The Lessons of the Eighties for Development

Ernest Stern
The World Bank, Washington, D.C.

SUMMARY: *Many LDCs development strategies of the 1960s and 1970s fell apart when capital inflows dwindled, real interest rates became positive, and growth in the industrial countries slipped. Out of the hardship came three valuable lessons: (1) the necessity of sustained adjustment, in demand management (including increasing efficiency of public expenditures), of improving the price mechanism and the supply response, and of reducing protection, (2) the need to do a better job af managing natural resources and developing human resources, and (3) the need of closer coordination of aid and official flows. Progress in these three areas lays the basis for optimism about the decade ahead.*

The 1980s has been the most difficult development decade since the war.

The steady upward progress in per capita income, a feature of the 1960s and 70s, faltered in the face of slow growth in world trade and of high real interest rates on accumulated debt. But despite the manifold difficulties, and indeed the human suffering, these have been hard years, but not lost ones for development. In fact, significant progress has been made towards a more efficient development process.

Developing country policies have matured, and industrial countries are learning the importance of keeping markets open and growing and of improving the quality of their official assistance. Out of the hardship have come three valuable lessons for development: the necessity of sustained adjustment, the primacy of better management of human and natural resources and the benefits of coordinating aid. From those foundations, the work of renewed development is gaining fresh momentum.

The problems we have seen in the eighties grew from roots in previous decades. What is now called a debt crisis is but the financial manifestation of a development crisis, one that affects highly indebted and other countries alike. The development strategies of the 1960s and 1970s were essentially unsustainable. They relied on a role for the state which, in many countries, but particularly in Africa, was far beyond the capacity of the available institutions or manpower. Relying on domestic markets too small to generate efficient industries, the strategies embraced an increasing number of social objectives and sought to finance these goals through subsidies which seriously distorted the incentive systems.

Speech to the Danish Economic Association, January 12, 1989.

The Lessons of the Eighties for Development

Ernest Stern
The World Bank, Washington, D.C.

SUMMARY: *Many LDCs development strategies of the 1960s and 1970s fell apart when capital inflows dwindled, real interest rates became positive, and growth in the industrial countries slipped. Out of the hardship came three valuable lessons: (1) the necessity of sustained adjustment, in demand management (including increasing efficiency of public expenditures), of improving the price mechanism and the supply response, and of reducing protection, (2) the need to do a better job af managing natural resources and developing human resources, and (3) the need of closer coordination of aid and official flows. Progress in these three areas lays the basis for optimism about the decade ahead.*

The 1980s has been the most difficult development decade since the war.

The steady upward progress in per capita income, a feature of the 1960s and 70s, faltered in the face of slow growth in world trade and of high real interest rates on accumulated debt. But despite the manifold difficulties, and indeed the human suffering, these have been hard years, but not lost ones for development. In fact, significant progress has been made towards a more efficient development process.

Developing country policies have matured, and industrial countries are learning the importance of keeping markets open and growing and of improving the quality of their official assistance. Out of the hardship have come three valuable lessons for development: the necessity of sustained adjustment, the primacy of better management of human and natural resources and the benefits of coordinating aid. From those foundations, the work of renewed development is gaining fresh momentum.

The problems we have seen in the eighties grew from roots in previous decades. What is now called a debt crisis is but the financial manifestation of a development crisis, one that affects highly indebted and other countries alike. The development strategies of the 1960s and 1970s were essentially unsustainable. They relied on a role for the state which, in many countries, but particularly in Africa, was far beyond the capacity of the available institutions or manpower. Relying on domestic markets too small to generate efficient industries, the strategies embraced an increasing number of social objectives and sought to finance these goals through subsidies which seriously distorted the incentive systems.

Speech to the Danish Economic Association, January 12, 1989.

Turning away from agriculture – the sector where most people, and most of the poor, made their living – the strategies were also anti-export. They increased dependence on external capital and avoided competitive pressures on protected domestic industries.

