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# Changing Perceptions and Altered Reality: Emerging Economies in the 1990s

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## PREFACE

This Small Volume is Being Published Under the auspices of the knowledge management program of the World Bank's Latin American and Caribbean Region (LAC). An important part of this program is to assist staff to reflect upon their experiences in the World Bank for the benefit of their colleagues. I am leaving the Bank after 25 years, 12 of which were spent in operations. I was the director of its China Department for nearly seven years and regional vice president for LAC for five and a half years.

A South Asian, arriving to work in Latin America and the Caribbean after having spent some time working on China, was bound to look at the countries for which he was now responsible from a different angle. That is the subject of the first section of the book. It tells how I first saw the Latin America region in early 1994, and how my perceptions changed over time. It also details some of the initiatives I took to improve ourin particular myunderstanding of the economic and social problems faced by the countries of the region.

The second section of the book deals with povertya long-time concern of mine. Throughout my stay at the World Bank, I was involved in one way or another with our work on poverty. When I moved to LAC, I brought this interest with me. From the very beginning I focused on two characteristics of Latin American and Caribbean poverty: the fact that most of it is urban, and that its incidence changes dramatically over time. Economic ups and downs have a profound impact on the number of people living in



poverty. This is the subject of a several speeches included in this volume. This section also includes a speech I gave in Pakistan on poverty in that country. It is included in this volume to underscore an important point: unless policymakers are vigilant, even when it is reduced significantly, as was the case in Pakistan, poverty can return with a vengeance.

The third section includes a number of speeches on various aspects of globalization. My emphasis in dealing with this subject was on three questions: what was meant by globalization, how did it affect the developing world, and was it possible to control the volatility associated with it by devising something called a new financial architecture.

The last section of the book presents four case studies dealing with countries in crises. The main point of including these case studies is to underscore the view that

crises in recent years have been the product of an interplay between domestic policies and changes in the external economic environment. Not one of the four cases included in this selection was the consequence of changes over which the countries experiencing difficulties had no control. In none of these cases were the causes of the crisis exogenous in their entirety; they came about largely because of actions the countries themselves had taken or had failed to take.

I write my own speeches. Even when some background work was done for me, I felt comfortable only when I was speaking from my own text. That notwithstanding, I would like to thank Robert Ayres for his help with the speech on crime and violence, Suman Bery for the chapter on the Mexican crisis, and Guillermo Perry for the speech on regional trade arrangements.

I owe a great debt to Jennifer Abner, who not only typed and retyped texts as my thinking developed while the speeches were being written, but also kept a watchful eye on my grammar, syntax, and flow of thought. This volume would not have seen the light of day but for her assistance. Thanks are also due to Joost Polak for overall editorial support in putting together this volume. Finally, I would like to thank the Latin American and Caribbean Region's knowledge management program for its support of this project.

SHAHID JAVED BURKI  
WASHINGTON, D.C.  
JUNE 1999

PART I  
AN EVOLVING VIEW OF DEVELOPMENT  
CHALLENGES

## PART I

### AN EVOLVING VIEW OF DEVELOPMENT CHALLENGES

In the First Section of this Collection, I Have Included Three pieces. The first is an overview of the way my thinking evolved in the last five and a half years, the period during which I was the Regional Vice President for Latin America and the Caribbean (LAC). This chapter is based on a talk I gave on May 14, 1999 at the last corporate retreat I attended for the LAC Region managers. It is essentially a personal account that provides, in a reasonably chronological order, the evolution of my own thinking about development issues of interest to Latin America and the Caribbean.

The second chapter deals with some of the initiatives that I took, such as establishing an external advisory group, launching a series of annual conferences on the development problems and prospects of the region, starting a regional studies program and a dialogue with nongovernmental organizations (NGOs), especially those working in the field, and developing a close working relationship with the Commonwealth Secretariat to deal with the special problems of small states.

One message I hope will emerge from reading these two speeches is that there is a good deal to be learned from the experiences in development of different geographical regions. Latin America and the Caribbean can learn from the East Asian and Pacific countries. Equally, there is a good deal that the LAC Region can teach East Asia. In terms of gross national product per head of population,

the two regions are more or less at the same stage of development, but they have adopted approaches toward change that are quite different. This experience reveals that there is not just one model of development. Economic improvements take place in many different ways, and each is dictated in part by the history, the culture, and the structure of the society seeking to transform itself. But change must also take cognizance of the external environment in which it must occur.

I have also included in this section the speech I gave at the third meeting of the Annual Bank Conference on Development in Latin America and the Caribbean (ABCD-LAC), held at Montevideo, Uruguay, in June 1997. This conference was devoted to discussing a subject that will continue to dominate the debate on development for many years to come: What is the best way to move toward large regional free trade areas? The leaders of the Western Hemisphere, in their summit

in Miami in December 1994, accepted the challenge of launching a free trade area encompassing all countries of the region by 2005. At the same time, such subregional arrangements as Mercosur in the Southern Cone and Caricom in the Caribbean were being promoted. Their development raised an important question. Do subregional arrangements hinder the movement toward global free trade? This question will gain in significance as world leaders prepare to launch another round of trade negotiations in the year 2000.

## Chapter 1

### Changing Perceptions and Altered Reality<sup>1</sup>

The Idea that I Should Devote Some Time at the corporate retreat of the World Bank's Latin America and Caribbean (LAC) Region to speak about the area for which I had been responsible for five and a half years came from Guillermo Perry. This was to be the last corporate retreat I chaired. On July 1, I was to hand over the job of Regional Vice President for the LAC Region to David de Ferranti, my designated successor. Perry suggested that as I was preparing to leave and to leave not only the region, but also the World Bank after 25 years of service, I should offer some thoughts on the way I saw the region.

I accepted Guillermo Perry's suggestion, but decided to do quite a bit more in addressing the managers of the LAC Region when we met on May 14. I thought it would be useful to:

Go back to the time when I took charge of the LAC Region in January 1994 and recall how I then saw the countries on which I was about to begin work. It was possible for me to do that since I had kept the notes I had used in my first talk to the region's senior staff, in March 1994.

Reflect on how my own thinking about the region had changed over the past five and a half-years. A great deal had happened during that time and in some of the events such as the peso crisis in Mexico in December 1994 I had played a fairly important role.

Provide some thoughts on how I believed the LAC Region itself

had changed during the past five years.

Say a few words about the way the world around the region had changed during this time.

1. This essay is based on the notes used for a talk at the corporate retreat of the management of the World Bank's Latin America and Caribbean Region on May 14, 1999 at Westfields Marriott Conference Center, Chantilly, Va.



And, finally, offer my views on how the World Bank Group could respond to the challenges it faced in the region over the next decade or so.

It would have taken a long time to do justice to these subjects. I touched upon them briefly, but promised my colleagues a longer, written version before I concluded my assignment with the World Bank.

#### I. My view of the LAC region in January 1994

I came to the Latin American and Caribbean Region after having served for nearly seven years in East Asia. From May 1987 to the middle of January 1994, I was the Director of the World Bank's China Department. While China was the focus of my attention, I also came to understand East Asia. It was during this period that the World Bank produced its East Asia Miracle Study.<sup>2</sup> I played a fairly active role in preparing that study, commenting on the various drafts and chairing some of the meetings in the World Bank to review and guide the work. In doing so, I developed an informed overview of the development experience of East Asia.

