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Chapter II

EVOLVING DEVELOPMENT STRATEGIES – BEYOND THE MONTERREY CONSENSUS

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A. Introduction

Policy reforms undertaken by developing countries in the 1980s and 1990s were strongly influenced by the international financial institutions, which emphasized stabilization and liberalization. Through their lending activities and political support from the major industrialized countries, the International Monetary Fund (IMF) and the World Bank were able to exercise considerable leverage on the design and implementation of developing countries' macroeconomic and development policies. The new policy agenda, which came to be labelled the "Washington Consensus", evolved over time, incorporating additional elements in response to the disappointing outcomes of reform programmes and to criticism that emanated from the international policy debate.

The elements that were added to the standard reform programmes primarily addressed the initially neglected social implications of adjustment and the institutional requirements for the success of reforms. Advocacy by various international organizations and civil society highlighted the issue of poverty in the developing world, and its linkages with adjustment policies in a globalizing world economy began to receive increasing attention in the early 1990s. This culminated in the formulation of the Millennium Development Goals (MDGs) at the United Nations World Summit in 2000. The increasing belief that local governments should take ownership of reforms led to revisions in the operational design of reform programmes in low-income countries. Moreover, with the recognition that external constraints were inhibiting the success of policy reforms, the international community stepped up its efforts to establish a global partnership for development. This resulted in far-reaching debt relief initiatives, new commitments to greater bilateral official development assistance (ODA) and the exploring of new sources of international development finance.

In this chapter it is argued that although the different amendments to the standard reform packages placed stronger emphasis on specific institutions for developing countries, they did not imply a fundamental change in the orientation of the reform agenda. There was the continued belief that improved factor allocation through market liberalization and opening up to international trade and finance would be key to solving the problems of developing countries by strengthening their productive capacity, raising productivity and accelerating technological upgrading.

This chapter is not intended to provide a comprehensive evaluation of the wealth of literature on the subject. Rather, it attempts to provide an outline of the evolution of mainstream thinking on development strategies since the early 1980s, and its influence on practical policy-making in terms of its implications for capital accumulation, productivity growth and technological progress. It discusses how the various adjustments to the reform programme are reflected in the different initiatives taken by the United Nations since the beginning of the new millennium, without, however, succeeding in reducing the income gap between the majority of developing countries and the developed world. Despite the revisions of and additions to the standard policy prescriptions for developing countries, the dominating philosophy underlying development policy, with its focus on efficiency gains from market-determined improvements in factor allocation, has remained unchanged. The experience of the past 25 years has shown that reliance on market forces alone is not enough to achieve the pace and structure of productive investment and technological upgrading necessary for catch-up growth and sustained poverty eradication. Inadequate attention has been paid to active government policies in favour of diversification and dynamic industrialization that take into account country-specific constraints, possibilities and capabilities. The chapter concludes with recommendations for a more fundamental reorientation of policy reforms, at both national and international levels, with a view to strengthening capital accumulation, innovation and productivity growth in developing countries – all prerequisites for better integration into the world economy and for reducing the income gap between rich and poor nations.

> The standard reform agenda was built on the belief that improved factor allocation through market liberalization and opening up to international trade and finance would be key to solving the problems of developing countries.

B. The emergence of the "Washington Consensus"

Development policies over the past 25 years have been shaped largely by policy prescriptions of the international financial institutions. Their influence on developing countries had increased considerably since the early 1980s following a dramatic rise in the current-account deficits of numerous developing countries over the course of the preceding decade. In the case of countries that had access to international financial markets, these deficits were initially financed by borrowing from those markets; the poorer countries that lacked such access had to rely on official loans, leading to their increasing dependence on external financing and a rapid build-up of external debt. When the United States shifted to a monetary policy of aggressive disinflation from 1978 onwards, dollar interest rates rose dramatically, which increased the cost of their accumulated external debt; meanwhile their export earnings suffered from weakening global demand.

As a result of their widening current-account deficits developing countries' use of IMF credit rose sharply, as commercial banks were unwilling to maintain their pace of lending. In 1982, the IMF took the lead role in managing the debt crisis affecting many developing countries that were carrying large amounts of commercial bank debt. The number of IMF-supported programmes rose from an annual average of 10 during the 1970s to 19 in 1980 and to 33 in 1985 (Jespersen, 1992). When it became apparent that in most cases the short-term horizon of the stabilization programmes was inappropriate to bring a lasting solution to the problem, the IMF established the Structural Adjustment Facility (SAF) for low-income countries in March 1986. Then in November 1987 it created the Enhanced Structural Adjustment Facility (ESAF) to provide additional balance-of-payments assistance through the International Development Association (IDA) to eligible low-income developing countries that faced protracted balance-of-payments problems. Lending under the ESAF was designed to support comprehensive reforms and adjustments, as reflected in the stringent conditionality attached to such lending, including the standard ingredients of IMF stabilization packages, such as a reduction in public spending, restrictive monetary policies and exchange-rate adjustment, but also structural conditions, such as import liberalization, privatization and deregulation of the domestic economy.

As noted by Schadler et al. (1993: 9), "[t]he strategy underlying the structural reform programme was to strengthen the financial position of the public sector and reduce government interference in the allocation of resources" with the objective of containing inflation and attaining fiscal and current-account balance. However, it did not address the question of how to raise productive capacity for export growth and employment creation, which would have required a more balanced mix of monetary and fiscal measures (Lipumba, 1995: 38). While imprudent domestic policies in the 1970s had contributed in many countries to increased vulnerability to external shocks, the debt crisis itself had been triggered by global factors. Yet a case-by-case approach was adopted in attempting to solve the problems, based on the belief that government failure was the sole cause of the crisis and that market discipline would prevent such failures in the future.

Structural adjustment policies placed emphasis on greater macroeconomic stability, a reduced role for the State, greater reliance on market forces and a rapid opening up to international competition.

Earlier, in 1979, the World Bank, which had previously focused its lending activities on the financing of investment projects, had responded to the difficulties facing developing countries by introducing structural adjustment loans, designed to assist countries in overcoming structural – rather than cyclical – impediments to payments adjustment. Like IMF programmes, World Bank structural adjustment lending placed emphasis on greater macroeconomic stability, but also on a reduced role for the State, greater reliance on market forces and a rapid opening up to international competition as key to unlocking growth potential. Its policy prescriptions to achieve these objectives included liberalization of trade and foreign exchange allocation, deregulation of interest rates and prices, reduced public sector involvement in agricultural marketing, privatization of public enterprises and restructuring of public expenditures.

IMF operations helped the borrowing countries in their efforts to remain current on their debt service payments and to maintain a minimum level of crucial imports, but the conditionality attached to the lending by the international financial institutions restricted the policy options that could be used to provide support to capacity-enhancing investment. Entering into an agreement with the IMF soon became a prerequisite for debt restructuring, and the willingness of bilateral or private lenders to extend new loans to developing countries increasingly came to depend on how closely these countries' economic policies conformed with the standard reform packages advocated by the Bank and the Fund. As a result, the structural adjustment programmes not only shaped the economic policies of countries that had to resort to borrowing from the international financial institutions, they also came to be widely accepted as the standard reform package for countries that were reviewing their development strategies for achieving closer integration into the globalizing world economy.

In 1989, the term "Washington Consensus" was coined to signify the standard set of policy prescriptions of the Washington-based institutions (Williamson, 1990). They were initially formulated for Latin America but were subsequently extended to developing countries elsewhere, and from the early 1990s onwards, also to economies in transition. In addition to the elements listed above, other policy elements considered appropriate by the advocates of the Consensus included tax reforms to lower the marginal rates and to broaden the tax base, opening up to foreign direct investment (FDI) and protecting property rights.[1] Although the term Washington Consensus was subject to various interpretations and misinterpretations, it became a reference point for discussions on development policies.[2]

> The Washington Consensus approach to development represented a shift away from the focus on capital accumulation to an almost exclusive reliance on improved factor allocation generated by market forces.

This policy orientation marked a shift from the development thinking and practice that had dominated the previous decades. Earlier approaches had advocated a more central role for government policies and the public sector in driving the development process. Thus, until the late 1970s, development strategies in most developing countries were built on a strong public sector and State intervention and regulation of economic activity. Many countries adopted a variety of price controls and State intervention in resource allocation, aimed at directing the economic process towards outcomes that were perceived to respond to prevailing social and human needs and the requirements of long-term development. State ownership of enterprises was often considered necessary in the absence of a critical mass of private, capitalist entrepreneurs. In addition, control over the financial sector and regulation of credit allocation were considered necessary in the absence of an efficient system of financial intermediation and sufficiently deep financial markets, and to ensure that the financial sector served the needs of the real economy and conformed with national objectives.

The diagnosis of "market failure" and the inherent instability of markets had provided an important theoretical basis to justify the need for government policies to correct such failures. This led to greater State intervention, not only as a provider of infrastructure and social services, but also as a capitalist investor in strategically important industries, and as a source of financing for private investment. This approach had been adopted not only in the economic and social policies of developing countries, but also by many developed countries. While sticking to market principles, they too had given a key role to various forms of State intervention: from active support for the private sector in post-war industrial reconstruction and State ownership of strategically important sectors – such as banking, energy provision and transportation – to an array of policy measures to support specific sectors and economic activities that were considered important for national economic security, for socially acceptable income distribution, for maintaining high employment and for meeting other fundamental objectives. Economic policies in developed and developing countries alike were still influenced by the Great Depression and by the experience that decentralized agents in the private sector, in their pursuit of self-interest, had not automatically been generating full-employment equilibrium and sustained growth.

In developing countries, igniting a process of industrialization was the central concern of economic policy. In Latin America during the Great Depression and the Second World War, previously imported manufactures that had become difficult to acquire were substituted by domestic production. Starting from this basis, inward-oriented industrialization was subsequently promoted by deliberate policies, including trade protection, directed credit and subsidies, and the creation of State-owned enterprises. Most development economists of the time generally regarded capital accumulation as the core process by which all other aspects of growth and economic transformation are made possible (Cairncross, 1955).[3] The importance of entrepreneurship, technical progress and innovation, and education and vocational training was well recognized, but it was also considered necessary for the "developmental State" to take the lead role. From this perspective, the reorientation of structural adjustment policies and the Washington Consensus approach to development represented a shift away from the focus on capital accumulation to an almost exclusive reliance on the efficiency-enhancing potential of improved factor allocation generated by market forces.