The combination of high commodity prices in the mid-seventies, highly liquid lenders and increased aid led to an explosive growth of capital flows to the developing countries, sustaining them in their policy course. Most of these countries used their access to borrowed funds to expand public spending both for new investment and for public consumption. Too many public investments, however, were prestige projects which, to survive, subsequently had to be highly protected at the cost of sharply expanding the scope of the price distortions. But the ready availability of capital obscured the effects of high cost production and reduced competitiveness. Official lenders like the World Bank and the IMF carried little weight in an environment where countries could simply say: »Fine, we'll do this without you.«

In an improbable world where industrial countries would grow at 3 or 4 percent a year forever, where there would be no cyclical downturns, and where world trade would increase at 5 to 8 percent a year, and real interest rates on long-term loans would be zero or negative, disaster might have been averted. In the real world it was inevitable.

Growth in the industrial countries slipped to an average of 2.4 percent a year in 1980-85, compared with 2.8 percent in 1973-80 and 4.7 percent in 1965-73. Prices of primary commodities which constitute the bulk of exports for most developing countries fell steeply and continously in real terms, reaching a post-World War low in 1986-87. Real interest rates, which had been negative in much of the 1970s turned sharply positive, raising the cost of carrying non-concessional debt. And economic management became immensely complicated by the volatility of exchange rates among the major trading currencies.

These changes in the world economic environment, and the attendant reduction in the growth of external capital flows, unveiled the inefficient domestic economic structures of many of the developing countries *and* the weakness of their institutions. The reduction in available external savings, together with the high cost of servicing previously borrowed funds, made it impossible to sustain previous consumption levels and investment patterns.

Foreordained, but not really forecast, both the depth of developing-world problems in the eighties and the time required to return to sustained growth caught all observers unprepared. A few figures bring the point home: in 1987 African exports were 74 percent of their 1980 level; per capita GDP of African countries fell by two percent a year between 1980 and 1985; in 1988, real per capital income in Latin America was still some six percent below the level achieved in 1980.

Of course, there were important exceptions, especially in Asia. The Korean miracle continued. India broke out of its historical low-growth pattern and made solid progress, and China managed both to reform its economy and grow rapidly. Impressive develop-

ment programs were mounted in Thailand and Indonesia. Turkey and Chile demonstrated that expanded growth, debt service and adjustment policies are *not* incompatible.

But in other countries in Latin America, Africa and Eastern Europe, the economic difficulties have continued and adjustment programs have been inadequate. Despite these continuing problems, there remains ground for optimism. Important lessons have been learned, and steps have been taken in the past few years which open the possibility of significant advances in the decade ahead.

The need for adjustment meausures

The first and most important of these lessons is that *adjustment measures are needed, are long overdue and must be sustained for extended periods. Moreover, these measures work.* In 1980 the World Bank introduced the concept of economic adjustment and pioneered lending in support of it. Frankly, the initial response to the Bank's call for adjustment was lukewarm. Borrowers and creditors alike thought the problems were temporary. Even after Mexico suspended payments in 1982 the structural nature of the problem was neither understood nor accepted.

As the years passed, however, policymakers have increasingly accepted that domestic economies have to be restructured to deal with the world as it is and as it is constantly changing. Volatility requires greater flexibility in economic management; reduced availability of external capital requires more domestic savings; increasing exports requires competitive industries and agriculture and hence incentives for modernization. We have seen a steady rise in the number of countries which have designed and are implementing adjustment programs. They now number 58, and the World Bank group has supported their efforts with 156 loans totalling $21 billion.

The World Bank uses a range of lending instruments to support adjustment programs in countries willing to undertake economic reforms. We work with the governments concerned to identify the particular components of the reform package and gear the lending activities to support these elements. We also work with aid donors and other lenders to ensure that those programs are properly financed.

It is important to recognize that for these countries, adjustment is inevitable. The debt crisis did *not* create this need, though debt problems make action more urgent. Basically, because the development strategies and macro-economic imbalances are not sustainable, countries have to shift resources into the production of tradeable goods and to reduce the share of consumption. The only choice is whether adjustment will take place in a disorderly way – the Peruvian example – or through a carefully thought-out program, as in Bolivia and Ghana. The evidence is that a well-planned adjustment program can minimize the social costs of the process and speed up the return to growth and development.

While adjustment programs differ from country to country, they have a number of common features. The first element and the one most commonly identified with adjust-

ment is *demand management* since the impetus for adjustment usually derives from rising inflation and mounting arrears in domestic and international payments, getting the macro-economic situation under control is a first, necessary step in the adjustment process.

