

## *Priorities for action*

The past forty years have witnessed many cases of remarkably rapid economic advance among the countries of the developing world—so rapid that some countries are on the point of “graduating” to the ranks of the high-income industrial countries. Most developing countries have made progress at a slower pace. Even so, in comparison with the industrial countries at a comparable stage of development, these countries have still done well, and their standards of living have improved greatly. Unfortunately, however, in some countries, especially in Sub-Saharan Africa, development is moving too slowly to make much difference in people’s lives. For them, better economic performance is not merely very desirable. It is literally a matter of life and death.

This wide range of experience has told us much, though by no means everything, about what works in development and what does not. Development has emerged as a fragile and multidimensional process. It depends on complex interactions among institutions, policies, and the global economic climate. There have been no shortcuts. Neither forced modernization of industry nor massive inflows of external resources led to the gains expected a generation ago. But steady—even exceptional—progress has come through actions that foster competitive markets, private initiative, and investment in physical and human capital.

It is true that many countries must overcome tremendous obstacles—adverse natural conditions, poor infrastructure, weak administrative capacity, entrenched special interests, and inadequate financial resources. Experience is nevertheless turning policy reform into the art of the possible. Comprehensive, market-friendly re-

forms have succeeded under varied economic and political conditions.

The progress of development in the 1990s will depend on concerted action by the global community, including industrial and developing countries and external finance agencies. Their joint task is to foster a global economic climate that promotes the exchange of goods, knowledge, and capital. It is the particular responsibility of the industrial countries and the finance agencies to

- Defend and extend the liberal order of international trade established after 1945
- Ease the flow of capital across borders
- Pursue domestic economic policies that promote global saving and steady, noninflationary growth
- Support the transfer of technology
- Protect the environment and conserve energy.

In discharging these responsibilities, the industrial countries will be directly furthering their own interests. At the same time, they will be laying the foundation for more rapid advance in the developing world.

As important as these actions by the industrial countries are, the future of the developing countries is largely in their own hands. Even if the industrial countries fail to play their part, the developing countries can do much to move forward more quickly. It would be a tragic mistake for them to use the weaknesses of economic policy in the industrial countries as a reason to delay essential economic reforms. The right strategy for the developing countries, whether external conditions are supportive or not, is to

- Invest in people, including education, health, and population control

- Help domestic markets to work well by fostering competition and investing in infrastructure
- Liberalize trade and foreign investment
- Avoid excessive fiscal deficits and high inflation.

These elements of the development strategy interact (see Figure 4 in the Overview). Investing in people spurs productivity all the more powerfully in an economy that already has undistorted domestic markets; at the same time, efficient domestic markets increase the returns from education and therefore make an expansion of investment in education easier to bring about. A stable macroeconomy makes it easier to withstand the external shocks that linkages to the global economy cause from time to time; conversely, global linkages provide access to foreign capital, which makes it easier to maintain domestic macroeconomic stability in the face of internal shocks.

Perhaps the most fruitful interaction is between efficient domestic markets and the global economy. Efficient markets attract foreign investment, which boosts productivity. At the same time, trading links to the outside world let countries pursue their international comparative advantage; that helps the domestic economy use its resources even more efficiently.

In many cases, there will be conflicts among policies as well as complementarities. Investing in education cannot be allowed to expand public spending in a way that threatens macroeconomic stability. In some countries there is a similar conflict between liberalizing trade and prudent macroeconomic policy: lower tariffs, unless offset by additional resource mobilization, may reduce government revenues and increase public deficits.

To implement a market-friendly development strategy while overcoming such conflicts requires, in many countries, reconsidering the role of the state. Many governments lack the administrative capacity to do as much as they might wish. Yet careful intervention is sometimes essential for development to occur. If governments are to do more in such areas (notably, providing better education and infrastructure) they must do less in others (especially micro-managing trade and industry). Administrative constraints aside, such a realignment would be highly desirable in any case. The resources for more public spending where it is essential can be found by cutting spending where it is wasted.

Military spending is a particular concern for all countries, rich and poor alike. Can recent declines

in defense spending in developing countries be sustained? The present vacuum in security arrangements and the repercussions of the conflict in the Gulf region make the answer uncertain. It could take very little to shift the dynamics of regional relations toward either new arms races or mutual restraint. An important complicating factor is that weapons producers will bid aggressively for developing-country business as their markets in the OECD countries and the Eastern Bloc become less lucrative. Developing countries and external aid and finance agencies would do well to tilt incentives the other way by discouraging arms production and promoting nonproliferation.