The previous orthodoxy of State-centered development strategies, with their high degree of interventionism, State *dirigisme* and protectionism, was considered responsible for market distortions leading to suboptimal resource allocation and underperformance of developing economies. The new approach recommended privatization, deregulation, trade and financial liberalization aimed not only to improve incentives for more efficient resource allocation, but also to reduce the need for State discretion. Even when there were market failures resulting from externalities, the provision of public goods, imperfect and asymmetric information, imperfect competition and incomplete markets, little justification was seen for policy intervention, since the consequences of government failures were considered to be much more serious than those of market failures. Equally important was that the standard set of reform policies implied a shift from a national perspective on development towards outward orientation, price determination by global markets and, despite the problematic experience of the second half of the 1970s, a greater reliance on foreign capital inflows. Thus, efficiency enhancement in resource allocation was sought to be achieved through liberalization and deregulation at the national level and through opening up to competition at the global level, as underlined by the importance given to liberalization of trade and FDI.

C. The outcome of orthodox reforms

The performance of countries that undertook orthodox reforms, including the transition economies in the 1990s, rarely met the high expectations. It was especially disappointing in comparison with that of economies that had followed alternative strategies, in particular the fast-growing newly industrializing economies (NIEs) in East Asia (*TDR 2003*, chap. IV). Average annual GDP growth in these economies exceeded 7 per cent throughout the period from 1980 to 1996. In China it was even higher with an annual average exceeding 10 per cent between 1980 and 2000. Latin America, on the other hand, registered an average annual GDP growth of 1.8 per cent in the 1980s and 3.3 per cent in the 1990s, and sub-Saharan Africa's average annual GDP growth did not reach 3 per cent in either decade. Moreover, the dramatic slowdown in the latter two regions compared to the 1960s and 1970s was accompanied by much greater instability. By contrast, growth remained consistently high in Asia, and was associated with less instability than during the preceding decades (table 2.1).

In Latin America, stabilization policies in the 1980s helped to bring inflation, which had often taken the form of hyperinflation, under control and to achieve a reasonable degree of monetary and fiscal discipline. However, the policy prescriptions soon came under criticism because of the disappointing overall performance of the economies where they were implemented, especially in terms of growth dynamics and capital formation. Moreover, it soon became apparent that the programmes had undesirable social repercussions. The per capita income in Latin America fell on average by 0.3 per cent per annum between 1980 and 1990

Table 2.1

GDP GROWTH IN SELECTED DEVELOPING COUNTRIES AND REGIONS, 1960–2004

(Average annual percentage change)

Region/country	1960–1965	1965–1970	1970–1975	1975–1980	1980–1985	1985–1990	1990–1995	1995–2000	2000–2004
Africa	5.4	4.9	4.4	3.8	2.2	2.6	1.1	3.4	3.9
Sub-Saharan Africa, excl. South Africa	3.9	3.9	3.9	1.9	1.7	3.2	1.5	3.7	4.2
Latin America	4.6	5.8	6.6	5.1	0.5	1.8	3.6	2.8	1.5
East Asia	5.0	7.5	6.8	7.6	7.1	8.2	8.8	4.9	6.2
China	2.1	5.3	5.1	6.1	11.0	7.8	12.9	8.5	9.4
First-tier NIEs	8.0	9.8	8.3	9.0	7.1	9.1	7.3	4.2	3.8
South Asia	4.5	4.9	2.3	3.6	5.3	5.9	5.0	5.3	5.7
India	4.2	4.9	2.4	3.0	5.3	6.6	5.3	5.8	6.1
Developing countries	4.8	6.0	6.4	5.1	2.9	4.3	5.4	4.1	4.4

Source: UNCTAD secretariat calculations, based on World Bank, *World Development Indicators*, various issues; United Nations Statistics Division (UNSD), *National Accounts Main Aggregates* Database; and Taiwan Province of China, *MacroEconomics* Database.
Note: Calculations are based on GDP in constant 1995 dollars.

(table 2.2), and income distribution deteriorated, in some countries dramatically. The decline in industrial output, combined with the compression of the public sector, implied a sharp increase in open unemployment and informal sector activities as well as a widespread deterioration in working conditions, including a significant fall in real wages, and a dramatic increase in poverty (Calcagno, 2001). The 1990s saw some recovery after the preceding "lost decade", but growth did not return to the levels experienced before the debt crisis and the poverty level remained unchanged.

In Africa, per capita income fell on average by 0.4 per cent in the 1980s, and thereafter scarcely any country returned to the pace of growth of the previous decades, even though they implemented structural adjustment programmes for many years. Of the 15 countries that the World Bank had identified as core adjusters in 1993, only three were classified by the IMF as strong performers by the end of the decade. Where there were improvements in growth performance, these could largely be explained by special circumstances that were unrelated to structural adjustment policies (*TDR 1998*, Part Two, chap. I, table 34). As in Latin America, programme implementation was also accompanied by deteriorating social indicators: the proportion of the population living on less than $1 a day in the least developed countries (LDCs) of Africa increased continuously from the second half of the 1960s – from an average of 55.8 per cent to 64.9 per cent in 1995–1999 (UNCTAD, 2002: tables 19 and 20). Estimates by the UNCTAD secretariat for 20 LDCs, including 17 from Africa, on the impact of SAF/ESAF programmes on poverty, show that, comparing the three years before and after the adoption of the programmes, the overall incidence of poverty rose by nearly one percentage point (UNCTAD, 2002: table 40). As frustration with the results of the adjustment programmes intensified, the view gained ground that structural adjustment programmes were "part of the problem rather than part of the solution of the development crisis in Africa" (Lipumba, 1995: 52).

There are differing views on the causes of the failure, and varying experiences suggest a complex relation between different domestic and external factors.[4] A major cause of the failure of

Table 2.2

PER CAPITA GDP GROWTH IN SELECTED DEVELOPING COUNTRIES AND REGIONS, 1960–2004

(Average annual percentage change)

Region/country	*1960–1965*	*1965–1970*	*1970–1975*	*1975–1980*	*1980–1985*	*1985–1990*	*1990–1995*	*1995–2000*	*2000–2004*
Africa	2.8	2.2	1.6	0.9	-0.7	-0.2	-1.5	1.0	1.6
Sub-Saharan Africa, excl. South Africa	1.3	1.2	1.1	-1.0	-1.2	0.2	-1.3	1.1	1.8
Latin America	1.7	3.1	4.0	2.7	-1.6	-0.2	1.9	1.2	0.1
East Asia	3.0	4.7	4.4	5.9	5.4	6.4	7.5	3.8	5.3
China	0.3	2.6	2.8	4.6	9.5	6.1	11.7	7.5	8.7
First-tier NIEs	5.0	7.2	6.1	7.1	5.5	8.0	6.1	3.2	3.2
South Asia	2.2	2.5	0.0	1.4	2.9	3.6	2.8	3.3	4.0
India	1.9	2.5	0.1	0.9	3.1	4.4	3.3	4.0	4.5
Developing countries	2.5	3.4	3.9	2.9	0.7	2.2	3.5	2.4	2.9

Source: UNCTAD secretariat calculations, based on World Bank, *World Development Indicators*, various issues; UNSD, *Population* Database and *National Accounts Main Aggregates* Database; and Taiwan Province of China, *MacroEconomics* Database.

Note: See table 2.1.

the reform programmes to meet expectations was probably that they were typically initiated during a situation of crisis, when domestic adjustment took a deflationary path. This necessitated a tightening of fiscal and monetary policy to bring down inflation, while global demand growth remained insufficient to give the needed expansionary stimulus. In addition, measures taken to deal with external shocks often aggravated pressure on the fiscal accounts (e.g. through the impact of currency devaluation on the domestic currency value of debt servicing and on the costs of imports for public investment). Rescue measures for the financial sector and the nationalization of private but publicly guaranteed external debt also represented a heavy additional burden on public finances (*TDR 1989*, chap. IV). Sizeable cuts had to be made in spending for productive infrastructure and social purposes as a result of the pressure for rapid fiscal adjustment. Stabilization policies adversely affected investment and brought the process of capital accumulation to a halt, in some cases even reversing it. In addition, the imposition of austerity measures led to serious social conflicts, thus contributing to growing instability.

Advocates of the orthodox policies attributed the unsatisfactory results to slippages in their implementation, partly reflecting lack of ownership by governments and other stakeholders in the countries undertaking the reforms. Indeed, the stringency of conditionality and the similarity of the reform programmes across countries often made it difficult for national policymakers to obtain the necessary support from domestic groups and institutions for implementation of reforms. By 1994, the World Bank officially recognized that the removal of distortions in product and factor markets alone would be insufficient to "put countries on a sustained, poverty-reducing growth path", and that it would require "better economic policies and more investment in human capital, infrastructures, and institution building, along with better governance" (World Bank, 1994: 2). The Bank did not, however, revise its definition of "good economic policies" by giving more weight to macroeconomic and sectoral policy measures aimed at strengthening productive private investment.

In most countries, the crisis was perpetuated by external constraints that became increasingly intrusive as economies opened up unilaterally to international trade and finance in the context of structural adjustment programmes. The fast pace of trade liberalization in many developing countries caused their trade deficit associated with any given rate of growth to become larger, adding to payments difficulties and increasing dependency on capital inflows. Since in open economies with flexible exchange rates, the interest rate and the exchange rate cannot be used as independent policy instruments, efforts to attract capital inflows involved a spiral of rising interest rates and an appreciating exchange rate. These negatively affected trade performance and fed into increasingly speculative capital inflows. In many developing countries and emerging market economies, the ensuing rising cost of capital hindered accumulation, and the loss of competitiveness induced a reduction in real wages. At the same time, high-interest-led capital flows generated credit expansion, consumption booms and speculative bubbles, which, owing to the lack of proper financial regulatory and supervisory institutions, were a source of financial instability and crisis (Eatwell and Taylor, 2002).

Private investment remained depressed, contrary to expectations that reduced State presence in economic activity would unleash a fresh wave of private entrepreneurial initiatives.

Contrary to orthodox expectations that the cuts in public sector deficits would crowd in private investment, and that a reduced State presence in economic activity would unleash a fresh wave of private entrepreneurial initiatives, private investment remained depressed. An “investment pause” had been expected to occur in the immediate aftermath of the reforms, but the situation persisted because of obvious inconsistencies between the various elements of the standard reform package. It did not pay sufficient attention to the importance of favourable monetary conditions for private investment, to the complementarity of public and private investment, and to the fact that State involvement – now drastically reduced – often ensures the provision of goods and services that private actors are unwilling to produce, but which create important positive externalities for a wide range of productive activities (*TDR 1993*, chaps. II and III).

