KEYNOTE ADDRESS

THE MYTH OF THE FRIENDLY MARKETS

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I return to these halls after a decade, with a feeling of great nostalgia. For 12 long years, I sat in these offices, I roamed around in these confusing corridors. I may have lost my way at times--only physically, I hope, not intellectually--but I must say that I left the Bank with a tremendous regard for this institution: for its enormous talent, for its intellectual ferment, for its great contribution to development debates. My own contribution to this institution will always remain somewhat debatable, despite the very gracious words of our chairman, Visvanathan Rajagopalan. But those were certainly very impressionable years that I spent here and I learned a lot. One of the essential lessons I learned in the Bank was that it is dissent, not conformity, that keeps an institution alive. I speak to you today in a very candid spirit, as a friend and as a former colleague. Honesty is a gift only friends can give.

We are certainly living through very exciting times. The development pendulum is beginning to swing once again, from an overcommitment to the public sector to an overenthusiasm for the private sector. There is a "garage sale" of public enterprises going on all over the world--from New Delhi to Rio, and from Warsaw to Moscow--enough to warm the heart of any idealogue of capitalism. We also see professional shock therapists roaming all over the globe in search of willing victims, delivering the message of overnight change. Certainly the long overdue return to the market has started in many developing countries and I welcome it. But my fear is that the pendulum may swing once again too far and we may all live to regret it. I hope that at least this development institution puts this issue of public and private sector role in its right perspective. In this context, let me pay a tribute to the *World Development Report 1991*. I read it not as a defence of the markets: I read it as an attempt to put the markets in their correct perspective, because the conclusion of the report was that "it is not a question of either state or markets: each has a large and irreplaceable role."

But before I come to the markets and what I call "the myth of the friendly markets," let me go back a little as to why an overcommitment was made to the public sector in many developing countries. Were we so ill-informed that we did not know what we were doing? I think, at that time, all of us, as we grew up during our formative years, faced the challenge of tremendous poverty in our societies. We realized that great disparity existed between various income groups and that we needed to pursue a range of social objectives, not only higher economic growth, to liberate our societies from poverty. In this search for social objectives, many developing countries lost their way. There was an innocent flirtation with socialism but unfortunately there was a mix up between ends and means. The means that were chosen were a large role for the public sector and, instead of a pursuit of the real social objectives, often it became bureaucratic capitalism. The economy was handed on a silver platter

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to the civil servants, often ill-trained and ill-paid. Many times they used controls and regulations, not to enrich the economy but to enrich themselves.

A very strange world emerged in the past 30 years. We had public enterprises in agriculture, industry, trade--all productive sectors--many of them inefficient and losing money. In Cameroon, for instance, the annual losses in the public sector enterprises exceeded the total oil revenue of the country. In the Philippines, these losses were 2 to 3 percent of the gross national product (GNP) and, but for these losses, the country could have increased its education and health spending by about 30 percent. In Sri Lanka, two-thirds of the budget deficit is explained by public sector enterprise losses. In Argentina, public enterprise losses exceed 11 percent of the GNP. These countries were short of financial resources. Yet they wasted their scarce financial resources, and even more scarce management skills, on inefficient public enterprises that could have been privatized with great benefit to all sides. As such, there was a strange "Alice in Wonderland" situation in many parts of the developing world. They committed their scarce resources and energies to things that the private sector could have done more efficiently and they did not then have enough resources left in their budgets to do the things that only the government could have done, particularly provision of social services and investment in education and health. Then they all complained about poverty of resources. As I look at these budgets, and I have handled budgets in my country, it was not the poverty of resources, it was the lack of political will. This is especially true when one considers military spending levels in these developing nations, which often exceeded their spending on education and health. Restructuring the priorities of many of these budgets would have really given them the resources they needed for urgent human development.

But after saying all this, let me confess to you today that I am very worried about the new ideology of the markets that is emerging globally. In many of these countries, markets are neither free, nor efficient, nor equitable. Unless there is a good regulatory role of the state, and unless free markets are combined with social compassion, we may have a good deal of upheavals coming in many of these countries.

