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Overview

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OVERVIEW

The past two decades have been shaped by a radical shift in development thinking and practice. In the wake of the debt and development crisis of the 1980s, a new policy approach looked to liberate enterprise from state intervention, deferring to the invisible touch of global market forces. The promise was for an end to macroeconomic chaos, stop-go development cycles and debilitating levels of debt, ushering in an era of sustained growth and poverty reduction. The collapse of the Berlin Wall gave this agenda global reach.

The agenda was embraced with particular enthusiasm in Latin America, and with the success of the Brady Plan the floodgates opened to foreign capital in the 1990s. The green light from international capital markets encouraged a quickening pace of reform, attracting foreign investment and making international competition the engine of renewed growth. But after some initial signs of success, familiar structural constraints have resurfaced. Most countries have failed to accelerate capital formation and technological progress, and diversify into more dynamic sectors. As spending outpaced the expansion of productive capacity and imports boomed, the growing reliance on external capital left many countries exposed to external policy shocks. Over the past five years, as global economic imbalances have generated such shocks with increasing frequency, Latin America has endured a "lost half decade", recalling the disappointing developments of the 1980s.

A passing familiarity with broader historical experience might have cautioned against advertising the originality of the new development agenda or encouraging exuberant expectations. Back in the 1920s, balanced budgets, independent central banks, flexible labour markets and a rapid opening to international competition also promised to get things back to normal. Instead, as unregulated financial flows spilled across the global economy, boom-bust cycles erupted on the periphery of Europe and in parts of the developing world, linked to instability in commodity export earnings and mounting levels of debt.

Fanaticism, according to the Spanish philosopher George Santayana, calls for a doubling of effort in the face of failure. Despite its pantheon of critical and creative minds, economics is also susceptible to such thinking. Indeed, as inflation has subsided and market forces enjoy an increasingly freer reign, the call for developing countries to pursue greater fiscal discipline, more deregulation and ever faster liberalization has intensified, even as growth prospects have dimmed in many places and poverty levels have risen.

In the 1920s, when the "market juggernaut" was rolling at full steam, John Maynard Keynes called for a "new wisdom for a new age" with "new policies and new instruments to adapt and control the workings of economic forces, so that they do not intolerably interfere with contemporary ideas as to what is fit and proper in the interests of social stability and social justice". Open-minded, tolerant and pragmatic approaches to the development challenge, consistent with today's increasingly interdependent world, are urgently needed to place economic policy once again at the service of social justice and stability.

Global trends and prospects

This is an anxious time for the global economy. The long anticipated rebound in the United States continues to be delayed, and there are concerns that the imbalances and excesses created during the high-tech boom of the 1990s could result in a long period of erratic and sluggish growth, with occasional surges and dips, accompanied by price deflation. With Europe undecided on, and Japan unable to find, the appropriate policy mix for sustained recovery, the world economy looks set to repeat the weak performance of the past two years and could still falter badly.

Adverse consequences for the developing economies, even the most resilient, are unavoidable. Brighter political conditions should help avoid a repetition of last year's recession in Latin America, but any recovery will be anaemic and fragile. Africa appears to be relatively insulated from global trends, but the continued weakness of many commodity prices means that it may not be able to repeat its performance of the past two years. Given the current level of development cooperation and the structural weaknesses across the region, there is now a growing consensus that it will be impossible to meet the Millennium Development Goals even under the most optimistic growth scenario for the world economy. Asia has until recently been able to maintain momentum based on domestic demand, exports to the United States and buoyant intraregional trade, but growth in the region is certain to slow.

The current downturn in the world economy was preceded, at the end of the 1990s, by widespread but misplaced optimism about the nature and sustainability of United States expansion as the single most important force driving global growth. This was noted in *TDR 2000,* at the time when the world economy was still moving at full steam and many observers thought that the United States economy had been liberated from the inexorable turn of the business cycle:

> Most forecasts of continued global expansion are based on the "Goldilocks" scenario in which the United States economy is neither too hot nor too cold, allowing Europe and Japan to grow and providing support for continued recovery in Latin America and Asia. In assessing the forecasts for accelerated global growth it is as well to remember that Goldilocks is a fairy tale.