I had been working in the Latin American region for less than two months when I offered my first thoughts about the problems and prospects of the area. During that time, I had read a great deal on Latin America and the Caribbean. I had benefited, in particular, from the seminal work done for the World Bank by Sebastian Edwards.<sup>3</sup> His book was as rich in detail and analysis as the East Asia Miracle Study. During that time, I also had the opportunity to visit three large countries in the region—Mexico, Argentina, and Peru. In Mexico I had a detailed discussion with Finance Minister

Pedro Aspe. When I met him, I had already read his lectures on reforms in Mexico. I asked Aspe one question at our first meeting: Why, having successfully implemented a number of reforms, had Mexico not succeeded in accelerating its rate of growth? Why was the Mexican economy growing at only 3.5 percent a year when it had brought about such a fundamental restructuring of its economy?

Aspe provided a simple explanation: A great deal of the asset base of the Mexican economy was created behind high tariff walls. The elevated protection levels, in turn, had produced a highly inefficient economic base. The renewal of this base, in a competitive environment created by reforms, would set the stage for

2. World Bank. *The East Asian Miracle: Economic Growth and Public Policy*. New York: Oxford University Press, 1993.

3. Edwards, Sebastian. *Crisis and Reform in Latin America: From Despair to Hope*. New York: Oxford University Press, 1995.

attaining higher levels of economic growth. I also had a brief meeting with President Carlos Salinas. The meeting occurred at a critical period for Mexico, as a few days earlier a group of Indians calling themselves Zapatistas had struck in the southern state of Chiapas. President Salinas told me that he thought a foreign hand was behind the Chiapas uprising. Nevertheless, he had appointed a long time associate, Manuel Camacho Solís, to mediate between the government and the rebels. It was clear to me that the troubles in Chiapas had caught the president by surprise.

In Argentina, I met with President Carlos Menem and Domingo Cavallo, Minister of Economy. Both were satisfied with the scope and direction of their economic reforms, and both were confident that Argentina had found the model to move the economy toward a high rate of sustainable growth. In a separate discussion with Cavallo, during the same visit, he indicated that he was concerned about the ability and willingness of provincial governors to follow Buenos Aires' lead, and adopt the reforms that had been initiated by the federal government. If the provinces did not climb on board, the full potential of the economy would not be achieved.

Peru was the next stop on this visit. In Lima, I spent an afternoon with Finance Minister Jorge Camet, at his beach house. A day later I spent several hours with President Alberto Fujimori. The visit with the president was a memorable one for two reasons. During the discussion, in which he was critical of the World Bank's approach toward lending for education, he switched on his computer and printed out a table. The table had statistics on the amount of money that was being spent by his government to build new schools for the poor. I want the World Bank to provide us

with money to construct schools, not to tell us how to train our teachers, what kind of courses we should teach, what kind of text books we should use. I told him that the Bank was interested not only in constructing school buildings but also in the quality of education that was imparted. I told him that the World Bank had been deeply involved in the reform of the educational sector in China. In fact, the first loan given by the Bank to China was for the reform of university education. That loan was followed by several others, in which the Bank combined lending for physical infrastructure with ideas about reforming the educational sector. Our insistence upon reform, therefore, was not confined to our program in Peru. There is more to education than building schools, I told the president.

It seemed that I had struck a chord with President Fujimori in that conversation. Later that day he took me on a drive through a number of settlements in the hills that overlook Lima, into which thousands of Peruvians have crowded. The

president drove himself and I sat by his side. It was a bulletproof Mercedes but, upon entering the settlements, he lowered the window on his side and waved to the people who recognized him and his car. They called him el Chino the Chinese. Anybody with my kind of eyes is Chinese for these people, he told me.

We stopped at a recently built school and he showed me around the facility. He had all the details in his head: how many students were enrolled, how much it had cost to build the school, even the amounts paid for various kinds of equipment. After the tour of the building, he addressed a large crowd and, following the speech, agreed to take some questions. A man got up. He was from a neighboring settlement. He wanted a building for his people. I must tell you this, responded the president. Education means more than building new schools. It means good teachers, good text books, good equipment, and the right attitude. I had obviously won a convert to the World Bank's view of approaching education in a comprehensive way.

Having done some reading and having visited some large countries in the region, I thought I knew enough about Latin America to begin to draw some comparisons between it and East Asia. I did this at a meeting of the senior staff I addressed in March 1994, a couple of months after having assumed the responsibility of Regional Vice President. To prepare myself for this meeting, I drew up a list of the differences that I saw between the two regions (Table 1). There were differences, not only in the economic fundamentals, but also in the way the two regions managed their political systems, the attitude of the governing elite toward economic reforms, the level of poverty and the state of human

development, and the composition of the societies.

It appeared to me that with considerably greater domestic savings rates, higher efficiency of invested capital, and better human resources, East Asia had equipped itself far better to sustain high levels of economic growth. The countries in Latin America and the Caribbean had a great deal of catching up to do. The East Asian model of development was the obvious one to adopt.

I was struck by the extent of poverty I saw in the LAC Region during my first series of visits. It was not only the consequence of a lower rate of economic growth than the one achieved by East Asia. Over a period of four decades from the early 1950s to the early 1990s most East Asian countries had seen dramatic reductions in the levels of poverty. China was able to reduce the proportion of its population living in absolute poverty, from about 60 percent in the late 1940s to only 9 percent in the mid-1990s. The system of communes played an important part in this development, as the Chinese authorities were able to use this form of local government to educate their people and provide them with

TABLE 1

Qualitative Differences in Promoting Development in East Asia and Latin America and the Caribbean

EAST ASIA

1. Decades of high growth rates with little fluctuation around the mean.
2. High growth rates provided considerable fiscal space for alleviating extreme poverty. Incidence of poverty declined significantly.
3. The most important part of the effort aimed at poverty alleviation was a commitment to improve the level of human development.
4. There was much greater decentralization of the authority to improve human development. Local governments were held accountable for achieving this objective.
5. Distribution of income and wealth was the most equitable in the developing world.
6. Domestic savings rates were high and increased during the period.
7. Efficiency of capital use was high, which meant a low incremental capital output ratio.
8. High domestic savings rates

LATIN AMERICA AND THE CARIBBEAN

1. Relatively low growth since the early 1980s, with increasingly high volatility.
2. Rates of growth only marginally higher than the rate of population growth left little space for devoting resources to alleviating poverty. There was little change in the incidence of poverty.
3. About the same amount of resources were committed to human development as in East Asia, but the quality of services provided was generally poor.
4. Human development programs were largely centralized, and the populist state generally wasteful.
5. Distribution of income and wealth was the most unequal in the developing world.
6. Domestic savings rates, both public and private, were low and showed no signs of improving.
7. Capital output ratio was high, therefore a low investment rate produced an even lower rate of growth.

made the countries largely self sufficient in terms of resources for investment.

9. The state was interventionist, but focused a great deal of its attention on picking winners for the private sector and promoting exports.

10. Although considerable authority was given to local governments, the state was strong at the center.

*(Table continues on the next page.)*

8. Low savings rates meant a high level of dependence on external flows.

9. The state was populist, either owning vital economic assets or intervening profoundly in the functioning of the markets, in particular labor markets.

10. In some countries, the state at the center had been weakened by decentralization. This was particularly the case with Brazil.



TABLE 1

Continued

## EAST ASIA

LATIN AMERICA AND THE  
CARIBBEAN

11. The economic decisionmaking elite were trained in the United States and was largely locally trained and Europe and maintained strong links therefore was not easily influenced by with foreign academics, think tanks, and international financial external actors. institutions.

12. Economic nationalism was much more pronounced. The elites were not inclined to buy openness as a development philosophy. 12. Economic openness became the central element in reform efforts. The Washington Consensus was the new economic ideology.