The social and political dimensions of development—poverty alleviation, social justice, political and civil liberties, popular participation, and decentralization—have been receiving more and more attention from the development community. Two recent publications have addressed the implications of a socially responsible development strategy for industrial and developing countries alike (UNDP 1990; World Bank 1990c). For the world community, new challenges lie ahead: to act on the findings of these and similar studies and measure performance such as the disparity between spending on education and health and spending on arms. Similarly, strategies will need to be designed and implemented to accelerate development for the most disadvantaged classes and communities—again, in many industrial countries as well as in the developing world.

The challenge of development is formidable indeed. No more important task confronts the human race. Enough has been learned, however, to justify some confidence about the future. The strategy outlined in this Report draws on this experience. The measures suggested are not a counsel of perfection. As many countries have shown, they are a workable program.

### **Tasks for global action**

This Report has stressed that favorable international conditions can make rapid economic development all the more possible. Industrial countries, with only one-fifth of the global population, account for four-fifths of world output, more than four-fifths of world trade, and almost all exports of capital and technology. Their effect on development grows as more developing countries turn outward. The prospects for global economic growth and rapid development will be strongly influenced by how industrial countries perform.

### *Global trade*

The world trading system is facing its biggest test in more than forty years. The global trade talks need to be revived, and the protectionism that has grown in recent years cut down. Quantitative barriers and subsidies in labor-intensive industries are particularly damaging to development: studies suggest that higher export earnings from ending these restrictions would exceed the value of average annual aid flows from OECD countries. Trade liberalization by OECD countries could roughly double developing-country exports of clothing and textiles. A 50 percent reduction in OECD agricultural protection could raise export revenues of developing countries by 2–40 percent. Commodity exporters would gain if the tilt in the industrial countries' protective structure against processed commodities were removed. OECD reforms in trade policy would have a significant positive effect on growth and employment in developing countries. They would also redirect some foreign investment to developing countries as investors lost sheltered domestic markets in industrial countries.

The stalemate in the global trade negotiations—coupled with growing regional linkages among the world's economies—may lead to new regional trading arrangements centered on Europe, Japan, and the United States. If these blocs fall into conflict, the world economy will lose much. At the same time, it may be easier to liberalize trade regionally rather than globally, and regional agreements may provide new momentum for liberalization worldwide. To be constructive, the regional arrangements need to be compatible with the GATT. They also need to be designed to create new opportunities for trade (through low internal and external barriers) without diverting trade away from partners outside the region (through large differences between internal and external barriers).

### *Capital flows and finance*

Despite encouraging signs, the problem of external debt continues to depress the prospects for the severely indebted countries. The Brady Initiative to reduce commercial debt and debt service marked an important departure, but so far it has produced results in only a handful of middle-income countries that have relatively strong economic prospects. Debt relief has been modest—on average much smaller than the market discount on

debt at the time negotiations were started. The Toronto plan to reduce bilateral official debt was another breakthrough. But even if Toronto terms were extended to all the official debt of the severely indebted low-income countries (excluding Nigeria), the remaining scheduled debt service would be more than twice the actual debt service paid in 1990. Thus these and new debt-reducing initiatives will need to be strengthened and supplemented in the new decade. In addition, the nonofficial debt of low-income countries remains to be addressed.

The agreements concluded so far have increased the debt exposure of the IMF and the World Bank relative to that of commercial banks. Because of the impact of the debt crisis on private sector lending to the developing world, bilateral and multilateral grants and loans will most likely contribute more than half of all resource flows to developing countries in the 1990s. An adequate volume of these flows is therefore crucial. The quality of these flows could be raised through increased coordination among aid and finance agencies; more effective support for market-oriented policy measures (providing greater support for fewer but more ambitious reforms); stronger emphasis on supporting private sector initiatives; greater attention to environmental policies; and features that "insure" debt-creating flows against price and interest rate volatility. When funds are channeled to finance imports (whether inputs or generalized balance of payments support), more fungibility will be needed. Tying aid funds to imports from particular countries greatly reduces their value; tying them to particular beneficiaries impedes the working of domestic market forces.