Indeed, the factors that helped the United States economy to surge ahead have also increased financial fragility and global imbalances. Accordingly, and as anticipated in *TDR 2001* in the wake of the current downturn, the unwinding of the legacy of the 1990s is proving a good deal more difficult than many had expected:

> Expectations remain quite high that a short Keynesian downturn in the United States can be corrected by appropriate monetary and fiscal action. ... But, even if the steady hand of recent years is maintained, there are doubts that traditional macroeconomic policies will carry the day, given the high level of private indebtedness, the surfeit of investment during the technology boom, and the uncertainties surrounding the dollar. ... The fact that such a long period of expansion has no recent precedent should make for cautious assessment of the current slowdown. However, on balance, the various conflicting pressures point to an uncertain future.

Thus, in spite of aggressive interest rate cuts by the Federal Reserve, investment has failed to recover as capacity utilization remains low despite the scrapping of excess equipment. The economy has so far avoided a more prolonged period of recession thanks to continued growth in consumer spending, which now appears to be losing momentum. Europe's ability to respond vigorously to the current downturn has continued to be compromised by the restrictions on fiscal policy imposed by the Stability and Growth Pact, and the monetary policy stance of the European Central Bank. Japan appears to have given up fighting deflation with macroeconomic tools, emphasizing instead international competitiveness and exports as a basis for growth. Consequently, even though growth rates have fallen everywhere, disparities in the strength of demand among the major industrial countries have persisted, with the United States economy still outperforming Japan and the European Union.

With weak policy responses to sluggish and uneven growth, there is increased reliance on currency adjustments to reduce trade imbalances and revive growth. The combination of the reduced attractiveness of United States assets to foreign investors and the continued increase in its current account deficit has created downward pressures on the dollar. However, this has so far been reflected primarily in a rapid depreciation of the dollar against the euro and some reversal of prior depreciation of Latin American currencies: East Asian economies, including Japan, have resisted the appreciation of their currencies by intervening in the foreign exchange markets and accumulating large reserves.

Since the bulk of the United States trade deficit is with East Asia, it is not clear if recent currency movements will reduce rather than aggravate trade imbalances between Asia and the rest of the world. Indeed, the events of recent months evoke memories of the competitive devaluations of the inter-war period. Certainly, it would be unrealistic to expect the international trading system to evolve in the right direction or international monetary stability to be maintained in the face of slow growth and mounting unemployment. A reversion to the pattern of unruly competition and conflict characteristic of the 1930s could derail the process completely.

Different developing countries are unequally prepared to deal with these increasingly volatile conditions. The weakness of global demand in the past two years has only had a limited impact on East Asia despite its dependence on exports, largely because the strong macroeconomic and balance-of-payments positions of countries in the region have allowed considerable room for domestic demand expansion to support growth, reinforced by strong intraregional trade linkages.

Such policy space was not available to most economies in Latin America facing stringent payments positions. In these countries the global downturn aggravated external financial difficulties, and macroeconomic policy has focussed on reducing current-account deficits and reassuring financial markets. While Asian economies generated large current-account surpluses through a rapid expansion of exports, the situation in Latin America in 2002 was reminiscent of the conditions prevailing during the debt crisis of the 1980s. The region received virtually no net inflows of private capital in 2002 after being the largest recipient in 2001, and it has had to combine a fall in output with a trade surplus and net transfers abroad, generated entirely by cuts in imports.

While prospects for East Asia and, to a lesser extent, Africa, depend on the evolution of their external trading environment, for Latin America financial conditions are equally important. In recent months extremely high yields and improved political conditions in some countries in the latter region, combined with sharp declines in equity and bond yields in industrial countries, have been attracting short-term, speculative capital, leading to the appreciation of currencies at a time when global prospects are deteriorating and long-term capital inflows to the region declining. It is unlikely that such short-term inflows mark the beginning of another cyclical upturn in private capital flows to the region, as happened during the 1970s after a long period of stagnation or in the 1990s after the debt crisis. These post-war surges in private capital flows to Latin America were idiosyncratic, driven by ad hoc responses to specific global circumstances rather than being parts of a recurrent cyclical pattern. The first was made possible by the end of the Bretton Woods system and the accompanying financial deregulation in industrial countries and the recycling of petrodollars. In the second, the Brady Plan, designed to relieve United States banks of non-performing loans, laid the ground for a surge in portfolio and investment flows which were further encouraged by progressive liberalization and privatization in the region. There is no guarantee of a renewed surge in capital inflows, and certainly not to the peaks reached during the 1990s.

