Development Debates in Historical Perspective

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1. Introduction

The concept of “development” was originally thought in strict economic sense –as rising per capita income. Under the United Nations leadership, it came to encompass its social and environmental dimensions: the International Labor Organization developed the concept of “basic needs” in the 1970s, and the United Nations Development Program that of “human development”. The environmental dimensions of development were also gradually incorporated and led to a broad concept of “sustainable development” that in the United Nations terminology includes the economic, social and environmental dimensions, as incorporated in particular in the “sustainable development goals” approved in 2015.

Development economics was born in the 1940s and 1950s in Eastern Europe and Latin America, the two regions of the developing world that had achieved an intermediate level of development. Paul Rosenstein-Rodan and Raul Prebisch are clear examples. From the start, it was associated with broader intellectual economic debates, particularly on the role of the state in economic policy, which had made a push forward in the 1930s with the Keynesian revolution.

The United Nations played an important role in development thinking and in advising developing countries at the time. ECLAC was an early leader in this regard, with Prebisch as the intellectual leader. The UN also became the center of the debates on the need to reform the world economic system. Since its creation, UNCTAD played a crucial role in this regard.

The ideas put forward by the new field of economics took place in a world economy that was already highly unequal in terms of levels of development, and characterized by a division of labor in which developed countries were exporters of manufactures and developing countries of primary goods. This was behind Prebisch’s view of the world system as a “*center-periphery*”. In his view and that of Hans Singer, one feature of that system was the tendency for the terms of trade to move against primary goods and, thus, of developing countries.

We should add that the basic conception of classical development economics was the need to industrialize to accelerate economic growth and technological change: the "*Industrialization Consensus*", as I have called it, to borrow from the contrasting term which came to be called the "Washington Consensus".

In terms of macroeconomic issues, a major topic was how export fluctuations were a major source of periodic balance of payments crises in developing countries. Given their strong dependence on the imports of machinery, equipment and many intermediate goods, the availability of foreign exchange was also seen by some classical development economists as a long-term constraint to growth. The strong role of the availability of foreign exchange in the macroeconomic dynamics of developing countries, and the subsidiary role of domestic demand, the issue most underscored by the Keynesian revolution, is that I have come to call "*balance of payments dominance*" –again in contrast with the concept of fiscal dominance that has played a central role in the macroeconomic literature.

The 1960s and 1970s led to three significant changes.

- The world economy started to offer developing countries increasing opportunities to export manufactures. This led to an increasing differentiation between those countries that were able to benefit from that trend and those that continued to depend on the exports of primary goods.

- Rise of a new brand of orthodox economics critical of state intervention. It included a strong criticism of import substitution as well as other forms of state intervention –e.g., in the financial sector, what this school referred to as "financial repression". The orthodox views were codified in what came to be known as the "Washington consensus".

- The third trend was the return –for the developing countries particularly in the 1970s— of private international capital flows, which had collapsed with the Great Depression in the 1930s. However, the volatility of those flows became a problem of its own, and implied a return to boom-bust financial cycles and associated crises, starting with the Latin American debt crisis of the 1980s. Such volatility became therefore a central element of the "balance of payments dominance" that affects developing countries.

The first and third were part of a “globalization” process, which offered very unequal opportunities to different groups of developing countries, with successful manufacturing exporters from East Asia leading the process but other countries experiencing slower growth, including “premature de-industrialization”. Globalization also generated crises that involved a large number of countries: the 1997 East Asian crisis that spread to large parts of the developing world; the North Atlantic financial crisis of 2008-09; the Covid-19 crisis, which has been the most global but its origins were not economic, and the current crisis.

2. The international division of labor and the terms of trade debate

In Prebish’s “center-periphery” system, and the views of Hans Singer, a major characteristic of the world economy was the tendency of the terms of trade of commodities—and thus of developing countries— to experience a long-term decline. This represented a major break with the views of classical economics –of David Ricardo, in particular—, according to which the laws of diminishing returns in primary production and the increasing returns in manufacturing implied that the terms of trade of primary goods would show a long-term improvement vis-à-vis manufactures.