### *Economic policies*

Industrial and developing countries both benefit from an ample supply of world savings, from steady economic growth in the OECD countries, from sound financial markets, and from prices, exchange rates, and interest rates that are free from shocks induced by policy. Industrial-country policies to increase private and public savings can supply the capital for new investment opportunities worldwide—such as in Eastern Europe, in the Soviet Union, and for rebuilding the economies of the Middle East. Policies that promote steady growth in the OECD countries will be helpful to developing-country prospects for exports and growth. As suggested in Figure 8.1, the growth rates of industrial countries and developing coun-

tries track each other fairly well. At the same time, disciplined monetary expansion and firm prudential regulation of capital markets can in turn reduce the volatility of prices, exchange rates, and interest rates—all important for flows of international trade and capital and thus for the prospects of developing countries.

### Technology

The price of imported technology is likely to rise for most developing countries, as industrial countries seek greater returns from innovation in such important fields as information technology, biotechnology, and new materials technology. As enforcement of patents increases, the use of licensing agreements will rise. Nevertheless, more rapid technological diffusion can occur through international action. Critical steps include multilateral agreements on intellectual property rights through the GATT and the World Intellectual Property Organization; international agreements that ensure developing-country access to licenses for foreign innovation; and limits on restrictive licensing clauses that ban or restrict exports. Encouraging firms in industrial countries to form alliances with producers in developing countries can promote better access to established technologies and foster new products and materials that are adaptable worldwide.

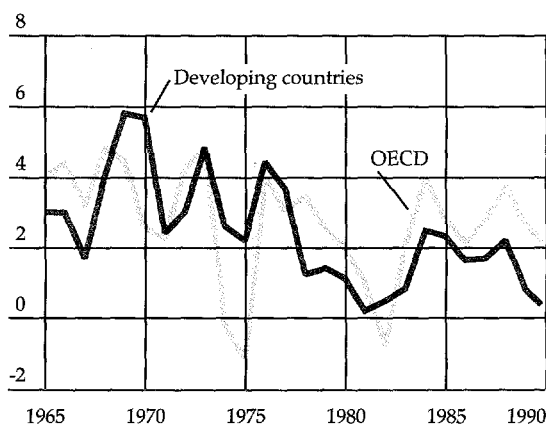
### The global environment

Stewardship of the global environment calls for bold leadership in both industrial and developing countries. The problems are unprecedented—they involve great uncertainty, risks of future catastrophe, and large distributional effects, both within and across countries. An international consensus will have to be forged and maintained on extremely controversial issues, including protection of the ozone layer and potential global warming. Need all countries share the burden of protecting the environment equally? Or might developing countries bear a smaller share of present costs because they contributed less to the stock of accumulated pollutants? International tensions could also intensify over environmental spillovers, as in the case of rivers shared by several countries (the Nile, for example, is essential to Egypt, Ethiopia, and Sudan).

The main priority worldwide is to establish incentives, regulations, and safeguards that lead to a proper allocation of resources for environmental

**Figure 8.1 The annual change in per capita GDP in OECD and developing countries, 1965-90**

(percent)



Source: World Bank data.

maintenance and energy conservation. Degradation of rivers in Eastern Europe and deforestation in Africa illustrate the dangers of poor or nonexistent environmental policies. Often, a first step is to eliminate subsidies for activities that harm the environment, including the colonization of forests that have poor soils and the excessive use of pesticides and fertilizer in agriculture. Removing such distortions improves economic efficiency (even as conventionally measured) while preserving the environment. If pollution is taxed and regulated, concern for environmental and energy conservation can be incorporated into public and private decisionmaking. It is also important to establish clear property rights: owners have a stake in preserving a resource. In some cases property rights can be vested in the state, with charges for the use of environmental resources, as in extractive reserves in the Amazon.

The global community is recognizing that economic development and environmental conservation need not be mutually exclusive: a wide range of environmental actions have high returns. They justify far stronger policies than those currently in force. International initiatives designed to support lending to protect the global commons—such as the new Global Environment Facility of the World Bank, the United Nations Development Programme, and the United Nations Environment

Programme—will be important in building an international consensus. *World Development Report 1992* will have the environment as its theme.

### Specific actions that work

Many of the problems countries face in the 1990s have been solved somewhere, somehow, during the last forty years. Experience can point to solu-

tions that are likely to work in the future. The strategy recommended in these pages is a practical one, grounded as securely in experience as in economic principles. Reforms can encounter difficulties of design and implementation (Box 8.1). But they have worked in various country contexts. To show that the lessons add up to a workable program, the Report concludes with examples of market-friendly reforms that have worked, and of

#### Box 8.1 For policymakers everywhere: seven lessons in reform

Successes provide the dos, failures the don'ts. The specifics of reform programs may vary across different regions and stages of development. But here are seven general pitfalls to be avoided—or, on the flip side, seven lessons for stronger efforts and better results.

