The recession that has afflicted the world economy since 1980 seems at last to be easing. But the economic conditions of many developing countries have worsened since the last World Development Report was published. Many middle-income countries have faced a greater liquidity crisis than was expected, brought on by high interest rates and reduced demand for exports. Low-income countries dependent on the export of raw materials have suffered from historically low commodity prices in real terms.

The developing countries' present difficulties are the culmination of events dating back a decade or more. They are a consequence partly of conditions in the industrial market economies and partly of their own policies. Part I of this Report underlines the increased interdependence of all countries brought about by the increase in trade and capital flows, and looks ahead to how the world economy might evolve during the next decade. Part II discusses how developing countries have managed their development efforts, and how these might be improved. Chapter 12 sets out concluding themes which should be read in conjunction with this overview.

The 1980–82 recession

The recession of the past three years was no simple repetition of the mid-1970s (see Table 1.1). Following the jump in oil prices in 1973, GDP growth rates in the industrial economies fell sharply for two years and then recovered rapidly in 1976, although in the three subsequent years growth was still well below the average for the 1960s. In contrast, growth rates were initially less depressed by the 1979 rise in oil prices, but subsequently failed to match the recovery seen after 1975. The second recession was shallower than the first, but it has lasted longer since industrialized countries tightened monetary controls to bring down inflation. As a result, unemployment in the industrial

### TABLE 1.1
**Key indicators, 1973–82**

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<td>(volume)$^b$</td>
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<tr>
<td>GDP growth</td>
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<td>−0.7</td>
<td>5.1</td>
<td>3.6</td>
<td>3.9</td>
<td>3.2</td>
<td>1.3</td>
<td>1.0</td>
<td>−0.2</td>
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<tr>
<td>Unemployment</td>
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<td>3.7</td>
<td>5.5</td>
<td>5.5</td>
<td>5.4</td>
<td>5.1</td>
<td>5.0</td>
<td>5.6</td>
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<td>8.0</td>
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<td>Inflation rate</td>
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<td>11.6</td>
<td>10.2</td>
<td>7.3</td>
<td>7.4</td>
<td>7.3</td>
<td>8.8</td>
<td>8.6</td>
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<td>Oil importers</td>
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<tr>
<td>GDP growth</td>
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<td>5.3</td>
<td>4.0</td>
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<td>5.6</td>
<td>6.6</td>
<td>4.2</td>
<td>5.0</td>
<td>2.2</td>
<td>2.0</td>
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<tr>
<td>Debt service ratio$^c$</td>
<td>12.6</td>
<td>11.4</td>
<td>13.3</td>
<td>12.6</td>
<td>12.7</td>
<td>15.7</td>
<td>14.7</td>
<td>13.9</td>
<td>16.6</td>
<td>21.5</td>
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<td>Oil exporters$^d$</td>
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<tr>
<td>GDP growth</td>
<td>9.1</td>
<td>7.2</td>
<td>3.7</td>
<td>8.2</td>
<td>4.8</td>
<td>2.4</td>
<td>1.2</td>
<td>−1.3</td>
<td>1.5</td>
<td>1.9</td>
</tr>
<tr>
<td>Debt service ratio</td>
<td>12.2</td>
<td>6.7</td>
<td>7.8</td>
<td>8.4</td>
<td>11.1</td>
<td>14.9</td>
<td>15.5</td>
<td>13.0</td>
<td>15.7</td>
<td>19.1</td>
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</table>

a. Estimated.
c. Service on medium- and long-term debt as a percentage of exports of goods and services.
d. Excludes China.
countries, which stayed high at about 5 percent after the first recession, has since climbed to more than 8 percent.

Developing countries are directly affected by fluctuations in the industrial world (see Figure 1.1). Overall their growth rates have been higher, but even those that have grown fastest have not been able to avoid the cyclical influence of industrial countries. They have also been affected by high interest rates. Both effects were powerful in the early 1980s—many developing countries have been squeezed between stagnating foreign exchange earnings and soaring interest payments on their debt.

Developing countries have reacted to these pressures in different ways. Those middle-income countries that had adopted outward-oriented trade policies—mainly in East Asia—have managed to maintain the momentum of export expansion and avoid serious new debt problems. But some countries, including several in Latin America that had borrowed heavily and adjusted less (or inappropriately) during the 1970s, have been hit by the high interest rates and have had to deflate in response to a liquidity crisis. In Latin America as a whole, according to preliminary estimates, GDP fell by 3.6 percent between 1980 and 1982.