Demand managment is of course the major focus of IMF-supported programs. The World Bank's role is to go behind the basic aggregates – government revenues, expenditures, credit, exports, imports, capital flows – to try to deal with the underlying reason why the balances are out of line.

Without such diagnosis and consequent remedial action, there is a very great risk that once conditions improve and financing picks up, unchanged practices will bring back the old problems, especially in public expenditures. Accordingly, one Bank objective has been to assist governments in increasing the efficiency of their social sector expenditures. For instance, almost everywhere, education is very expensive per student because it emphasizes secondary and higher education at the expense of primary. We believe that most countries with the current level of outlays can educate more people and educate them better.

We have also tried to help governments design their systems to recover a greater share of the costs of services from those who can afford to pay. In many developing countries the largest subsidies in the health sector, for example, go to patients of elite urban hospitals, not to the users of rural health clinics.

Recognizing that the general efficiency of capital use in the public sector in many countries has been disastrously low, the Bank also has undertaken major public investment reviews to help countries identify inappropriate and inefficient projects. These reviews also help to establish a better balance between new investment and maintenance. Building new roads makes little sense if existing roads cannot be maintained; adding electric generating capacity makes little sense if existing plant operates at only 70 percent or less of capacity; and building new maternal and child health centers makes little sense, if nurses are not trained and medicines not provided. Sadly, there are many examples of precisely such practices, often supported by donors.

A second key area of adjustment is *price reform*, especially to try to correct the pervasive bias against agricultural production. In many developing countries, particularly in Africa and Asia with large smallholder populations, higher agricultural prices generally benefit the poorest sections of the population. They also provide incentives for modernization, increased production and exports or import savings.

One of the impressive results of adjustment has been the responsiveness of small farmers to improved incentives, whether for cocoa in Ghana or maize in Malawi. There is ample evidence that given appropriate incentives, farmers will increase their use of agricultural inputs and shift into crops with higher relative prices.

The other side of the price reform coin is the need to bring down high rates of effective protection against the flow of manufactured goods. In this regard, the achievement has

been quite remarkable. Led by Mexico, a large number of developing countries have lowered protection despite the enormous political difficulties of doing so, familiar obstacles in industrialized and developing countries alike. While the owners and workers of highly protected enterprises have been major impediments not just to lower protection but to adjustment as a whole, success in reducing protection in developing countries represents a valuable lesson in the political economy of policy reform.

The efforts have begun with the removal of non-tariff barriers and their substitution by admittedly high rates of tariffs. The second step is to move towards more uniform rates of effective protection by lowering some of the highest rates. The third step is to bring down the entire structure of rates. Surprisingly, reduced levels of protection have not resulted in wholesale bankruptcies and layoffs. Much more often, rents have dropped and competitiveness has risen. The private sector in many developing countries has shown unsuspected capacity to move into new areas of production, improve the quality of output and gradually transform its efficiency and productivity.

A third aspect of price reform is the elimination of controls over a wide range of products and services, tackling two very clear, unhealthy by-products of price controls: they breed corruption and bring *harm* to the poor and benefit to the rich. Artificially, cheap interest rates mean a shortage of capital, and when capital is scarce, it is *not* the small farmer who has access; when energy is supplied at a fraction of the world market price, tremendous amounts of capital are consumed to keep up with demand – a demand principally driven by industries which sell their product at market prices and pocket the subsidies. Utilities, of course, do not earn enough money to build up rural distribution networks.

In addition to macro-economic stability and efficient pricing signals, adjustment programs have also included the *institutional improvements and investments needed to generate a supply response.* Bank Group efforts and support have emphasized improving the performance of public enterprises in order to rewrite one of the saddest chapters in the whole development story of the late-seventies and early-eighties. Loading these enterprises with extraneous objectives, employment creation, regional development and so on, governments have not permitted them to get on with the job of efficient production. In one country after another, the result has been that enterprises cannot even cover their operating expenses. They become a tremendous drain on the public budget.

While it takes time to turn this situation around, the evidence is that it can be done. Governments have sought World Bank advice in deciding which enterprises to close, which to restructure and operate in the public sector, and which to sell off to private operators. In countries as contrasting as Mexico and Togo, these enterprises are being turned from a drain on the economy to a positive contribution to development. My

favorite example of what can be achieved through opening up a sector to private competition is in Niger where private traders have been allowed to compete with the public food importing agency. Not only did prices fall and foodstuffs become more widely available, but the state enterprise improved its performance and made a profit for the first time.