Policies promoted with a view to getting relative prices “right” at the micro level failed, because in too many cases they got prices “wrong” at the macro level.

In Latin American countries, more investment-friendly macroeconomic policies were constrained initially by the urgent need to combat inflation, and, later, by the need to remain attractive for external capital flows in a context of increasing current-account deficits, as discussed in chapter IV below. In Africa, dependence on private capital flows was less pronounced than in Latin America, but declining prices for primary commodity exports due to weak growth in global demand until the beginning of the new millennium, and the resulting deterioration in the terms of trade and the purchasing power of exports were the most constraining factors for capital accumulation and output growth. In the absence of external financing to compensate for the terms-of-trade losses, adjustment had to take the form of severe import compression and a sharp decline in investment.

As a result of these factors the share of investment in Latin American GDP, which had averaged over 25 per cent in the 1970s, had fallen to 18 per cent by the early 1990s, recovering to about 20 per cent at the end of the 1990s (figure 2.1; and *TDR 2003*, chap. IV). The standard policies geared to improving factor allocation did not succeed in bringing about an investment recovery in sub-Saharan Africa either: the average ratio of investment to GDP dropped from 24 per cent in the 1970s to 17 per cent at the beginning of the 1990s, a level from which it has barely recovered so far. This downward adjustment had an impact mainly on public investment, but contrary to conventional wisdom, this did not “crowd in” private investment. Indeed, the share of private investment in GDP continued to remain lower in the late 1990s than it had been in the 1970s.

In these circumstances, capital formation in most economies in Latin America and Africa was unable to keep pace with the increased need for productivity enhancement and technological innovation, which are basic requirements for the success of export-oriented development strategies. Consequently, they were ill-equipped to meet the challenges posed by opening up to international markets and exposing actual and potential domestic producers to international competition. In sub-Saharan Africa and Latin America, this meant not only sluggish growth and slow structural change, but also in some cases deindustrialization (*TDR 2003*, chap. VI).[5] Between 1980 and 1990 the share of manufacturing output in GDP fell, from 17.4 per cent to 14.9 per cent in sub-Saharan Africa, and from 28.2 per cent to 25 per cent in Latin America. By 2000, the share of manufacturing was still at the same low level in sub-Saharan Africa, while in Latin America it had fallen further, to 17.8 per cent.

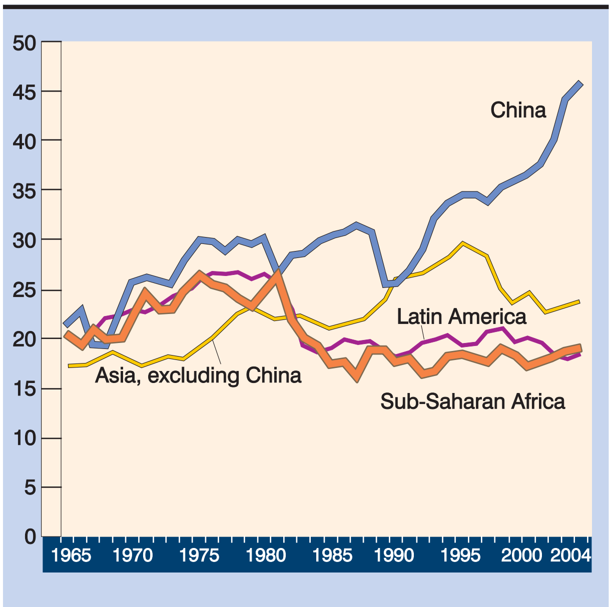
Policies promoted with a view to getting relative prices "right" at the micro level failed, because in too many cases they got prices "wrong" at the macro level (i.e. the real interest rate and the real exchange rates). This meant that they did not create more incentives for investment, innovation and diversification of production, despite the retreat of government and the freeing of market forces. Indeed, they led to greater instability of the key macroeconomic prices due to continuing market failures resulting, for example, from asymmetric information and adverse selection in financial markets, as well as inadequate sequencing of liberalization of product and factor markets in an environment of weak institutions. Even in instances where microeconomic incentives were generated, macroeconomic disincentives, structural constraints and institutional weaknesses prevented them from creating a vigorous supply response. And whatever efficiency gains liberalization and deregulation generated, they did not produce faster growth, but led to growing inequality.

After more than a decade of liberalizing reforms, the payments disorders in many countries remained as acute as before, and their economies had come to depend even more on external financ-

Figure 2.1

GROSS FIXED CAPITAL FORMATION IN SELECTED DEVELOPING REGIONS AND CHINA, 1965–2004

(Per cent of GDP)



Source: UNCTAD secretariat calculations, based on World Bank, *World Development Indicators, 2005*.

Note: Latin America comprises Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Uruguay and Venezuela. Asia comprises China, India, Indonesia, Malaysia, Pakistan, the Philippines, the Republic of Korea, Thailand, Taiwan Province of China, and Turkey.

ing in their efforts to achieve the growth rates necessary to tackle their deep-rooted problems of poverty and underdevelopment. In Latin America, average growth was lower by 3 per cent per annum in the 1990s than in the 1970s, while trade deficits as a proportion of GDP remained constant. In sub-Saharan Africa, growth fell but deficits rose. But despite the lack of success, the "consensus" of the 1990s firmly stuck to the notion that there was no alternative to these policies.

Meanwhile, development successes occurred where prescriptions along the lines of the Washington Consensus had limited or no influence on national policies, notably in the East Asian economies. Their average growth rates exceeded 8 per cent per annum over many years, and, until the crisis in the late 1990s, the imposition of policies by the international financial institutions was avoided. The East Asian economies, which followed a more selective and gradual approach to liberalization than the developing countries that followed the orthodox reform agenda, achieved more stable and faster growth. They also achieved successful integration into international trade relations based on sustained capital accumulation at a high level and a managed and gradual opening up to international markets (*TDR 1999*, chap. IV). There are differing views on the respective roles of market forces and State intervention in these success stories, but there can be little doubt that policy and institutions tailored to local conditions and histories played an important role.[6]

Development successes occurred where prescriptions along the lines of the Washington Consensus had limited or no influence on national policies.

The dramatic downturn in the East Asian economies in the late 1990s occurred because governments failed to manage integration into global capital markets with the same prudence and strategic reasoning they had previously adopted in managing trade liberalization. As in other countries earlier, especially in Latin America, capital-account opening made the economies of the region more vulnerable to financial disturbances. In 1997 massive capital outflows prompted a financial crisis, which resulted in IMF intervention with its standard reform packages applied in several crisis-stricken countries. Although the adjustment programmes were combined with massive financial assistance, they led to a sharp recession and a dramatic deterioration in the poverty situation. This inevitably prompted a questioning of the IMF's diagnosis before and after the crisis and, consequently, the appropriateness of its policy prescriptions. Nevertheless, owing to the structural strength of the productive sector and the strong position of their exporters on world markets, most of these countries recovered rapidly after a sharp real devaluation, and terminated their collaboration with the IMF.

D. Second-generation reforms and debt reduction

1. *A new focus on poverty and institutions*

The disappointing results of policy reforms in the 1980s and 1990s, and the related critiques emanating from the international policy debate led to the recognition in the 1990s that the initial reform package would have to be supplemented by measures to mitigate the adverse social effects of the reforms.

Almost two decades of focusing on price reform in product, labour and financial markets, as well as on external trade, increasingly led to the recognition that key to the success of policy was a better understanding of what the market mechanism could be expected to deliver in developing countries, or, as Rodrik (1999: 2) put it: "The encounter between neo-classical economics and developing societies served to reveal the institutional underpinnings of market economies."[7] Thus the enlarged policy agenda evolving in the 1990s placed greater emphasis on country-specific institutions and focused on good governance, including combating corruption as a major element, to make the State and non-market institutions more effective (Hayami, 2003). Strengthening property rights came to be regarded as the key institutional element for solving the problem of insufficient investment. Moreover, the enlarged policy agenda, sometimes called the "post-Washington Consensus" (Stiglitz, 1998) or "second-generation reforms" (Kuczynski and Williamson, 2003), emphasized the reduction of poverty and the mitigation of its effects as immediate objectives of development policies, requiring direct government involvement.[8]

In part, the new emphasis on health, education and infrastructure was also an outcome of the notion that development is more than economic growth – a notion that gained widespread acceptance in the 1990s (Cornia, Jolly and Stewart, 1987; Sen, 1999). It also found expression in the creation of the Human Development Index, used by the United Nations Development Programme (UNDP) since 1993 as a standard measure of human well-being, as well as in the World Social Summit held in 1995, which pledged to make the conquest of poverty, the goal of full employment and the fostering of social integration the overriding objectives of development.

There can be little doubt that the functioning of markets is strongly influenced by supporting institutions, and that capital accumulation is closely linked to the consolidation of property rights. However, the view that institutional shortcomings were the main reason why the policies of the Washington Consensus did not live up to their promises served to shift attention away from the shortcomings of the principles underlying those policies and their theoretical foundation. The quality of institutions in developing countries had been no better in previous decades when growth performance was more satisfactory. Similarly, poverty reduction was not an entirely new objective of development policies, as it had been a stated goal of the World Bank since the early 1970s (Hayami, 2003: 58); however, the assumption implicit in the initial structural adjustment approach was that it would occur as a trickle-down effect of growth.

The logic of market-oriented reforms was to improve efficiency and economic performance, leading to higher growth and overall living standards by redirecting resources from inefficient, non-tradable goods and import-substituting production to export activities with the help of new investment and productivity increases. This would be made possible by opening up to capital inflows. The restructuring process induced by more openness to international competition was expected to lead to only a temporary displacement followed by a rapid reabsorption of the labour force into activities where the economy had the greatest comparative advantages. Poverty would naturally be reduced by increased efficiency of labour allocation and income growth. As growth turned out to be insufficient in most countries to make even a dent on poverty alleviation, and the more efficient reallocation of resources lagged behind the speed of destruction of inefficient activities, the focus shifted to policies that would directly address the problem of poverty. The implicit assumption that the determinants of growth, the effects of trade, financial integration and market liberalization are independent of, or exert only a temporary effect on, poverty and income distribution was reflected in the reorientation of mainstream thinking; the modified approach added social policies to the standard measures of liberalization and to the operations of the IMF and the World Bank (Berg and Taylor, 2000).

> The disappointing results of policy reforms led to the recognition that the initial reform package would have to be supplemented by measures to mitigate the adverse social effects.