13. The economic elite aggressively sought increased foreign market shares for domestic output. 13. The economic elite was happy to offer a large domestic market share to foreign enterprises, particularly in services, including commercial banking.

14. The governing elite in several countries remained suspicious of Western-style democracy. Several of them put forward Asian values as a sociopolitical philosophy appropriate for their region. 14. Western-style liberal democracy was adopted by almost all countries in the region.

15. Although the countries of the region had been through the period of demographic transition, a sizeable proportion of the population remained in the countryside. 15. The countries of the region were going through a period of significant demographic change, with massive population flows from rural to urban areas.

16. There were few megacities, and urban poverty was not a prominent factor of urban life. 16. There were many megacities, and extreme urban poverty was highly visible.

17. There was reasonable social tranquility. The Philippines stood out as an exception for a while.

17. Urban crime and violence had begun to take a heavy social and economic toll. Estimates suggested the economic toll at 2% of lost GDP a year in Colombia.

18. Societies were mostly homogenous linguistically, culturally, and ethnically. Even where differences existed as in Malaysia and Indonesia workable solutions had been found.

18. There were serious ethnic, cultural, and social divisions. Large segments of the population especially indigenous people felt excluded.

The references here are to the period 1982-92.

basic health care. Other East Asian countries followed variants of the Chinese model, channeling a significant amount of public resources into human development with the help of local authorities, who were held responsible for delivering good results.

In looking at the situation in Latin America and the Caribbean, it occurred to me that it would not be easy to transport the East Asian model of poverty alleviation to this region. A high rate of economic growth and a high quality of investment in human development would clearly produce positive results. But the much more segmented social structure in Latin America did not provide the incentives the decisionmaking elite had in East Asia to work with the poor. Simply put, the Latin American elite did not take full responsibility for the poor, and were less committed to alleviating poverty among indigenous groups living mostly in the continent's highlands, or that of the descendents of the slaves brought from Africa.

Other characteristics of the Latin American elite also distinguished them from their East Asian counterparts. A good proportion of them had been educated in the West particularly in the Ivy League colleges in the United States. They maintained strong links with the academic community there, and were open to the ideas about development that surfaced in American universities and think tanks. The Washington Consensus was one important product of this continuing discourse.

The East Asian economic elite, on the other hand, had a considerably more insular outlook. They were educated mostly in their own universities and drew largely on their own think tanks for new ideas. Consequently, they were much less open to the kind

of philosophy that was at the center of the Washington Consensus. They were quite comfortable with the belief that the much-admired *East Asian miracle* was the result of home-grown ideas and not the product of imported thinking.

I thought it was important that we keep one other difference between the situations in East Asia and Latin America in mind while designing our (the World Bank's) development approach. The two regions had gone through the period of demographic transition during which fertility rates had declined significantly. This transition had occurred earlier in East Asia but, by the time I started work in Latin America, similar declines were taking place there as well.

However, there were significant differences in the distribution of population. Latin America and the Caribbean were much more urbanized. Some three-fourths of the region's population lived in urban areas, and most of the urban population was crammed into half a dozen mega- or near-megacities: Mexico City, São Paulo, Rio de Janeiro, Caracas, Bogota. All large cities had *favelas*, or shantytowns.

Most of the favelas were perched on hillsides surrounding the megacities. They lacked basic services, such as water supply and sanitation. Most of them had alarming rates of youth unemployment and high levels of crime and violence.

By contrast, the East Asian population was more evenly distributed between the cities and the countryside. There was poverty in the cities of East Asia in Jakarta, Manila, Shanghai, and Guangdong but it was less acute and concentrated than in the cities of Latin America and the Caribbean.

With the help of this comparative analysis, assuming, of course, that East Asia had found the right recipe for both promoting growth and alleviating poverty, I began to define the World Bank's mission in Latin America and the Caribbean. It included the following eight elements:

Helping to keep in place the sets of policies included in the Washington Consensus. The adoption of these policies had produced a remarkable amount of macroeconomic stability in the region, which had long been plagued with extreme volatility.

Launching a serious effort at accelerating the pace of economic growth. It was my belief that the region could double its rate of GDP growth, from 3 to 3.5 percent to 6 to 7 percent a year, within a decade. To do so would require adopting yet another set of policies, a second generation of reforms. I spelled out these policies in an essay co-authored with Sebastian Edwards, who was the Chief Economist of the LAC Region at the time. The essay, titled *Quickening the Pace*,<sup>4</sup> was published in June 1995.

Preventing the state from slipping back into populism. There was a

danger of that happening, as the rewards of structural change implied by adopting the Washington Consensus policies had not reached the poorer segments of the population. These fears were expressed in another essay, again co-authored with Sebastian Edwards. The essay was published in June 1996, under the title *Dismantling the Populist State*.<sup>5</sup>

Improving the quality of the programs directed at developing human resources. The LAC Region committed slightly more public resources to education and health than did East Asia, when measured in terms of proportion of gross domestic product. However, the quality of the services provided was much poorer. The World Bank engaged in programs to reform the educational and health systems all over the region. Of special significance

4. Burki, Shahid Javed, and Sebastian Edwards. Latin America after Mexico, *Quickening the Pace*. The World Bank, Washington, D.C., 1995.

5. Burki, Shahid Javed, and Sebastian Edwards. *Dismantling the Populist State, the Unfinished Revolution in Latin America and the Caribbean*. The World Bank, Washington, D.C., 1996.

were the contributions made in Argentina, Brazil, Mexico, and several Central American countries. This subject was the focus of our attention at the second Annual Bank Conference on Development of Latin America and the Caribbean, held in Bogota in June 1996.

Reforming institutions in different sectors of the economy, including legal and judicial systems. Our work in this area drew on the new institutional economics, which began to distinguish between transaction and transformation costs. Transaction costs could be lowered by means of institutional reforms. Reducing this cost would increase total factor productivity and contribute to quickening the pace of development. These ideas were fleshed out in two documents I edited with Guillermo Perry, the new chief economist. They were published under the titles *The Long March*<sup>6</sup> (June 1997) and *Beyond the Washington Consensus: Institutions Matter*<sup>7</sup> (June 1998).

Dealing with the social and economic problems posed by urban poverty, crime, and violence. I gave a speech on the subject at a conference held at Rio de Janeiro, in March 1997 [See Chapter 6 in this volume.] I also invited the NGO community to work with the World Bank in this area. This invitation led to a workshop in Rio de Janeiro, May 14-16, 1998.<sup>8</sup>

Institutional strengthening of the agencies needed to deal with volatility caused by the rapid changes that were taking place in the global financial system. Our efforts in this area began in Mexico in 1995, with a loan of \$1 billion at that time, the largest ever given by the World Bank aimed at reforming the banking system. Subsequently, we deepened our involvement by working on the

reform of the pension and social security systems, as well as central banking and fiscal federalism in several countries of the region, notably Argentina, Brazil, and Mexico.

Bringing the state closer to the people by working with civil society and helping to reform local governments. Our fifth ABCD-LAC conference dealt with this subject and a conference volume, titled *Beyond the Center, Decentralizing the State*, edited by Guillermo Perry, William Dillinger, and myself, was issued in June 1999.

6. Burki, Shahid Javed, and Guillermo E. Perry. *The Long March, a Reform Agenda for Latin America and the Caribbean in the Next Decade*. The World Bank, Washington, D.C., 1997.
7. Burki, Shahid Javed, and Guillermo E. Perry. *Beyond the Washington Consensus: Institutions Matter*. The World Bank, Washington, D.C., 1998.
8. Urban Poverty Workshop, May 14-16, 1998, Rio de Janeiro.