The *Prebisch-Singer (P-S) Hypothesis*, as it came to be called, can be understood as involving two different theoretical variants.

> The first drew on the negative impact that the low income-elasticity of demand for primary commodities –and particularly, for agricultural goods— had on the terms of trade of developing countries.
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> The second –and, in my view, a more interesting one—was based on the asymmetric functioning of factor markets in the developed vs. developing countries: the fact that the second group of countries faced a labor surplus –what in Arthur Lewis terminology came to be known as an “unlimited supply of labor”.

The fundamental difference between the two variants was that in the first case the downward pressure was reflected directly in the barter terms of trade, whereas in the second it was generated

through factor markets –the factorial terms of trade– and only indirectly, through the effects of production costs on commodity prices.

Another important difference is that the first variant applied only to primary commodities, whereas the second should affect all goods and services produced in developing countries. Singer posed this very clearly in 1998: the terms of trade between standardized manufactures produced by developing countries would also tend to deteriorate relative to the innovative products of developed countries. This meant that, even though developing countries could industrialize and produce manufactures, the fact that these products were standardized meant that they did not create new economic rents. Instead, the rents associated with innovations were captured by developed countries' entrepreneurs.

The concept of labor surplus fitted well the complementary terms-of-trade theory of Arthus Lewis, according to which the international terms of trade were determined by relative wages in developing versus developed countries, which were determined, in turn, by the levels of productivity in the production of food (or of subsistence goods in general) in the two groups of countries.

As pointed out, according to the second variant, the trend in the terms of trade was not associated with the types of goods produced but rather with the structural characteristics of the countries that produced them. The *North-South models* developed in the 1980s, by Ronald Findlay and Lance Taylor, among others, formalized this analysis. A common feature of these models was that, due to differences in economic structures, wage increases in the North were proportional to the rise in productivity, while the unlimited supply of labor implied that real wages were not determined in the South by technological change, which was then "exported" to the rest of the world through lower prices.

The expansion of world trade also offered since the 1960s opportunities for the diversification of primary good exports towards goods of higher income elasticity of demand and value added. This included manufactured goods, as well as an array of perishables –fruit, vegetables and flowers—, the development of which required special transportation and handling.

On top of the now well established view on the features of the center-periphery system, the literature identified since the 1980s the risks of "*Dutch-disease*" effects of commodity booms and, in particular, the de-industrialization processes that they could generate. Latin America became the best example of this process, but it also limits the industrialization of Sub-Saharan Africa.

In relation to the empirical validity of the P-S Hypothesis, the literature written up to the end of the 1970s was ambivalent. A breakthrough was a World Bank 1988 paper by Enzo Grilli and Maw Cheng Yang, who showed that there was indeed evidence of a long-term deterioration in real non-oil commodity prices through the twentieth century. This paper became a milestone in the debate.

The later empirical literature has reinforced this conclusion, although indicating also that that the adverse trend of the commodity terms of trade was a feature of the twentieth century (particularly after World War I), not of the nineteenth or the twenty-first centuries. In turn, the adverse trend in the twentieth century is largely explained by two major downward shifts: one after World War I and the other in the 1980s. In both cases, these adverse shifts represent the delayed effects of sharp slowdowns in world economic growth. An additional conclusion is that the adverse price trend in the twentieth century was particularly strong for tropical agricultural goods. This literature also showed that, beyond short-term fluctuations, there are long-term cycles of commodity prices –as long as 30 year long.

3. From the Industrialization Consensus to market reforms, and to a revival of industrial (production sector) policies

An important implication of the P-S Hypothesis is that the transmission of technological change in the world economy was "relatively slow and uneven". Therefore, industrialization was the principal means at the disposal of developing countries to share in the benefits of technological progress, absorb surplus labor from the rural sector, and raise through both of these mechanisms the standard of living of their population. For the intellectual leaders behind this Hypothesis, the case for industrialization was thus broader than the issues associated the tendency of the terms of trade. In Prebisch's view, it was essential to speed up technological transfer from the center to the periphery, and in Singer's analysis to exploit the strong technological externalities generated by manufacturing. The terms of trade debate may have sidetracked the discussion from what remained for several decades a broader consensus on industrialization.