By 1990, the World Bank had already recognized the need to develop special social funds, which, due to a number of factors, including limited funding, poor targeting and inadequate sequencing, only made a marginal contribution to reducing poverty and reversing adverse shifts in income distribution (Cornia, 1999: 132). The introduction of the Poverty Reduction Strategy Papers (PRSPs) in 1995 was a more significant step aimed at reducing poverty. The PRSP approach recognized that stabilization and adjustment policies exert, at least temporarily, an adverse impact on the poor, which can be mitigated through safety nets and targeted spending programmes.

This approach also responded to another weakness of the previous adjustment policies by strengthening ownership, partly through a reorientation of conditionality and partly through a revision of procedures for programme implementation. PRSPs are to be prepared by national authorities in developing countries with the broad-based participation of civil society, including enterprises and representatives of the poor, but they are subject to joint approval by the Bank and the Fund. In the same context, and in line with the shift of emphasis towards measures that would directly address the incidence of poverty, the IMF replaced its Enhanced Structural Adjustment Facility (ESAF) with the Poverty Reduction and Growth Facility (PRGF). The preparation and implementation of PRSPs became a prerequisite for debt relief under the enhanced Heavily Indebted Poor Countries Debt Initiative (HIPC Initiative) of the IMF and World Bank (see chapter III, section C below) and for access to Poverty Reduction Support Credit (PRSC) introduced by the World Bank in 2001. Bilateral grants, concessionary loans and debt relief also became closely linked to the poverty reduction policies and strategies.

The focus shifted to policies that would directly address the problem of poverty.

Compared to the ESAF conditions, the PRSP process gives countries greater autonomy in designing social safety nets and targeted spending programmes, but not in the formulation of their macroeconomic policies and development strategies. With respect to the latter, little autonomy is left to governments to define alternative paths to poverty reduction that would place more emphasis on measures to stimulate output growth and employment creation. Regarding the macroeconomic and structural adjustment contents of PRSPs, there has been no fundamental departure from the kind of policy advice espoused under former structural adjustment programmes (UNCTAD, 2002; ODI, 2001).

Curing the symptoms of poverty can lead to intertemporal trade-offs if public spending is diverted away from broader development targets that would have a longer lasting impact on the causes.

The PRSP approach emphasizes the reallocation of existing fiscal resources to areas that can have a direct impact on the well-being of the poor. Such a reallocation responds to an ethical imperative and can go some way in solving the most pressing social problems. However, there are limits to the extent this can be expected to achieve sustained poverty eradication. Despite the positive welfare impact of social spending, real progress in poverty reduction may be handicapped as long as macroeconomic and adjustment policies continue to push in the opposite direction, generating impulses that hamper capital formation and lead to regressive changes in income distribution. The World Bank noted that “most recipients consider the focus of the initiative to be excessive on social sectors, and too little on growth and ‘wealth creation’” (World Bank, 2003: 46).

The new emphasis of PRSPs on achieving quick results by redirecting public expenditure to areas such as primary health care and education may not have a lasting impact on poverty as long as structural change remains slow and capital accumulation insufficient to boost growth and create productive employment. Although output growth alone is not enough for improving the living standards of all social segments, it is likely to be a necessary condition for a sustained reduction of poverty. Indeed, growth and sustained poverty reduction appear to be fundamentally dependent on the same forces and policies that lead to productive restructuring, capital accumulation and productivity increases. From this perspective, coordinated policies of capacity development in new industrial activities for enhancing efficiency and reducing the adverse effects of labour displacement can also eradicate poverty at its source. PRSPs, therefore, can give rise to serious intertemporal trade-offs to the extent that the cure of the symptoms involves a diversion of public spending away from broader development targets that would have a longer lasting impact on the causes, such as those discussed in chapter V of this *TDR*.

2. Debt relief and the proliferation of conditionality

The solution to the debt crisis of the 1980s was initially sought through ad hoc debt renegotiations. At the end of that decade the recognition that the success of policy reforms and structural adjustment was also contingent on external financial constraints provided the rationale for the Brady Plan, which addressed the debt servicing problems of middle-income developing countries. The plan represented an important change in focus for the resolution of these problems: from policies designed to create large trade surpluses to those that would reduce the debt burden and improve access of the debtor countries to the international capital markets in order to refinance their debts. After years of insistence by the international financial institutions on a country-by-country approach to deal with the debt overhang that had emerged simultaneously in many countries at the beginning of the 1980s, the Brady Plan represented an international effort to resolve the debt crisis. The plan was designed to give debtor governments additional "breathing space" by allowing them to divert part of their debt service payments to more productive uses, which in turn would eventually enable them to grow out of their debt problems.

Similarly, the launching of the HIPC Initiative in 1996 was designed to support policy reforms in the poorer countries that were primarily indebted vis-à-vis official creditors. It implied recognition that the debt problems of these countries were a major hindrance to their faster growth, and that the causes of their debt problems were at least partly systemic in nature. The HIPC Initiative advanced slowly, largely because fulfilling the conditions attached to it was an exercise that frequently exceeded the institutional and administrative capacities of the poorest countries.

The international initiatives to deal with the debt problem of developing countries improved the context for growth-oriented development policies. They enlarged the fiscal space to support domestic economic and social development, as well as the scope for importing the capital goods and technologies essential for a dynamic growth process and successful trade integration. However, the impact of debt reduction on the liquidity situation of the beneficiary countries has in many cases been limited, particularly where, prior to the granting of the debt relief, debt service payments were in arrears (see also chapter III, section C). Therefore, in most countries, official debt relief needs to be complemented by increased flows of official development assistance (ODA), as far as possible in the form of grants for the poorest countries, in order to increase the capacity of the State to provide essential public goods and infrastructure. This would also help prevent a new build-up of debt and maintain debt sustainability in the medium and long term in countries where faster capital formation is not possible without imports of capital and intermediate goods that exceed export earnings potential.

> The proliferation and widening scope of conditionality has faced growing criticism over the years.

The debt relief initiatives also served to perpetuate the key elements of the orthodox reform package and the Washington Consensus through the conditionality attached to them or through the increasing dependence of exchange rates and balance-of-payments performance on market sentiment. Although there was broad agreement that new lending by the international financial institutions and the provision of official debt relief should be linked to certain conditions, the conditionality actually applied came under growing criticism over the years, not only because of its deflationary bias, but also because of the proliferation and widening scope of the conditions (Goldstein, 2000; Kapur and Webb, 2000; and Buira, 2003).

The original rationale for conditionality by the Bretton Woods institutions was to protect their financial integrity and preserve the revolving character of their resources. But as the operations of the IMF and World Bank in developing countries expanded, their conditionality became tighter and more complex, encompassing areas which are within the purview not only of other international organizations but also of national development strategies. And with “second-generation reforms”, conditionality expanded further, into issues of political and economic governance.

The average number of structural conditions, covering a wide range of policy areas – from trade and finance to public enterprises and privatization, and even labour market institutions and social safety nets – doubled between the 1970s and 1980s. At the end of the 1990s there were more than 50 structural policy conditions for a typical Extended Fund Facility programme, and between 9 and 15 for stand-by programmes. The number of structural performance criteria in the IMF programmes for the three Asian countries struck by the 1997 crisis was four times the average for all Fund programmes over the period 1993–1999, prompting assertions that there was a “temptation to use currency crises as an opportunity to force fundamental structural and institutional reforms on countries” (Feldstein, 1998). On a strict definition of conditionality used by Kapur and Webb (2000: 5–7), the number of conditions attached to lending by the Bretton Woods institutions at the end of the 1990s ranged between 15 and 30 for sub-Saharan Africa, and 9 and 43 for other regions. If conditionality is loosely defined, the number increases to between 74 and 165 for sub-Saharan Africa, and between 65 and 130 for the others.

Structural conditions entail permanent changes in legislation and institutions, and circumscribe policies in such a way that their reversal may be extremely difficult and costly.

Many observers, both within and outside the Bretton Woods institutions, have questioned the effectiveness of conditionality in preventing policy failures and improving economic performance.[9] Evidence shows that with the proliferation of structural conditions in the 1980s and 1990s, the degree of compliance with the programmes declined (Mussa and Savastano, 1999). More importantly, there has been very little correlation between compliance and economic performance. For instance, in 1993 the World Bank identified 15 countries in sub-Saharan Africa as a core group of adjusters on the basis of their compliance with the policies recommended, including their implementation of significant institutional changes. However, the subsequent economic performance of these countries was quite disappointing. Only three were among what the IMF classified as strong performers towards the end of the 1990s. In other words, the majority of countries that accounted for much of the faster growth in sub-Saharan Africa in the second half of the 1990s were not among the high-compliers five years earlier; while most of the countries that were thought to be pursuing sound policies by World Bank criteria were not among the subsequent strong performers (*TDR 1998*: 124–125 and table 34).

The Fund’s extensive use of structural conditions in its lending programmes is widely considered to be in violation of its own guidelines for conditionality established in 1979. These guidelines explicitly state that performance criteria should be confined to macroeconomic variables, and that they can relate to other variables only in exceptional cases when their macroeconomic impact is significant. As argued by a former Research Director of the IMF, these guidelines aimed at making conditionality “less intrusive by limiting the number of performance criteria, insisting on their macroeconomic character, circumscribing the cases for reviews, and keeping preconditions to a minimum. Yet, these restraining provisions have not prevented the intensification of conditionality in every direction that the guidelines attempted to block” (Polak, 1991: 53–54).[10]

There is a rationale for macroeconomic conditions to be formulated at aggregate levels, such as the volume of adjustment in public spending or in monetary aggregates, without going into what items should be involved; in other words, leaving these to the discretion of the national authorities. Such conditionality would be justified as a device for risk management by the lender (Kapur and Webb, 2000: 1–2), but it would not permanently circumscribe the space for development policy. Structural conditions by their nature are different, because they entail permanent changes in legislation and institutions, and circumscribe policies in such a way that their reversal may be extremely difficult and costly.[11]

E. The MDGs and the Monterrey Consensus

Following several major international conferences in the course of the 1990s, all of which addressed, in one form or another, the issue of poverty and its social and human impact, the expression of international concern with the problem of persisting poverty culminated in the formulation of the Millennium Development Goals (MDGs). Seven of these eight goals address objectives to be pursued at the national level, with support by the international community. Only Goal 8 – Develop a global partnership for development – adds an international dimension to the agenda. The formulation of the MDGs by the Heads of State and Government at the United Nations Millennium Summit in 2000 reflects the degree of dissatisfaction with development progress and the setback in the fight against poverty under the policy conditions that had prevailed over the previous two decades. It is also a response to the lack of progress in achieving a truly global approach to closing the large and widening gaps in income and living standards by the turn of the millennium. Goal 8 has a number of subsidiary targets, which implicitly recognize the role of the external environment and the shared responsibility of the developed countries for the achievement of the other seven goals.

