# 1

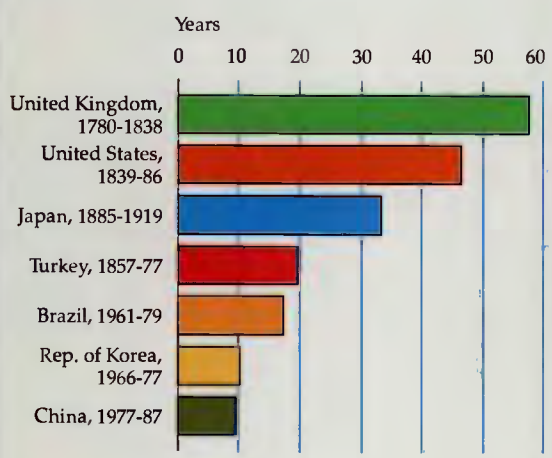
# *The world economy in transition*

Radical change is under way in the global economy. Recently more than a dozen countries have launched major economic reforms. Democracy has swept Eastern Europe and is making inroads in the developing world. The European Community has moved closer to political and economic union. If these events are cause for optimism, others are not. War in the Middle East, increasing difficulties with the Soviet Union's economic transition, and slowing world growth have been setbacks.

This Report will show that what matters most for any country's economic development is its own approach to economic policies and institutions. But global economic conditions are important. So whereas the rest of this Report is largely about what countries themselves can do to improve their performance, this chapter looks at the global context in which those actions will be cast.

In some ways the international economy will be unfavorable to development in the coming decade. Interest rates may remain high, and growth is likely to remain slow worldwide. No early end to the debt crisis is in sight—nor is any substantial resumption in North-South capital flows. The need to protect the environment poses an additional challenge. Yet there are also favorable signs for development. Real reform is being carried out in Eastern Europe. Ghana, Indonesia, Mexico, and other countries are striving to sustain their earlier programs of reform; Peru, Tanzania, and Viet Nam, for example, have embarked on new ones. If more countries do the same—and if their actions find support in greater openness in international trade and finance—rapid progress is indeed possible.

**Figure 1.1 Periods during which output per person doubled, selected countries**




*Note:* For the rationale for the choice of periods, see the technical note at the end of the main text.
*Sources:* For United Kingdom, Crafts 1981; for Japan, Maddison 1989; for others, World Bank data.

## The long view

Economic history shows that it is possible for countries to develop rapidly and indeed that for many countries the pace of change has accelerated. It shows at the same time that many countries have developed very slowly, if at all. The key to development, clearly, is to understand why the range of experience has been so wide.

The time required for substantial changes in the quality of life has shrunk steadily over the centuries (Figure 1.1). Beginning in 1780, the United

Kingdom took fifty-eight years to double its output per person. Starting in 1839, the United States took forty-seven years. Starting in the 1880s, Japan did it in only thirty-four years. After World War II, many countries doubled their per capita output even faster than Japan: for example, Brazil in eighteen years, Indonesia in seventeen, the Republic of Korea in eleven, and China in ten. This change in pace indicates that the industrial revolution gained momentum over a long period, whereas catching up has been a more and more rapid process.

The pace of progress has hastened not only for income and material consumption, but also for other aspects of welfare. Many developing countries have approached the life expectancies of the industrial world in a remarkably short time (Figure 1.2). These changes reflect better diet, housing conditions, and access to medical care. The latter, in turn, were possible thanks to increases in food production and distribution, growth in family incomes, medical advances, public investments in safe drinking water and sanitary waste disposal, and, more recently, the development of health care systems.

Technological progress, more than any other single factor, has fueled this economic advance. Innovations have produced great strides in agriculture, industry, and services. Famines disappeared from Western Europe in the mid-1800s, from Eastern Europe in the 1930s, and from Asia in the 1970s. In Africa the challenge of eradicating famine remains. Over time, countries have tended to converge with respect to some aspects of performance more than others. There has been a particularly strong tendency toward convergence in indicators of basic health. Large falls in infant mortality have been achieved by many countries—even those with very low incomes. The countries now classified as developing have better standards of basic health than the industrial countries did when they were at the corresponding level of income. The same holds for literacy, although less so. Convergence in per capita income has been much more disappointing.

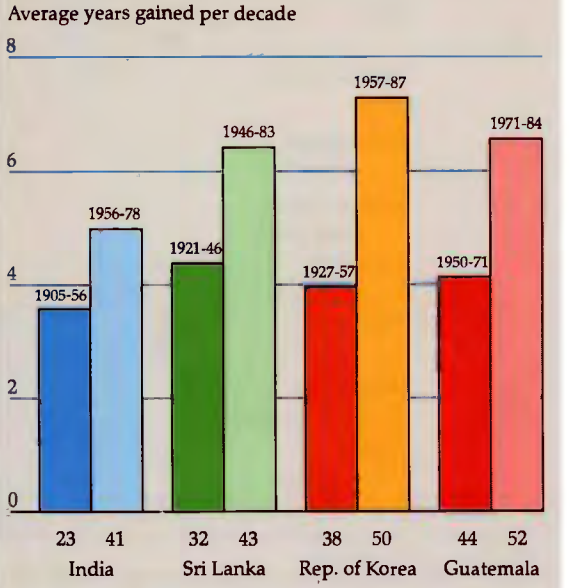
Despite the dramatic progress in some countries, the differences in per capita incomes are vast across countries and regions. Table 1.1 shows the great strides that have been made in raising incomes around the world. But it also shows the great income differences and the lack of progress in many parts of the world.

Economic theory suggests that productivity and per capita incomes would converge across countries over time, assuming that the countries which are now developing get access to the new technology introduced by the industrial countries (see Chapter 2). There is evidence that this has happened in the industrial countries. With interruptions caused by war, the variation in their per capita incomes has declined steadily over the past century. This convergence began with the industrial revolution. In the nineteenth century, Australia, Canada, Japan, the United States, and Western Europe began to industrialize and to grow at an accelerating rate. Some other nations followed in the early twentieth century. But by 1945, most of the world had failed to make much progress.

Asia, the world's most populous region, has recently begun to catch up—in some cases, at a spectacular rate. But Sub-Saharan Africa has seen its per capita incomes fall in real terms since 1973. In 1950 the region's per capita income was 11 percent of the industrial-country average; now it is 5 percent. Latin America has also slipped, especially since 1980. There are disparities within groups of countries, too. They are growing among the less advanced economies as a whole, and especially in East and South Asia.

Extraordinary progress is possible even when countries seem doomed to fail. Forty-three years

**Figure 1.2 Gains in life expectancy, selected countries and periods**




*Note:* The numbers below each bar indicate life expectancy at birth at the beginning of the period. For the rationale for the choice of periods, see the technical note at the end of the main text.
*Sources:* Data before 1978, Gwatkin 1978; later data for all countries except India, WHO 1989; for India, United Nations 1989.

**Table 1.1 Historical trends in GDP per capita**
*(1980 international dollars)*

| Region or group | 1830 | 1913 | 1950 | 1973 | 1989 | Growth rate 1913–50 | Growth rate 1950–89 |
|---|---|---|---|---|---|---|---|
| Asia | 375 | 510 | 487 | 1215 | 2,812 | −0.1 | 3.6 |
| | (40) | (23) | (15) | (16) | (28) | | |
| Latin America | .. | 1,092 | 1,729 | 2,969 | 3,164 | 1.2 | 1.2 |
| | .. | (49) | (52) | (40) | (31) | | |
| Sub-Saharan Africa | .. | .. | 348 | 558 | 513 | .. | 0.8 |
| | .. | .. | (11) | (8) | (5) | | |
| Europe, Middle East, and North Africa | .. | .. | 940 | 2,017 | 2,576 | .. | 2.0 |
| | .. | .. | (29) | (27) | (26) | | |
| Eastern Europe | 600 | 1,263 | 2,128 | 4,658 | 5,618 | 1.4 | 2.0 |
| | (64) | (57) | (65) | (63) | (56) | | |
| Developing economies | .. | 701 | 839 | 1,599 | 2,796 | .. | 2.7 |
| | .. | (32) | (25) | (22) | (28) | | |
| OECD members | 935 | 2,220 | 3,298 | 7,396 | 10,104 | 1.1 | 2.3 |

*Note:* Data presented are simple averages of GDP per capita. Numbers in parentheses are regional GDP per capita as a percentage of GDP in the OECD economies. Regional groupings include only non-high-income countries. Hungary is included in Eastern Europe group, not in Europe, Middle East, and North Africa.
*Sources:* For 1830–1965, Maddison, background paper. Data for 1950–65 for Africa and the Middle East are based on OECD; data after 1965 are based on growth rates from the World Bank data base. Benchmark values are 1980 international dollar estimates from Maddison, background paper, if available; from Summers and Heston 1984, otherwise.

ago an influential government report in an important developing country observed that labor today shunned hard, productive jobs and sought easy, merchant-like work. The report showed that workers' productivity had fallen, wages were too high, and enterprises were inefficient and heavily subsidized. The country had virtually priced itself out of international markets and faced a severe competitive threat from newly industrializing China and India. It was overpopulated and becoming more so. This would be the last opportunity, concluded the prime minister in July 1947, to discover whether his country would be able to stand on its own two feet or become a permanent burden for the rest of the world. That country was Japan. The central question of this Report is why countries like Japan have succeeded so spectacularly while others have failed.