Hopes are also being pinned on a successful Doha round of trade negotiations to bolster confidence and kick-start the global economy putting trade ahead of growth. Certainly, international trade surged from the late 1980s, growing considerably faster than output until the beginning of the new millennium when it fell not only behind growth of world output but also in absolute terms. While trade is expected to recover in 2003, again there is a danger of optimistic extrapolations. The growth of world trade during the 1990s was driven by a number of structural and institutional changes, which are unlikely to be repeated, at least with the same intensity. These changes included the rapid liberalization of imports in developing countries; the spread of international production networks for some of the most dynamic products in world trade, resulting in a rapid expansion of intra-industry trade with a prominent North-South component and the round-tripping and double-counting of goods in the measurement of world trade; and a surge in capital inflows which helped to boost trade by allowing imports to expand faster than exports in many developing countries. While similar forces could still propel an independent recovery in trade, they are unlikely to match the earlier rise, if only because they will lack the same first-mover boost. Under current conditions, a rapid expansion of trade and further trade liberalization will depend crucially on a rapid recovery of demand and production in the world economy rather than the other way round.

The world economy is now facing a widening deflationary gap created by deficient global demand. There is a global glut in both labour and product markets, with too many goods chasing too few buyers and too many workers chasing too few jobs. Intense price and exchange-rate competition among major exporters have been adding to instability and deflationary pressures, while many developing countries facing tight payments positions are being forced to curtail imports. These difficulties are similar to those that the Bretton Woods Institutions were created to resolve. If decisive action is not taken to restore stability in financial and currency markets, to start a global recovery and reverse the rapid rise in unemployment, there is a real threat that trade imbalances and the coexistence of continued rapid growth in some parts of the world with stagnation, decline and job losses elsewhere could deepen the existing discontent with globalization among a wide section of the world's population, triggering a political backlash and a loss of faith in markets and openness, and leading to international economic disintegration with the burden falling disproportionately on the poor and underprivileged. This is perhaps the first real test for economic policy in a post-Bretton Woods globalized world.

Guided by fiscal and monetary orthodoxy, the measures so far applied in some leading economies have been inadequate for striking a better balance, even as inflationary pressures have dissipated and unemployment is rising again. Indeed, with prices already declining in some larger developed and developing economies, the risk of a deflationary spiral is an increasing worry to policy makers everywhere. Although the likelihood of such a spiral is still controversial, it is nevertheless clear that there is now a real danger of a "liquidity trap" emerging, where monetary policy becomes incapable of checking and reversing the falls in output and employment. This is precisely the context in which it is most apt to adopt Keynesian policies to expand liquidity and effective demand, both at the national and global level. An effective policy response should include a fiscal stimulus over and above that provided by automatic stabilizers: an increasingly interdependent global financial and trading system can scarcely function efficiently with only one policy tool, monetary policy, especially without an appropriate degree of policy coordination and agreement on its objectives. Policy should also address the liquidity needs and the debt burden of developing countries facing stringent external financial conditions. For all countries, therefore, the prospects for prosperity hinge on international cooperation as well as on the intensity of their own efforts.

Capital accumulation, economic growth and structural change

The increased diversity in economic performance of developing countries in the current global downturn reflects differences in their domestic conditions. In this respect the contrast between East Asia and Latin America is particularly striking. The poor economic performance of most middle-income Latin American countries in comparison with East Asia suggests that their productive structures, institutions and policies do not have the flexibility and resilience needed to respond to external shocks with the same vigour and effectiveness as in East Asia. In this respect, the current economic landscape in the developing world has an uncanny resemblance to conditions prevailing in the early 1980s, when external shocks, including widespread recession in the industrial world and tightened financial conditions, pushed Latin America into a deep crisis while most East Asian economies were able to swiftly adjust and continue, after a brief pause, on their high growth paths.