> There is no agreement as to what constitutes the necessary internal conditions for adequate levels of productive investment, and what role domestic policies could play to improve those conditions.

The targets under Goal 8[12] that have a direct bearing on the orientation of economic policies and development strategies are: to promote "an open trading and financial system that is rule-based, predictable and non-discriminatory"; to deal "comprehensively with developing countries' debt problems through national and international measures to make debt sustainable in the long term"; to "develop decent and productive work for youth"; and, "in cooperation with the private sector, [to] make available the benefits of new technologies."

The outcome of the subsequent International Conference on Financing for Development, the Monterrey Consensus of 2002, can be considered a programmatic complement to the MDGs. It acknowledged that the capability of developing countries to realize the MDGs is heavily influenced by external factors. In particular, concerns were expressed about the general steady decline in ODA during the 1990s. Indeed, at the beginning of the new millennium, total ODA provided by the member countries of the Development Assistance Committee (DAC) as a share of their combined GNI was only about 0.22 per cent, a historical low (OECD, 2006). The Monterrey Conference also recognized that a solution to the external debt problem and progress in dealing with the systemic issues of coherence and consistency of the international monetary, financial and trading system could make a significant contribution in support of development.

Box 2.1

THE MONTERREY CONSENSUS ON INVESTMENT-FRIENDLY POLICIES

In January 2002, Heads of State and Government gathered in Monterrey, Mexico, to address the challenges of financing for development. In the outcome document, the Monterrey Consensus, they agreed on a number of leading actions to eradicate poverty, achieve sustained economic growth and promote sustainable development. Considerable attention was given to the crucial role of investment for growth and development, and to policies in its support (United Nations, 2002).

The Monterrey Consensus recognizes the key role of capital accumulation for development, noting that in the "pursuit of growth, poverty eradication and sustainable development, a critical challenge is to ensure the necessary internal conditions for ... sustaining adequate levels of productive investment and increasing human capacity" (para. 10), and that "an enabling domestic environment is vital for ... increasing productivity (and) ... encouraging the private sector" (para. 10), leaving open the question of what constitutes an enabling environment.

When noting that "improvements in public spending that do not crowd out productive private investment" are necessary (para. 15), and that "investments in basic economic and social infrastructure, social services and social protection ... are vital for enabling people ... to better adapt to and benefit from changing economic conditions and opportunities" (para. 16), the Monterrey Consensus highlights the complementarity between public and private investment in the development of local capacities. This aspect of State involvement in economic activity was largely neglected in the standard reform packages until the mid-1990s; public finances were squeezed for many years and previously existing institutions that had provided social services were often dismantled.

Finally, the Monterrey Consensus points to the need for a "sound system of financial intermediation ... to foster productive investments" (para 17). It thereby addresses a major constraint to stronger domestic capital formation in many developing countries, made worse as a result of financial liberalization and deregulation. However, as the experience of today's developed countries shows, a sound system of financial intermediation takes many years to evolve. The question therefore arises as to the options available for the large number of countries that are still far from having such a

The Monterrey Consensus also addressed a number of questions in the areas of trade, financial and macroeconomic policies for development, and it explicitly pointed to the challenge facing developing countries to ensure the necessary conditions for adequate levels of productive investment. From the perspective of development strategy, the important point here is that, while the Consensus does not call into question the alleged beneficial effects of trade and financial openness, it draws attention to the necessity of favourable "internal" conditions for productive investment. Yet there is no overall agreement as to what constitutes the necessary internal conditions, and what role domestic policies could play to improve those conditions. In this respect, the Monterrey Conference failed to recognize a major lesson that could be drawn from more than 20 years of orthodox policy reforms: the need to revise the role of monetary and fiscal policies to directly stimulate capital accumulation and growth, and to reconsider the possible contribution of sectoral policies and institutions to technological upgrading. Moreover, there is a remarkable imbalance in the Monterrey Consensus in terms of its bias in favour of FDI as compared to domestic investment (box 2.1). Yet FDI in Latin America and Africa has in general not been in sectors and technologies that are capable of generating sizeable growth and value added, and its impact on domestic income has often been limited because TNCs operating in tradable goods

Box 2.1 (concluded)

system. In the absence of a mature system of private financial intermediation it would be advisable for these countries not to wait for market forces to generate such a system; rather, they should identify locally viable instruments of public policy that would accelerate its development on the one hand, and provide risk capital to strengthen the productive sector of the economy on the other.

The text of the Monterrey Consensus cited above testifies to the considerable attention given at the Conference to the need to improve the conditions for domestic investment, although the policy conclusions against the background of the preceding 20 years remained rather vague. The text places even greater emphasis on FDI, thus paying tribute to the principles of the (post-) Washington Consensus. While five paragraphs of the Monterrey document address the issue of domestic investment, without going beyond general recommendations, seven paragraphs address the issue of FDI. They offer an array of recommendations that are much more concrete, especially with regard to measures aimed at attracting FDI. The Monterrey Consensus suggests that in order

> to attract and enhance inflows of productive capital, countries need to continue their efforts to achieve a transparent, stable and predictable investment climate, with proper contract enforcement and respect for property rights, embedded in sound macroeconomic policies and institutions that allow businesses, both domestic and international, to operate efficiently and profitably (para. 21).

It goes on to remind developing-country governments that

> special efforts are required in such priority areas as economic policy and regulatory frameworks for promoting and protecting investments, including in the areas of human resource development, avoidance of double taxation, corporate governance, accounting standards, and the promotion of a competitive environment. Other mechanisms, such as public/private partnerships and investment agreements, can be important (para. 21).

Finally, paragraph 22 points to the need for

> international, regional and national institutions in source countries to provide export credits, co-financing, venture capital and other lending instruments, risk guarantees, leveraging aid resources, information on investment opportunities, business development services, forums to facilitate business contacts and cooperation between enterprises of developed and developing countries, as well as funding for feasibility studies.

sectors frequently use a high proportion of imported inputs. Policies in support of FDI have been found to benefit development only when embedded in a broader development strategy that ensures its complementarity with domestic investment and its creation of dynamic linkages with domestic activities as well as an appropriate regulatory framework (*TDR 2003*, chap. VI).

The Monterrey Consensus contributed to the evolution of development policy thinking by emphasizing the need for increasing ODA as a precondition for many developing countries to make decisive progress towards growth and achievement of the MDGs, especially through increased spending on education, health and basic social infrastructure. However, like other new initiatives that had "augmented" the standard reform package before, the Monterrey Conference did not lead to a new consensus on a policy agenda geared at stimulating capital formation and structural change, leaving the take-off of a dynamic growth process to market forces alone. An "enabling environment" for economic development is certainly strongly influenced by the way markets operate, but it is also characterized by externalities of various kinds. Yet policy prescriptions focusing on "getting the prices right" have limited the scope for active government policies to address such externalities, which in many cases will be decisive for investment decisions (see chapters V and VI of this *Report*).

F. Beyond the Monterrey Consensus

On a more practical level, and with a greater focus on the role of governments, the report of the United Nations Millennium Project[13] of 2005, entitled *Investing in Development* (also known, as the *Sachs Report*), represents a further step in the same direction (UN Millennium Project, 2005). As the title indicates, the report's main emphasis is on investment, and indeed, more on domestic investment than on FDI. This is because it primarily addresses the problems of low-income countries that have very limited access to FDI, and because very little can be expected from FDI for solving social problems and reducing poverty. Thus the report makes a strong case for a substantial increase in public investment to achieve faster and socially acceptable growth, and it suggests financing the greater investment through a combination of higher domestic taxation and a substantial rise in official external financing, especially in the form of grants.

In the aftermath of the Millennium Summit and the Monterrey Conference, several developed-country governments had already made commitments for gradually but substantially increasing their ODA. This is in line with UNCTAD's call in 2000, for a doubling of ODA to sub-Saharan Africa, based on an estimate that a net capital inflow of at least an additional $10 billion per annum would be needed for a decade or so in order to lift the countries in that region onto a growth path that would allow a gradual narrowing of their income gap with the more advanced countries (UNCTAD, 2000, sect. E). UNCTAD had argued that a doubling of official capital inflows, in combination with policy measures to raise the efficiency of investment, could set off a process of accelerated growth that would reduce, in a decade or so, both the resource gap of the region and its dependence on aid. Subsequent estimates made by the World Bank, the Economic Commission for Africa (ECA) and others confirmed that a doubling of aid was indeed necessary to help initiate faster development in countries and sectors that do not attract private investment and that cannot afford to borrow extensively from commercial sources. The need for more aid has been well recognized by major donors, and various initiatives have been launched since 2002 to this end, which are also endorsed in the *Sachs Report*. These include a proposal for an international finance facility, or a special airport tax earmarked for the financing of health expenditures in the poorest countries. These initiatives signal serious efforts by the international community to strengthen the global partnership for development (see also chapter III, section C below).

The *Sachs Report* recognizes the importance of country-specific national policies and institutions in the development process,[14] thus rediscovering a significant role for the State in development. To some extent, this implies a reorientation away from the past orthodox approach, which considered dismantling the "inefficient" public sector to be the most important precondition for unleashing private economic activity. However, the *Report* does not offer a new approach to dealing with the problem of insufficient capital formation and growth. In line with the policy proposals of the "second-generation reforms", the *Sachs Report* also relies on investment in health, education and basic infrastructure for attaining the MDGs. By suggesting that in countries with extreme poverty

Box 2.2

ECONOMIC GROWTH IN THE 1990s - LEARNING FROM A DECADE OF REFORM: QUOTATIONS FROM THE WORLD BANK REPORT

- "Growth-oriented action, for example, on technological catch-up, or encouragement of risk taking for faster accumulation may be needed." (10)
- "There are many ways of achieving macroeconomic stability, openness, and domestic liberalization." (12)
- "Different policies can have the same effect, and the same policy can have different effects, depending on the context." (13)
- "Like that of policies, the effect of institutions depends on the context." (13)
- "The role of activist industrial policies is still controversial but is likely to have been important." (83)
- "The available evidence suggests that restrictions on short-term capital flows may have a role to play in the pursuit of outcomes-based macroeconomic stability in developing countries." (116)

Source: World Bank, *Economic Growth in the 1990s - Learning from a Decade of Reform,* Washington, DC, 2005.