## The setting for development

The key to global development has been the diffusion of technological progress. New technology has allowed resources to be used more productively, causing incomes to rise and the quality of life to improve. Scientific and medical innovation has proceeded at a breathtaking pace during the past two hundred years (Box 1.1).

Using new technologies effectively has often required adaptation and innovation in economic institutions, and occasionally political and social institutions, too. New means of transport extended markets and thereby increased the division of labor, leading, as Adam Smith observed, to more specialization: goods and labor were traded for money instead of bartered, and so on. Today, creating and strengthening market institutions is the biggest task for the former socialist countries of Europe and for many of the developing countries.

### *Global integration*

Trade was crucial in the spread of technology. Countries have usually developed more quickly as part of the world economy than in isolation, although protection has stimulated growth in some instances. Historically, trade wars have retarded global development.

The Great Depression and its aftermath are perhaps the clearest example of this. The collapse of the post World War I trading system did not trigger the Great Depression, but it did contribute to its depth, spread, and duration. The stock market crash of October 1929 caused demand and trade to slump. After the failure to reach a cooperative trade agreement in 1929, the United States raised

### Box 1.1 Innovations that changed the world

During the past two hundred years, a series of major scientific and technological advances have dramatically changed the course of development.

**Health and medicine**

In the nineteenth century, improved nutrition played the lead role in increasing people's life expectancy and in reducing infant mortality rates. In this century progress has come from the medical sciences. Jenner's smallpox vaccine (1790) opened the way for the vaccination of cholera, typhoid, and anthrax. Pasteur established the relationship between microbes and immunity (1880). Half a century later came Fleming's discovery of penicillin (1929), its clinical application (1941), and the development of other antibiotics. As a result, the morbidity rate of tuberculosis in the United States, for example, declined from 79 per 100,000 in 1939 to 9 in 1988. Widespread immunization programs have contributed to dramatically reduced infant mortality rates, which are estimated to have declined in low-income economies from 124 per 1,000 live births in 1965 to 72 in 1985.

**Food production**

Steady increases in food production in the nineteenth century, followed by more dramatic increases in the twentieth, made possible some remarkable improvements in people's nutrition. The green revolution in the 1960s and 1970s was possible because high-yielding hybrid varieties of wheat and maize, dwarf varieties of rice, and chemical fertilizers and pesticides were introduced. India doubled its average yield of wheat within a few years after the introduction of these improvements in 1966–67. In China, where rural reforms provided added flexibility in farming practices, new grain varieties and farming techniques made it possible to support 22 percent of the world's population on 7 percent of its arable land.

**Transport, energy, and communications**

The industrial revolution in Europe began with inventions that augmented labor with machinery and new sources of energy. After Savery's steam engine (1698) and Newcomen's improved engine (1712), Watt's more efficient engines (1770 and 1796) brought steam into wide use. The production and transport of coal grew quickly. Next came improvements in oil refining (1850s), then a method of drilling for oil. The internal combustion engine (1876) and the technologies for electricity generation and transmission (1886) were part of the same progression, transforming old industries and launching new ones. Transportation was revolutionized along the way, with the steamship and the locomotive (1830s), the automobile (1885), and the airplane (1903). Harbors, highways, railways, and airports brought trade to the remotest of places.

The telegraph (1844), telephone (1876), radio (1895), and television (1925) changed the way people interact. With the electronic computer (1924), communication satellites (1960), and fiber optics (1977), information is now transmitted and processed at breathtaking speed, yet at practical cost.

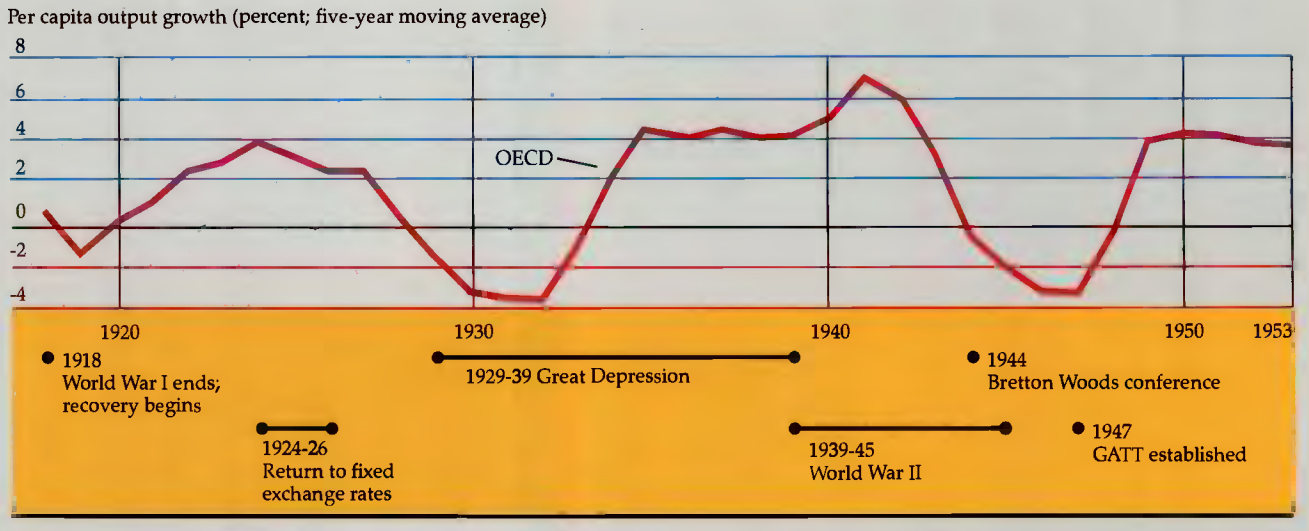
tariffs in the Smoot-Hawley Act of 1930. America's trading partners retaliated. World trade fell by two-thirds—from $3 billion in October 1929 to $1 billion in July 1932. Some of the contraction was the result of the Depression, but the hostility toward trade caused damage that took decades to repair.

The deterioration of the climate for trade in 1929 had followed a long period of peacetime market integration. Britain had entered the nineteenth century with an unwieldy system of tariffs and customs laws accumulated over five hundred years. The transition to liberal trade was not easy. High duties on grain imports (the Corn Laws) assured landlords relative prosperity, while consumers paid high prices and export-oriented manufacturing was stifled. In 1845, when the potato crop failed in Ireland, mass starvation followed. This disaster paved the way for the repeal of the Corn Laws, and Britain moved to a more liberal trade regime. Other countries followed. Expanding agricultural markets lessened protectionist pressures, and the period from 1848 to 1873 became one of freer trade throughout Europe.

This process of international integration was reinforced by integration within countries. Innovations in transport were crucial. Accelerating market integration, along with new manufacturing technologies, led to rapid increases in productivity.

Though this shift toward international integration undoubtedly spurred development, it also exposed countries to external economic shocks, and hence to occasional setbacks. Dramatically lower freight rates for shipping appear to have caused profits and wages to fall, but wages fell less so the cost of labor rose in real terms. Cheap grain from North America, Argentina, Australia, and the Ukraine was brought to Europe. Many countries raised their tariffs, on manufactures as well as

**Figure 1.3 Per capita output growth in the OECD and developing countries and significant world events, 1918-88**




*Sources:* For events, Pollard 1990; for data, see the technical note at the end of the main text.

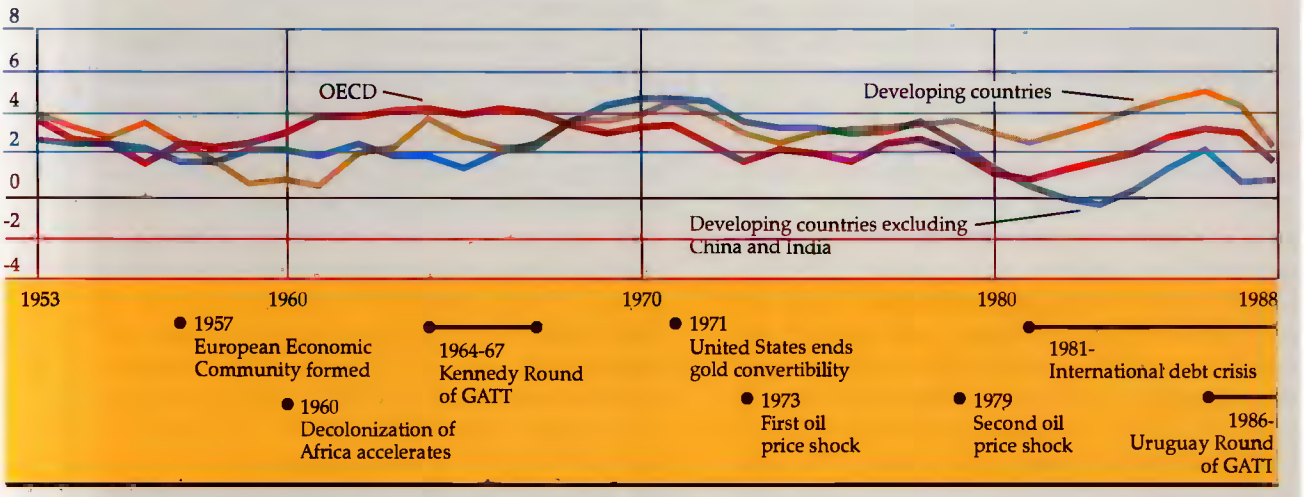
food. By 1913, the average tariff on manufactures was 20 percent in France, 18 percent in Italy, and 13 percent in Germany. Meanwhile, however, the first great global boom in trade had pulled many developing, primary-product exporters along. Argentina had grown so fast that by the 1920s its per capita income was 80 percent of Britain's.