What is perhaps more unsettling is that current difficulties in Latin America follow many years of intensive market-based reforms adopted in response to the debt crisis of the 1980s with the support of the international financial institutions. These reforms, collectively referred to as the "Washington Consensus", aimed to remove structural and institutional impediments to growth, improve productive capacity and trade performance, and put an end to stop-go development associated with excessive indebtedness and periodic balance-of-payments crises. While claiming success in controlling inflation and bringing monetary and fiscal discipline, the evidence examined in Part II of this year's *Report* shows that the reforms have failed in exactly the same areas in which previous policies of import substitution had also failed. Just as significantly, the problem lies as much with what has been included in the reform packages as with what has been left out.

Investment and growth: the record

Between 1960 and 1973 Latin America and East Asia grew at much the same rate, and average per capita income in 1973 in the four first-tier NIEs was lower than that in the five largest countries in Latin America by $850. Thereafter, performance started to diverge sharply, with East Asia growing at more than double the average rate in Latin America between 1974 and 2000. Furthermore, the slowdown in Latin America was accompanied by increasing instability: in most countries of the region, growth in the period 1980–2000 was slower and less stable than in the previous two decades. Only Chile enjoyed a more rapid and sustained growth rate accompanied by greater stability.

Why growth rates differ between countries and regions has generated a myriad of explanations. Nevertheless, there is general agreement that growth cannot be sustained without an adequate level of investment. Certainly, as discussed in past *TDRs*, a strong and sustained investment drive by national elites, often from very low levels, has been a defining feature of successful development episodes in the post-war period. The minimum level needed for a satisfactory growth performance will be influenced by country-specific factors, but a 20 per cent share of fixed investment in GDP has been suggested as a target threshold in poorer countries, rising towards 25 per cent as countries climb the income ladder.

In the first half of the 1980s, there was a drop in the share of investment in almost all developing countries, often below these thresholds, and in some cases below the level needed to replace depreciated capital. Drastic policy changes introduced in response to the debt crisis to restore macroeconomic stability, correct price distortions and free market forces were expected to improve the investment climate and prepare the ground for a recovery led by private investment. However, the strategies adopted for activating a dynamic process of capital accumulation and growth, based on a combination of increased FDI and reduced public investment and policy intervention, have not produced the expected results.

In Latin America where such reforms have gone furthest, there has been a steady and persistent fall in the share of public investment, along with increased FDI, often through the sale of public assets. There was only a weak recovery of total investment from the second half of the 1980s, often led by less productive categories such as housing construction, before hovering around 20 per cent of GDP in the 1990s, well below previous peaks. In many cases, investment in machinery and equipment during the 1980s stagnated or declined sharply, before posting modest recoveries in the 1990s. This shift in the structure of investment towards less productive activities appears to have contributed to the weakening of the link between capital formation, technological upgrading and output growth. Furthermore, the conditions that attracted foreign enterprises to Latin America have not been conducive to faster capital formation: FDI as a proportion of GDP was higher by some 1.7 percentage points in the 1990s compared with the 1980s, but the share of gross fixed capital formation was lower by 0.6 percentage points. This trend characterized all the major economies, except Chile, and is equally apparent when the contrast is with domestic private investment.

In the East Asian economies a very different investment regime has been established. The rising share of investment in GDP throughout the 1970s was only briefly interrupted by the turmoil of the early 1980s and it recovered strongly during the second half of the decade as moderate devaluations and temporary wage restraints allowed countries to build a dynamic investment-export nexus, before accelerating rapidly in the first half of the 1990s. The regional peak of 30 per cent of GDP was surpassed in a number of countries, in some cases by a considerable margin. Investment in machinery and equipment along with expanding construction in physical infrastructure were important features of East Asian investment. This improvement in overall investment was in most cases associated with a stable or rising share of public investment with strong crowding-in effects. For some countries, such as Malaysia, the surge was closely associated with increasing FDI, but this was not a common feature in the region.