An interesting parallel discussion was Alexander Gerschenkron theory of "late industrialization" of Western Europe. The major challenges required *strong state intervention* (but perhaps the industrialization of England also did, according to research by Ha-Joon Chang). But the challenges were greater for the "late-late industrialization" of Latin America and Eastern Europe or Asia, and the "late-late-late industrialization" of Sub-Saharan Africa.

Industrialization was, of course, a major challenge in many ways, as it took place in an unequal world economy.

- The first was that technology had to be imported, but also that there were learning process associated with technology transfer.
- Additionally, imported machinery was more capital intensive than what made sense for the developing world, given their abundant labor supply and lower wage costs.
- Industrialization also involved significant linkages among sectors, which required policies that could help develop them.
- It also involved macroeconomic issues, particularly how to finance the long-term capital required by industrial sector, and using export income in order to finance imports of capital goods.

A central element of state intervention to support industrialization in the developing world at the time was *protectionism*. It had been at the center of US policies since its independence. It became a rule in the last decades of the nineteenth century in many developed countries and in several politically independent developing countries, particularly in Latin America. In turn, the Great Depression of the 1930s led to the explosion of protectionism worldwide and to the collapse of international trade. In this context, looking at the opportunities that domestic markets provided to encourage industrialization through import substitution was not only natural but, in a strong sense, the only alternative available.

The rising anti-colonialist movements in Asia and Africa and the de-colonization process that took place in the post-World War II years, gave industrialization and protectionism an additional political push in those parts of the world, as an expression of national self-determination.

Furthermore, the reconstruction of world trade after World War II concentrated initially on flows among industrial economies. The opportunities for developing countries, particularly for manufacturing exports, came only in the 1960s, and benefited those countries where industrialization was already underway, thanks to prior import-substitution processes.

The idea that the structural transformation of the economies implied industrialization was at the center of the work of Simon Kuznets, and in relation to the development process of that of Hollis Chenery, who became the first Chief Economist of the World Bank in the 1970s. This institution came to be one of the centers of analysis on this issue, as reflected in the first World Development Reports, particularly the second, published in 1979, on "Structural Change and Development Policy". More generally, the link of industrial development to long-term economic growth became one of the strongest observed "regularities" in development.

The implementation of the "Industrialization Consensus" faced, of course, major challenges, some of which have already been mentioned:

- The first was that the machinery and equipment, in which technology was embodied, had to be imported. An alternative was attracting the firms that controlled the technology through foreign direct investment.

- Strong support for domestic firms, including with protection and export subsidies, was a necessary complement –in the latter case, when export opportunities opened up.

- National development banks, as well as public-sector investments in new industrial sectors, came to occupy an important place in supporting investment in several developing countries.

- Additionally, given the capital intensity of imported technologies vs. abundant labor supplies, developing countries generated dualistic economic structure, in which some labor would be employed in the modern sectors but a large proportion were left in the traditional agricultural activities or were absorbed in a growing urban informal sector.

- To be successful, industrialization also required the creation of significant linkages among sectors, which generated externalities and required policies to help develop those

> linkages. This implied that the development process was characterized by major complementarities, in wide contrast to the emphasis on substitution (in the choice of consumers or the selection of production techniques) emphasized by neoclassical microeconomic theory. Albert Hirschman classified the associated complementarities as a mix of "backward" and "forward" linkages.

The idea that there are strong complementarities gave rise to another series of concepts that came to occupy a central role in classic development debates. The most important were Paul Rosenstein-Rodan's "big push" and Ragnar Nurkse's "balanced growth". In both cases, the central idea was the need to design a policy package that involved the simultaneous development of complementary industries. In contrast, Hirschman argued that this required developing countries to implement policies that were beyond their capacities. As an alternative, he formulated the view that the development process takes place through a sequence of imbalances, which implied that the policies it required were sequential rather than simultaneous. In his view, imbalances actually played a positive role if they generated policy innovations and induced investments to correct them.