Foreign trade was financed in the late nineteenth century by a surge of foreign lending from Europe, to the newly settled countries of the temperate zones and to czarist Russia. Technological breakthroughs in chemicals, electrical products, and automobiles—sometimes called a second industrial revolution—added new products sought in import markets. British foreign lending in 1913 reached half of national saving and 5 percent of national income. World War I cost continental Europe much of its productive labor power and physical capital (Figure 1.3). Farm output had expanded significantly outside Europe during the war. So the gradual recovery of European agriculture lowered prices after 1925. Prices collapsed after the October 1929 crash. The period from 1918 to 1925 was one of great instability in exchange rates, tariffs, trade agreements, and regulations.

The Great Depression and World War II shattered the global economy and badly shook the confidence of the developing countries, especially in Latin America, in trade as an engine of growth. The need for international agreements on trade and currencies was greater than ever before. The Monetary and Financial Conference of the United and Associated Nations at Bretton Woods in July 1944 set out to create "a world in which countries did not close their eyes to the repercussions of their actions on others" (Robinson 1975). The conference led to new rules and institutions for international monetary and exchange relations (under the International Monetary Fund), long-term capital flows for reconstruction and development (under the World Bank), and international trade (eventually embodied in the General Agreement on Tariffs and Trade, GATT). Even before these institutions were fully operational, the Marshall Plan supported postwar reconstruction in Western Europe; productivity missions from the United States toured Europe and Japan, helping to develop trade relations and to spread information on technology.

The Soviet Union decided not to join the Bretton Woods framework and formed a parallel international system. Eastern European nations nationalized their economies and adopted Soviet-style central planning. The Council for Mutual Economic Assistance (CMEA) was set up to coordinate their economic activities.

The Marshall Plan sponsored the formation of the European Payments Union, creating the institutional basis for free trade within Western Europe. The GATT spurred the move toward broader multilateral trade agreements. The formation of the European Economic Community (EEC) in

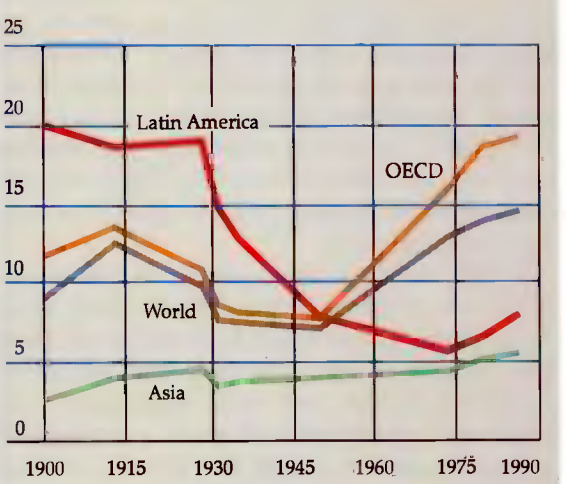



1957, the formation of the OECD, and successive rounds of GATT agreements all pushed the same way. Investment in Europe and Japan increased to record levels as these countries sought to catch up technologically with the United States. Economic growth between World War II and the early 1970s was faster than ever before. The developing countries, many of which were newly created nations, joined this growing global system but with varying degrees of commitment. East Asia embraced trade with enthusiasm; South Asia, Africa, and Latin America were more reluctant.

After supporting unprecedented growth in trade and global integration for nearly three decades (Figure 1.4), the international framework shifted in the 1970s. Fixed exchange rates became insupportable, and the United States suspended the convertibility of the dollar in 1971. In 1973 EEC governments floated major European currencies. The shock induced by the decision of the members of the Organization of Petroleum Exporting Countries (OPEC) to raise oil prices disrupted international trade and capital flows. The trade system came under great stress. A slide toward protection began that still threatens the liberal trading order established after 1945.

That is the background against which the governments of developing countries must choose their trade policies. Today more than 4 billion people, or nearly 80 percent of the world's population, live in developing countries. Their share in global output is less than 20 percent; their share in world trade is 17 percent. As a group, these economies still have a long way to go before they are fully integrated with the global economy.

**Figure 1.4 The share of exports in GDP, selected country groups, 1900-86**
*(percent)*




*Note:* Export share in GDP can be viewed as a proxy for integration. GDP data are in international dollars; exports in U.S. dollars.
*Source:* Maddison 1989.

*The global effect of shocks*

Despite the revival of protectionism since the 1970s, the world economy remains highly integrated. This, as history has shown, exposes countries to external shocks. The shocks of the 1970s and 1980s have been severe. The collapse of the Bretton Woods system, sharp rises in food and other commodity prices, and soaring oil prices in 1973–74 and 1979–80 affected nearly every economy. In the aftermath of the second oil price shock, the United States adopted a mix of monetary and fiscal policies in the early 1980s that pushed interest rates high worldwide. For oil-importing developing countries, the scale of the shocks of the 1970s varied, but in most was less than 10 percent of GDP. However, the terms of trade and interest rate effects grew in the 1980s. In Sub-Saharan Africa and Latin America the combined effects were estimated to average more than 10 percent of GDP—larger than in other developing regions.

Although policies in the industrial countries contributed to the quick recovery from the recession after the 1973-74 oil price shock, they also led to high rates of inflation later in the decade. Many industrial countries followed an accommodating monetary policy which resulted in low and, in some countries, even negative real interest rates during the 1970s. Large international capital flows resulted from the recycling of surpluses of oil exporters. But the upswing came to an abrupt halt with the second oil price shock in 1979–80 and the sharp tightening of monetary policy in the large industrial countries. Between the late 1970s and the early 1980s, the real dollar London interbank offered rate (LIBOR) rose from −1 percent to 6 percent, growth and trade sharply decelerated, and the prices of oil and other commodities declined. Exporters of these categories, and those who depend on worker remittances derived from these exports, suffered setbacks. There was little cooperation in forming policies among the large industrial countries.

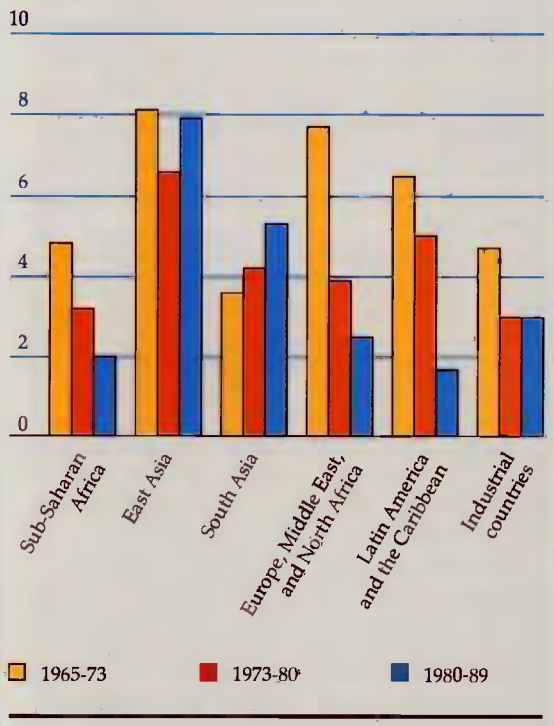
A debt problem that would be transmitted worldwide unfolded in the 1970s as many developing countries borrowed to increase consumption, invest in doubtful projects, and finance imported oil (which was then subsidized). The volume of international bank lending increased by nearly 800 percent during the decade, to about $800 billion. Most commercial lenders to developing countries did little to investigate how loans were used, relying instead on sovereign guarantees. The productivity of investment in low- and middle-income countries may have fallen by a third between the 1960s and the 1970s. Their external debt grew from $63 billion in 1970 to $562 billion in 1980.

The debt crisis emerged as the world recession, high real interest rates, and terms of trade shocks of the early 1980s caused acute debt-servicing problems for severely indebted nations. Interest payments owed by the developing countries grew 40 percent during the period 1980–83 to $64 billion. That was about 3.2 percent of their GNP, compared with less than 1 percent only a few years earlier. Mexico declared a debt moratorium in 1982. Many other countries were forced into debt restructuring agreements with official creditors and commercial banks. By 1982, commercial banks had virtually ended their voluntary lending to most developing countries. Aggregate net financial transfers to developing nations (disbursements of long-term loans minus total debt service) swung from a net inflow of $36 billion in 1981 to a net outflow of $30 billion in 1989. In severely indebted countries, investment fell sharply; this weakened the recovery when the international environment later improved. In the 1980s, real GDP growth slowed in Sub-Saharan Africa, Latin America, and the Middle East, North Africa, and Eastern Europe (Figure 1.5).