Now let me focus on one major point. Markets are not very friendly to the poor, to the weak, to the vulnerable, either nationally or internationally. Often we act as if markets are free. They are not. I have seen that in my country. The markets are often the handmaiden of powerful interest groups, and they are greatly affected by the prevailing distribution of income. If it is an income ratio of twenty-six between the top 20 percent of the population relative to the bottom 20 percent, as it is in Brazil, the market allocates resources to the rich. In fact, Brazil spends 12 percent of its GNP on social services. But the main beneficiaries are higher income groups. About 88 percent of its public sector health budget is spent on expensive urban hospitals for a few rather than on primary health care for all. Brazil gives eighteen times more subsidy to university students than to primary education while only 1 percent of the enrollment in its universities comes from the bottom 20 percent of the income group. That is why Brazil has four times the child mortality of Jamaica, despite having twice the per capita income of Jamaica and despite spending more on social services. This dramatically illustrates how even the distribution of public services is skewed in favor of the rich, not just the allocation of resources in the market, if the initial distribution of income and assets is extremely unequal in a society. Markets cannot become neutral or competitive in such a situation unless the playing ground is made more even and playable to begin with.

I think that one particular question is very vital to understand the role of the markets. Is everybody in a position to compete in the market or are some people going to fall outside the marketplace because they do not have enough education, health, and nutrition to compete on any footing, let alone equal footing? That is why I believe that a much better distribution of income and assets, of credit, of power structures, and certainly a better distribution of knowledge and skills is vital to make markets work more efficiently.

Now you may not often be able to distribute income and assets more equitably. There are many practical problems, there are several political limits. But you can distribute knowledge and skills quite equally in many countries and that is a tremendous leveling force to enable people to compete in the market. That is why I strongly believe that unless there is a tremendous investment in human capital formation in many of these countries, the markets will continue to work inefficiently and inequitably, and may be hijacked by the rich.

This is also true of global markets. The next *Human Development Report* that we are producing on behalf of the United Nations Development Programme (UNDP) is focusing on whether global expansion trickles down to poor nations and poor people. Global markets are unfortunately not particularly friendly to poor nations or poor people. Just think for a while about some of the dramatic conclusions that this report highlights about the global markets:

- Developing countries are being denied at least US$500 billion of economic opportunities in the global markets every year because of trade restrictions, immigration controls, and uneven capital flows. This is about ten times the amount of annual foreign assistance they receive.

- The poorest 20 percent of the world's population receives only 0.2 percent of global commercial credits, 1 percent of world trade, and 2.7 percent of global foreign private investment.

- The indebted nations of Latin America paid four times higher real interest rates in the 1980s compared to the industrial countries (17 percent compared with 4 percent) because of the major fall in their commodity prices.

- Capital markets worked in such a fashion in the 1980s that the poor nations started transferring US$50 billion a year of net resources to the rich nations every year by the end of the decade.

- Commodity markets worked in such a way that primary commodity prices (excluding oil) declined to their lowest levels since the great depression and Sub-Saharan Africa alone lost more than US$50 billion in export earnings between 1986 and 1990 because of depressed commodity prices.

- Sub-Saharan Africa's share in global trade markets declined from 3.8 percent in 1970 to 1.0 percent in 1989, despite many trade concessions.

- The real income disparity between the top 20 percent and the bottom 20 percent of the world's population exploded to 150 times by 1990--more than twice the level of 1960--as a natural working of the global markets.

The basic point is that markets do not automatically favor the poor, the weak, the vulnerable. Unless some policy steps are taken to enable the poor to compete on an equal footing, they may stand to lose a great deal from the workings of the unregulated market system. So our first step must be to accept the logic of the marketplace but then to turn around and make these markets work more efficiently in the interests of all the people. What we need are people-friendly markets. After all, markets are only a means: people are the end.

If we wish to establish people-friendly markets, which are accessible to all the people, which encourage full participation in the mainstream of economic life, which extend their potential benefits to everyone rather than to a privileged few, then some preconditions must be met. There should be a more equitable distribution of income, productive assets (particularly land), and credit. There must be sufficient human investment to enable people to compete on an equal footing. There must be no barriers to market entry--religious, ethnic, gender, or any other barriers. There must be competitive market conditions and regulations for monopolistic practices so as to prevent the powerful few from bending the markets to serve their own narrow interests. There must be a regulatory role of the state to ensure that external diseconomies are not created for the entire society in the pursuit of private greed and that those who create such external "bads" (such as environmental pollution) are made to pay for the privilege. In other words, people-friendly markets require a very activist role of the government, not to overregulate economic enterprises but to create conditions of more equitable access to competitive markets.