The two largest low-income countries—China and India—have come through the current recession with encouraging resilience. They were not so heavily dependent on foreign trade, had little commercial debt, and so were not much affected by high interest rates. They have also made impressive progress in agriculture; India’s low GDP growth in 1982 was largely due to the failure of the monsoon.

Low-income countries in Africa, being more dependent on primary commodity exports, have suffered badly from the world recession. Their per capita income has continued to fall, and there is now a real possibility that it will be lower by the end of the 1980s than it was in 1960. To prevent this happening will require policy reforms by many African governments, a recovery of commodity prices, and a large expansion of international aid to the region.

All developing countries will find the difficulties of the past few years greatly eased by a recovery in the world economy. Since January 1983 there have been encouraging signs that recovery is under way. In addition:

- Nominal interest rates have fallen well below their peak, reached in 1981. Taking account of the foreign exchange holdings of developing countries, each percentage point off Eurodollar interest rates saves them over $2 billion net in interest payments in a full year. The ratio of debt service to export earnings is expected to fall from a peak of 20.7 percent in 1982 to below 17 in 1984.

- Oil prices have come down, partly in response to the recession, but also because of conservation measures. For net oil-importing developing countries every dollar off the price of a barrel of oil reduces their import bill by approximately $2 billion in a full year. Some oil exporters have overborrowed and are now seriously strapped for foreign exchange. However, they should benefit if, as seems likely, oil prices harden again in the medium term. (This subject is discussed in Chapter 3.)

It would be premature to assume that the industrial countries will achieve sustained and steady growth such as they experienced in the 1950s and 1960s. Continued rapid growth in the early 1970s was checked by the recession of 1974–75, and the subsequent recovery in 1976–79 was not sustained. For the present, inflation has been curbed, but interest rates and exchange rates continue to fluctuate widely, reflecting (and often contributing to) a pervading sense of uncertainty. Industry and agriculture have been slow to adjust to new patterns of comparative advantage. The objective of the industrial countries must be continued recovery with restructuring, but as yet there are too few signs that underlying structural problems are being adequately tackled.
International collaboration

Development is a long-term proposition; its im- petus is maintained by policies that must be both directed at fundamental change and viable in the short term. In the 1960s developing countries as a group made considerable progress in raising pro- ductivity and real incomes, and in improving so- cial indicators such as literacy and life expectancy. Progress continued into the 1970s, but more slowly as countries encountered short-term economic difficulties. Since 1980 short-term problems have been on a larger scale and now threaten the develop- ment strategies of numerous countries.

The requirements of a far-sighted recovery strat- egy come, in part only, from policy reforms intro- duced by the developing countries themselves. Others are the responsibility of the international community, and particularly of the industrialized countries.

The crisis of the past few years has highlighted the bonds that join the economies of the de- veloped and developing countries. The most publi- cized bonds—the financial links between banks in the industrialized countries and borrowers in de- veloping countries—were once the least visible. Yet they in turn are intertwined with international trade: borrowing countries can service their debts only if they earn enough foreign exchange from exporting. These truisms would hardly be worth repeating were it not that government policies often seem to defy them.

Trade and protectionism

Protectionist sentiments have been growing in the industrial countries. The main reasons have been an implacable rise in unemployment and the fi- nancial difficulties of companies that are no longer internationally competitive. The temptation to seek relief by import controls has been considerable, at times irresistible. Among many measures to pro- tect ailing industries, governments have erected a formidable set of controls against the textile ex- ports of developing countries. The Multifibre Ar- rangement, covering as much as 15 percent of de- veloping-country manufactured exports, is the most extreme example of trade restriction since govern- ments started to undo the protectionism that con- tributed to the depression of the 1930s. In other industries, too, the exports of developing coun- tries have faced new (particularly nontariff) trade barriers.

Nevertheless, as Chapter 2 illustrates, protectionism has not prevented a substantial growth in trade. Developing countries increased the volume of their exports by an average 5.1 percent a year in 1970–80 (for manufactures alone, the growth rate was 15.9 percent a year). Also, their market share of manufactured goods consumed in industrial economies has increased from 1.7 percent in 1970 to 3.4 percent in 1980. But the danger lies in the future. Although gains in price and efficiency from freer international trade are still widely ap- preciated, developing countries are often victims of short-sighted government action. The political challenge is first to halt and then to reverse the drift toward protectionism. The ministerial meet- ing of GATT held in November 1982 set the stage for liberalization. Greater participation by devel- oping countries in GATT would help strengthen its role as the most appropriate forum for continued negotiations to reduce trade barriers.