## II. How my perceptions about the LAC Region changed

As discussed in the previous section, a great deal of my initial perception about the Latin America and the Caribbean Region was formed by a comparison I made with the situation I had left behind in East Asia. It was inevitable that my reading of the region would change as my understanding of it deepened. I traveled extensively in the region, attended dozens of conferences and workshops and talked with the leadership groups in almost all the countries in the region. As a result, there was a profound change in my thinking concerning at least three areas.

First, the reform movement that goes under the generic title of the Washington Consensus was much stronger and had much greater popular support in most countries than I had realized in the early months of 1994. The strong political and social support for the movement derived mostly from the distaste for hyperinflation the citizenry had developed over the years. What economists began to emphasize later, was known to the people much earlier: inflation exacts a heavy tax on the poor. Those with assets can protect themselves against sharp increases in prices. In fact, some segments of the population in particular, the bankers actually benefit from it. But the poor pay a heavy price. It was not surprising, therefore, that Carlos Menem, who had been elected President of Argentina in 1990 on a populist platform, was applauded by the people when he opted for a liberal program of economic reform. Argentina's success in introducing reforms and stabilizing the economy made it possible for Menem to amend the constitution and win another term for himself in 1995. The Real Plan in Brazil, authored by Finance Minister Fernando Henrique

Cardoso in 1994, not only won him the presidency that year but also made it possible for him to amend the constitution and win another term for himself in 1998. The political base of support for reforms in Latin America was much stronger than I had realized when I took office in January 1994.

Second, the redefinition of the role of the state in economic management was also much more profound. After nearly half a century of mismanagement, the state in Latin America and the Caribbean had lost the respect of the citizenry. As suggested in the preceding section, this was not the case in East Asia when I left the region in 1994. In Latin America and the Caribbean, *dirigiste* policies had won few admirers among the people. If any benefits had accrued from this approach, they were mostly for the more privileged segments of the population. The rich had become considerably richer, while the poor had generally stayed where they were. Therefore, the Latin American citizenry was comfortable with the idea of transferring the ownership of all kinds of economic assets from the state to the private sector.

Argentina went the farthest in this direction, but other countries also followed. Not only were the people prepared to trust the private sector, they were also willing to allow foreigners to own and manage large segments of the economy. Foreign firms acquired assets in the financial sector and won contracts to manage public utilities in a number of countries. The citizenry was prepared to exchange the loss of jobs in return for better services in telecommunications, transport, water supply, and power distribution.

Third, the acceptance of deep reforms and a significant re-demarcation of the role of the state were made possible by the democratization of most of the continent. Again, coming from a region that was still not fully convinced about the virtues of fully participatory political systems, I had initially missed the significance of this important development. The affection for democracy was also a form of reaction against dozens of populist leaders who had assumed power in the previous decades, promising returns to the citizenry that they could not, or did not, deliver. In most countries, but not in all, the roots planted by democracy into the region's soil ensured that the governments in power would make a serious effort to help all the people, and not just a small segment of the population. Democratization of the political system was producing a number of significant changes across the region and, for the first time, giving voice to the disadvantaged. Peace movements in El Salvador and Guatemala, and the successes achieved by the indigenous people of Ecuador and Peru, and in the southern states of Mexico, had all contributed to the strengthening of democracy. In many ways, the state was stronger in Latin America in 1998<sup>99</sup> than it was in East Asia.

These new perceptions the seriousness of the reform effort, the change in the role of the state, the move toward a democratic political order, and the willingness of leadership groups to learn from one another provided me with a better sense of what was happening in the region. However, it is not possible for me to say with conviction that all these important developments are utterly irreversible, that in the future some governments in the region will not take a different course. Peru and Venezuela are two examples of Latin American countries where some reaction to the developments of the last decade and a half may be setting in.

### III. Changes in the region itself

While my own understanding of the region changed as I came to understand it better through travel, discussions with its leaders, business people, academics, and members of civil society, the region also changed in many different ways. A gen-

uine effort was being made in most countries to bring the state closer to the people. There was now a serious dialogue taking place between the leadership elite and civil society. The most dramatic event in this direction was launched by President Andrés Pastrana of Colombia after his election in 1998.

The process of decentralization was also underway in many countries, not always with positive results. It had caused serious fiscal difficulties in some large countries. In Brazil, intractably large fiscal deficits could be blamed on the decentralization of authority to the states and municipalities. This form of decentralization had been included in the 1988 constitution, and was taken full advantage of by the leaders of states and municipalities. Colombia had also experienced fiscal difficulties after changing its constitution to allow greater decentralization.

These problems notwithstanding, some countries were setting good examples of decentralization that produced positive results. The most successful experiment to date in this respect is taking place in Argentina, where decentralization combined both delegation of authority with a prescription for accountability.

There was also a palpable concern in several countries but unfortunately not in all with the poor quality of governance. It was being recognized that the people's faith in reforms and democracy would be seriously undermined by a loss of confidence in the quality of governance provided to them. There is no doubt that James Wolfensohn's reference to corruption in his speech to the Annual Meetings of the World Bank and the International Monetary Fund in 1995, contributed to concern about the debilitating effects of corruption. Other actors in the field notably

Transparency International, a nongovernmental organization operating out of Berlin, but with active chapters in most developing countries, including those in Latin America highlighted their concern about corruption and the heavy cost it exacted on society and the economy.

While several governments became aware of the need to improve the quality of governance, they also began to appreciate that such an effort would involve many different activities and initiatives. Exceptionally critical for this effort was the reform of the legal and judicial systems, without which people hurt by corruption and poor governance would not have appropriate remedies. It is not surprising that a number of countries in the region requested assistance from the World Bank and the Inter-American Development Bank to strengthen legal and judicial institutions. The World Bank financed two projects in Venezuela, one to reform the legal system, the other to improve the efficiency of the judiciary, particularly that of the Supreme Court.

In several countries, institutions representing civil society had begun to get more actively involved in shaping public discourse and public policy. This form of

activism posed a dilemma for the World Bank, especially in Mexico, a country where the process of democratization had gathered momentum under President Ernesto Zedillo. The Mexican authorities were not particularly happy with the World Bank's desire to consult with the NGOs. They raised a legitimate concern that the members of the legislative assemblies were meant to represent the people. If the Bank wished to develop an understanding of people's aspirations, should it not direct its attention toward the members of the elected bodies national and provincial assemblies?

On moving to the Latin America and the Caribbean Region, I sought to cultivate a closer relationship with the NGO community a subject I have covered at greater length in Chapter 2. In a meeting held in Paipa, Colombia, in the summer of 1995, I made a commitment that all field offices in the LAC Region would be staffed with social scientists experienced in dealing with nongovernmental organizations. Within one year, all the offices in the region there were 11 in all at the time had been staffed. These people not only strengthened our dialogue with the civil society, they also helped us improve our understanding of the policy and programmatic interventions that were needed to help the poor out of poverty.

IV. The world around the region also changed in dramatic ways

While the region was changing quite decisively, the world around it also changed in dramatic ways. The most significant impetus from the change in the external environment came from the collapse of communism in Eastern Europe in the late 1980s and the disintegration of the Soviet Union in 1991. After this, the United

States, the only remaining superpower, viewed its relations with the developing world in a different light. As far as the countries of the Latin America and Caribbean Region were concerned, the United States focused on four aspects: inflows of drugs from the drug producing and processing countries in Latin America; the flow of cheap labor from labor surplus areas, such as Mexico, Central America, and the Caribbean nations; the flow of trade; and the flow of capital. The United States was also interested in strengthening democratic institutions in Latin America and the Caribbean, and in improving human rights.