It is not just the level or composition of investment that matters. A comparison of investment cycles over the past four decades suggests that the cycle is a good deal more volatile in Latin America than in East Asia. Furthermore, investment has played a much more significant role in the recovery phase of a typical cycle in the latter region than in the former. Thus, in Latin America, in a typical cycle, the investment recovery has been much shorter and the slowdown, when it came, has been much more pronounced. This implies that counter-cyclical policies gain added importance in Latin America, but their scope is limited due to greater fiscal and monetary fragility.

Industrialization, deindustrialization

The historical experience of advanced economies shows that establishing a broad and robust domestic industrial base holds the key to successful development because of its potential for strong productivity and income growth. This process is associated with a strong investment drive in industry, rapidly rising productivity and a growing share of the sector in total output and employment. As the economy matures, growth in demand for manufactures slows down relative to productivity growth, and the share of the sector in the economy levels off and eventually starts to decline. In today's advanced economies, such a process of "deindustrialization" occurred at very high levels of industrial productivity and income, and under relatively rapid overall rates of economic growth, accompanied by a persistent rise in the share of services, many of them closely related to the needs of industry.

Industrialization still matters for developing countries lower down the income ladder. The presence of scale economies, gains from specialization and learning, as well as favourable global market conditions, implies that the creation of leading industrial sectors, along with related technological and social capabilities, remains a key policy challenge. Still, there is considerable room for diversity in the timing and the pace of industrial development across countries, reflecting differences in resource endowments, size and geographical location. Such diversity, including the pace and pattern of capital accumulation and trade performance, is also strongly influenced by policy choices.

A steady rise in the shares of industrial output and employment characterized most of the developing world in the 1960s and 1970s. In some regions, notably Latin America, the increases were especially pronounced thanks to a strong industrial drive under the import substitution industrialization strategy; indeed, with the possible exception of China, the Southern Cone countries were, at the time of the debt crisis, the most industrialized part of the developing world, as measured by the share of industry in total employment. This pattern has become a good deal less uniform since then, with premature deindustrialization in a context of slow growth becoming a common feature across parts of the developing world.

The East Asian economies have continued to industrialize at a rapid pace, with the first-tier NIEs reaching productivity levels consistent with industrial maturity as a new generation of late industrializers from the region were expanding rapidly, combining rising investment and manufacturing value added both in absolute terms and as a share of GDP. By contrast, industrial stagnation and decline has been the norm in Latin America as well as in Africa where in most countries a declining share of investment in GDP has combined with a falling share of manufacturing value added in a context of slow and erratic growth. Among a selection of 26 countries examined in this *Report* only eight have succeeded in raising the share of manufacturing value added in GDP between the 1980s and the 1990s, together with a rising share of investment in GDP. In East Asia this is noticeably the case for the second-tier NIEs. The Republic of Korea and Taiwan Province of China have reached the more mature stages of industrialization, combining rising investment ratios with relatively stable shares of manufacturing in GDP. In Latin America, none of the major economies ended the 1990s with a higher share of manufacturing value added in total output than in the 1970s.

This process of deindustrialization is sometimes interpreted as a benign shift to a pattern of development more consistent with national resource endowments and comparative advantages, following a period of "excessive" and "wasteful" industrialization under import-substitution strategies. Such an interpretation might be valid for China where the decline in the share of industry in the economy since the mid-1980s has been associated with a significant acceleration of investment and growth. But this is not the case for the major Latin American countries except Chile. In the latter, industrialization also lags considerably behind the levels achieved by similar resource-rich countries, such as the Scandinavian economies, when they were at comparable income levels.

In successful episodes of industrialization, rising shares of investment and manufacturing value added in GDP have also been associated with a rising share of manufacturing exports in both total exports and GDP. In economies where there has been increasing participation in international networks producing manufactures such as electronics, automobiles and textiles and clothing, manufacturing exports have grown more than manufacturing value added by a large margin because of the high import content of such exports. This is the case for Malaysia, for example. By contrast, in China there was a small decline in the share of manufacturing value added in GDP, but a large increase in manufactured exports in the context of rapidly rising investment and GDP.