Economic growth accelerated in the industrial countries in the second half of the 1980s. Less regulation and lower taxes, combined with the falling price of oil in 1986, expansionary monetary policies, and greater policy cooperation, led to increased activity. Low inflation, moderate wage increases, and high business profits spurred private investment, especially in Japan and Europe. A number of developing countries at this time had strong trade linkages in manufactures and comparatively stable macroeconomic climates. They were able to take advantage of the industrial countries' recovery, and raised their growth rates.

Greater integration in the 1980s led trade and financial flows to grow faster than output. But it was another decade prone to shocks, making the task of adjustment for most developing countries all the harder. There were wide swings in exchange rates, and international interest rates were erratic. The U.S. current account balance swung from a $7 billion surplus in 1981 to a $162 billion deficit in 1986, gradually declining to about $110 billion in 1989. (The United States absorbed about 23 percent of the merchandise exports from developing countries in 1989—more than the combined

**Figure 1.5 Estimates of the growth of GDP, 1965-89**
*(percent)*




*Note:* GDP estimates are least-squares in real terms.
*Source:* World Bank data.

flow to Japan, Germany, and France.) In recent years, this deficit is estimated to have absorbed an average of 4–5 percent of the world's savings. Meanwhile, debt overhang and a sharp decline in financial flows to developing countries led the combined current account deficit of these countries to decline from about $70 billion in 1980 to $50 billion in 1989.

*Succeeding in an integrated world*

Even in the face of the negative external shocks of the past twenty years, some economies performed remarkably well—notably those in East Asia. But most have struggled, especially during the past decade. Often, this was not for want of effort. Many developing countries modified their economic policies when their debt troubles mounted in the early 1980s. The need for such adjustment grew in 1982 with the deep recession in the industrial countries and a steep decline in the real prices of primary commodities. Many governments cut their budget deficits, altered certain relative prices (the real exchange rate, the real interest rate, and the internal terms of trade between agriculture and industry), and restructured their activities. A number also replaced quantitative trade restrictions with tariffs and reformed their tariff structures. Balance of payments deficits fell sharply. Despite much progress, however, fiscal imbalances remain. Deficits have often been reduced by cutting public investment rather than by containing current expenditures or reforming taxes to increase revenues.

The new economic climate has posed challenges in industrial countries as well. Structural rigidities, energy price controls, misaligned exchange rates, and trade barriers prevented adjustment and slowed recovery in the 1970s and early 1980s. Policy then began to shift. Macroeconomic management focused on the fight against inflation (although monetary policies became more accommodating as inflationary pressures eased in the latter half of the 1980s). Fiscal and regulatory policies emphasized supply-side incentives; taxes on both household income and business profits came down. Most countries began reducing the role of the public sector. Major structural reforms included the privatization of publicly owned enterprises and the liberalization of product, labor, and financial markets.

During the 1980s, the backwardness of the command economies contrasted sharply with the rapid technological advance in the market-oriented economies of Asia and the West. Economic performance deteriorated in the Soviet Union (Box 1.2) and other East Bloc economies. Some countries, notably the former German Democratic Republic and Poland, have undertaken extremely bold reforms. Economic conditions in nearly all these economies are grave, and projections suggest that the bottom of the decline still lies ahead.

*Recent developments*

A seven-year expansion in the world economy came almost to a halt in 1990. Signs of slowing economic activity in a number of large industrial countries became evident as monetary policies were tightened in response to production at near-capacity levels and rising inflation. The slowdown became more widespread and pronounced with the Gulf crisis in August 1990. Increased uncertainty had adverse effects on consumer and business confidence, which in turn led to markedly

## Box 1.2 The Soviet economic crisis

Mikhail Gorbachev, after sounding a cry of alarm when he rose to leadership in 1985, used three words repeatedly in his call for reform: perestroika (restructuring), uskoreniye (acceleration of growth), and glasnost (openness). The economy was in trouble, and corrective measures had been postponed for too long. He pointed out that the Soviet Union produced more shoes and far more steel than the United States, but the quality of the shoes was poor and the use of steel wasteful.

Was this a short-term crisis? Or was it more deeply seated? Clearly not the former, as President Gorbachev recently pronounced: "Today, when we talk about radical restructuring of economic management, it is vital to recall what the real situation was in our country back in the late 1970s and early 1980s. By that time the rates of economic growth had fallen so low, as to virtually signify stagnation." A sharp drop in industrial production had been accompanied by the exhaustion of natural resources in populated regions and by the increasing obsolescence of plant and equipment. Death rates and infant mortality rates were rising.

Between 1985 and 1987 perestroika was put in place to retool and modernize industry and to increase the attention to quality control. Accompanying measures included improving worker initiative and making the bureaucracy more accountable. Despite some initial success, however, reforms did not address underlying systemic problems.

Uskoreniye proved elusive. Real output stagnated, and the fiscal deficit rose from 2.5 percent of GDP to 8.5 percent.

The program's failure spurred more serious efforts to reform the economy in 1987 and 1988. The material allocation system was scrapped. Prices were allowed to move in a freely negotiated range. The soft budget constraint was hardened. Cooperative enterprises were encouraged, and private family enterprises were legalized. Foreign trade was decentralized, and a currency retention scheme was introduced along with a system of differentiated exchange rates and limited foreign currency auctions.

Because the measures were introduced piecemeal, they had the opposite of their intended effect. Imports from the convertible currency area grew strongly, while manufactured exports scarcely changed. Increases in enterprise autonomy were circumscribed by the system of state orders, which covered most of industrial output. The dismantling of the traditional system of planning began, but the inflexible and distorted official price system—and the state distribution agency—were left largely intact. Throughout the late 1980s, the capital stock and labor force declined.

In 1990, net material product—according to official estimates—declined by 4 percent, and inflation was running at 12 percent. The traditional centrally planned system had largely collapsed, but a functioning market system had not yet replaced it.

Transforming the Soviet economy will be difficult. It will require many of the actions discussed in this Report: stabilizing the macroeconomy, reforming prices in a context of greater domestic and international competition, and reforming property rights and government institutions.

lower growth of consumer spending and business investment in the industrial countries. The financial requirements of the unification of Germany and war-related reconstruction in the Middle East exerted upward pressures on short-term interest rates in Germany and Japan despite the economic slowdown in 1990 and early 1991. Real GDP growth in the industrial countries slowed to about 2.6 percent in 1990, compared with 3.3 percent in 1989 and 4.5 percent in 1988.

Canada, the United Kingdom, and the United States have been in recession. Growth has also slowed elsewhere in western Europe. Equity prices in Japan have fallen by about 50 percent, and the quality of commercial bank portfolios in both Japan and the United States has deteriorated. Although the slowdown of the industrial economies is likely to be short-lived and shallow, the recovery is expected to be only gradual. The financial problems of the private sector in several large economies will continue to hamper growth. Output in the industrial countries is expected to expand by less than 2 percent in 1991.

In the developing countries, real GDP growth declined from 4.3 percent in 1988 to 2.9 percent in 1989 and to only 2.2 percent in 1990, the lowest since 1982. The main reasons—in addition to continuing macroeconomic instability and domestic policy weaknesses—were falling non-oil commodity prices, high international (nondollar) interest rates, and slower growth in world trade.

Oil prices rose from less than $20 a barrel (Brent crude grade) in July 1990 to $35–40 after Iraq's August invasion of Kuwait and the subsequent U.N. embargo on oil exports from Iraq and Kuwait. By the end of the war and the freeing of Kuwait in early 1991, oil prices had declined to about $20 a barrel. If prices remain in that range, the effect of

the 1990 oil price shock on the industrial economies will be small and short-lived. For the industrial economies as a group, the terms of trade loss of the 1990 shock is estimated to be one-third that of the 1973–74 shock and only one-sixth that of 1979–80.

By contrast, the consequences for Eastern Europe have been severe because countries there have begun to pay for oil with hard currency. For oil-importing developing countries as a group, the effect of the increase in the oil price on the current account balance is estimated to have been about 7 percent of their combined exports. In addition, the Arab Republic of Egypt, Jordan, and Turkey have had extensive economic relationships with Iraq and Kuwait. These and other countries—Bangladesh, India, Morocco, Pakistan, the Philippines, Sri Lanka, and Sudan—have to pay higher interest rates on debt service, and have lost trade and service contracts and workers' remittances. Revenues from tourism have also fallen sharply.

Output contracted sharply in the Middle East, Eastern Europe, and (because of a severe recession in Brazil) Latin America. Growth also slowed in Sub-Saharan Africa. However, in countries covered by the Special Program for Assistance to Africa, which have been implementing reforms, output grew faster than the population. In Asia, because of the improved performance of China and some of the newly industrializing economies (NIEs) in the region, the growth rate accelerated to 3.5 percentage points more than the average for the developing countries as a whole. Output growth in the developing countries is expected to recover somewhat in 1991, to about 3 percent. Nevertheless, by early 1991 conditions were still deteriorating in many countries—especially those most affected by the Gulf War.

## Prospects for world development

Many factors will have an important bearing on the global climate for development in the coming years: the growth of world trade, the policies adopted by the industrial countries, the state of the international capital markets, and so on. In every case the degree of uncertainty is large (see Box 1.3). To arrive at a view about the prospects for growth in the developing countries, judgments need to be made (either explicitly or implicitly) for each of these external factors. Without knowing anything else about the outlook, it is clear that there will always be a premium on economic flexibility. Countries that can respond easily to any of a range of outcomes are likely to fare best.