There was an attempt to manifest all these concerns and interests during the preparation for the Summit of the Americas, to be held in Miami in December 1994. The summit was called by President Bill Clinton, in response to the criticism that he and his administration had ignored Latin America and the



Caribbean. The president had not visited the region since his election in 1992.

Initially the World Bank, not being a hemispheric institution as are the InterAmerican Development Bank and the Organization of American States, was not included among the agencies and institutions called upon to help with the preparation of the Summit. Later, Lawrence Summers, at that time Undersecretary of the U.S. Treasury, and Richard Feinberg, in charge of the Latin American desk at the National Security Council, invited me to several meetings at which the agenda was being prepared. My constant preaching that the Summit should focus on trade and capital flows may have had some impact. Ultimately, the summiteers gave trade a good deal of attention and promised to create a Free Trade Association of the Americas (FTAA) by 2005. It had become clear that economic issues would take center stage in the U.S. dialogue with its southern neighbors now that the Soviet challenge had disappeared.

While the governments were engaged in dialogue, it was clear that the markets had their own agenda for the region. Flushed with liquidity,<sup>9</sup> the markets had discovered the emerging economies, including those in Latin America, as attractive places to invest some of their available funds. The flow of private capital to the developing world grew from \$42 billion to \$256 billion, a sixfold increase in seven years.

This was in some respects a fortunate development for Latin America. Short of domestic savings, it was always in search of foreign capital to finance investment (and, at times, also consumption). The markets were now prepared to provide this

capital relatively cheaply spreads over LIBOR or U.S. Treasury Bills declined to incredibly low levels. But this change in the external environment did not come without a cost. With the markets ever watchful, the recipients of external capital had to be very careful that they did not offer any surprises. Any unpleasant or unexpected development, such as the violence in Chiapas; irresponsible political behavior, such as the decision by Governor Itamar Franco, of the State of Minas Gerais, not to service the debt owed to Brasilia; or dirty devaluations, such as those that were made in Mexico in December 1994 and in Brazil four years later, could have harsh negative consequences.

The Latin American countries were to discover that the markets could get nervous quickly and, once their confidence was shaken, could move their capital out almost as rapidly as they had brought it in. Volatility was now a prominent characteristic of the changed environment in which the emerging economies lived.

9. The reasons for market liquidity are discussed in the speech Volatility, Contagion, and Possible Dollarization. which appears as Chapter 12.

This volatility brought all kinds of concerns, prompting moves toward the definition of a new financial architecture. But it was to become apparent, at least to those who were prepared to take note, that the markets were more inclined to self-regulate rather than trust the development of a new structure of international finance built by the governments of developed and developing countries working together.

There were other factors at play in changing the environment in which the Latin American and Caribbean countries were now operating. Three of these were of particular importance. First, the information revolution and the growth of the Internet changed for good the way people and countries interacted. Second, a sharp and totally unexpected demographic change in the industrial countries, produced by a precipitous decline in fertility, made the decisionmakers think about the consequences of large increases in dependency ratios. As the demographic changes worked their way through the economic system, fewer and fewer workers would be obligated to support more and more people. The working population was not prepared to pay for the continuously swelling ranks of retirees. At the same time, advances in medical science continued to lengthen life expectancy. Quickly and surprisingly, a political consensus developed in most industrial countries in particular, in those belonging to the Anglo-Saxon world that senior citizens must look after themselves. As the state became reluctant to put more resources into social security systems, people handed over their savings to pension and mutual funds. But the senior citizens also demanded high rates of return on these funds, which were available mostly in the emerging markets.

Finally, the markets were constantly innovating, developing new instruments for mediating capital available between developed countries and the emerging economies that were in dire need of financing. One consequence of all this was a state of great flux. That is why it is so necessary to change the language of our discourse to stop talking about recurrent crises and to begin to factor into our thinking the idea of living with perpetual volatility. There is more than just semantics involved. The view that the world is dealing with crises that keep hitting the global markets generates the need for crisis prevention policies a line of credit that can be activated when capital flies out of a country. However, if we accept the notion that we now live in a world that is in a state of constant flux, we must strengthen both domestic institutions in the emerging world and the institutions in the industrial countries that come in contact with developing countries.

## V. The future role of the World Bank.

In light of the above, it might be useful for the World Bank to revamp itself to deal with the rapidly changing global financial situation. First, it must be able to deal with perpetual volatility. At the moment, the Bank is more concerned with being able to deal with crises. However, if we accept the notion that future exchanges among countries will be marked by perpetual volatility, the Bank must deal with that situation. Its emphasis, therefore, must be on institution building: the establishment of institutions that can guide policymaking in a volatile world.

Second, the Bank must find ways to deal with the more intractable features of persistent poverty and inequality. These include the poor quality of assets available to disadvantaged groups, including the low level of access to human development; the absence or serious shortage of financing that will make it possible for the poor to increase their earnings; crime and violence that deter and distract from development and poor physical infrastructure, which, among other things, makes it costly to get to work.

Third, in articulating its development approach, the World Bank must emphasize the importance of regional work. The countries face a number of problems that lend themselves to regional approaches and solutions. Trade, environment, financial regulations, and transport are some of the areas and sectors where regional imperatives need to be considered along with an understanding of country-specific solutions. As it is presently organized, the Bank is much more focused on the problems of individual countries, or the development of new thinking in various sectors in which it is involved. It is not always able to pay

attention to regional concerns. However, as we have learned in recent years, some problems are better handled in a regional context. These include environment, management of river systems, transport, the control of infectious diseases, and a number of development initiatives that make sense only when countries work together.

Fourth, the Bank needs to acquire skills in a number of relatively new areas. These include banking and capital markets development, higher education, institutional health care, social protection, social security, decentralization and fiscal federalism, private sector finance and management of infrastructure, and the implementation of such treaties and protocols as Montreal and Kyoto. The Bank must recognize that its clients are operating in a rapidly changing global environment, in which new initiatives have to be taken regularly.

Fifth, the World Bank must develop the capacity to take full cognizance of how the global economic system is evolving and how this evolution influences its clients in the developing world. It is the only institution with a global reach and a

memory that reaches back to the time when economic development acquired the status of a separate discipline. This global memory and knowledge must be harnessed for the benefit of the billions of people to whose welfare it has committed itself.

In conclusion, I should mention that the knowledge management program, under whose auspices this volume is being produced, allows people such as myself to spend a few moments reflecting on what they have learned during their years working for the World Bank. I had the opportunity to spend over 12 years in two emerging regions: East Asia and the Pacific in one part of the developing world, and Latin America and the Caribbean Region in the another. This sharpened my understanding of the process of development. I began to recognize how difficult it is to lift people out of poverty and countries out of backwardness. Every bit of experience and every bit of knowledge help those who are engaged in this business. As a South Asian with years of work experience in China and East Asia, I came to the Latin America and Caribbean Region with some well-formed views of development. Initially, I applied them to my work in Latin America and the Caribbean, but I soon discovered that there were many experiences in the region that could be transported back to East Asia.

In the World Bank, many people like me have rich regional experiences. I hope they, too, will be encouraged to reflect upon them for the benefit of others.

## Chapter 2

### Development Challenges: Reaching a Better Understanding

I Became Regional Vice President For Latin America and the Caribbean in January 1994, after serving as the World Bank's director for China for nearly seven years. I left the assignment and the World Bank in July 1999. In this period of five years a great deal happened both in the individual countries and in the region for which I had responsibility at the World Bank.<sup>1</sup> In this chapter, the only one written specifically for this collection, I describe some of the initiatives we took while I was in charge of the World Bank's operations in the region.