Debt and capital flows

Capital markets have become highly integrated over the quarter century since currency convertibility was established. While this integration has many merits, a sharp rise in international interest rates can turn an acceptable debt service burden for a developing country into a debt crisis.

Viewed globally, the world debt situation is manageable, though recent difficulties require close international cooperation to achieve a sustained recovery in international trade and to assist those borrowers facing acute debt servicing problems. Such problems can have one of two causes—shortage of liquidity or genuine insolvency. The first arises when a borrower is temporarily unable to earn or borrow enough foreign exchange to meet its debt service payments, often because interest rates are themselves unexpectedly high. Insol- vency has far more serious and permanent con- notations: a borrower simply does not have the resources to service its debt, even though it makes maximum use of available resources.

The debt problems of most major developing countries are caused by illiquidity, not by insol- vency. Sustained high interest rates alone may convert a liquidity problem into a solvency prob- lem. A recovery in world demand, lower interest rates, and determined restructuring of their own economies will restore the ability of developing countries to service their debts. In the meantime, they need continued inflows of capital to ease their liquidity shortage.
That need has been recognized by several initiatives taken over the past year. Central banks have cooperated to provide emergency loans to some countries, notably through the Bank for International Settlements. The International Monetary Fund's resources have been substantially expanded. During 1982 the debts of twelve developing countries were rescheduled and thirteen others were under negotiation in the first quarter of 1983.

But the ad hoc debt rescheduling characteristic of the past is no solution for countries with deep-seated problems. Close collaboration by creditor governments, commercial banks, and the international financial institutions is needed to facilitate long-term adjustments to restore financial viability.

While steps are being taken to ease the debt difficulties of the main middle-income borrowers, too little has been done to assist the low-income countries seriously affected by the 1980-82 recession. They depend on official aid for 84 percent of their foreign capital inflows, so their capacity to import and to invest is directly affected by the aid programs of the industrialized countries. Aid as a proportion of the GNP of DAC members was no higher in 1981-82 (0.37 percent) than in the late 1960s. In real terms official development assistance from all sources, including members of OPEC and the CMEA, rose by 5.7 percent a year in the 1970s. Concessional aid for Africa would need to rise at about double this rate over the next ten years if the per capita income of the low-income African countries is to rise by 2 percent a year—a very modest target.

National development efforts

The benefits of international cooperation can do no more than supplement the efforts of the developing countries themselves. Earlier World Development Reports have reviewed cross-country experience in selected sectors to identify policies that promote development. This year Part II of the Report takes a wider perspective, exploring management issues that cut across all sectors. The underlying concern is the search for greater efficiency in the pursuit of governments' social and economic objectives. The current economic slowdown makes the task more urgent, as well as more difficult.

Too often development is discussed only in terms of policies, without regard to the institutions and people who decide and execute them. This Report seeks to redress the imbalance. It examines the role of the state, stresses the importance of appropriate incentives (especially prices) to foster development, and discusses the institutional arrangements needed to formulate a consistent development strategy and carry it out. The Report draws on country experience to identify ways of making state-owned enterprises and project management more efficient, and, more generally, improving the performance of the bureaucracy.

This stress on efficiency is compatible with efforts to assist the poor, although in times of financial stringency governments often cut programs for the poor. Well-designed programs to improve management of public projects, reduce inflationary budget deficits, make bureaucracies more responsive, limit nonessential activities, and share the management burden with the private sector so that vital public services are performed well—all these complement efforts to assist the poor. Today's difficult economic situation requires more than ever a critical appraisal of those well-intentioned initiatives that have gone awry—the costly subsidy that mainly benefits the better off, or the state enterprise that employs a bloated labor force at relatively high wages. To raise the standard of living of the very poor, scarce resources must be carefully targeted as well as efficiently managed.

Role of the state

The boundary between the state and the private sector is never clear-cut and varies widely from country to country. For this reason, it is misleading to discuss efficiency in terms of ownership. What matters more is creating the conditions that encourage efficiency in both private and public sector activities. Such an environment is largely determined by governments, not simply in the way they affect the private sector through legislative and fiscal measures but also by the way they manage their own affairs.