PRSPs should be aligned with the MDGs, the *Sachs Report* again advocates implicitly the types of national policies and the same reliance on the "invisible hand" to guide private decisions on resource allocation and accumulation that had characterized the structural adjustment policies of the IMF and World Bank and the post-Washington Consensus.

Also in 2005, the World Bank published a study, entitled *Economic growth in the 1990s - Learning from a Decade of Reform*, which acknowledges a number of mistakes and shortcomings of the previous approach with structural adjustment policies, and draws lessons from these for the design of development strategies (box 2.2).[15] First, it suggests that "reforms need to go beyond the generation of efficiency gains to promote growth", as economic growth also "entails structural transformation, diversification of production, change, risk taking by producers, correction of both government and market failures, and changes in policies and institutions"; and it goes on to suggest that, consequently, "growth-oriented action, for example, on technological catch-up, or encouragement of risk taking for faster accumulation may be needed" (World Bank, 2005: 10, 11).

Second, it recognizes that there is no one-size-fits-all set of successful policies: "There are many ways of achieving macroeconomic stability, openness, and domestic liberalization ... Different policies can have the same effect, and the same policy can have different effects, depending on the context" (World Bank, 2005: 11, 13). It admits, for example, that for achieving macroeconomic stability it may be worth considering the imposition of restrictions on capital flows, because "notwithstanding the theoretical arguments in favour of capital account openness, the evidence on growth is inconclusive and volatility clearly increased" after capital-account opening

(World Bank, 2005: 17). The authors of the World Bank study, while laying strong emphasis on the important role of institutions, also underline the need for diversity in institutional development, because, "like that of policies, the effect of institutions depends on the context" (World Bank, 2005: 13). Third, the World Bank study recognizes that "Key functions to be fulfilled in sustained growth processes are the accumulation of capital, allocative efficiency, technological progress, and the sharing the benefits of growth", and that "the role of activist industrial policies is still controversial but is likely to have been important" (World Bank, 2005: 83, 85) in the successful experiences of growth and catching up.[16]

Thus, *Learning from a Decade of Reform* testifies to the growing uncertainty about the commitment to the Washington Consensus, including the different augmentations of that Consensus. But it is probably an exaggeration to interpret that study as a "radical rethink of development strategies" (Rodrik, 2006: 7), because the basic paradigm remains largely intact. The authors do not go very far in their redefinition of the role of public policies in support of capital accumulation and technological change. This is probably because they remain sceptical about the capacity of national governments to carry out effective discretionary policies. The experience of the 1990s leads them to suggest that "government discretion cannot be dispensed with altogether, so it is important to find ways in which it can be exerted effectively" (World Bank, 2005: 14). There can be no doubt that rendering discretionary government intervention more effective must itself be part of a comprehensive reform programme, but the World Bank study suggests that this be limited to certain activities "ranging from regulating utilities and supervising banks to providing infrastructure and social services" (World Bank, 2005: 14). It thereby excludes direct support measures to promote capital accumulation, or sectoral policies to help diversification, upgrading of the production structure and strategic integration into the international trading system.

G. Towards a fundamental policy reorientation[17]

Beyond the stocktaking and the propositions of the *Sachs Report,* and the translation of the *Learning from a Decade of Reform* into implementation of reforms, it will be necessary to analyse the range and kind of policy instruments that individual developing countries have at their disposal to remedy the widespread weakness of private capital formation, productivity growth and technological upgrading. For instance, the *Sachs Report* considers household savings as the most important source of financing investment, without reflecting on how these savings could be generated and to what extent such higher savings would imply lower domestic absorption, and, thus, a disincentive for investment and job creation, especially in the non-tradables sector. In this context, the provision of incentives for the self-financing of investment by firms and the productive use of rent from the exploitation of natural resources are likely to be much more relevant than household savings, which are only one element of national savings (Akyüz and Gore, 1994). The design of the tax system, for example, can play an important role in this regard. The *Sachs Report* considers taxation only as a potential source of the fiscal income required to finance an increase in public investment, whereas the major importance of the design of the tax system for the incentive structure, and thus for the propensity to invest in different production and trade activities, is neglected.

The varying experiences among developing countries, and the evidence provided in this regard in the World Bank study, *Learning from a Decade of Reform,* suggest that more proactive government policies in support of capital accumulation and productivity enhancement are needed for successful integration into international economic relations and as a basis for sustained improvements in the welfare and incomes of all groups of the population.

More proactive government policies in support of capital accumulation and productivity enhancement are needed for successful integration into the global economy and for sustained improvements in the welfare and incomes of all groups of the population.

The market-based reforms pursued in a majority of developing countries since the early 1980s have not lived up to the promises of their proponents. It has not been possible to combine greater macroeconomic stability and external balance with rates of growth that are high enough to close the income gap with the more advanced countries, while at the same time reducing poverty and enabling people. In part, this is probably due to shortcomings in the model of the social and economic realities in the developing world that has been underlying the conventional reform agenda. Within this model, the potential impact on growth of efficiency gains, resulting from leaving adjustments in relative prices to autonomous market forces, has been overestimated. So also has the effect of "crowding in" of private investment as a result of reduced State economic activity. The failure is also likely to be partly due to an excessively deflationary macroeconomic policy stance, not least because savings are not as sensitive to higher interest rates, as assumed, and private investment does not rise in response to higher household savings (see also annex 2 to chapter I).

To meet the challenges of open developing economies, the scope for national policymaking will have to be widened beyond what has been acceptable under the Washington Consensus approach.

But in part, the explanation may be found in the reduced number of policy instruments available to policymakers under the development paradigm of the past 25 years. As discussed in the preceding sections of this chapter, much of the internationally supported liberal reform effort "sought to introduce policies that would limit the discretion of national authorities in growth strategies" (World Bank, 2005: 14). Indeed, a key problem faced by policymakers, as demonstrated by Tinbergen (1956) and Hansen (1967), is that there are not always an adequate number of effective instruments to attain all the objectives that they may wish to pursue, because, formally, it takes at least as many instruments to carry out a policy as there are linearly independent goals. This can lead to incompatibility of targets and create difficulties in formulating consistent policies, even in an economy that is not subject to external constraints.

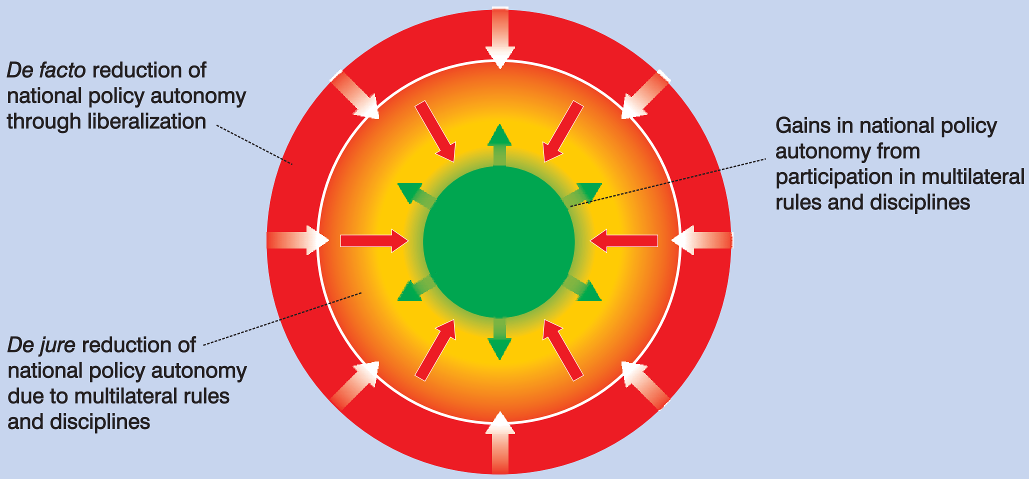
For instance, deregulation of domestic financial markets reduces the ability of monetary authorities to control credit conditions through instruments such as caps on bank interest rates, or restrictions on the volume and direction of credits. Similarly, as integration into global markets is deepened through the removal of restrictions over the movement of goods and services, money and technology, the range of policy instruments shrinks. This is because external influences over national policy targets become stronger, and the trade-offs between internal and external objectives intensify. For instance, it would not be possible to control both the interest rate and the exchange rate while maintaining free capital movement. In an open capital-account regime the exchange rate and the interest rate are both potential policy instruments, but only one of the two can actually be employed independently.[18] From this perspective, economic opening up involves not only the elimination of barriers to the movement of goods and services, money and capital, and labour and technology, but also commitment to obligations and acceptance of rules set by international economic governance systems and institutions, thereby weakening na-

Box 2.3

ECONOMIC OPENNESS AND NATIONAL POLICY AUTONOMY

Economic openness is not only about the elimination of barriers to the movement of goods and services, money and capital, and labour and technology, but also about integration into international economic governance systems and institutions. Both these processes have often overlapped and reinforced each other. On the one hand, liberalization of markets has reduced the number of instruments under the control of policymakers, much in the same way as sovereign policy-making is circumscribed by enhanced multilateral disciplines. On the other hand, multilateral rules and practices have generally weakened the influence of national policy instruments on national policy objectives by promoting liberalization and closer integration into world markets. The figure below attempts to illustrate the potential impact of openness on national policy autonomy, notwithstanding the potential positive effects of trade integration.

IMPACT OF ECONOMIC OPENNESS ON NATIONAL POLICY AUTONOMY



tional policy control over domestic economic variables and development targets (box 2.3).

The autonomy of national economic policy is often defined in terms of the effectiveness of domestic policy instruments in influencing national targets.[19] Even in a closed economy this autonomy is constrained, since formal command over policy instruments does not automatically translate into full control over national targets. This *de facto* constraint is due to a number of factors. First, the relationships between instrument and target variables are often unstable, and knowledge and information about these relationships are sometimes insufficient. Second, there can be trade-offs in the effectiveness of different instruments, as well as in the objectives sought, and it may not be possible to attain all of them simultaneously with the instruments available. Such trade-offs can exist in many areas of policy, for example, be-

Box 2.3 (concluded)

It shows that in the process of integration into the global economic system, policy autonomy in developing countries is restricted at two levels, but it can also gain from such integration, as the policy autonomy of other countries is also restricted.