Some friends who knew more about Latin America than I did at that time viewed the region as a sunset place for the World Bank. I was told that with the successful adoption of adjustment policies by most of the countries of the region, and the growing interest in the area by the world's financial markets, the World Bank's work was largely done. It would be appropriate to scale down our efforts in the region, and redeploy our staff and resources to those parts of the world where we were really needed—the poor countries of Asia and Africa, and the countries making a transition from socialist to market economies.

That our work in Latin America and the Caribbean was not finished became apparent to me as soon as I began to compare the region's economic and social characteristics with those of East Asia and the Pacific. A great deal remained to be done. There were large



pockets of poverty in the region, in which the level of social development was not much better than in Sub-Saharan Africa. There was great inequality in the region in fact, measured in terms of the Gini coefficient of income distribution, it was the most unequal region in the world. In many of these countries, the state was an extraordinarily weak instrument for serving its citizens. It had to be strengthened. Environmental degradation of the enormously rich resources of the region had to be countered. A number of countries in the region were working to form new trading alliances or strengthen those that already

1. See Chapter 1 for an overview of how I saw the Latin America and Caribbean Region when I joined it, and how my perceptions changed over time.

existed. These and several other issues were challenges of development that the World Bank needed to address. Our job was not done.

The conclusion that development work in the region was not even close to being finished was reinforced by the Mexican peso crisis of December 1994, when suddenly and unexpectedly one of the strongest countries in the area was thrown into chaos. Only ten weeks earlier, the international community had heralded what was viewed as an extraordinarily successful effort at economic reform, launched by President Carlos Salinas and his economic team headed by Finance Minister Pedro Aspe. At the Annual Meetings of the World Bank and the International Monetary Fund in Madrid, there was a consensus that Mexico presented a model that could be followed by the rest of the developing world in particular by the emerging markets.

What went wrong in Mexico? A great deal has been written in answer to this question, and I have also made a small contribution to the growing literature. That contribution is included in this book as Chapter 16. The crisis in Mexico demonstrated vividly that the World Bank needed to remain engaged even in those countries in which the private sector was heavily involved. To remain engaged, we needed to remain fully cognizant of developments in the region.

It soon became obvious to me that I had to take some steps and adopt some initiatives to improve our understanding of the development challenges these countries faced. Some of the new things I did include organizing an external advisory group, placing more emphasis on poverty alleviation in our work program,

launching a program of annual conferences on development in the region (ABCD-LAC), publishing annual reports on the region, developing close working relationships with the nongovernmental organizations operating in the region, and establishing a regional studies program as a research arm of the vice presidency.

The first order of business for me was to inform myself better about the economic problems and prospects of the region. Not being very familiar with the development challenges faced by the countries in Latin America and the Caribbean, I thought it would be useful if I assembled a group of external advisors to help me understand the complexities of the task we faced. The group included academics, bankers, senior officials who had served the governments of the region, and people affiliated with think tanks working in the region. The group included economists, political scientists, and business people.<sup>2</sup> We met two

2. The current members are Andres Bianchi, Juan Cariaga, Jaime Carvajal Urquijo, Manuel Chiriboga, Leslie Delatour, Enzo del Bufalo, Sebastian Edwards, Eduardo Jose Escasany, Peter Hakim, Rudolf Hommes, Carlos Langoni, Mirna Liévano de Marques, Moisés Naim, Alfonso Romo Garza, Luis Rubio, Elena Viyella de Paliza.

to three times a year to discuss the latest developments in the region and how they should be factored into the Bank's work. All members of the group reinforced my conviction that the World Bank will have an important role to play in the region for a long time to come. They also brought many useful insights to our work and made several important contributions to the way we conducted our policy dialogue with the countries in the region.

I recall one meeting held at Puerto Iguazú, Argentina, in November 1997. We had just returned from the annual World Bank-IMF meeting held in Hong Kong, and the crisis in Asia had held the attention of the policymakers meeting there. There was a fear that the crisis could spread to Latin America. Brazil, with high and unsustainable fiscal deficits, seemed especially vulnerable. I asked the external advisory group to produce a short policy paper that we could transmit to the Brazilian authorities. They did so, and the note was sent to Brasilia, where it was read with great interest by the authorities.

Managing recurrent crises was not the only reason it was necessary for the World Bank to remain involved in and committed to the LAC Region. We needed to provide help finance and ideas to assist these countries in overcoming the problems of poverty and extreme income inequality. There was a change in the World Bank's leadership in June 1995, and with it came a renewed emphasis on poverty alleviation as the most important element in the World Bank's development mission. James Wolfensohn succeeded Lewis Preston as President of the World Bank Group, and he immediately undertook a program of visiting the countries in which the institution was active. His second regional visit was to

Latin America, and in July I traveled with him to six countries: Haiti, Jamaica, Brazil, Argentina, Colombia, and Mexico in 11 days. We saw a great deal of poverty, both urban and rural. We met a large number of poor people. We visited Cité de Soleil in Haiti, Rivertown in Jamaica, met with the Indian tribes living in the Amazon region during a brief stop at Manaus, visited the favelas in Salvador and Rio de Janeiro in Brazil. We saw schools and clinics in the capital city of the State of Tucumán in Argentina, and visited Chiapas in Mexico.

I had seen a great deal of poverty during my professional life. In the mid-1960s, soon after returning to Pakistan from Oxford, I had been put in charge of the West Pakistan Rural Works Program, the main objective of which was to provide employment opportunities to the poor in the countryside. I traveled extensively in the country and saw the disadvantaged in many parts of the region: in Balochistan, the *barani* (rainfed) area of North Punjab, in the hills of the Northwest Frontier, and in the desert of Sindh. I joined the World Bank in 1974 and became involved almost immediately in articulating what came to be called the basic needs strate-

gy.<sup>3</sup> Later, while working as the World Bank's Operations Director on China, I was able to obtain a good understanding of how the Chinese had addressed the problem of poverty. In 1949, when the communists took power, some 50 to 60 percent of the population was poor. When I left my China job, the number of people living in poverty was estimated at 85 million, out of a population of over 1.1 billion. This translated into a proportion of people who were poor of less than 8 percent. The Chinese had succeeded spectacularly in alleviating mass poverty.

With this background, I was able to gain a good appreciation of poverty in Latin America and the Caribbean. Some elements of the Latin American situation differed markedly from other Third World regions. With three-fourths of the Latin American population living in urban areas, poverty in the region was far more often urban than rural. In large cities, there were pockets of poverty that had existed for a long time. Favelas in Latin America were different from the city slums in other parts of the developing world in that they had established a strong culture of their own. Crime and violence were an integral part of that culture, and they took a heavy toll on some segments of the population—women and youth in particular.<sup>4</sup> The visit accompanying James Wolfensohn provided some useful insights that helped me oversee our program as it evolved in the Latin American region.

By this time, our thinking about the priorities we should assign in our work in Latin America and the Caribbean had evolved to the point that it merited a broad dialogue with the development community. To that end, we decided to hold a conference in June of each year that would focus on a chosen aspect of the

development equation. Called ABCD-LAC (Annual Bank Conference on Development in Latin America and the Caribbean), this conference series was inaugurated in 1995 in Rio de Janeiro. At the first meeting, we looked at the region's experience with the process of structural adjustment.<sup>5</sup> Sebastian Edwards, at that time chief economist of the Latin America and Caribbean Region, and I wrote a short paper titled *Quickening the Pace* that was issued at the time of the conference. The main argument of the paper was that the countries had to make an effort to increase economic growth rates. A high rate of economic growth was absolutely critical to helping the region's poor out of poverty.