- *Lack of ownership undercuts the program.* Programs initiated primarily because of the external financing that supported them, not because of conviction about their benefits, have often withered away for lack of government commitment to carrying them through. For a program to be viewed as a country's own, nationals need to participate in its design and development. Building an internal consensus is critical.

- *Flip-flops in reform hurt credibility.* Flexibility in policymaking is important. But when policies have been reversed capriciously—for example, when a tariff reform was soon followed by an import surcharge—the private sector has adopted a wait-and-see attitude. Rather than responding energetically to a new reform, private agents act tentatively, if at all. Flexibility is important, yet bold, seemingly irreversible steps by the government build confidence. They are especially needed in countries with a record of policy reversals.

- *Institutional demands must not be glossed over.* In many countries, ambitious changes could not be followed through because the country lacked trained personnel and adequate institutions—an independent judiciary, clearly defined and enforced property rights, and a strong central bank. Reform is a complex process of interwoven tasks, and there need to be mechanisms for interministerial coordination in order to carry them out. The development of institutional capacity needs to be emphasized from the outset, because institution-building takes time and results will not be immediate. In the meantime, it helps to implement actions that economize on scarce capabilities—such as deregulating domestic markets, liberalizing agricultural marketing, and removing quantitative restrictions.

- *Attention to macroeconomic instability is fundamental.* Continuing fiscal imbalances can derail reforms. Severe macroeconomic instability has caused more than one trade and financial liberalization program to fail. In highly inflationary settings, upfront and drastic reduc-

tion of the fiscal deficit is paramount. Many structural reforms can help: liberalizing agricultural marketing, switching from quantitative restrictions to tariffs, privatizing loss-making state enterprises, and improving tax administration.

- *Vulnerable people must not be forgotten.* The social costs of inaction are generally much larger than those of adjusting, but it is necessary to cushion the effect of adjustment on the most adversely affected groups. Cutbacks in public spending can hurt vulnerable groups. Reforms that allow agricultural prices to rise help poor farmers, but often hurt the rural landless and urban poor. Thus special programs of assistance to the poor are needed during the reform. Attention to politically powerful groups is also often necessary to sustain the changes. And programs to compensate and retrain discharged civil servants are often needed when the public sector retrenches.

- *Partial attempts often fail.* Partial efforts have been ineffective. When domestic deregulation did not accompany external liberalization, investment and output responded slowly. And when trade reform did not accompany domestic deregulation, investment went to the wrong sectors. When tariff reduction was not complemented by a broadening of the domestic tax base and a reduction in tax exemptions and subsidies, fiscal imbalances emerged, threatening the trade liberalization. There is thus a premium on simultaneously taking complementary actions.

- *It pays to be realistic.* Policymakers and external agencies need to be realistic in preparing the financing plan to support the reforms. Many countries may also need to reassign funds from low-priority to high-priority areas, for example, by switching some expenditures from the military to infrastructure and social programs. Realism also applies to expectations about what the reform is going to achieve. It pays not to promise too much too soon, yet to be loud and clear about the importance of reforming—and to contrast the outcome of reform with the alternative outcome of not reforming. Realistic expectations about the benefits and costs of the changes make the sustainability of the program more likely.

opportunities to make reform work again in the future.

#### *Investing in people*

Few policies promote development as powerfully as effective investment in human resources. An estimated 80 percent of the world's population lives in the developing countries—a proportion that is rising. Crucial issues in many of these countries include expanding primary education, alleviating poverty, and controlling population growth through better education, health care, and family planning. Opportunities exist to improve primary schools in Bangladesh, to reduce poverty in Bolivia through local action, and to fight poverty with population policies in the Sahel and elsewhere.

***Extending and improving primary education.*** Bangladesh has few resources except its people—much like Japan a hundred years ago. Yet more than two-thirds of its adults are illiterate, a consequence of historically low school enrollment. Primary school enrollment is currently only 59 percent (49 percent for females), and the quality of education is poor. Teachers are often inadequately trained and supervised; they spend relatively few hours with students and have insufficient classroom materials. Only one-quarter of those children who start primary school complete it. Recently, Bangladesh has developed a comprehensive reform program. It will provide new low-cost classrooms, an innovative curriculum for students who do not go beyond primary school, and new teacher training institutions. There will be more women teachers, and all teachers will have greater autonomy. These steps will receive considerable external support but will also require larger government expenditures. Although many resources must be committed to relief and reconstruction because of the recent cyclone, long-term investments in primary education remain crucial. To date, Bangladesh has spent only 1.7 percent of GNP on education (compared with 3 percent for the poorest fourth of developing countries as a group); furthermore, secondary and college education have claimed a large share of this budget.