### *World trade*

The Uruguay Round of GATT talks, begun in 1986, continued into 1991. These talks are the first to include developing countries as main participants. If the Uruguay Round succeeds, it will lead to better market access for industrial and developing countries; lower tariffs worldwide; significant cuts in agricultural subsidies; more discipline in the use of industrial subsidies; and the extension of multilateral arrangements to services, trade-related investment rules, and intellectual property rights. The most difficult of these areas has been agriculture. There are large differences between the negotiating positions of the United States and the European Community on the size and speed of cuts in export subsidies, domestic price supports, and import barriers. Aside from agriculture, however, progress has been made, notably in textiles and clothing, services, tariff cuts, trade-related investment rules and intellectual property rights, and dispute settlement. A successful outcome to the talks is critical for the world trading system. A good agreement will greatly improve the prospects for the developing countries.

EUROPEAN INTEGRATION. As the European Community dismantles national barriers to the free movement of goods, services, labor, and capital, it could become the world's single biggest market. Over five to seven years, according to the European Commission, the region's aggregate GDP could jump by 4.5 to 7 percent as a result of integration alone. Project 1992 also involves steps toward monetary union, which may lead to a single currency for Europe. This, combined with the effects of market unification, could increase long-term growth in western Europe by about 1 percentage point a year.

THE RISE OF EAST ASIA. Between 1965 and 1988, the East Asian economies increased their share of world GDP from 5 to 20 percent and of world manufactures exports from 10 to 23 percent. Japan has emerged as the second largest economy in the world, whereas a number of developing economies in the region have joined the ranks of the high-income economies. By the end of the 1980s, the four NIEs of East Asia accounted for half the manufactured exports of developing countries. The region's financial power had grown commensurately. At the regional level, closer economic relations developed within the Association of Southeast Asian Nations. A new Asia-Pacific Economic

### Box 1.3 The climate for development in the 1990s

| | Pessimistic | Optimistic |
|---|---|---|
| *World trade* | GATT negotiations collapse; unilateral policies by large industrial countries lead to trade wars; trade declines overall, though by less within regional blocs. | GATT makes real progress; regional GATT-compatible agreements produce dramatically greater integration in Europe, Asia, and the Western Hemisphere; world trade expands rapidly. |
| *Capital flows* | International capital markets are overcautious, and transfers to developing countries fail to pick up. | Capital flows to the developing countries resume; greater confidence spurs direct foreign investment. |
| *World finance* | Major institutions fail in Japan and the United States, leading to high risk premiums, low investment, a prolonged economic slowdown, and possibly higher inflation; the debt crisis continues to impede growth in the developing regions. | Major institutions muddle through; financial reforms and regulatory changes reduce systemic risks; economic recovery is rapid; Brady Initiative and its successors gradually reduce developing-country debt burdens. |
| *Industrial-country policy* | Large industrial countries fail to cooperate; they follow poor macroeconomic policies, and financial instability and low growth result. | Macroeconomic policies of the large industrial countries stabilize financial markets and lead to sustained growth. |
| *Security* | The decline of the superpowers leads to regional crises and ethnic strife within and among countries; arms races divert economic resources; terrorism, drugs, and poverty undermine internal security. | End of cold war reduces tensions among superpowers; new international security arrangements are developed through a strengthened United Nations. |
| *Technology* | Technologies required for competitive products become more and more sophisticated and labor-saving; technology flows are restricted by protectionist policies and firm strategies; developing-country advantages resulting from cheap labor and raw materials diminish. | New technologies improve health and productivity (especially in agriculture); multinationals develop wider global production networks; computers reduce advantages of large markets; better communications make it easier for countries with adequate human capital to catch up in productivity. |
| *Energy* | Oil prices remain volatile because of ongoing political and social instability in the Middle East, which continues to be the main supplier of oil. | New political arrangements in the Middle East, combined with constructive dialogue between producers and consumers of petroleum, lead to a period of unusual stability in real oil prices. |
| *Environment* | Damage to the environment mounts, with economic repercussions; global resources dwindle; the frequency of local environmental disasters increases. | Environmental ill-effects prove less costly and less immediate than predicted; new national and international policies take adequate steps to protect scarce resources. |

Cooperation group, loosely resembling the OECD, began annual ministerial meetings; its members are Japan, the United States, and ten other Pacific Rim nations.

COOPERATION IN THE WESTERN HEMISPHERE. With the United States–Canada Free Trade Agreement in effect, the United States declared an "Enterprises for the Americas Initiative" to improve trading relationships throughout the Americas. Mexico and the United States may enter "fast track" negotiations on a free trade area; any accord would be a first for countries with such large income differences.

How far do all these developments signal a breakdown in the open trading order of the post-

war years? How will the trading prospects of many low-income countries be affected? The answer is unclear. Some of the recent trade initiatives have strong regional dimensions, but none so far has involved raising external barriers. In the end the outcome will depend on whether the extra trade created by regional integration will outweigh the trade diverted by it. If the Uruguay Round collapses, the risk that the regional groups will turn inward is far greater.

*International capital flows and finance*

In the 1980s, international capital flowed mainly among the industrial countries. Several large countries, including the United States, became net capital importers; that is, their domestic investment exceeded their national savings (Table 1.2). Developing countries were bypassed by international lenders and investors, mainly because of their high external debts and deteriorating economic and political conditions. During the decade, aggregate net resource transfers to these countries shifted from positive to negative. The investment-output ratios of the low- and middle-income countries fell in the 1980s and have not recovered.

SAVINGS-INVESTMENT BALANCES. The pattern of savings-investment balances across broad country groups is not likely to depart over the medium term from the broad trend established in the past few years. A shrinking U.S. current account deficit and higher oil revenues for oil-exporting countries may be offset by more imports, reconstruction costs, and military spending in the Gulf. Lower private and public savings in Japan, and falling current account surpluses in the Asian NIEs (because of exchange rate appreciation and slower growth in world trade) will also help to reduce the imbalances of the 1980s. Germany's current account surplus will decline as unification increases investment demand. And the demand for international credit and investment in Eastern Europe and the Middle East may rise just as the industrial economies recover from the slowdown of 1990–91. All this implies that international interest rates are likely to remain high over the medium term.

The current account deficit of many developing countries may therefore rise at a very moderate pace—from $51 billion or 1.8 percent of GNP in 1989 to about $70 billion in 1995 and about $90 billion by 2000, averaging 1.5–2.0 percent of GNP over the 1990s. As debt repayments reduce interest payments on existing debt, new net flows will cause interest payments to rise. Outflows on factor services will also rise because the higher stock of direct foreign investment will expand the flow of remittances. By the mid-1990s the severely indebted developing countries could still be exporting more goods and nonfactor services than they import, although the balance should narrow significantly. The current pattern of net capital flows—which resembles that of the 1960s in the relative importance of official flows, direct investment, and private lending—might prevail well into the 1990s. High international interest rates, together with only a modest growth of international financial flows to the developing countries in the next several years, could slow development. The baseline projections, however, forecast an acceler-

**Table 1.2 Global savings and investment**
*(percentage of world GDP, unless noted)*

| *Category and group* | *1970–73* | *1974–80* | *1981–85* | *1986–88* | *Level in 1988 (billions of dollars)* |
|---|---|---|---|---|---|
| *Gross national savings* | | | | | |
| High-income OECD members | 16.5 | 16.2 | 14.6 | 16.3 | 2,997 |
| (United States) | (5.2) | (4.8) | (4.9) | (3.8) | (664) |
| Other high-income economies[a] | 0.8 | 1.3 | 1.2 | 1.0 | 175 |
| Low- and middle-income economies | 4.1 | 6.1 | 6.3 | 5.0 | 875 |
| World total[b] | 21.4 | 23.6 | 22.1 | 22.3 | 4,048 |
| *Gross domestic investment* | | | | | |
| High-income OECD members | 16.0 | 16.1 | 14.5 | 16.2 | 2,981 |
| (United States) | (5.0) | (4.6) | (5.0) | (4.4) | (740) |
| Other high-income economies[a] | 0.7 | 0.9 | 1.0 | 0.8 | 151 |
| Low- and middle-income economies | 4.6 | 6.0 | 5.6 | 4.5 | 781 |
| World total[b] | 21.2 | 23.0 | 21.1 | 21.5 | 3,913 |

a. Derived as a residual; high-income countries minus OECD.
b. World savings and investment differ because of discrepancy in world current accounts.
*Source:* World Bank data.

**Table 1.3 Aggregate long-term net resource flows to developing countries, 1980–95**

| Component | Level (billions of dollars) | | | | Share (percent) | | |
|---|---|---|---|---|---|---|---|
| | 1980 | 1986 | 1989 | 1995[a] | 1980 | 1989 | 1995[a] |
| *Net flows*[b] | 82.8 | 51.2 | 63.3 | 103 | 100.0 | 100.0 | 100.0 |
| *Official grants* | 12.5 | 14.0 | 18.6 | 25 | 15.1 | 29.4 | 24.3 |
| *Official loans (net)* | 20.1 | 19.6 | 18.0 | 31 | 24.3 | 28.4 | 30.1 |
| Bilateral | 12.2 | 6.3 | 6.1 | 10 | 14.7 | 9.6 | 9.7 |
| Multilateral | 7.9 | 13.3 | 11.9 | 21 | 9.5 | 18.8 | 20.4 |
| *Private flows* | 50.2 | 17.6 | 26.7 | 47 | 60.6 | 42.2 | 45.6 |
| Private loans | 41.1 | 8.1 | 4.3 | 12 | 49.6 | 6.8 | 11.6 |
| Direct foreign investment | 9.1 | 9.5 | 22.4 | 35 | 11.0 | 35.3 | 34.0 |

a. Projections.
b. Excluding IMF transfers.
*Source:* World Bank 1990d.

ation of developing-country growth rates from those of the 1980s on the premises of increased domestic savings and a greater efficiency of investment (Table 1.3).