3. Our work in this area was published in a book, *First Things First* (New York: Oxford University Press, 1979), which I co-edited with Paul Streeten.

4. One of the best recent portrayals of urban poverty in Latin America is in the highly proclaimed Brazilian movie, *Central Station*, nominated for an Academy Award this year.

5. *Annual Bank Conference on Development in Latin America and the Caribbean 1995: The Challenges of Development*, edited by Shahid Javed Burki, Sebastian Edwards, and Sri-Ram Aiyer.

Accelerating the pace of growth, however, required that a number of policies be adopted and directed at increasing the rate of domestic savings, as well as improving the efficiency of the resources that were invested.

The second ABCD-LAC was held in Bogotá in June 1996, and dealt with the issues of rural and urban poverty.<sup>6</sup> There, Edwards and I again issued a pre-conference publication, this time titled *Dismantling the Populist State*. The paper reflected a worry on our part: while the Latin American and Caribbean states had adopted most of the adjustment policies recommended by the development community, their citizens had not received much by way of benefits—especially those who lived in poverty or close to the poverty line. Disappointed by this, would the people want their governments to opt once again for highly interventionist states? Rapid democratization in Latin America and the Caribbean now provided its citizens the opportunity to vent their feelings through the ballot box. Would they use the opportunity to abandon the new model and go back to a populist state? We thought that it would be appropriate to warn political and economic leaders that there was a real chance that such a backlash might occur, especially if governments continued to neglect the poor and less advantaged. Now fully enfranchised, the people might force their economic systems to abandon the new orientation toward openness and liberalization. This was to happen in Venezuela in 1998, when the voters ignored the traditional parties and elected Hugo Chavez, an army officer turned politician. Chavez fought his election in populist terms. His appeal was largely based on the fact that he was seen as a person not belonging to the establishment. But I am getting ahead of the story!



The third conference of the ABCD-LAC series was held in June 1997 at Montevideo and focused on the question of open regionalism. Uruguay provided the right setting for this meeting. The Uruguay Round of trade negotiations had radically transformed the way the world did business. The creation of the World Trade Organization, which took the place of the General Agreement on Tariffs and Trade, had created an institutional framework to facilitate the move toward a rule-based global trading system. Uruguay was also important because it was the seat of the evolving trading arrangement among the countries of the Southern Cone—Argentina, Brazil, Paraguay, and Uruguay. A paper prepared by a World Bank researcher had given the impression that our institution was opposed to the establishment of regional trading arrangements. The paper's main

*6. Annual World Bank Conference on Development in Latin America and the Caribbean 1996: Poverty and Inequality*, edited by Shahid Javed Burki, Sri-Ram Aiyer, and Rudolf Hommes.

finding was that the Mercosur arrangement's main impact was in the area of trade diversion rather than trade creation.<sup>7</sup> In other words, Mercosur had not really improved general welfare. The paper's largely negative conclusion about the economic impact of regionalism had been circulated widely in Latin American and the Caribbean, and had been reported on extensively in the press. We took a different approach. In my introductory statement,<sup>8</sup> I argued that open regionalism was an acceptable form of trade openness in that it did not discriminate against countries not included within a regional arrangement. In fact, such arrangements and Mercosur was one of them could be treated as the first step toward the promised Western Hemispheric free trade area that is supposed to become a reality by the year 2005.

Instead of providing a short essay as a backgrounder for the conference as Sebastian Edwards and I had done for the Rio de Janeiro and Bogotá meetings, for the meeting at Montevideo Guillermo Perry and I decided to be more ambitious. Perry had succeeded Edwards as the region's chief economist and was anxious to explore some regional issue in greater depth than Sebastian Edwards and I had done for the earlier conferences. Accordingly, we published a document titled *The Long March, a Reform Agenda for Latin America and the Caribbean in the Next Decade*, in which we suggested that the process by which the region could attain a high level of sustained growth would require many years of serious work on the part of its policymakers. While continuing with the policies included under the generic title of the Washington Consensus, the countries in the region will have to undertake a number of what we described as second generation efforts. These include, in particular, reforming their financial

sectors. The salience received by the financial sector had been prompted, in part, by the experience of the 1994-95 crisis in Mexico, in which the weakness of the banking sector had added considerably to the difficulties the country had faced. By the time this volume was compiled, the Bank had sponsored a study on the Mexican crisis by the Carnegie Foundation.<sup>9</sup>

For the fourth conference of the series, held in June 1998, we moved to El Salvador and focused on the role that institutions play in promoting development, alleviating poverty, and improving the distribution of income. Guillermo Perry and I, continuing with the practice of the previous year, edited a volume of essays

7. Yeats, A. *Does Mercosur's Trade Performance Raise Concerns about the Effects of Regional Trade Arrangements?* Policy Research Working Paper Series, No. 1742, World Bank, Washington, D.C., 1997.

8. See Chapter 3 in this book.

9. Edwards, Sebastian, and Moisés Naim, editors. *Mexico 1994: Anatomy of an Emerging-Market Crash*. Washington, D.C.: Carnegie Endowment for Peace, 1997.

that covered a number of areas in which institutional reforms had to be undertaken seriously to ensure sustained growth in the region. In assembling these essays in the volume titled *Beyond the Washington Consensus: Institutions Matter*, we drew extensively on the literature produced by institutional economists. Their main contribution was to separate transaction from transformation costs, while suggesting that, in societies and economies where institutions functioned well, transaction costs were considerably lower than in those that had weak institutional bases. Improving institutions, therefore, could reduce transaction costs and contribute to increasing total factor productivity. In an institutionally rich environment, a unit of investment would produce higher returns than in countries where institutions were weak. In looking at institutional development, we paid particular attention to the need to strengthen the financial sector. The El Salvador meeting was held while most of East Asia was in the throes of a serious economic crisis. If there was one thing common to the genesis of the crises in various East Asian countries, it was weakness in their financial sectors. This weakness had not been spotted by most observers who had studied the East Asian miracle. Analysis after the fact, however, identified what came to be called crony capitalism as one important cause for the severe jolt delivered to the countries of East Asia.

The last ABCD-LAC conference held during my tenure as vice president of the region chose decentralization as the subject for discussion. This time, the conference volume, edited by Guillermo Perry, William Dillinger, and myself, focused directly on the subject of the conference instead of providing a broad overview as the two earlier volumes *The Long March* and *Institutions Matter*

had done. We adopted a political definition of decentralization, limiting our attention to the process of devolving political, fiscal, and administrative powers to subnational units of government. By choosing this definition we excluded some other forms of decentralization. One is deconstruction, in which the central government increases the autonomy of its regional offices. Another is privatization, through the sale of assets, the granting of concessions, and public-private alliances. We chose to investigate the political process for two reasons. First, it is the most ambitious and perhaps most risky of all forms of decentralization. Second, it is unique in its behavioral implications: decentralization shifts the structure of local accountability from central government to local constituents. The conference volume was published under the title *Beyond the Center: Decentralizing the State*.

It would not be an exaggeration to say that by the time I left my job as the regional vice president for Latin America and the Caribbean, we had succeeded in establishing two traditions that made a significant contribution to our under-

standing of the development challenge faced by the countries in the area. The first tradition was to hold an annual conference on the economic development of Latin America and the Caribbean (ABCD-LAC). The second was to publish an annual report, edited by the regional vice president and the chief economist, on a subject of critical importance to the region. The sixth annual ABCD-LAC conference is scheduled to be held in Spain, and will deal with the issue of the economic challenges facing the region as it begins life in the 21st century.