(i) Liberalization of markets and dismantling of restrictions on cross-border movements of goods and services, money, capital and labour weakens the *de facto* policy autonomy and influence of national policy instruments over macroeconomic and development policy objectives, as indicated by the outer ring in the figure. This is the case, for example, when capital-account opening reduces the autonomy of national monetary policy, or when opening up to international trade reduces the effectiveness of sectoral support measures as an instrument of income distribution policy.

(ii) Multilateral rules, disciplines and obligations, as well as commitments resulting from bilateral agreements reduce *de jure* sovereign control over policy instruments, as indicated by the second ring of the figure. This is the case, for example, when conditionality attached to assistance from the multilateral financial institutions reduces the autonomy of governments to determine the size and structure of public expenditures, or when accession to the WTO reduces the scope for import protection through tariffs.

(iii) This loss of policy autonomy can be compensated to a certain extent by the gains that can be had from participating in the system of multilateral rules and disciplines, as indicated by the third ring. Examples of such gains are the possible impacts of improved access to external markets on the effectiveness of national policies aimed at increasing supply capacity and productivity in certain sectors, or the benefits of multilateral surveillance over exchange rates for gearing monetary policy to domestic objectives. And, ideally, the possibility to influence in some way the choice and design of the multilateral rules and disciplines could help safeguard, if not promote, national interests.

The extent to which economic openness influences policy autonomy in an individual country, and the extent to which a loss of autonomy in one area can be compensated by gains in another depends on the nature of the rules and disciplines, which in turn largely depends on the way in which the rules and disciplines are created and how they are adapted to changing circumstances. Where this balance lies largely depends on each country's specific conditions. This pattern is, in principle, valid for all countries, although countries with less bargaining power in international processes and with less economic weight in the world economy are likely to experience a greater net reduction of policy autonomy than those with more influence. Thus, there is an "optimum degree of openness" (Bhaduri, 2005) for each country, at which the net benefits of integration are maximized.

tween full employment and price stability, growth and income distribution or, more generally, between efficiency and equity. Third, policy instruments can only be used within certain boundaries or are constrained by certain policy decisions taken in the past which might limit the policy space available for the present. For instance, there is a limit on how far nominal interest rates can be lowered – a problem faced in Japan in recent years – or discretionary action in fiscal policy can be restricted by debt service obligations resulting from debt accumulation over the years (Akyüz, 2006a).

This gap between *de jure* sovereignty of national economic policy and *de facto* control over national economic development widens with the degree of economic openness, with similar consequences.[20] While external liberalization narrows policy autonomy by weakening *de facto* control over national economic development, insertion into international economic governance systems and institutions does so by reducing the *de jure* sovereignty of national economic policy. For instance, there is little difference between loss of autonomy to use tariffs as a means of curbing imports because of WTO rules and commitments on the one hand, and loss of ability to use the exchange rate as an effective instrument for external adjustment because of capital-account liberalization on the other.

If the average developing country is to reach the MDGs, and if the income gap between rich and poor nations is to be narrowed, developing countries will have to grow much faster than they did in the past 25 years. Therefore, the scope for policies to meet the challenges of open developing economies will have to be widened beyond what has been acceptable under the Washington Consensus agenda. In this context lessons could well be drawn not only from the cases of successful catching up in East Asia, but also from the policy practices that formed the basis for private sector development in practically all of today's developed market economies, especially with respect to the instruments employed and intermediate targets they pursued to sustain a dynamic growth process (see, for example, Chang, 2002). Central to these successful strategies were investment-friendly macroeconomic policies, the use of a broad array of fiscal and regulatory instruments in support of capital accumulation, technological upgrading and structural change, and the existence of effective institutions to support and coordinate private and public-sector activities.

> Lessons can be drawn not only from the cases of successful catching up in East Asia, but also from the policy practices that formed the basis for private sector development in practically all of today's developed market economies.

Meanwhile, globalization has advanced further – itself the result of policy decisions – but its outcome for development and income distribution, both among and within countries, is dependent on global economic governance and national policies. Against this background, active policies in support of economic development and industrialization must be designed, and their instruments adapted to an outward-oriented strategy. Such a strategy in turn can be nurtured by integration into the global trading and financial systems, provided that national policies and the rules and procedures governing these systems are coherent.

Since a global partnership for development has generally been accepted as a policy imperative for the new millennium, appropriate policy instruments at the national level should be complemented by some operating and controlled at the international level. Examples are ODA grants to improve global income distribution, international macroeconomic policy coordination for managing global demand, or global collective action in the form of multilateral disciplines designed to minimize negative externalities and maximize the positive ones resulting from interdependence. Multilateral discipline is a form of global collective action whereby governments voluntarily agree to reduce sovereignty on a reciprocal basis by subjecting their policies in specified areas to certain rules in the expectation that such an action would lead to a net benefit.

Indeed, interdependence provides the principal rationale for multilateral disciplines because it gives rise to externalities, spillovers and arbitrage opportunities. For example, financial crisis in a country can spread across several other countries through contagion, including to economies with sound policies and good fundamentals. Lax financial standards or excessively liberal tax policies could give rise to regulatory arbitrage and migration of businesses at the expense of countries with more prudent regulations or progressive tax systems. In such cases, the main objective of multilateral disciplines would be to prevent negative externalities or minimize global public "bads".[21] But multilateral cooperation and discipline can also help maximize global public goods. For example, countries may be unwilling to undertake unilateral trade liberalization even when they believe that it would bring efficiency gains, for fear of its adverse repercussions for balance of payments, aggregate demand and employment, but collectively they may be able to do so by securing reciprocal market access.[22] Greater stability of the international financial system is another global public good that can result from multilateral disciplines. It would liberate national monetary policy from the task of stabilizing capital flows and exchange rates thereby providing additional flexibility for macroeconomic policy geared to improving the environment for domestic investment and technological change.

An outward-oriented strategy can be nurtured by integration into the global trading and financial systems, provided that national policies and the rules and procedures governing these systems are coherent.

An additional case for policies at the international level is that, with the opening up to international trade, external demand conditions have become increasingly important determinants of national investment decisions. Output and employment growth require an expansion of demand, both at the aggregate level and at the level of sectors that serve as engines in a dynamic growth process. Although the potential of domestic markets to support diversification and industrialization from the demand side in an appropriate macroeconomic setting should not be underestimated, in most developing countries, diversification and industrialization in many sectors implies a strong outward orientation, because domestic markets are too small to achieve the economies of scale required to make industrial production viable. The need to rely on external demand for growth and employment creation is stronger, the smaller the domestic market and the greater the degree of openness. Therefore, policies pursued in other countries and competition with producers in other countries become co-determinants of growth. Appropriate multilateral rules and regulations in trade and finance can thus be of considerable benefit for launching and sustaining a dynamic growth process in developing countries to the extent that they ensure access to markets of other countries, reduce the scope of unfair competition and provide for stability of external monetary and financial conditions.

At present two asymmetries in multilateral arrangements merit particular attention. First, international trade is organized around a rules-based system, with certain core principles applying to all participants, but this is not the case in international money and finance. This asymmetry is all the more important because adverse international spillovers and arbitrages generated by self-centred national monetary and financial policies can be much more damaging than those created by trade and trade-related policies, particularly for developing countries (see *TDR 2004*, chap. IV). Second, there is an asymmetry between developed and developing countries in terms of the extent to which multilateral rules and practices restrain policy autonomy. The choice of which aspects of international economic interactions should be brought under multilateral disciplines and which rules and practices should be established in areas subject to such disciplines is not neutral in terms of how the requirements of the development trajectories of industrial and developing countries are accommodated, even when there is a level playing field in the application of the rules. In the current international set-up the more advanced countries have more influence on these choices than the developing countries.[23] The absence of a rules-based system in money and finance is one dimension of this asymmetry, since it permits developed countries which have a disproportionately large impact on global monetary and financial conditions to escape multilateral discipline, while allowing considerable leverage over weaker countries through conditionalities attached to multilateral lending by the Bretton Woods institutions. Another dimension is the existence of rules and regulations in support of the free movement of industrial goods, money, capital and enterprises, which favour advanced countries, but not labour, agricultural products or technology –

There is an asymmetry between developed and developing countries in terms of the extent to which multilateral rules and practices restrain policy autonomy.

areas that would bring greater benefits to developing countries.

At the national level, additional policy instruments should be explored to support actual or potential domestic producers in their efforts to integrate into the international trading system, and to achieve and maintain international competitiveness in a dynamic process. Examples of such national policy instruments include more flexible fiscal instruments, such as public investments or subsidies on the expenditure side of the public budget, and taxation or tariffs on the income side. However, the success of such instruments also depends on how monetary policies and capital-account management shape the macroeconomic environment. Also at the national level, different forms of heterodox, non-monetary instruments, such as an incomes policy, could free monetary and fiscal policy from the task of domestic stabilization, while sectoral policies (which also offer a strong potential for regional cooperation) could be part of a consequent upgrading strategy.

In a dynamic process of structural change, the targets and instruments of economic policy must themselves evolve over time.

The choice of national policy instruments needs to take into account the fact that in a dynamic process of structural change, the objectives, targets and the instruments themselves evolve over time. For example, the objective of diversification of primary production will typically be followed by greater diversification into manufacturing, and industrial upgrading and diversification of activities into industrial services, although not all countries will have to follow precisely the same pattern. Or certain economic activities may merit a country-specific form of State support at a promising initial stage, but that support may no longer be warranted when those activities have matured, and at some point in the future their phasing out may actually need to be supported by publicly sponsored social and rehabilitation programmes. At the same time, new, promising activities may merit infant-industry support. Similarly, State intervention in one form or another for credit allocation to support enterprise development and structural change may diminish over time as the financial sector deepens and improves its capacity for intermediation of risk capital, which may itself be a target of active government policies. Therefore, a pragmatic approach will be needed, aimed at solving problems as they emerge in the process of achieving national objectives. This calls for considerable flexibility in the policy-making process, including in the selection and application of policy instruments.[24]

Widening the scope of policy instruments beyond those that were deemed acceptable under the development paradigm of the past 25 years would not only allow the pursuit of additional goals, it would also increase the number of potential combinations of instruments, which in many cases will be decisive for the success or failure of a strategy. For example, public expenditure for research and development is unlikely to fuel growth when the results of these activities are not translated into innovation at the product or production level, particularly when monetary or financing conditions for investment are unfavourable. Similarly, productivity-enhancing measures in agriculture will not translate into significant acceleration of growth and alleviation of poverty if rural workers that eventually become redundant cannot be absorbed into industrial production due to unfavourable exchange-rate developments that hamper exports. These examples illustrate a key aspect of successful catch-up experiences, which seems to have been "the connection between macropolicy and structural policy, in which the links between sectoral policies, trade and macroeconomic growth contributed significantly to economic dynamism" (Bradford, 2005: 14). Moreover, administrative and institutional capacities are a key determinant of the effectiveness with which available policy instruments can be applied.