The opportunities for export development, particularly from the 1960s, introduced a new element in the development debate. Chenery became in the late 1970s a leading thinker in arguing that the use of those opportunities was an important source of success in the developing world. He claimed that sustained economic growth required a transformation of the structures of production compatible with both the evolution of domestic demand and the use of the opportunities provided by international trade.

The call for greater integration into international trade was made in a radical way by more orthodox thinkers, and particularly by his successor as Chief Economist of the World Bank, Anne Krueger, who argued that protectionism associated with import substitution policies generated inefficiencies, and particularly an "anti-export" bias that reduced growth opportunities. Trade liberalization and full integration into international trade was thus essential for developing countries to accelerate economic growth.

An interesting contrast was made by development economist who studied the East Asian export experiences. Alice Amsden argued that export performance generated a "reciprocal control mechanism" that allowed incentives generated by government policies to be aligned with

performance. Her work, as well as that of Ha-Joon Change and Robert Wade on the East Asian success stories indicated that they were associated with *active government development strategies* aimed at diversifying manufacturing exports towards sectors with higher technological contents. Therefore, these success stories were export-led but also involved strong state encouragement of industrialization. Since the late twentieth century, China adopted, with a lag, similar policies, in equal or even more aggressive ways.

The contrast was that of the countries that did not, and followed the recommendation to stronger trade liberalization. This led to the experiences of "*premature de-industrialization*", particularly of Latin America.

The opportunities for export development did not eliminate, therefore, the classical case for industrial policies, as part of active industrialization strategies, though they certainly changed the type of industrialization needed. The revival of industrial policies over the past decade or so is behind this way of thinking.

My understanding of this issue is that, borrowing from Kuznets, Chenery and the classical development economists, growth is always a process of structural transformation. A successful policy must be based, therefore, on the *dynamic efficiency,* understood as the capacity to generate new waves of structural change. This concept is in sharp contrast with static efficiency, the central focus of traditional microeconomic and international trade theories. It requires state intervention but also innovative ways of interaction between the public and the private sectors, as emphasized by Mariana Mazzucato in her work.

The dynamics of production structures may be understood as the result of the interaction between two basic forces:

- *Innovations*, broadly defined as new technologies, new activities and new ways of doing previous activities, and the learning processes that characterize their full realization and their diffusion through the economic system.

- The *complementarities* underscored by classical development economics, and the networks of production activities that they generate –"value chains", as they have come

to be called. The public and private sector institutions required to enhance these structural processes are crucial, and also subject to learning.

No innovative process is passive: it requires investment and learning. This is an important lesson from the work of Jorge Katz and Sanjaya Lall. As the recent work of Keun Lee emphasizes, climbing up the ladder in the world hierarchy entails shortening technology transfer periods, taking "detours" to manage existing intellectual property rights and, most importantly, gradually becoming a more active participant in technology generation. In broad terms, it requires *national innovation systems* to be built up, which should include an institutional framework to coordinate the various actors engaged in innovation and learning—research and development centers, universities, extension services, and the innovating firms themselves. And it requires, of course, strong state investments in science and technology.

Two final comments on global trends are in place. The first is that the ongoing shift away from manufacturing into services is transforming the global economy. The rise of modern services, especially those associated with Information and Communications (ICT) technologies is as essential as manufacturing, and has been at the center of recent successful development experiences. We also know that at high levels of income the dynamics of services eventually overtake that of industrialization, and that the revolution in ICT has induced major changes in manufacturing itself. These issues, as well as the innovations that take place in these sectors and the value chains that they generate should certainly be today at the center of development strategies. There are, of course, other technological waves that are equally important, notably that to generate energy that is consistent with global climate change goals, and those that are associated with new biological technologies and their effects on both medical treatment and agriculture. This is why a prefer to talk about the need for "production sector policies" and not only industrial policies, which in a sense focus on manufacturing.