In economies lagging in industrialization, declining shares of investment and manufacturing value added in GDP have usually coincided with a stagnant or falling share of manufactures in total exports. This is the case for most Latin American countries. In Mexico, as in China, however, the share of manufactured exports in GDP did increase during the 1990s compared with the 1980s as a result of its increased participation in international production networks, while the share of manufacturing value added in GDP fell. Unlike China, however, Mexican GDP growth has been poor, with the per capita average annual growth rate barely exceeding the Latin American average. Indeed, a more detailed examination of Mexico's industrial structure shows that in some sectors such as clothing, exports grew rapidly while domestic value added fell; by contrast, in some other sectors not integrated with international production networks, growth in value added was strong but export performance was below average. Thus, despite several years of economic reforms, privileged access to the largest and most dynamic market in the industrial world, and large inflows of foreign investment, the Mexican economy has been unable to establish a dynamic process of industrialization and economic growth.

Trade and competitiveness

In recent years international competitiveness has provided a framework for understanding how industry, trade and development are linked together. However, a degree of caution is needed in applying this concept to economic challenges facing developing countries. In the first place, strictly speaking, the concept may be useful to define the position of individual enterprises vis-à-vis each other, but not for comparisons among economies as a whole or even among industries comprising many firms with different characteristics. Many countries which contain highly competitive firms in certain industries find it necessary to protect others against foreign competition, and this is true at almost every level of industrialization and development. Furthermore, from a corporate perspective it may matter little whether international competitiveness is improved through productivity growth, wage cuts or a devaluation of the currency, but from a broader socio-economic point of view, these have totally different implications for economic and social stability and welfare. Finally, competitiveness is a relative concept and there is an adding-up problem; it is not possible for all countries to simultaneously improve the competitiveness of their firms in a given industry. On the other hand, the success of several developing countries in simultaneously raising productivity and wages can improve their overall economic welfare without altering their relative competitive positions in the sectors concerned.

The real challenge for developing countries from this perspective is how to combine strong productivity growth with increased employment, a growth of real wages that does not outpace productivity and stretch the external constraint, and a nominal exchange rate that maintains purchasing power parity. This challenge has been met with different degrees of success in different parts of the developing world during the past two decades.

East Asia's pattern of structural change has been accompanied by a significant and continuous improvement in productivity across a broad range of industrial sectors, in most cases closing the gap on the technological leaders. Most of the countries in that region, but especially the Republic of Korea and Taiwan Province of China, have been consistently successful in basing their trade performance on strong productivity growth. The fact that this was compatible with rapidly rising real wages and relatively stable exchange rates is a clear indication of their successful integration into the global economy. The second-tier NIEs and China have replicated the same pattern, albeit less vigorously; in particular in sectors organized through international production networks, growth in labour productivity and wages was much less impressive than export performance.

Outside of East Asia, exchange rate depreciation or wage restraint appear to have been much more common routes to seeking greater competitiveness. But none of the countries that pursued this route achieved sustained improvements in export and value-added performance to the same extent as countries that succeeded in raising productivity and wages in a virtuous process of capital accumulation and employment growth.

In Latin America, overall productivity in manufacturing declined or remained stagnant and the level of wages fell in most countries during the 1990s. In some cases, there was an improvement in overall manufacturing productivity as a result of labour-shedding rather than investment and the expansion of employment. Even in strong exporters such as Mexico, the rise in manufacturing productivity was small and wages remained stagnant. The competitiveness of manufacturers in many countries in the region was further undermined by sharp currency appreciations, particularly in Argentina, Brazil and Peru.

In most countries in Latin America where weak investment has stunted productivity growth and upgrading, the rapid opening up to international competition and FDI has tended to shift the production structure away from sectors with the greatest potential for productivity growth towards those producing or processing natural resources. The demand for labour also fell as capital intensity increased in resource-based manufacturing industries. In a number of countries, there was a particularly sharp decline of productivity in traditional labour-intensive sectors such as textiles and clothing. Where investment has increased in the context of international production chains, the tendency has been for an apparent increase in the technology content of exports without a similar increase in domestically generated value added. In sectors intensive in research, the productivity lag behind the technological leaders has widened considerably. By contrast, it is notable that some industries that have continued to receive support through industrial policies of one kind or another have seen a considerable improvement in their productivity and trade performance.