***Alleviating poverty through local action.*** To protect the poor during the economic recovery of the mid-1980s, the government of Bolivia initiated an emergency social fund to finance small, technically simple projects formulated and implemented by a variety of public, private, and voluntary organizations. A new social investment fund, also responding to local requests, will extend coverage of health, education, and sanitation services to the poorest Bolivian communities. NGOs and local authorities will develop and implement projects under competitive bidding. In La Paz, for example, health

centers and water supply and sewerage facilities are being planned in neighborhoods of rural migrants. In high-poverty areas with no access to health and education services, established organizations will be encouraged to expand their activity in the underserved community. To minimize costs and ensure project sustainability, appraisal criteria will be rigorous, including economic analysis and recovery of operating costs if appropriate. Such community-based programs can address the current needs of the poor and encourage the institution-building that leads to sustained poverty reduction.

***Fighting poverty with population policies.*** In the Sahel, resources are thinly stretched. Even with much aid, there is too little for an adequate standard of living—and much too little to finance human and physical investments. Yet fertility rates are among the world's highest, and the population is growing ever faster (2.2 percent a year in the 1960s, 2.9 percent in 1987). Investments in human resources are thus inadequate: primary school enrollments are half as high as in the average low-income country. In parallel with development agencies, the governments of the Sahel need to act decisively to lower population growth. The scope for progress is great: the proportion of women using contraceptives is extremely low compared with such African countries as Botswana and Zimbabwe. Agency assistance for population control programs is likely to be available.

#### *Making markets work*

To promote efficiency in the domestic economy, governments need to strengthen price signals, deregulate markets, and upgrade infrastructural investments and key institutions. Opportunities include providing infrastructure in Nigeria, improving industrial markets in India, revitalizing financial markets in Ghana, and establishing a new legal framework in Hungary.

***Providing infrastructure.*** Poorly designed and maintained infrastructure has hindered growth in Nigeria. Firms have been forced into private provision, unproductive factor substitution, and output reduction. Telecommunications services are unacceptably poor, with one telephone line per 500 inhabitants (50 percent of the average for Sub-Saharan Africa); firms depend on private radios and messengers for basic communications. Many infrastructure deficiencies are the result of rapid population increases in urban centers and of inappropriate pricing policies. In Lagos, as the population grew by more than 3 million during two decades, water was freely provided; inadequate government financing prevented expansion of the service. National priorities include improving both the physical and communications

infrastructure as well as the financial planning and management of infrastructure projects. Nigeria is initiating a long-term venture to decentralize infrastructure services and to mobilize the private sector. Selected merchant banks are already working with state and local governments to reappraise, cofinance, and supervise urban infrastructural development. This will include rehabilitating and maintaining roads, water supply, solid waste disposal, and sanitation services. The national telecommunications network is being commercialized. Investments will be directed toward improving the utilization of facilities and expanding them in high-demand areas. These reforms will promote the expansion of output throughout the Nigerian economy.

**Improving industrial markets.** India's industry has never achieved its potential. Manufacturing accounts for a smaller share of GDP than in comparable countries. Along with highly protective trade policies, excessive regulation is to blame. Throughout the mid-1980s in many subsectors, an industrial license was required to establish a new plant, to expand output by more than 5 percent in a year or 25 percent in five years, to manufacture a new product, or to relocate. Plants remain uneconomically small, product mixes do not match demand, technical progress is slow, and capacity is underused. Recent experience with partial liberalization—including relaxation of restrictions against entry and expansion, and foreign technology diversification—has been positive. Excessive regulation remains. It includes barriers to adjustment and exit, and labor rules that protect a small number of privileged workers. Liberalizing trade would complement deregulation, lowering the overall cost structure and checking excessive profits in the monopolized sectors. These objectives will not be achieved easily because the government will have to overcome the opposition of protected enterprises and the regulatory bureaucracy. But past successes indicate that further deregulation could attract reasonable public support.