The final and much-debated area of adjustment to examine is the *impact on the poor.* On one side, the argument goes that successful adjustment will restore growth and, other things being equal, should result over time in greater poverty reduction than would occur without adjustment measures. On the other side it is pointed out that in the near term, macro-economic adjustment has often involved a reduction in consumption in relation to GDP or even in absolute terms. Morover, actions to reduce fiscal deficits are likely to put pressures on the outlays of most importance to the poor. While not inevitable, such cuts often happen in practice.

In fact, both sides are right. Planned and orderly adjustment programs are a *sine qua non* for restoring rapid growth; without resumed growth, poverty will persist. At the same time, planned and orderly adjustment can and should encompass targeted measures to protect the poor. The governments of Ghana and Bolivia, with support from the Bank and donor governments, have undertaken important programs to protect workers laid off from previously protected industries and others who might be adversely affected by adjustment measures. Social services to the poor can be protected through efficiency measures; subsidies can be targeted much more effectively on vulnerable groups. Protecting the lower income groups is not inconsistent with adjustment, but it will not happen unless governments make it an explicit component of their adjustment programs.

Adjustment programs are comprehensive. They affect every area of the economy. The question is do they work? The positive evidence is only just starting to come in.

In the early stages we in the Bank overestimated the rapidity with which countries would get results. We have since found that the response capacity of both the private and public sectors is limited. It takes time to strengthen the institutions, the financial system, the supporting infrastructure, so that the right kinds of goods and services can be produced.

Moreover, the political aspects of the adjustment effort cannot be underestimated. The changes in development strategy involved challenging 20 years or more of practice. The conviction that past strategies are unsustainable is neither instantaneous nor universal. And major political forces have benefited from past practices. Among them are the officials who controlled licenses, prices and supplies; the industrialists who made large profits behind high levels of protection; the industrial unions who staffed inefficient enterprises. These, and others, tended to oppose policy changes which threatened increased efficiency, more competition and the end of monopolies. Not only did these

pressures often make implementation slow and imperfect, but not all countries which initiated adjustment programs were able to sustain them. Programs were abandoned in Yugoslavia and Panama, in Zambia and the Ivory Coast.

Nonetheless, we are seeing results. In Turkey and Chile adjustment programs have been sustained, exports have grown, investment has resumed – as has growth. In Morocco and Tunisia major restructuring efforts have laid the foundation for a resumption of growth. And even in Africa adjustment efforts are starting to yield progress. A recent analysis which compared the adjusting countries of Africa with those which have no adjustment programs shows that while both groups had a GDP growth of less than 1 percent in 1981-84, those with such programs grew by 3.8 percent in 1985-87 while those without adjustment programs grew by 1.8 percent. For the reformers investment began to grow in 1985-87 by five percent per year while in the non-adjusting countries it continued to decline. After declines in real per capita consumption in both groups in 1981-84, that of the adjusting countries grew modestly in 1985-87 – by 0,5 percent – while it continued to decline in the non-adjusting countries. Exports grew by over five percent per annum in the adjusting countries, while it continued to decline at almost the same rate in the non-adjusting countries, *even though* their export prices improved while those of the adjusting countries did not.

The evidence is not complete and it is, as always, hard to isolate the causes of such results. There is certainly no cause for complacency. But neither is there much basis for arguing that the changes in development policies, if sustained over time, do not improve prospects for growth.

One final point about adjustment. It is significant that until the Bank became involved, no institution reviewed economic management from a structural perspective. Some of the changes now being implemented sound so basic as to be mere common sense. Yet the Bank, and all the donors, proceeded in the belief that development finance was project financing; that sound project design could assure results regardless of economic policies and management; and that, somehow, structural, sectoral or macro-economic conditions were inappropriate issues to deal with in providing development financing. We were wrong and in our tolerance contributed to much damage. It is important that we continue to refine our understanding of the adjustment process and that even when the debt problem is history, we not give up our interest in economy-wide issues, since a sound incentive framework is essential to effective aid, regardless of its form.