State-owned enterprises are an obvious example of how a government's approach to management can influence the whole economy. Both developed and developing countries are keen to find ways to make state enterprises more efficient. The more successful initiatives have been those which defined unambiguous and attainable objectives, gave a wide measure of freedom to managers to meet those objectives, and developed performance indicators that enabled government to monitor progress.

The state's role as employer—in many devel-
oping countries, the largest employer in the modern sector—also influences the whole economy. Most developing countries have abundant unskilled labor combined with a shortage of skilled workers. The results are political pressure to overstaff the public sector at the lower grades, which is inefficient and expensive, and fierce competition between the public and private sectors at the top. Experience has shown that the public sector can keep competent staff only by offering pay and other benefits that do not lag much behind the private sector and by offering a premium to key specialists.

A third area in which governments can improve their own administrative arrangements is in the making of economic policy. Current structural adjustment problems underline the need for greater attention to policy analysis. Planning has been excessively concerned with producing detailed, long-term blueprints for development, to the neglect of both policy analysis and the preparation of public investment programs. The process of planning—formulating a development strategy, analyzing policy, and assessing investment options—matters more than the plans themselves.

Many countries still lack the close links among policy analysis, investment analysis, and budgeting needed to define and carry out a development strategy. They also need more timely and reliable feedback, which can be obtained by better monitoring of the economy. Selective tracking of government activities is the key, whether through data collection, auditing, or project evaluation. In particular, more of the resources of central statistical offices should be devoted to assembling essential data on national accounts and other information relevant for policy analysis.

Even when governments have effective methods for managing state-owned enterprises, their own employees, and the formulation of economic policy, they can still find themselves overstretched by the range of responsibilities they have assumed. Administrative capacity is limited in every country; in some developing countries it is the scarcest resource of all. Reducing the burden on senior administrators is therefore a precondition for greater efficiency, and much can be achieved by decentralizing—both within the public sector and to groups outside it.

**Burden-sharing**

Day-to-day decisions can be devolved to those who are responsible for carrying them out, and who have the advantage of detailed knowledge not possessed by those at the center. Decentralizing is a way to increase the responsiveness of government to those it serves and can involve those outside government—community organizations, for example—whose active support is often necessary in promoting development. It can also take the form of subcontracting, with some public services provided by private operators.

Decentralizing is not solely a matter of involving a wider range of people in discharging the responsibilities of the public sector. Governments, including socialist governments, can also make greater use of markets and prices, since they avoid the heavy administrative requirements of centralized planning controls. While greater reliance on markets may appear to carry risks, many governments have learned that their own interventions can easily misfire. The costs of market failure need to be balanced against those of bureaucratic failure. The practical advantage of relying more on markets is that the public sector can then concentrate on improvements in those activities for which market solutions are inappropriate.

However, the willingness to use prices to allocate resources is on its own not enough. Governments also need to ensure that prices really do reflect relative scarcities. Relative prices changed rapidly during the 1970s, partly because of floating currencies and two sharp increases in the cost of oil. Many countries failed to adjust their domestic prices to these international changes, so price distortions assumed serious proportions. Cross-country analysis for 1970-80 reveals that the best economic performances tend to be closely associated with the lowest price distortions (the details are given in Chapter 6). However, countries that have tried to correct price distortions have seldom found it easy. To obtain good results, adjustment programs must be tailored to the circumstances of individual countries and managed with close attention to timing, pace, and scope.

**Political commitment**

The underlying assumption of this Report is that all governments of developing countries, whatever their political complexion and their concern for equity, do attach priority to economic and social development. Governments nevertheless vary greatly in the commitment of their political leadership to improving the condition of the people and encouraging their active participation in the development process. When political leaders are
recognized for their integrity, vision, and concern for the public welfare, these qualities can be reflected in the ethos and performance of the public service and will have a profound effect on all sections of society. But if corruption is rife, public bureaucracy is likely to become demoralized and self-serving.

Perhaps the most important task of national economic management is to enlist the skills and energies of the population at large in raising the productivity of capital and labor. The routes followed in pursuit of these objectives must depend on the nature of the political system, but the morale of the labor force will always be a critical factor.

The economic fluctuations of the 1970s, and their culmination in the recession of 1980–82, have underscored the uncertainty of the economic environment in which farmers, businesses, and governments have to operate. Readiness to take risks and show flexibility in responding to unforeseen events are therefore essential ingredients of successful management.