The evidence on international specialization suggests that developing countries are becoming increasingly similar to major industrial countries in the structure of their exports but not in the structure of their manufacturing value added. The disparity between the two is greatest for countries participating in international production networks, and still greater in Latin America than in East Asia. Only the first-tier NIEs, notably the Republic of Korea and Taiwan Province of China, have been successful in simultaneously upgrading both their production and export structures towards the patterns of advanced industrial countries, by moving into a comparatively wide range of medium and high-technology products. In most of Latin America and Africa, both industrial production and exports continue to be dominated by resource-based products.

In countries closely linked to international networks, manufactured exports appear to be much more technology intensive and dynamic than domestic manufacturing value added. This divergence between the technology intensity of domestic value added and of manufactured exports is largely a reflection of the high (technology-intensive) import content of such exports. Domestic value added reflects the contribution of unskilled labour-intensive operations in the production process for goods, which are predominantly technology- or capital-intensive. Thus the growing similarity of developing and industrialized countries' export structures is basically an illusion based on double counting the exports of high-tech intermediate goods.

A stylized picture of diversity in industrial development

The comparative analysis in this *Report* of trends in capital formation, growth and industrialization since the early 1980s in Latin America and Asia offers a stylized picture of where developing economies stand in relation to each other:

- *Mature industrializers*: This group includes the first-tier NIEs, notably the Republic of Korea and Taiwan Province of China, which have already achieved industrial maturity through a rapid accumulation of capital, growth in industrial employment, productivity and output, as well as manufactured exports. These economies still have a share of industrial output in GDP above the levels of advanced countries, but industrial growth has started to slow down.

- *Rapid industrializers*: These are countries with a rising share of manufactures in total output, employment and exports, based on strong investment and upgrading from resource-based and labour-intensive activities to middle-range technology products. This group includes the second-tier NIEs and, to a lesser extent, China and perhaps India.

- *Enclave industrializers*: This group includes countries which have also moved away from dependence on commodity exports by linking to international production chains with a heavy reliance on imported inputs and machinery. However, their overall performance in terms of investment, value added and productivity growth is poor.

- *Deindustrializers*: This group includes most countries in Latin America, which have achieved a certain degree of industrialization but have been unable to sustain a dynamic process of structural change through rapid accumulation and growth. In a context of rapid liberalization, there have often been declining shares of manufacturing employment and output and a downgrading to less technology intensive activities. In some countries in this group, notably Chile, there has been a less destructive pattern of deindustrialization as a result of a fast pace of investment, accelerating growth based on natural resources, although this process appears to have reached its limits.

Countries in any one of these groups may also share some of the characteristics of those belonging to another. For instance, China and Malaysia have both expanded their manufactured exports much faster than value added by participating in international production networks, but unlike Mexico, their investment and growth performance is impressive. There are also borderline cases between rapid industrializers and deindustrializers: Turkey, for example, is closer to the former while Colombia is closer to the latter group.

The Washington Consensus revisited: theory and practice

Latin America and East Asia have been on divergent development paths for the past two decades. It is notable that all the major Latin American countries are in the groups that lack dynamism in industrialization, structural change and productivity growth, while most of the major East Asian economies are at various stages on the route to successful industrialization. With few exceptions, countries in the former region have been unable to remove structural impediments to rapid and sustained accumulation and growth.

Understanding the different trajectories certainly requires sensitivity to specific local conditions and histories. But institutional and policy choices have also mattered, particularly where, as in the case of Latin America, there have been pronounced discontinuities due to the rapid switch from an inward- to an outward-oriented development strategy.

The new strategy in Latin America can claim some success. Inflation has been brought under control and a reasonable degree of monetary and fiscal discipline has been established in the region. However, the record in terms of growth, employment and poverty reduction has been disappointing. The experience does not support the underlying logic of the new policy approach, namely that an import-substitution growth strategy could effectively be replaced by a market-driven, outward-oriented strategy simply by eliminating inflation, downsizing the public sector, and opening markets to foreign trade and capital.