Strengthening multilateral rules and regulations on the one hand, and national policies in support of capital accumulation and strategic integration into the world economy on the other, may not always be easy to reconcile, because policy-making at the international level has to serve the interests of a large number of countries. In order to ensure coherence between national and international policies, including the setting of rules and regulations, each set of policies has to be designed with a view to its implications for the other. While the options for national policies will be circumscribed by international policies, the latter should be designed in such a way that they allow maximum scope and flexibility for the application of domestic instruments. This is especially true for countries where growth and development are severely handicapped by their governments' inability to use policy instruments that are essential for their successful integration into the international trading and financial systems.

Options for active government policies to encourage investment and technological progress in support of a dynamic process of growth and structural change that benefits from – rather than being constrained by – integration into the world economy are discussed in subsequent chapters of this *Report*. ■

Notes

1 There is a large body of literature that explains, justifies or criticizes the Washington Consensus. Notable among the more recent contributions are Kanbur, 1999; Naim, 2000; Rodrik, 2006; and Williamson, 2000 and 2002a.

2 In the words of Williamson, who first introduced the term, the Washington of the Consensus was "both the political Washington of Congress and senior members of the administration and the technocratic Washington of the international financial institutions, the economic agencies of the US government, the Federal Reserve Board, and the think tanks" (Williamson, 2002b: 1). He added that Washington itself "does not, of course, always practice what it preaches to foreigners." It may be added that the Consensus also included leading international banks and the majority of governments of creditor countries.

3 For a detailed analysis of the relationship between capital accumulation, economic growth and structural change, see *TDR 2003*, especially chaps. IV and V.

4 It is difficult to establish a strong causal link between individual elements of the reform programme, such as trade liberalization, and the outcome for growth and income distribution, not only because of the complex relationship between each element of the reforms, but also because the effects of various reform elements and stabilization measures influence each other. For the controversies over the relationship between trade and growth, see for example Srinivasan and Baghwati, 1999; and Krueger, 1998, on the one hand, and Rodrik, 1998; and Ocampo and Taylor, 1998, on the other.

5 In terms of the Schumpeterian concept of "creative destruction" as the driving force in the capitalist economy, the strategy implied a "destroy first" approach to economic and structural change. Trade liberalization was intended to "free" up productive resources from "inefficient" activities, and it was assumed that these resources would spontaneously be redeployed to more efficient activities. This is the opposite of the Schumpeterian approach, in which "creation" has the lead role, and it also differs from the experience of structural change in the East Asian catch-up process.

6 There is an extensive literature on the role of trade and industrial policy, as well as institutions, in the East Asian cases of successful development. See, for example, Akyüz, 1999; Amsden, 1989; Bradford, 1994; Chowdhury and Islam, 1993; Rodrik et al., 1994; and World Bank, 1993. The lessons that can be drawn from East Asian experience have also been discussed extensively in past TDRs, in particular *TDR 1989*, Part One, chap. V; *TDR 1994*, Part Two, chap. I; *TDR 2002*, chap. III; *TDR 2003*, chaps. IV and V.

7 In Rodrik's view, "three sets of disparate developments conspired to put institutions squarely on the agenda of reformers. One of these was the dismal

failure in Russia of price reform and privatization in the absence of a supportive legal, regulatory, and political apparatus. A second is the lingering dissatisfaction with market-oriented reforms in Latin America and the growing realization that these reforms have paid too little attention to mechanisms of social insurance and to safety nets. The third and most recent is the Asian financial crisis which has shown that allowing financial liberalization to run ahead of financial regulation is an invitation to disaster" (Rodrik, 1999: 3).

8 The term "second-generation reforms" refers to a set of reforms, not clearly standardized, but including the following elements in addition to what is generally understood to be stipulated by the Washington Consensus: improvement of corporate governance, fighting corruption, introducing greater flexibility in the labour market, accession to WTO agreements, introducing financial codes and standards, prudent capital-account opening, application of non-intermediate exchange-rate regimes, ensuring independence of the central bank together with inflation targeting, creation of social safety nets, and targeted poverty reduction.

9 See, for example, Stiglitz, 2002b: chap. 2; Gilbert, Powell and Vines, 1999: 616–619; Ocampo, 2001: 13–14; International Financial Institutions Advisory Commission Report, 2000: 43–62; and Kapur and Webb, 2000.

10 In response to mounting criticism, the IMF issued new guidelines in 2002 (IMF, 2005) without, however, addressing the fundamental problem of intrusiveness of structural conditionality. See also IMF/IEO, 2005.

11 A case in point is trade liberalization, which, since the 1980s, has become an essential component of IMF surveillance and conditionality. It is generally recognized that unilateral trade liberalization undertaken mainly by low-income countries working under Fund programmes put them at a disadvantage in multilateral trade negotiations (WTO, 2004). A country liberalizing unilaterally acquires no automatic rights in the WTO vis-à-vis other countries, but it could become liable if it needs to take measures in the context of Fund programmes that are in breach of its WTO obligations.

12 The targets are: (a) Develop further an open trading and financial system that is rule-based, predictable and non-discriminatory, including a commitment to good governance, development and poverty reduction – nationally and internationally; (b) Address the least developed countries' special needs. This includes tariff- and quota-free access for their exports; enhanced debt relief for heavily indebted poor countries; cancellation of official bilateral debt; and more generous official development assistance for countries committed to poverty reduction; (c) Address the special needs of landlocked and small island developing States; (d) Deal comprehensively with developing countries' debt problems through national and international measures to make debt sustainable in the long term; (e) In cooperation with the developing countries, develop decent and productive work for youth; (f) In cooperation with pharmaceutical companies, provide access to affordable essential drugs in developing countries; (g) In cooperation with the private sector, make available the benefits of new technologies – especially information and communications technologies.

13 The United Nations Millennium Project was established in 2002 as an independent advisory body to identify strategies to achieve the MDGs, particularly in those countries deemed to be far off-course in progress. The *Sachs Report* synthesizes the analyses prepared by the 10 task forces established under the project.

14 The *Sachs Report* contains 10 recommendations for policy action to achieve the MDGs: (1) Developing country governments should adopt the MDG-based poverty reduction strategies (MDG-BPRSs) bold enough to meet the MDG targets; (2) The MDG-BPRSs should provide a framework for strengthening governance, promoting human rights, engaging civil society, and promoting the private sector; (3) Developing country governments should craft and implement the MDG-BPRSs in transparent and inclusive processes, working closely with civil society organizations, the domestic private sector, and international partners; (4) International donors should identify at least a dozen MDG "fast-track" countries for a rapid scale-up of ODA in 2015; (5) Developed and developing countries should jointly launch a group of Quick Win actions to save and improve millions of lives and to promote economic growth; (6) Developing countries should align national strategies with such regional initiatives, and direct donor support for regional projects should be increased; (7) High-income countries should increase ODA from 0.25 per cent of donor GNP in 2003 to 0.44 per cent in 2006 and 0.54 per cent in 2015 to support the MDGs, particularly in low-income countries, and debt relief should be more extensive and generous; (8) High-income countries should open their markets to developing countries' exports and help Least Developed Countries (LDCs) raise export competitiveness through investment in critical trade-related infrastructure, including electricity, roads and ports; (9) International donors should mobilize support for global scientific research and development to address special needs of the poor in areas of health, agriculture, natural resource and environmental management, energy and climate; (10) The UN Secretary-General and the UN Development Group should strengthen the coordi-

nation of UN agencies, funds, and programmes to support the MDGs, at headquarters and country level.

15 Similarly, a report by the World Bank's Independent Evaluation Group, issued in March 2006, found that Bank support for trade over two decades helped open markets but "was not as effective in boosting exports and growth, and alleviating poverty as anticipated". As a consequence the report suggests that "If developing countries are to reap larger gains from trade liberalization, the reforms need to be combined better with investments and institution building and measures to mitigate adverse effects" (World Bank/IEG, 2006: Press release at: www.worldbank.org/ieg/trade/docs/press_release_trade_evaluation.pdf).

16 For a discussion of the positive effects of industrial policy in East Asia, and a methodological critique of quantitative tests that fail to identify such positive effects, see Rodrik et al., 1994; and Wade, 1996.

17 This section draws in large part on Akyüz, 2006b.

18 For the distinction between potential and actual policy instruments, see Bryant, 1980: chap. 2.

19 The distinction between instruments and targets constitutes the basis of the theory of economic policy first elucidated by Tinbergen, 1952; see also Hansen, 1967; and Bryant, 1980: chap. 2.

20 The impact of openness on policy autonomy goes back to Tinbergen, 1956; see also Cooper, 1968. For the distinction between *de facto* control over national development and *de jure* sovereignty of national economic policy, see Bryant, 1980: chaps. 10–12.

21 Interdependence creates opportunities for individual countries to use commercial, macroeconomic, financial or exchange-rate policies in pursuit of certain national objectives, such as accelerating industrial development or creating jobs at the expense of the others. This could trigger retaliatory policy action by those affected. In the absence of multilateral disciplines and cooperation, this process can easily create instability and disruptions in international economic relations, leaving all countries worse off. In economic policy, the provision of international economic stability as a global public good appears to be one of the most compelling reasons why multilateral discipline is needed.

22 The increased significance of international externalities associated with growing interdependence among countries has resulted in the broadening of the concept of global public goods and growing public interest in their provision, which often requires global collective action. Global security, international economic and financial stability, global environment, knowledge, humanitarian assistance and global health are now typically included among global public goods; see Kaul et al., 1999; Phillips and Higgott, 1999; Stiglitz, 2002a; Bryant, 2003; and Kaul et al., 2003.

23 The need to strengthen the voice and participation of the developing countries in global economic governance has been noted in six paragraphs of the Monterrey Consensus: paras. 8, 38, 53, 57, 62, and, in greater detail, para. 63.

24 This seems to be the reasoning behind the argument by Rodrik (2004: 3) that "the analysis of industrial policy needs to focus not on policy *outcomes* – which are inherently unknowable ex ante – but on getting the policy *process* right. We need to worry about how ... private and public actors come together to solve problems in the productive sphere ... and not about whether the right tool for industrial policy is, say, directed credit or R&D subsidies."

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