Natural and human resources

A second lesson from our experience is that while our focus needs to be on adjustment, we cannot any longer neglect *the need to do at better job of managing natural resources and developing human resources.* The 1980s have been a difficult time to maintain government allocations for expenditures on some of the longer term sustainable development pro-

grams. It is now obvious that developing countries are facing simply enormous environmental problems, particularly in the areas of deforestation, desertification and urban pollution. The efforts made in the industrial countries and initiatives such as the Brundtland commission have brought a great increase in both environmental awareness and in acknowledging the interdependence of these issues among industrial and developing countries.

The missing component in the past has been recognition by the developing countries themselves that these problems require urgent action. Their attitude is changing. At the government level there is increasing realization of the cost of inadequate attention to environmental issues. In India, the Philippines, and China, for example, indiscriminate logging and failure to protect upland watershed has contributed to siltation of dams, downstream flooding and soil erosion. Failure to consider wastewater treatment requirements at the project-planning and siting stage has led to much more costly clean-up later on. Among the most exciting developments has been the increasing influence and role of domestic public opinion in developing countries such as India and Thailand and the growth of non-governmental organizations lobbying for clean air and water and biological preservation.

Recognition of the problem and commitment to doing something about it, however, are only part of the issue. Not only do the interventions needed to protect the environment range across a number of different areas; they are also difficult to implement and manage. Understandably impatient, many of the critics in the industrial countries often fail to take into account how difficult these programs are.

Deforestation in Nepal, for example, is an enormous problem leading to erosion, loss of agricultural land and silting of rivers and dams. In 1987 the government embarked on an intensive campaign to heighten public awareness of the need to reverse the trend of deforestation. In line with its policy of decentralization, it has shifted responsibility for promoting reforestation and other forest management activities to the district and community levels. Legislation has been enacted to permit the communities to retain the revenue obtained from the sale of forest products. Incentives for management of private forests have also been improved. These efforts have been supported by a number of community forest projects which provide financing for local communities to purchase more seedlings and to strengthen programs and forest management. So the program includes public information, legislative changes, improved incentives, building of institutions and appropriate supporting investments. It requires a complex interaction of these components and inevitably needs to be started on a limited but replicable basis. Realistically, it will take considerable time before it can be extended to the country as a whole, but that does not make the prospects bleak, only distant. It would be easy simply to throw money at the problem, but, to be a success, such a complex program needs careful design and implementation.

And coordination

The third lesson to be drawn from the setbacks of the 1980s is that we can substantially improve the quality of donor efforts to assist development, by *closer coordination of aid and official flows*. The uncoordinated assistance of the 1970s was often more the product of pressures in the industrial countries from exporters, than a response to the needs of borrowing countries. As a consequence, all lenders – not just those who were pushing low-priority projects – have seen defaults or rescheduling of their loans.

The recognition that coordination of effort is likely to make us all better off has begun to sink in, and the international community is gradually developing a number of collective-action instruments. The number of consultative groups, sector meetings and consortia chaired by the World Bank has increased from ten in 1981 to 45 in 1988. UNDP has instituted a series of country Round Tables. The IMF and the World Bank are collaborating in assisting governments of low-income countries to prepare Policy Framework Papers as a basis for IMF and IDA adjustment lending. The Paris Club has spearheaded a major easing of the terms of outstanding debt to borrowers. The World Bank's numerous assessments of public investment programs are made available to other donors and lenders to provide guidance on sectoral and project priorities.

Aid coordination is proving especially important and effective in the field of adjustment, where the proper level of funding is critical to success. At the same time, adjustment funding must be closely associated with agreed policy changes if the external resources provided are not to end up simply in a temporary consumption subsidy. In May 1985, the Special Facility for Africa was established to help finance structural and sectoral adjustment programs and rehabilitation projects in 25 low-income African countries. Between 1986 and 1988, this facility mobilized approximately one billion SDRs in direct contributions plus a further 600 million SDR in bilateral co-financing of adjustment programs. This mechanism was extended through the development in 1987 of the Special Program of Assistance for low-income debt-distressed countries in Africa which are undertaking adjustment. In this program, donor co-financing of IDA adjustment credits acts as a mechanism to mobilize resources in the amounts and at the time needed for funding the progress of reform. Representing a substantial shift in donor funding towards support for adjustment, the program has evolved to bring greater uniformity to donor policies on issues such as untieing of assistance, procurement and disbursement procedures and to ease the administrative burden on recipient countries of different donor practices. Since its establishment in late 1987, 20 bilateral and multilateral donors have pledged $2.2 billion to supplement IDA adjustment credits in 19 low-income African countries.