Even when markets are fully competitive, it is inevitable that some people will fall outside the market place and require a social safety net. Because the preconditions for people-friendly markets are often missing in many economic and political systems, particularly in the developing countries, the need for such a social safety net often increases. Every society develops a certain social consensus over time as to how to balance market efficiency and social compassion. In the United States, the New Deal was an historic watershed when the American Society articulated a new social consensus between markets and government action -- a social contract that is still there despite some recent weakening. Even today, the United States transfers about 10 to 15 percent of its national income to the more vulnerable groups in society through medicare, food stamps, unemployment benefits, and other social security programs. In Nordic countries, this ratio is above 30 percent. In many developing countries, less than 5 percent of their national income is often spent on such social safety nets, while the need for social programs is much greater in these societies than in industrial countries because their income and asset distribution is generally worse, their markets are generally less competitive, their barriers to market entry are generally more formidable, and their systems of democratic accountability are generally less institutionalized. And yet many international consultants and financial institutions have the courage to advise these developing countries to dismantle even their existing meager social safety nets in the pursuit of market growth. Obviously, they feel that there are no political limits to change in these poor lands while they would cringe at suggesting a fraction of similar structural adjustment in their own richer societies.

And that is why we are witnessing a new era of professional shock therapists. They often emerge from the inner sanctums of Harvard and Yale, with their academic innocence still intact, and they carry the message of instant change to many far-off lands whose cultures and political systems they least understand. Let me quote you a few passages about shock therapy from an article by Mr. Conrad, former Deputy Prime Minister of Czechoslovakia, which appeared in the *New York Times* on January 5, 1992. He says that, unfortunately, the doctrine of shock therapy is out of touch with reality and it ignores the impact of such an approach on the worst-educated skill classes of Eastern

Europe. In Czechoslovakia, where radical reforms have been in place for a year, the outcome in 1991 was a 22 percent falloff in industrial output, an increase in unemployment from 2.5 to 8.5 percent, an inflation rate of 5 percent, a 33 percent decline in domestic demand, and a 40 percent shrinkage in the gross domestic product. Mr. Conrad admits that all of these trends are obviously the consequences of 40 years of communist mismanagement but he contends that their sudden intensity results from shock therapy. And he notes, very pertinently, that it took Margaret Thatcher 12 years to privatize Britian whereas Eastern Europe gets only 2 years. He concludes with the sad observation that shock therapies are untested beyond the economic laboratories of Cambridge, Massachusetts.

Let us review the dismal record of stock therapy. It has not succeeded in many societies. The human and social costs of change have been unnacceptable and have often led to political upheavals.

Take China for instance. It experienced an unprecedented rate of GNP growth of 8 to 10 percent a year in the 1980s. Economic output went up at a fantastic pace throughout the decade. But what happened to social progress? During the same period, many social indicators began to weaken. Life expectancy went down, particularly for females. Health indicators deteriorated because, with the disappearance of the communes, there also disappeared the nationwide system of primary health care nurtured by barefoot doctors. Income distribution deteriorated; unemployment and inflation emerged in a society with no prior experience of these phenomena. People did not begin to share the fruits of market productivity before they began to witness the human distress in freer markets, with a weakening of the social safety nets, which used to be taken for granted in these societies. Many people asked the legitimate question: why is there a weakening of the social indicators when the society is experiencing a higher income growth? Some of these questionings, to my mind, led to the confrontations in the Tiananmen Square. And I do believe that the Chinese policymakers are right in graduating the pace of change and watching more carefully how economic and social progress are balanced.