These disappointing results have been explained by lacunae in the initial reform agenda, policy slippages and the failure to move to "second-generation reforms"; that is, by omissions rather than commissions. However, by overlooking more traditional macroeconomic fundamentals, such as aggregate demand, real interest rates and real exchange rates, the policy choices and institutional reforms designed to remove state-induced distortions have, themselves, weakened long-term growth prospects. The new policy orientation has failed to produce an appropriate macroeconomic environment for investors and firms to encourage and support the creation, expansion and improvement of productive capacity while at the same time unleashing the forces of global competition. In other words, the policy reforms have been unsuccessful because the "creative" element of Schumpeter's process of "creative destruction" has failed to bring about real transformation of the productive structure through higher investment and technological change:

- While exchange-rate-based stabilization policies succeeded in reducing inflation by relying on capital inflows, the resulting currency appreciations and gyrations in exchange rates, together with high interest rates needed to attract foreign capital, have meant that monetary conditions in Latin America in the 1990s were too stringent and unstable to provide a sound basis for capital accumulation. An index combining the real exchange rate and the real policy interest rate shows much tighter monetary conditions in Latin America than in East Asia throughout the 1990s, while they had enjoyed similar conditions throughout the 1960s and 1970s.

- Trade and financial liberalization, together with the initial surge in demand and growth brought about by rapid disinflation caused external balances to deteriorate, and debt once again started to grow, outpacing the capacity to service it. This, together with increased inflows of FDI, meant that payments for factor services became an increasingly large component of the current account balance, which in turn necessitated considerable deflation to achieve external adjustment. On balance, FDI inflows have contributed to financial instability as they have increased external obligations without generating the required capacity to service them.

- Fiscal balances have also deteriorated as the interest component of public expenditures has risen with the issue of new debt at higher interest rates. This has reduced the scope for fiscal adjustment without depressing domestic activity and tax yields, while increasing the size of the deficits to be financed.

- Capital account liberalization and capital flows have caused serious disruptions in the mechanisms for fiscal and balance of payments adjustment. Excessive inflows have rendered adjustment mechanisms inoperative while excessive outflows have led to deflationary overkill.

- The inconsistencies of macroeconomic, trade, FDI and financial policies have carried over to the pattern of structural changes. Efforts to build technologically sophisticated sectors to match those in the advanced economies have been damaged while at the same time weak productivity performance in more labour intensive sectors has led to increased competition from lower-wage economies. The squeeze from these two sources has led to deindustrialization in Latin America in a context of labour shedding and sluggish growth.

Thus while the new policy direction has successfully uprooted the previous regime it has failed to establish a flourishing alternative. More worrying still, in terms of future prospects, has been the loss of policy autonomy, at both the microeconomic and macroeconomic levels, and the narrowing of the room for policy manoeuvre. Rethinking options requires a candid assessment of the economic record of the past two decades and of the experience of the more successful cases of industrialization and development. It also requires a move away from generalized approaches to accommodate the diversity of conditions and challenges facing the developing world.

As much depends on countries reaching their potential growth rate, a wider range of more strategic policies to support higher rates of investment and upgrading will be needed. These will require active policies, particularly on such matters as industrial support, technological progress and public infrastructure, all of which will have to be tailored to the special circumstances of the countries concerned.

In many cases, easing the balance-of-payments constraint will require reducing dependence on foreign capital and promoting stronger investment-export linkages. This means a more activist trade and investment agenda, which will need to take account of the realities of the current trading system. Expectations of what FDI can achieve in the current context need to be more realistic. Ways must be found to improve the contribution of FDI to technology, productivity and exports. This will require a reconsideration of the policy approach to FDI, drawing lessons from more successful experiences.

A viable exit from this vicious circle of low and unstable investment and growth, high interest rates and rising indebtedness is likely to require direct action to reduce the burden of debt service. At the very least, as the last of the Brady Bonds is retired, new approaches to dealing with the outstanding debt are urgently needed, including a renegotiation of interest rates to levels closer to the real returns that can be earned from investment and a reduction of domestic and external debt to levels that do not compromise the objectives of rapid and sustainable growth and a reduction of poverty to internationally agreed levels.

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