**Revitalizing financial markets.** Ghana needs to invigorate its financial sector. The country's remarkable 1983 Economic Recovery Program stabilized its economy and removed many structural distortions. But private investment is still only 6 percent of GDP. Credit has been an important constraint. Until 1989 the state-run banking system functioned under strict credit limits for reasons of macroeconomic stability. Sixty percent of the system's assets are nonperforming loans inherited from the crisis of the mid-1980s; this "credit" cannot be shifted to profitable projects. Poor performance has made bankers excessively risk-averse and encouraged large transfers of savings outside the banking system. Revitalized financial institutions and markets could go a long way toward providing capital for private investment.

This could be achieved by shifting monetary control to indirect methods and by clearing the banks' balance sheets. Permitting new kinds of instruments and financial intermediaries would promote the growth of competitive financial markets, encouraging bankers and producers to take advantage of the economic recovery.

**Establishing a new legal framework.** In Eastern Europe, Hungary has the most experience of markets and private ownership. Yet its legal system has many gaps. Most of the basic laws are recent: a company law (1989) provides for limited liability organization; a transformation act (amended in 1990) spells out how state companies are to be turned into joint-stock companies; and a securities act (1990) provides rules for the issuance of securities. Hungary has no act to determine rights over real estate, and there is no incentive to take companies to bankruptcy under current laws. Accounting practices differ from the West's (the country's outputs and inputs are not valued at market levels, which makes it nearly impossible to estimate enterprise assets). A new law in 1991 will require international accounting standards. An autonomous central bank is being introduced. Hungary needs experience with these new institutions. For example, an important public offering had to be halted recently because no clear provisions had been made for distributing shares when the offering was oversubscribed. To establish confidence, the stock exchange needs a track record, and the legal system a body of precedents. All this will take time. Hungary will need to train thousands of accountants, bank staff and regulators, lawyers, investment bankers, and others with related skills.

#### *Opening up to trade and technology*

Experience shows that policies for openness are crucial for rapid growth. Equally important are domestic efforts to improve the productivity of agricultural and manufacturing exports. The need to remain competitive is no less important for commodity exports than for manufacturing. Institutional reforms can also strengthen links with the global economy. Opportunities include liberalizing trade in Pakistan and building institutions for technological development in Thailand.

**Liberalizing trade.** Trade reform in Pakistan could invigorate industry and lift a long-standing constraint on growth—a shortage of foreign exchange that is caused by a persistent anti-export bias. Until recently, imports have been restricted by quotas and exports by product- and firm-specific output licensing. Thus Pakistan's exports still consist largely of primary commodities (cotton and rice) which have volatile prices and uncertain growth prospects. Trade reforms are urgently

needed to make exporting attractive relative to import substitution. Pakistan is now beginning such reforms. Under the first phase of its program, protection is being shifted from nontariff barriers to tariffs. Because many nominal protection rates will remain above 100 percent and the rate structure will remain highly dispersed, a sequence of tariff reductions will then be required to reduce protection and make the overall level of protection more neutral. Because import taxes are a large share of total tax revenues, domestic tax reforms are needed as well. A realistic exchange rate policy, coupled with fiscal and monetary discipline, is also needed to complete Pakistan's shift to an outward-looking strategy.

**Building institutions for technological development.** For countries such as Thailand that have established global links in a wide range of manufactured products, the next task is to strengthen technological linkages: to develop institutions that foster the absorption, adaptation, and diffusion of technology. Much of Thailand's technology trade is now conducted by subsidiaries of foreign firms; the country's capacities to absorb and generate technology have not yet caught up with its competitive trading position. Technological inflows could be strengthened by reducing duties on imported capital goods. Technology diffusion could be encouraged by eliminating the anti-subcontracting bias of tax policy. Externalities in the absorption and diffusion of technology, particularly in agriculture, also justify public investments in Thailand's technological capabilities. Government institutions and private providers that offer industrial extension (in technology search, assessment, negotiation, design) should be strengthened, and public research (in universities and other institutes) should be redirected toward commercial needs. Coherent systems of standards, testing, and certification also need to be developed. Finally, there are strong reasons to invest in human capital, especially in science and technology training, secondary education, and international exchanges in engineering and science.

#### *Fostering macroeconomic stability*

Low and stable inflation, which can only come from financial discipline in the public sector, is the best foundation for successful microeconomic reform. It enables prices to do their job as signals for resource allocation, and it strengthens the incentives for saving and investment. Examples of stabilization are Indonesia and Mexico.