EXTERNAL DEBT. The international strategy for dealing with the more than $1.3 trillion in outstanding developing-country debt (this figure includes the debts of Eastern Europe) reached a turning point in 1988 and 1989. The emphasis shifted from debt rescheduling to the reduction of debt and debt service. Using debt buybacks, reduced interest rates, exchanges of debt at a discount for new secured debt, and so on, Brady Initiative agreements to reduce commercial debt and debt service have already reduced debt in Costa Rica, Mexico, and the Philippines by $9.5 billion. New debt reduction and rescheduling mechanisms for the official debt of low-income countries, adopted at the Toronto economic summit of June 1988, have been now applied in nineteen countries. These cover $5.8 billion, or 11 percent of bilateral official debt. Despite this new strategy, the debt crisis continues to dampen prospects for many of the forty-six severely indebted countries (see Chapter 8).

AID. Official development assistance (ODA) on highly concessional terms, representing about 90 percent of all grants and net lending from official sources, is the principal form of resource transfer to the poorest countries. In 1989 it accounted for nearly two-thirds of new resource flows to low-income countries and four-fifths of the flows to the poorest countries. In Sub-Saharan Africa, net flows of ODA were 8 percent of GNP, or $28 per capita, in 1989 (WDI, table 20).

The volume of aid extended by member governments of the Development Assistance Committee (DAC) of the OECD bilaterally and through multilateral channels rose by an annual average of about 3 percent in real terms in the 1980s. That was in line with the growth of their economies. In 1989 the ratio of aid to GNP ranged from 0.15 for the United States to 0.32 for Japan, 0.78 for France, and 0.94 for Denmark and the Netherlands (WDI, table 19). Although some DAC governments (Denmark, France, Italy, Norway, Sweden, and Switzerland) increased their aid as a share of GNP, the amount of aid fell as a share of GNP for several large contributors (Germany, the United Kingdom, and the United States). As a result, the DAC countries' aid-GNP ratio remained constant at 0.35 percent throughout the 1980s. As the decade progressed and many developing countries experienced economic distress, however, it became an objective to make aid more effective. There was a growing awareness of the limitations of government in promoting growth. This led aid-granting and developing-country governments alike to recognize the role of the private sector and to stress the importance of better domestic policies. More and more, aid-granting countries will take effectiveness into account when setting their aid budgets. An adequate volume of aid is essential.

DIRECT FOREIGN INVESTMENT. Flows of direct foreign investment (DFI) are likely to grow in response to policy reforms. However, they will probably remain concentrated in globally integrated, middle-income countries with well-developed infrastructure. In 1989, about 70 percent of DFI flows to developing countries came from Japan (18 percent), the United Kingdom (20 percent), and the United States (32 percent). Just twenty developing economies, mainly in Asia and Latin America, accounted for 90 percent of the net flows between 1981 and 1990. The economic reconstruction of

Eastern Europe and the USSR will increase the competition for DFI. Nevertheless, for the smaller, reforming developing countries even modest increases in DFI flows can have a measurable effect on growth.

FINANCIAL INSTITUTIONS. The financial situations of some of the biggest banks and insurance companies of the United States and Japan have been weakened by rising interest rates, falling share and real estate prices, and bad investments. A ratio of market capitalization to assets of 8 percent is to be applied to all international banks by December 1992, as agreed in the Basle Accord. As these institutions struggle to raise capital, they are cutting back on new lending. Japan and the United States appear determined to contain the problem by bolstering deposit insurance and restructuring failed institutions. But the credit markets, already influenced by the financing requirements of Eastern Europe and the Middle East, are bound to be affected. Upward pressure on interest rates will remain for the medium term.

OECD POLICY. The macroeconomic policies of the industrial countries affect the external climate for development in a variety of ways. Most important, perhaps, by promoting steady and noninflationary growth at home they can improve the outlook for developing-country exports.

The industrial countries' macroeconomic policies also influence the demand for, and supply of, global savings, and thereby the level of world interest rates. Conversely, financial integration has made the task of setting national macroeconomic policy much more complicated. Diverging or inconsistent policies have often been the main cause of volatility in financial markets. To counter this, the Group of Seven industrial countries (G-7) have in recent years achieved a greater degree of policy cooperation, which can be credited with some of the equilibrating adjustments among the main exchange rates since 1985. But coordination of interest rate changes and intervention in the currency markets may not always be sufficient, and occasionally may even be counterproductive. Pooling information on broader aspects of macroeconomic policy, notably on projected fiscal imbalances, would be helpful.

*An uncertain world*

The global trading and financial systems are the most obvious and familiar aspects of the economic climate with which the developing countries will have to contend. But there is a long list of other uncertainties. In each case, it is easy to imagine outcomes that might greatly help the development effort—and others that might cripple it.

SECURITY. East-West political tensions have eased. In itself, the end of the cold war should improve the prospects for global growth. But this is also an opportunity to make significant cuts in U.S. and Soviet military spending. New treaties and shifting alliances are rapidly reducing conventional forces in Europe. By 1994, the weapons of the former Warsaw Pact members will number at most one-third of their 1988 levels. Savings from western military budgets might persuade governments that their earlier commitments to increase aid to the developing countries can now be met. But aid from the Soviet Union to its friends in the developing world is sure to be tightly squeezed. The Soviet Union's acute economic difficulties have already caused severe disruption to its trade with developing countries such as India. A political breakdown is imaginable that might send a flood of refugees into the countries of Eastern Europe, which already face the formidable problems of economic transition.

Military spending is about 5 percent of GNP in the industrial countries as well as the developing countries. But military spending is about half of the combined spending on health and education in the industrial countries, whereas these two magnitudes are about the same in developing countries. Large military spending has undoubtedly claimed scarce resources, and probably slowed growth in the developing world. Perhaps, on the one hand, there will now be fewer conflicts reflecting cold war ideologies. On the other hand, superpower disengagement could encourage some developing countries to build and exercise greater military power. More states may assert their regional ambitions. Ethnic tensions within countries could aggravate these trends, as could new conflicts over regional resources such as water and oil.

POLITICAL CONSIDERATIONS. The 1980s witnessed political reforms and shifts to participatory forms of government in many parts of the world. In recently published work, scholars and policymakers have placed greater stress on personal freedom and pluralist government, not only as values in their own right, but also as factors that are associated with development. Whatever the merits of such arguments, fairness and pluralism loom ever larger in the aid-granting countries' consideration of aid effectiveness and aid priorities.

ADVANCES IN TECHNOLOGY. Because most innovations originate in industrial countries, and because research tends to focus on problems of local concern, technical advances may systematically favor industrial-country producers and consumers. Industry studies suggest that new technology may have reduced the competitive disadvantage of industrial-country manufacturers. Some firms in traditionally labor-intensive subsectors (for example, textiles, clothing, and shoes) are beginning to reopen operations in high-wage countries.

Although differences between low- and high-wage producers may have narrowed in some industries, advances in communications and transport have shifted the advantage to production chains that combine operations in industrial and developing countries. Assembly and other labor-intensive processes can be efficiently located, where wages are low. New trends in automation, multipurpose plants, and modular product design are reducing the minimum economic size of production units. This will make it easier to establish facilities in smaller, specialized markets.

New technology offers the possibility of entirely new products and processes, including some that could dramatically improve the lives of the world's poor. Past breakthroughs in medicine and agricultural genetics had precisely such effects; advances in biotechnology could soon make farmers in developing countries much more productive. At the same time, however, advances in the materials sciences may displace raw materials produced by developing countries. Innovation could reduce the demand for petroleum, feedstocks, and metals, shifting input requirements toward commonly available materials.

THE ENERGY OUTLOOK. The global demand for energy is expected to increase by about 2 percent a year in the 1990s. Demand will grow fastest in the developing countries, where continuing urbanization will raise the demand for petroleum in residential use and power generation. Increases in industrial-country demand for petroleum will be mainly the result of its use in automobiles and other forms of transport. Natural gas will expand further as a major energy source—especially in developing countries and the USSR, where safety and environmental concerns will cause a shift away from nuclear power.

In the short term, oil prices will be influenced by security and other considerations in the Gulf area, and by the ability of OPEC to exert its influence. In the medium term, petroleum production from non-OPEC sources will level off by the mid-1990s. The Gulf will continue to be the major supplier of oil; indeed its share of world oil production will rise from 36 percent in 1989 to 43 percent in 2000. There is likely to be a moderate rise in the real price of petroleum in the medium term. In some countries, domestic prices could rise more rapidly if environmental concerns lead to higher energy taxes. The range of domestic energy prices is extremely wide. In 1989 gasoline prices in the United States and a number of developing countries were only a fraction of those in western Europe.