The second is that world trade slowed down significantly since the 2008-09 North Atlantic financial crisis. To this we must add the disruptions of value chains generated by the Covid-19 crisis (nearshoring), but also by new waves of protectionism, particularly between the US and China. All of these have generated both threats to existing trade patterns, the effects of which are re-shaping globalization.

4. **Macroeconomic policies and development**

In the initial stages of development economics, the major macroeconomic issues were the availability of savings to finance the investment needed for industrial development, and the foreign exchange required to pay for the imports of machinery, equipment and intermediate goods that that process required. With the return of capital flows and the growing role of domestic private finance, the attention increasingly focused on how to manage the boom-bust cycles in private flows, avoiding also possible domestic financial and international debt crises.

In the debates that characterized the early decades of development economics, the first of these issue involved the management of fluctuation in commodity prices and, from a longer-term perspective, how savings or foreign exchange gaps could affect the growth process.

In relation to commodities, an important proposal was the possibility of moderating price fluctuations with the creation of international commodity agreements. Although there were precedents since the 1920s, the creation of commodity agreements became a strong trend in the mid-1950s and early 1960s after the collapse of the commodity price boom that had taken place in the early post-World War II period. Several consumer countries participated in those agreements. The Organization of Petroleum Exporting Countries (OPEC) was created in 1960, but its decisions in the 1970s to reduce oil supplies, which generated two major price shocks, contributed to the lack of support of consuming countries for commodity price agreements in general.

Domestic stabilization funds are also essential to manage commodity price fluctuations. They save commodity export revenues during price booms to have them available when the succeeding crises hit. One of their objectives was stabilizing domestic commodity prices, with taxes or forced savings imposed on producers during booms, matched with compensatory subsidies or refund of forced savings during crises. A good example was the Colombian National Coffee Fund, created in 1940 to manage the domestic effects of the Inter-American Coffee Agreement. The Norwegian oil fund is generally recognized today as the best instrument of this kind, but several oil exporting countries have similar instruments. Another good example is the series of Chilean stabilization funds for its main export, copper, the first of which was launched in 1987. But these stabilization funds are missing in most commodity-exporting countries.

From a long-term perspective, the essential issue was the possibility that the availability of foreign exchange would become a major constraint on economic growth. A basic issue underscored by classical development economics was the effects of the asymmetry between the high income-elasticity of the demand for imports by these countries vs. the low elasticities of demand for their export goods, particularly for several commodities. Under these conditions, the availability of foreign exchange could become the basic determinant of economic activity. The work of Anthony Thirwall has been the most influential in the analysis of this issue. This underscores the role that active export strategies and, more generally, structural diversification play in overcoming possible *foreign exchange gaps*.

A central issue today is how to manage *capital account volatility*. The literature on this topic has identified a sort of hierarchy of volatility of capital flows, with FDI being the more stable, and short-term bank lending and portfolio flows the more unstable, according to Dani Rodrik and Andres Velasco, among others. In this context, according the Guillermo Calvo, the major risk that developing countries face is the possibility of a "sudden stop" of volatile financial flows, which can generate "twin crises" –combined external and domestic financial crises—if the abundance of external financing has generated a parallel boom in domestic financing.

The management of external financial cycles require active counter-cyclical fiscal and monetary policies. In the first case, the best is the design of fiscal rules that determine the medium-term trajectory of the fiscal balance and debt ratios, but allow for deviations around that trend to counteract positive and negative terms of trade shocks to smooth the fluctuations in aggregate domestic demand. However, the domestic political economy tends to generate pressures in most developing countries to spend in good times, which in turn limit the policy space to adopt expansionary policies when crises hit. The limited availability and higher costs of financing may also constrain counter-cyclical fiscal policies during crises. If austerity policies are adopted as a result, the political pressure to expand during the subsequent upswing in economic activity would be strong. For these reasons, and in contrast to developed countries, pro-cyclical fiscal policies tend to prevail in developing countries.