Take the example of Sri Lanka. It was regarded as a model of human development for a long time but is beset with ethnic conflicts recently. What really changed in society? Sri Lanka has been experiencing a high level of literacy and life expectancy for many years, with Tamils and Sinhalese living together for many decades. In 1979, an adjustment package formulated by the International Monetary Fund (IMF) directed that the free rice rations given to every family be modified and targeted more narrowly (and more efficiently it was suggested) on the very poor through a scheme of food stamps. The scheme made it easier for civil servants to hijack the free nutrition poor families were previously getting. By trying to focus the food stamps only on the poor, Sri Lanka only succeeded in excluding many poor families from the scheme. There is sufficient evidence that nutritional levels of the poor declined significantly in the 1980s. This at a time when average per capita income growth had accelerated. The consequent upheavals should have come as no surprise. I know the reality of so-called ethnic troubles. I have seen them in my own country. They ultimately represent social and economic grievances that simply boil over. And what is then the response of the state? Sri Lanka ended up spending more on its police and its security than it was previously spending on food subsidies. What a cruel choice for a finance minister--he has to opt to put bullets in the stomachs of his people rather than food, even when the bullets cost more. And all because the IMF was monitoring expenditure on food subsidies but not expenditure on police and security. And how unnecessary, because higher income growth should have permitted higher, not lower, social spending.

The basic point, which many professional shock therapists forget, is that the opening of market mechanisms need not inflict unacceptable social and human costs on the people. Their challenge is to design strategies that can combine rapid change with the minimum possible human costs. It is no use shrugging away the social pain with the banal observation that pain is inevitable in a major transition to the markets. Maybe so, but the most critical question is the distribution of pain: is it borne only by the masses or also by the privileged economic groups in societies? My own perception is that much of the pain for the poor people can be avoided if the burden of adjustment is placed on the favored strata of society--military establishments, industrial tax evaders, the feudal rentier class, corrupt civil servants, and higher income groups. The international institutions should calculate the distribution of the pain of adjustment in a society and try to protect the poor within the society, rather than nonchalantly walk away from the issue. How lightly the issue of more equitable distribution of pain was treated by outside consultants and institutions can be illustrated by just one example: their criminal silence on military spending levels in the developing countries in the last three decades.

During the last three decades, military expenditures in developing countries increased by 7.5 percent a year, three times as fast as in the industrial countries. Military spending in the developing world rose from 7 percent of global military expenditures in 1960 to 18 percent in 1985. There are eight times more soldiers than physicians in these countries today. Many poor countries are spending two to three times more on their military establishments than on the education and health of their children. We have a situation today where military generals go around in air-conditioned jeeps while small children sit in windowless school rooms and suffocate. And yet never in these three decades did the level of military spending become a question of aid conditionality. There was more tolerance for military subsidies than food subsidies. International institutions carried out no serious economic analysis of military spending levels in the developing countries. No attempt was made to collect data on military debts--a frightening omission. No information was made available on military assistance. No international screams went up against powerful military establishments in the developing countries. Sometimes those who pride themselves on designing "rational" aid conditionality for the poor nations should pause and think whether their machoism extends only to beating up on the poor or also to standing up to powerful vested interests.

Let me not drift away from the main subject, however. The basic point is that it is possible to combine the painful transition to the market with social safety nets for the poor if some of the irrational spending priorities are changed in the system. The advocates of shock therapy should first look for some decent solutions, which can combine gradual reform with acceptable social pain, fairly equitably distributed.

Let me add as an aside that I sometimes design many tortures for these professional therapists--when it is late in the evening and I am out of any creative ideas. My favorite torture for the alumni of Cambridge, Massachusetts, is to oblige them to go to their own Senators to persuade them to pass just a 10 percent increase in gas prices (which they defeated last year) before proposing a 500 percent increase to many far-off lands. A second-best solution would be to make them the Finance Minister of Pakistan for a week--a sure cure for many firmly held theoretical convictions, as I know from my personal experience. A milder form of torture would be to make them reread their Mark Twain who said, "one's sense of idealism is in direct proportion to one's distance from the scene."

Let me conclude. I sincerely believe that opening up of the markets is the best thing that has happened to the developing countries and to the former socialist bloc. But I also believe that this transition to the markets must be accompanied by a regulatory role of the state to make the markets accessible to all people and a compassionate role of the community to extend social safety nets to the victims of the market place. This is a time to strike a balance, not to go to any excesses.

Some analysts have contended that the recent years have seen the demise of socialism and the triumph of capitalism. Let me add this thought. If this is the demise of socialism, let us hope it is not the demise of all social objectives. And if this is the triumph of capitalism, let us hope that it is not the triumph of only private greed. We have come to a new crossroads in history when individual initiative must be combined with social objectives. It is not one or the other: it is both. And the future course of our societies may well depend on how skilifully we combine market efficiency with social compassion.