ENVIRONMENTAL DAMAGE. Widespread misuse of resources ranges from the overexploitation of fishery, land, and forests to local and international pollution of the environment. Studies in Germany, the Netherlands, and the United States have found that environmental damage from air, water, and noise pollution amounts to between 0.5 and 2.5 percent of GNP annually. This exceeds the estimated cost of pollution controls. The harm (including that caused by climate change) may be greater in the developing world. The annual cost of deforestation is estimated at 6–9 percent of GNP in Ethiopia and 5.7 percent of GDP in Burkina Faso. Estimates of the costs of substantially limiting pollution are generally much smaller—typically about 1–2 percent of GNP in industrial countries.

Long-term growth and environmental conservation need not be mutually exclusive, although well-designed environmental policies may reduce short-term economic growth as conventionally measured. Such policies make sense nonetheless. They would increase economic welfare and be far more efficient than strategies expressly designed to limit economic growth. Some harmful activities, however, cannot be monitored. And in other cases a straightforward technical solution is precluded by political considerations; examples include protection of the oceans and the atmosphere.

Experience in combining greater regard for the environment with continued economic growth is limited, but encouraging. The industrial countries reduced their energy demand per dollar of GNP by 23 percent between 1970 and 1987. Controls have successfully reduced many sorts of pollution at only a small cost, if any, in growth as conventionally measured. Emissions of sulphur oxides per dollar of GNP, for example, have been cut by more than half in virtually every industrial country. But much remains to be done. In the United States, where energy prices are low, consumption

per capita is more than twice as high as in Japan. Reducing the demand for energy will require both a shift to energy-efficient outputs and energy conservation through higher prices. There can be no question that greater efforts to protect the environment are needed, but the exact scale of the undertaking is, and probably will remain, uncertain. So this is yet another variable in the situation that will confront the developing countries over the coming years.

### Quantitative global scenarios for the 1990s

Long-term projections have serious limitations. This is particularly true just now, with so many uncertainties in the world economy. Accordingly, the projections published in *World Development Reports* have become more guarded in recent years (Box 1.4). The two central scenarios presented here reflect some of the doubts concerning the global economic background. The baseline scenario assumes moderately favorable external conditions, and the downside scenario assumes moderately unfavorable conditions (Table 1.4). (Extreme scenarios, resulting either in very high or very low growth for the world economy during a decade, although plausible, are considered unlikely.) The downside scenario does not allow for major adverse events—a financial crisis, a precipitous rise in energy prices, or a trade war. The baseline case assumes that there will be moderate progress in domestic-policy reform in many of the developing countries. Variations of this baseline case are also considered by taking the external setting to be fixed while exploring different assumptions about domestic policy in the developing countries (Chapter 8). Unsurprisingly, very good policies yield considerably higher growth rates, whereas backsliding leads to much slower growth than in the baseline.

The baseline scenario makes the following assumptions. The average price of oil will follow a gently upward path in real terms. The United States will reduce its structural fiscal deficit. The recession in the United States and some other industrial countries will be mild and short-lived. Growth in Europe and Japan, after a moderate slowdown in the short run, will remain relatively strong as policy reforms lead to faster growth in productivity. Real interest rates will remain high for the medium term. The Uruguay Round will make substantial progress in key areas of negotiations, but not in agriculture. Project 1992 will yield a significant long-term growth dividend for Europe. Net inflows of capital into developing countries will gradually expand. Most developing countries will continue to implement policy reforms.

The assumptions of the downside scenario differ as follows. The price of oil will be somewhat higher. The Uruguay Round will drag on inconclusively, producing no medium-term benefits in expanded trade. Financial difficulties in the United

**Table 1.4 The international economic climate in the 1990s: a comparison of recent and projected indicators**
*(average annual percentage change, unless noted)*

| | | | | *Projections for the 1990s* | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | *Trend* | *Recent experience* | | *World Bank baseline,* | *World Bank downside,* | *IMF baseline,* | *Project LINK,* | *WEFA Group,* | *DRI,* |
| *Indicator* | *1965–89* | *1980–89* | *1990* | *1990–2000* | *1990–2000* | *1991–96* | *1991–95* | *1991–95* | *1991–95* |
| *High-income OECD members* | | | | | | | | | |
| Real GDP | 3.1 | 3.1 | 2.6 | 2.9 | 2.2 | 3.1 | 2.8 | 3.2 | 3.1 |
| Inflation[a] | 6.6 | 3.8 | 3.7 | 3.6 | 4.3 | 3.4 | 3.4 | 4.4 | 3.3 |
| Interest rate (percent) | | | | | | | | | |
| Nominal[b] | 8.6 | 10.2 | 8.4 | 7.4 | 9.6 | .. | 7.7[c] | 8.6 | 7.9[c] |
| Real[d] | 3.1 | 5.8 | 4.3 | 3.4 | 5.1 | 3.9 | 4.0[c] | 4.3 | 4.9[c] |
| *World trade*[e] | 4.1 | 4.1 | 5.0 | 5.8 | 4.5 | .. | 5.6 | 4.3 | .. |
| *Real price of oil*[f] | 9.3 | −10.1 | 22.2 | −0.6 | 0.9 | −3.0 | 0.9 | 0.8 | −2.0 |

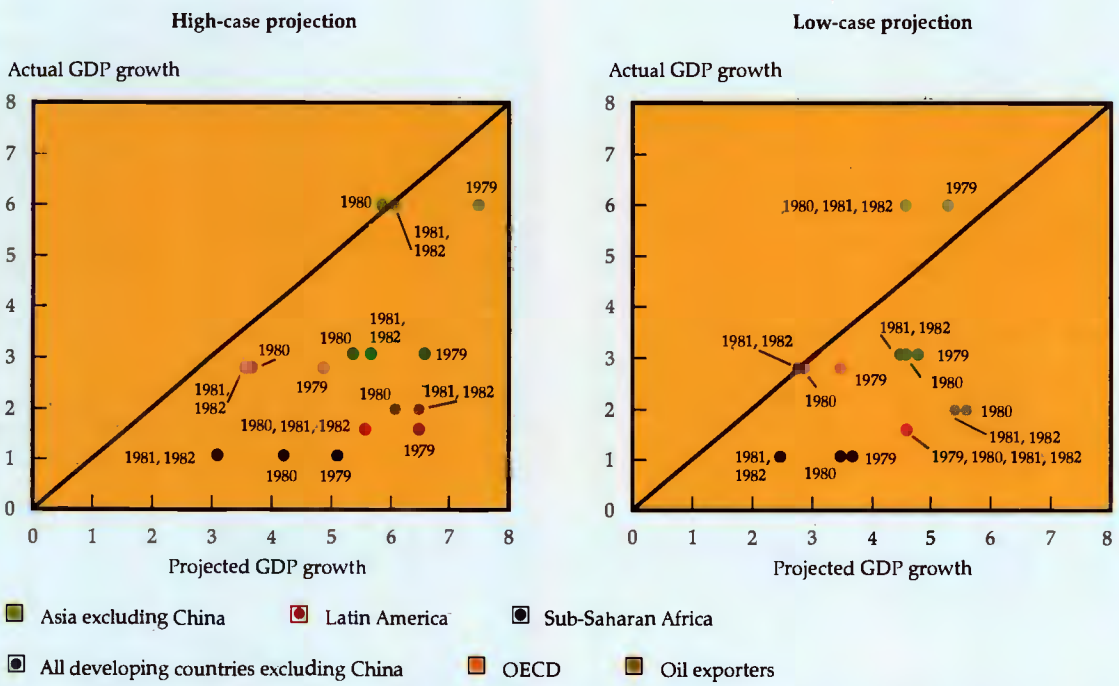
a. GDP deflators in local currency for World Bank and IMF projections; for others, inflation is measured by consumption price deflator.
b. Six-month LIBOR on dollar deposits.
c. U.S. three-month Treasury bill rate; the real rate is the Treasury bill rate deflated by the U.S. GNP deflator; DRI projections are for the U.S. long-term government bond yield deflated by the U.S. GNP deflator.
d. LIBOR deflated by U.S. inflation rate (percentage change in the GNP deflator).
e. World volume of exports.
f. Average OPEC price of oil deflated by the manufactures unit value exported by industrial countries; Project LINK's is the average price for Saudi Arabian exports deflated by the GNP deflator.
*Sources:* World Bank data; IMF 1991; WEFA Group 1991; DRI/McGraw-Hill 1990; Project LINK 1991.

## Box 1.4 How well did early *World Development Reports* foresee growth in the 1980s?

*World Development Reports* of a decade ago—and the predictions by the rest of the international community—were generally too hopeful about growth in the 1980s. The Reports' high-case scenario—with good policies and a return everywhere to the strong performance of 1960–78—proved far too optimistic. The low-case scenario was much closer to the mark for both industrial and developing economies.