This linking of bilateral funds through co-financing to multilateral projects will be increasingly important in the future. It preserves some politically important features of bilateral aid, by retaining for the donor the choice of which operation to support in which

country and at what level, and also keeps the label and thus the recipient's recognition of the source of the assistance. On the other hand, it provides assurance that the project has been vetted by a multilateral agency, that adequate financing will be available and that it will be supervised as part of an ongoing program.

These three areas – adjustment programs, sustainable development and aid coordination – are the core around which Bank country assistance programs are being built.

First, we have greatly expanded our lending for adjustment: it is now 25 percent overall and 40 percent of our lending for Africa. At the same time, we have continued the traditional business of the Bank, supporting well-designed and appraised investment projects, adapting, as a development agency should, to the changing needs of our borrowers. The bulk of our lending is still for investment, though it is often now for maintaining existing investments or for balancing and modernization of capacity rather than increasing it. But we and our borrowers have learned that efficiency cannot be achieved in isolation from the overall policy framework and the capatity of institutions

Second, we have undertaken a major expansion of our activities in the environmental field. In 1987 the Bank established a central environmental department as well as four regional environmental divisions. It is our goal not only to be able to review *every* Bank project early on for its environmental impact but to make national environmental problems an integral part of our country strategies.

Third, we see aid coordination as a key responsibility of the Bank group and will continue to expand our activities in this area.

The progress being achieved in these three areas – effective adjustment measures, programs for sustainable development and improved aid coordination – lays the basis for optimism about the decade ahead. We have seen an extraordinary turn-around in the willingness of many developing country governments – from Mexico to Togo to Morocco – to put their own house in order. Whether their efforts will yield higher growth rates in the decade ahead, however, will depend in large part on the support they receive from the industrial countries, most importantly, the latter's willingness of the industrial countries to keep their markets open and growing for developing country exports.

Another element of the support is the willingness of the industrial countries to provide needed external capital, both on concessional and commercial terms and from both official aid and the private sector. Earlier in the decade, some could justifiably doubt whether external capital would be well used. In some countries the flows simply delayed adjustment, while in others inefficient projects persisted with help from donors or foreign financiers.

Now, however, the skeptics should be silenced. The evidence is that many developing countries have taken bold and dramatic measures at great political cost. The challenge is now for the industrial countries to provide the support which is needed if these measures are to result in higher living standards and reduced poverty in the developing world.

Performance indicators for IDA Recipients in Africa[a].

	Countries with Strong Adjustment Programs		Countries with weak or no Adjustment Programs	
	1981-84	1985-87	1981-84	1985-87
External Economic Indicators				
Merchandise export prices (% change/yr.)	-2.6	-1.3	-3.5	0.2
Growth of merchandise export earnings	-2.8	5.4	-3.3	-4.5
Growth of total import volume	-6.4	3.6	-4.2	-2.3
Policy Reform Indicators				
Total government expenditure/ GDP (%)[b]	31.4	31.3	28.7	29.8
Fiscal deficit /GDP (%)[b]	8.9	7.0	8.1	9.5
Revenue/GDP (%)[b]	22.5	24.5	20.6	20.3
Of which grants	4.5	5.8	4.0	4.2
Consumer prices (% change/yr,)	23.5	17.0	16.1	32.3
Economic Performance Indicators				
Growth of GDP (constant 1980 prices)	0.7	3.8	0.5	1.8
Gross domestic investment/ GDP (%)	18.3	17.1	16.7	14.9
Growth of real investment (% change/yr.)	-3.3	5.3	-6.2	-3.4
Gross domestic savings/GDP (%)	6.3	7.1	2.8	6.1
Growth of real per capita consumption (% change/yr.)	-2.0	0.3	-3.2	-1.8

Notes: ([a])Country coverage varies by indicator depending on available data over the entire period covered. Averages are unweighted. ([b])Includes grants.
Source: World Bank, AFTTF.