In the case of monetary policy, counter-cyclical policies face two major dilemmas. The first one is that, if domestic monetary policy is counter-cyclical way, it may increase rather than reduce the

volatility of capital flows –i.e., bring more capital flows during booms if monetary authorities increase interest rates to reduce domestic demand, and generate more capital flight during crises if they reduce interest rates. For this reason, the recommendation of the traditional macroeconomic literature is to let exchange rates be flexible. Expressed in terms of the "trilemma" of open economies, in economies with open capital accounts, the authorities can control the exchange rate or the interest rate, but not both.

However, this generates a second dilemma, because of the negative effects on growth that the appreciation of the exchange rate during booms may generate, both through the reduction of investment in tradables sectors in the short term but also to the unstable incentives generated by the instability of the exchange rate in the long term. In other words, this policy may contribute to the "Dutch Disease" effects of export booms. A growing literature has shown that long-term growth in developing countries is positively associated with the capacity to guarantee a competitive and relatively stable real exchange rate.

The limitations that monetary policy faces in open developing economies generate a case against full capital account liberalization and to actively use regulations to manage the associated volatility. The broad agreement that capital market liberalization generates stronger business cycles in developing countries was supported by a major 2003 International Monetary Fund (IMF) study led by Eswar Prasad. There is also strong evidence and a broad consensus in the literature that capital account regulations help improve the composition of capital flows toward less reversible flows, and provide room for counter-cyclical monetary policies. The IMF's "institutional view" on capital account management, adopted in 2012, accepted that the full liberalization is not always desirable, and that regulations can play a positive macroeconomic role to manage capital account volatility.

Capital account regulations must be complemented at the domestic level with regulatory policies aimed at avoiding unsustainable credit booms, and managing the maturity and currency mismatches in portfolios. The provision of counter-cyclical financing at the national level is also crucial. National Development Banks can play a counter-cyclical, aside from their long-term development goals, in fact counteracting the pro-cyclical character of private financing at the national level.

5. The current crisis

The current crisis has many dimensions, underscored by the concept of "polycrisis", which has become a fashionable term. I will concentrate on the economic dimensions, but many are associated with the geopolitical tensions, particularly of the war between Russia and Ukraine, but also the growing tensions between the US and China. In economic terms, they involve at least seven effects:

- The remains of the Covid-19 crisis, including the large inequalities in the access to vaccines and the possible effects of the elimination by China of mobility restrictions.
- The mix of inflation and interest rates, and the possible recessions (although not quite stagflation).
- The food crises in many parts of the developing world, largely generated by the effects of the war in Ukraine, but also to natural disasters associated to climate change.
- The worldwide rise of interest rates and rising risk margins that generated an outflow of capital from emerging economies in 2022.
- The high debt ratios generated by the Covid-19 crisis but also by high interest rates, which has generated debt crises in many developing and emerging economies.
- The reversal of climate change policies generated also by the war in Ukraine, as well as the clearly insufficient efforts to adopt policies to reach the climate change goals reached in Paris in 2015.
- The changes in world trade that are taken place due to the slowdown in international trade, the disruptions of value chains generated by the Covid-19 crisis (nearshoring) but also by new waves of protectionism, particularly the between the US and China. To this, we must add the increasingly inward orientation of China.

In the face of these events, let me end with comments on three urgent policy issues:

- The need to improve international tax cooperation, improving on the 2021 agreement in the OECD Inclusive Framework, in its two dimensions: limiting tax competition and fair taxation of multinational companies. To these we should add combating tax evasion.

- The need for counter-cyclical financing of developing and emerging economies, including in that regard the central role of Multinational Development Banks. To this we should add larger active Official Development Assistance and adequate funds to finance climate change mitigation and adaptation.

- Both permanent institutional frameworks to renegotiate public sector debts, but also a new ad hoc mechanism to manage the current debt crises.

We could add that globalization is changing, both due to economic and geopolitical events. A major issue, as argued by Dani Rodrik, among others, is that it should be more friendly to developing and emerging economies. The rupture of multilateralism is the major constraint in this regards. From this forum I want to underscore that the United Nations should be the center of a revitalized multilateralism, both to manage the geopolitical but also the sustainable development challenges well captured in the SDGs, one of the major agreements in world history.