading industrial sectors, along with related technological and social capabilities, remains a key policy challenge. Still, there is considerable room for diversity in the timing and the pace of industrial development across countries, reflecting differences in resource endowments, size and geographical location. Such diversity, including the pace and pattern of capital accumulation and trade performance, is also strongly influenced by policy choices.

A steady rise in the shares of industrial output and employment characterized most of the developing world in the 1960s and 1970s. In some regions, notably Latin America, the increases were especially pronounced thanks to a strong industrial drive under the import substitution industrialization strategy; indeed, with the possible exception of China, the Southern Cone countries were, at the time of the debt crisis, the most industrialized part of the developing world, as measured by the share of industry in total employment. This pattern has become a good deal less uniform since then, with premature deindustrialization in a context of slow growth becoming a common feature across parts of the developing world.

The East Asian economies have continued to industrialize at a rapid pace, with the first-tier NIEs reaching productivity levels consistent with industrial maturity as a new generation of late industrializers from the region were expanding rapidly, combining rising investment and manufacturing value added both in absolute terms and as a share of GDP. By contrast, industrial stagnation and decline has been the norm in Latin America as well as in Africa where in most countries a declining share of investment in GDP has combined with a falling share of manufacturing value added in a context of slow and erratic growth. Among a selection of 26 countries examined in this *Report* only eight have succeeded in raising the share of manufacturing value added in GDP between the 1980s and the 1990s, together

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