**Stabilization as a prelude to growth: Indonesia.** In 1967 Indonesia's Suharto government inherited an extensively nationalized, highly regulated, unstable economy. It gradually rationalized economic management during the next fifteen years, but strong

economic growth came mainly from rising oil revenues. After 1983, spurred by declining oil prices, Indonesia has implemented ambitious adjustment measures and policy reforms.

Macroeconomic reforms in 1983 focused on devaluation, the reduction of the government's investment program, tax reforms, and deregulation of interest rates. There was a second major devaluation in 1986 and a new, flexible exchange rate management program in 1989. Microeconomic reforms began with bank deregulation and some liberalization of foreign investment. Starting in 1986, the authorities streamlined the investment-approval process; the Investment Priority List was later replaced by a short negative list. The government also deregulated key industries such as plastics and shipping. Trade policies also needed reform: the import-licensing system had put restrictions on more than 1,500 categories. In 1985, customs administration was contracted to a Swiss surveillance company, and dismantling of quantitative barriers began in 1986. Within two years the share of imports subject to controls fell from 43 to 21 percent.

The early phases of adjustment, which concentrated on macroeconomic stabilization, dampened economic activity, but growth was strong by 1987. Indonesia grew by nearly 7 percent in 1989, and investment recovered. Non-oil exports paid for 86 percent of imports, compared with 29 percent in 1981-82. A former minister who oversaw the reforms attributes their success to the extended period of weakness in oil prices which forced the government to pursue a consistent policy that eventually won popular support.

**Stabilization as the prelude to growth: Mexico.** In the 1960s, Mexico grew rapidly under the early stages of an import substitution strategy. By 1976, it faced large fiscal and balance of payments deficits and worsening inflation. These troubles receded with large discoveries of oil and heavy external borrowing. But within a few years Mexico's debt more than quintupled, setting the stage for the collapse of credit and the sharp economic decline of 1982-83.

Mexico has turned the corner on these difficulties. Macroeconomic reforms began in 1983, when an IMF-supported stabilization program halved the fiscal deficit. By 1987, however, inflation was rising again because of declining oil prices, rising interest payments, and a rapidly expanding fiscal deficit. The government responded by negotiating an "Economic Solidarity" pact with labor, farming, and business interests in order to contain basic prices and wages, and by adopting forceful fiscal and exchange rate reforms. As a result, between 1987 and 1989 the fiscal deficit declined from 16 to 3 percent of GDP, and the annual inflation rate from 159 to 20 percent.



Microeconomic reforms have concentrated on reducing government involvement in the economy. The number of SOEs has been reduced from 1,100 in 1982 to 350 in 1990 through mergers, liquidations, and sales; the huge state telephone and steel monopolies are also scheduled for sale. Recently, the government deregulated large, politically sensitive industries such as tortilla manufacturing and trucking; liberalized key prices; and has begun to restructure ownership rights in agriculture and to reprivatize banking. Major external-sector reforms began in 1985. Mexico acceded to the GATT, eliminated more than three-quarters of its import-license restrictions, lowered average tariffs by half, developed favorable regulations for export processing, and substantially reduced export taxes and restrictions on fruits and vegetables. By 1987, exports of manufactures overtook oil exports. The rules governing foreign investment were substantially liberalized in 1989; negotiations continue on a free trade agreement with the United States.

The reforms are beginning to bear fruit. GDP growth climbed into the 2–4 percent range in 1989 and 1990 and is projected to rise to 5 percent in 1991. Inflation is under control and real wages, which had fallen by more than 40 percent in the 1980s, are growing. The strategy of reform was shaped by Mexico's broadly based, single-party system. Relatively conservative policies were followed, but the burden of adjustment was distributed across different economic groups. Mexico's close relations with the United States also helped by increasing the return from outward orientation and by facilitating the renegotiation of Mexico's staggering debt.

#### *Environmental policies*

Water pollution and land degradation have grave local consequences. Deforestation and air pollution have effects worldwide. These and other problems need to be addressed through more effective policies. Issues include reducing water pollution in Indonesia and preserving the Amazon rainforests.