The projections for the 1980s made in the Reports between 1979 and 1982 reveal two trends (see Box figure 1.4). First, as the world economy moved into deep recession, both the high- and low-case projections for the 1980s were revised downward. The revisions for Sub-Saharan Africa were fairly significant, which mainly reflected the sharp economic deterioration there. Second, even the low-case projections were too

**Box figure 1.4 The World Bank's long-term projections of average GDP growth for the decade of the 1980s compared with outcomes**
*(percent)*




*Note:* Years refer to the edition of *World Development Report* in which the projection was published. If outcomes matched projections exactly, the data would fall along the diagonal line. Points below the line indicate optimistic projections; points above, pessimistic ones. For more information on the projections and outcomes, see the technical note at the end of the main text.
*Source:* World Bank data.

States and Japan will push risk premiums higher than in the baseline. That, together with a greater perception of financial risk and uncertainty, will depress private investment and cause slower productivity growth in the G-7 countries. Net capital flows to developing countries will grow more slowly, with private flows playing a negligible role. Most developing countries will continue economic reform, but at a slower pace than in the baseline.

Quite different outcomes, obviously, are possible. The GATT talks might succeed in all the areas of negotiations, including agriculture. World trade could then expand by 7 percent or more a year starting in the mid-1990s—faster than in recent years (but still below the 9 percent annual average

optimistic for Latin America and the oil-exporting countries but somewhat pessimistic for Asia.

Why the errors? World trade grew at 4.7 percent a year in the 1980s, not at the high case's 5.7 percent. Real interest rates, high in 1979–81, were expected to come down quickly (they didn't), and large inflows of capital were expected to flow into developing regions (they didn't). Nor did the projections look for a sharp decline in the oil prices.

The 1982 Report assumed that by 1990 (in the low case), the total external financing of the low- and middle-income countries as a group would be $147 billion—with $19.5 billion in direct foreign investment, $54.5 billion in official development assistance, and $74 billion in commercial flows. Instead, the estimated net external financing (excluding China) in 1990 was $63 billion, 43 percent of the assumed level. And ODA was only about 0.35 percent of the OECD countries' GNP, not the 0.7 percent targeted a decade before.

These assumptions about capital flows to the developing countries in the 1980s were based on an optimistic projection of global saving for 1990. The OECD was expected to run a current account surplus of $55 billion in 1990, and the high-income oil exporters were to have a large combined surplus throughout the 1980s. Instead, the OECD had a $90 billion deficit in 1990, whereas the large oil-exporting developing countries were in deficit for much of the 1980s and only recently moved into a small surplus. Although the early Reports recognized the potential severity of the debt crisis, they did not foresee the large negative transfer of resources from developing countries after the mid-1980s.

Perhaps most important, many assumptions about the domestic policies that underlie the developing countries' projections were not satisfied. For example, one cause of the poor performance of Latin America in the early 1980s was domestic policy weakness—leading to large fiscal deficits. In contrast, the better domestic policies of Asian economies in the 1980s moved their economic performance fairly close to the high case.

The Reports are careful to state that their projections are *not* to be seen as "precise forecasts for the future." Those projections are nevertheless often taken as indicating the World Bank's ability to map the growth paths of member countries.

of the 1960s). Eliminating Multifibre Arrangement restrictions and lowering agricultural subsidies in industrial countries could mean significant gains for the developing countries. Alternatively, the impetus to faster growth could come from faster expansion of intraregional trade in the Western Hemisphere, Europe, and the Pacific Basin. Because many companies established by foreign investments are trade-intensive, the recent acceleration of such investment could generate further trade growth later on.

If, however, Project 1992 leads to more protection in Europe, and other regions retaliate, the growth of world output might decline. Losses resulting from a trade war, compared with a projection assuming liberalization, could amount to 3–4 percent of world output. Industrial-country restrictions on imports reduce the GNP of the developing countries by 3–4 percent; the harm is greater for major exporters of manufactures.

*Alternative projections*

The *baseline scenario* suggests that the growth in some developing regions may be disappointing over the next few years. The average increase in output of 4.9 percent a year masks big differences among regions (Table 1.5). High real interest rates in the industrial countries will hurt all the developing countries; a continuation of negative transfers will restrain growth in the highly indebted ones. But some of the countries that did badly in the 1980s are now implementing major policy reforms; more countries should see their per capita growth rates rise significantly in the medium term. The countries that have so far failed to introduce reforms are likely to fall further behind.

The average growth of per capita income in the severely indebted middle-income countries may climb to 2.0 percent a year. That compares with an average of -0.5 percent a year in the 1980s. The projection assumes that positive net financial transfers to several countries in the group will resume in the medium term, although in the aggregate they will remain negative for some time. Some of the large economies that have embarked on wide-ranging reform (Brazil, Mexico, and Venezuela) may be able to achieve a significantly faster growth rate than projected by the mid-1990s.

The Asian NIEs should continue growing at rates significantly above average for developing countries, albeit more slowly than in the 1980s. By the year 2000 some current NIEs should have joined the ranks of the industrial economies. Under the assumption that they adopt favorable domestic policies, China and India are also expected to grow faster than the average for developing countries.

The economic situation in many poor countries, however, could remain precarious. Average per capita incomes in Sub-Saharan Africa are expected to grow less than 1 percent a year in the first half of the 1990s, and somewhat faster later. Even by 2000

**Table 1.5 Real GDP and real GDP per capita growth rates for low- and middle-income economies, 1965–2000**
*(annual percentage change, unless noted)*

| Region or group | GDP, 1989 (billions of dollars) | Population, 1989 (millions) | Real GDP growth | | | Real GDP per capita growth | | |
|---|---|---|---|---|---|---|---|---|
| | | | Trend, 1965–89 | Projection for 1990s | | Trend, 1965–89 | Projection for 1990s | |
| | | | | Baseline | Downside | | Baseline | Downside |
| *All low- and middle-income economies* | 3,303 | 4,053 | 4.7 | 4.9 | 4.1 | 2.5 | 2.9 | 2.2 |
| *Region* | | | | | | | | |
| Sub-Saharan Africa | 171 | 480 | 3.2 | 3.6 | 3.5 | 0.4 | 0.5 | 0.3 |
| Excluding Nigeria | 142 | 367 | 3.3 | 3.6 | 3.1 | 0.4 | 0.4 | 0.0 |
| Asia | | | | | | | | |
| East Asia | 895 | 1,552 | 7.2 | 6.7 | 5.6 | 5.2 | 5.3 | 4.2 |
| South Asia | 351 | 1,131 | 4.2 | 4.7 | 4.2 | 1.8 | 2.6 | 2.1 |
| Europe, Middle East, and North Africa | 828 | 433 | 4.2 | 3.6 | 3.2 | 2.2 | 1.8 | 1.4 |
| Latin America and the Caribbean | 964 | 421 | 4.3 | 3.8 | 3.1 | 1.8 | 2.0 | 1.3 |
| *Income group* | | | | | | | | |
| Low-income economies | 996 | 2,948 | 5.1 | 5.5 | 4.8 | 2.9 | 3.5 | 2.9 |
| Middle-income economies | 2,308 | 1,105 | 4.5 | 4.5 | 3.7 | 2.5 | 2.6 | 1.9 |

*Note:* For group totals, see the technical note at the end of the main text.
Source: World Bank data.

average incomes in Africa will be less than in 1980. In some thirty countries undergoing major reform, however, the quality of investment projects is improving, external financial support is available, and both output growth and investment are higher than the average for Sub-Saharan Africa. Some of these countries could also benefit indirectly from Project 1992 (because of the expected higher level of demand for commodities in Europe).

Growth prospects in Eastern Europe crucially depend upon how well governments manage the transition to a market economy. The baseline projections show a slow pace of growth in the short to medium term but significantly faster growth after the mid-1990s. Prospects for the large oil producers in North Africa and the Middle East depend not only on the success of their economic reforms but also on oil prices. The baseline projections indicate that these countries could grow at a modest pace of 3.5–4.0 percent a year.

In the *downside scenario*, the average growth of the industrial countries is lower in the 1990s by 0.7 percentage point. Real interest rates are assumed to rise sharply (Table 1.4). Output growth in the developing countries is about 1.1 percentage points lower in East Asia, 0.7 points lower in Latin America, and 0.5 points lower in South Asia and Sub-Saharan Africa (excluding Nigeria). Oil importers fare worse than these averages, because oil prices are high in the downside scenario. For the developing countries as a group, the average rate of GDP growth is similar to the 1980s.

More extreme scenarios, although plausible, are unlikely. But a "low case" scenario, based on great turbulence in the trading and financial systems and highly unstable oil prices, could result in a 1.7 percentage point drop from the baseline in the average industrial-country growth rate and a 2.0 percentage point drop in the developing-country growth rate during the 1990s. Alternatively, a "high case" scenario could result in 1.1 percentage points higher growth in the industrial countries than the baseline and 1.6 percentage points higher average growth in the developing countries.

*Domestic reform or external conditions: which matters more?*

The projections in Table 1.5 assume that only the external environment changes. They do not consider the effect of policy and institutional changes in the developing countries. How much of a difference might reform make? This is an extremely difficult question to answer quantitatively, as opposed to qualitatively. Estimates based on the work of the World Bank's country economists, presented in Chapter 8, show that international conditions are important, and that domestic policies and institutions are even a greater factor in long-term growth. Estimates for forty countries suggest that, on average, better domestic policies could raise GDP growth by twice as much as better external factors. What are the appropriate policies and institutions? Answering this question in qualitative terms is the task of the rest of this Report.