**Reducing water pollution.** In Indonesia, worsening water pollution has been caused by neglect of the environment during economic growth. Only 40 percent of Java's population has access to safe water; the eight major rivers on the northern coast are seriously polluted; and groundwater withdrawal has caused saline intrusion into the aquifers that provide water for domestic use. In Jakarta it costs \$20–\$30 million a year simply to boil water for home use. Costs associated with illness and with reduced property values, although unquantified, are undoubtedly high. With urban and industrial uses of water expected to grow at rapid rates, large shortages are forecast within a decade or so. Solutions

involve systematic attention to efficiency (40 percent of municipal water is "lost"), stiff fines for polluters, and appropriate fees for irrigation (farmers now pay for only 13 percent of irrigation costs). Indonesia has been slow to address these problems because the mechanisms of water resource administration are still evolving. Autonomous river basin authorities could provide a better framework for planning, coordination, and monitoring. Clean water will not come cheap; it is estimated that \$1 billion will be needed to meet the water supply needs of Jakarta alone.

**Preserving the global commons.** The Amazon rainforests of Brazil, Colombia, Ecuador, and Peru are a world resource—a symbol of the global environmental challenges of the 1990s. Thirty thousand species of plants live in the rainforests. But the Amazon's deforested area has grown from 1 percent in 1975 to 8 percent in 1990. It is now larger than France. The entire world is threatened by the loss of biodiversity and increased carbon emissions. In Brazil, deforestation was encouraged because of massive road building in the Amazon, tax incentives, and demographic pressures. Much new action is needed to discourage nutrient mining—the one-time extraction of the nutrients of the forest canopy and soil—and to encourage sustainable, forest-based activities. Road construction needs to be evaluated in terms of global as well as local costs and benefits. Strong agroecological zoning can establish large, protected reserves and prevent the granting of titles on poor soils. Initiatives in this direction are currently mired in complex local politics. Compensation will be required to create incentives for local action, to relieve the financial burden on poor farmers, and to offset the opposition of ranching and logging interests. Because benefits will accrue worldwide, international support will be both necessary and appropriate.

#### *Implications of good policies*

What would happen if the world community implemented policies in the spirit of those outlined above? No one can know for sure, but some broad estimates are possible based on the projections of several country models at the World Bank, which assess long-term growth under different assumptions about country policies and international conditions. These models reflect a wide range of country-specific data and assumptions. Their results need to be interpreted cautiously, but nevertheless provide illustrative magnitudes for the changes that are possible.

The results suggest the importance of both the global context and domestic action for long-term growth (Table 8.1). The global economic climate

**Table 8.1 Changes in GDP growth rates relative to the central case, 1990–2000**  
(percentage deviation)

Domestic policies	Global economic climate		
	Poor	Good	Very good
Very good	1.0	1.5	2.0
Good	-1.0	Central case	0.5
Poor	-3.0	-2.0	-1.0

Note: The changes in the growth rate given in each cell are unweighted deviations from the "central case." The figures are rounded.

Source: World Bank data; see the technical note at the end of the main text.

makes a difference. Compared with the baseline scenario (a good global economic climate), favorable external conditions could raise growth by 0.5–1 percentage point a year. This is significant. The variation in growth rates attributed to different domestic actions could be even larger. Holding the global situation constant, the difference between good and poor domestic policies would yield on average 1.5–2 percentage points growth per year—on average, about twice the improvement from better external conditions. Given the uncertainty about the quality of the global economy, countries that can adapt their domestic policies flexibly to changing circumstances will be at a great advantage. Even if global conditions are inhospitable, the reward for good domestic policies is very high.

What are the long-term implications of these projections? Holding the external context fixed to its baseline path, the projections say that the difference between poor and very good policies is worth, on average, 3.5 percentage points of

growth a year. After ten years, with compounding, a country with very good policies would be more than 40 percent better off than another that started with the same income but pursued poor policies. If that growth advantage were sustained, the first country would have twice the income of the second after twenty years—which would make a crucial difference in poverty reduction.

### A global challenge

In the time it takes to read this paragraph, roughly a hundred children will be born—six in industrial countries and ninety-four in developing countries. Here lies the global challenge. No matter what the outlook in the industrial economies, the world's long-term prosperity and security—by sheer force of numbers—depend on development.

Development is better understood today than before. The institutions of market economies have proven more complex than the textbooks suggest, especially when interactions with political, social, and environmental processes are taken into account. Nonetheless, sound general principles have emerged to guide policy.

Despite the uncertain outlook for the 1990s, a measure of optimism is justified now that more and more countries are opting for a market-friendly approach. With strong international cooperation, the opportunities for development will be brighter. There is more agreement today than at any time in recent history about what needs to be done and how to do it. What remains is to put these ideas into practice everywhere.