I had long been associated with the NGO community. When I became the director of the Bank's International Relations Department in the spring of 1983, I revived the World Bank-NGO Committee. I chaired the committee and expanded its membership by bringing in the nongovernmental organizations from the developing world. Until that time, the Bank's limited dialogue had been conducted only with northern NGOs. Most of them had narrow focuses: concern with preventing the further deterioration of the environment, saving rain forests, helping indigenous peoples preserve their culture, and ensuring that the populations displaced by development projects were adequately resettled. The southern NGOs were closer to the people and to the communities they served. It was appropriate for these NGOs to seek a closer working relationship with the World Bank and other development agencies, to try to influence their thinking, and to agitate when they felt that more harm than good was being done by the programs and projects funded by these agencies. By including these NGOs in the Bank-NGO Committee, we added a dimension to our dialogue that had been missing in the deliberations.

Upon moving to the Latin America and Caribbean Region, I continued to maintain a close working relationship with the NGO community. We began the practice of holding a regional NGO workshop every year. At the first of these, in the summer of 1995, I promised to appoint a social scientist in each World Bank field office. We had 11 such offices, and, within a year, each of them had a person responsible for working directly with the NGO community.

The next NGO workshop was held in the summer of 1996, in Nicaragua. The high point of this meeting was my invitation to the NGOs to work with us, the World Bank, to devise ways to reach the poor living in urban areas, in particular in the favelas of large cities. I asked the NGOs to help us formulate policies and programs with which we could reach these disadvantaged people. It took a while for the NGOs to organize themselves to work with us, but once they did, we held a very successful joint workshop in 1998 in Rio de Janeiro.

These annual meetings have contributed a great deal to improving the World Bank's ability to reach the poor. In a number of countries, the World Bank has established funds that provide small amounts of money for investment in infra-

structure (roads, bridges, water supply schemes), building schools and clinics, and improving the environment in which the communities live. These funds benefit a great deal from the expertise available through the NGOs.

The final initiative worth mentioning is the one launched after the arrival of Guillermo Perry in the region as the chief economist. We launched a regional studies program with a number of objectives: to provide solid underpinnings for operational work, to develop a region-wide perspective on key policy issues, and to promote the acquisition of new knowledge on policy questions of strategic interest to the region.

The first set of studies carried out under this program concentrated on five broad areas:

Institutions, governance, and regulation;

Poverty, labor markets, and social protection;

Human capital formation;

Macro-financial vulnerability and contagion, and

Financial markets development.

Did we gain some new insights from this program? Did we deepen our knowledge and improve our methodologies? Were we better informed to do operations as a result of the regional studies program? I would answer all these questions in the affirmative. Let me explain why by giving some examples.

Included in the category of governance and regulation was a large project on violent crime that developed a methodology to measure



crime rates in major cities in the region, determine their causes, and estimate their costs. This quantification provided a yardstick to evaluate the effectiveness of policy interventions related to crime. Fiscal decentralization was another study included in the same category. This study focused on estimating the efficiency and equity of decentralization in the sector of education.

In the category of poverty and labor markets, we carried out studies aimed at improving poverty and inequality indicators in the region. We also explored empirically the determinants of labor demand and supply using micro data. We were interested, in particular, in the impact of trade liberalization and labor market reforms on major countries.

In the area of macro-financial vulnerability and contagion, we included a study on financial contagion that focused on the role of financial sectors in the transmission of crises across and within countries. It examined the behavior of mutual funds as propagators of crises in emerging markets.

These, then, were some of the more important initiatives I took during the five-and-a-half years I spent as the regional vice president for Latin America and the

Caribbean. I mention them here as an indication of how the new organizational structure in the World Bank allows considerable space and opportunity to its senior managers to try new ideas and launch new initiatives to better serve their clients. My colleagues in other regions found different ways to improve their knowledge of the areas for which they were responsible. I have written this short essay for this little volume to suggest why I did a few things that were not done before I came to this region and what their impact was on our work and on our knowledge.

## Chapter 3

### Toward Open Regionalism in LAC<sup>1</sup>

#### Introduction

The World Bank's First Annual Conference on Development in Latin America and the Caribbean, held in Rio de Janeiro, focused on the challenges of reform. Our second, in Bogotá, focused on poverty and inequality. And this, our third conference, here in Montevideo, will focus on trade and regional integration. Thus, aptly, the title of this conference is Trade: Toward Open Regionalism.

#### The World Bank and trade policies in LAC

The World Bank has supported liberal trade policies for a long time. In addition to strong theoretical arguments in favor of open trading regimes, there is overwhelming empirical evidence, both in LAC and worldwide, that such policies promote economic development. In turn, economic growth is a necessary condition for reducing poverty. Greater trade openness, therefore, can help reduce poverty. Furthermore, trade liberalization ensures that long-term economic growth in LAC will be more labor intensive, which helps poverty reduction because a greater share of national income goes to workers. Consequently, when most of the region was practicing protectionist, inward-looking trade policies, the World Bank was promoting a change in outlook. When most of the region dismantled its protectionist regimes in the late 1980s and early 1990s, the World Bank was there to help with technical

assistance and structural adjustment and trade reform loans. We also supported the establishment or strengthening of safety nets to protect the

1. Remarks at the World Bank's Third Annual Bank Conference on Development in Latin America and the Caribbean, Montevideo, Uruguay, June 29-July 1, 1997.

poor from any potential short-term consequences of the rapid reform. We now support a policy of open regionalism for Latin America and the Caribbean.

Why do we use the term open regionalism?

Regional integration in LAC, or regionalism, needs to be assessed from a historical perspective. LAC regional integration in the 1960s and 1970s had both positive and negative aspects. On the positive side, the regional liberalization of trade flows provided at least some space for greater competition, thus promoting efficiency and export development in an otherwise closed environment. On the negative side, given that regionalism was designed to prolong the rapidly declining role of import substitution by giving the protectionist model a second breath, it may have retarded the process of trade and investment liberalization.

The revival of regional integration in the early 1990s is clearly a different process. The new regionalism has emerged as a by-product of the decisions made by most governments to liberalize their economies. In general, it has proceeded hand in hand with unilateral trade liberalization and an opening to foreign investment.

Let us first consider the evolution of tariff and nontariff measures affecting imports from the rest of the world. Figures 1 and 2 show that protectionist policies have been dismantled in the major LAC countries during the last decade, especially since 1991.

Furthermore, Table 1 shows the same pattern for Mercosur countries when comparing the average tariffs imposed by its member countries in 1986 with those included in the Ouro Preto Treaty objectives.<sup>2</sup> These facts leave no doubt that regionalism has

gone hand in hand with unilateral trade opening in the last decade, in sharp contrast with what happened in the 1960s and 1970s. That is one reason why we talk of open regionalism in LAC today.

The same is true with respect to investment flows. Regionalism in the 1990s has gone hand in hand with a substantial liberalization of investment regimes. Nowadays, several countries in LAC treat foreign direct investment (FDI) in exactly the same manner as domestic investment. New regional trading arrangements (RTAs) have explicit provisions to facilitate investment flows, including national treatment provisions.<sup>3</sup> This is in sharp contrast to the restrictive regimes

2. The presidents of Mercosur countries met in Ouro Preto, Brazil, on December 17, 1994. The objectives are the tariff levels that will be in place by 2006.

3. Such provisions are included in the Mercosur, Andean Community, Central American Common Market (CACM), Caribbean Community (CARICOM), NAFTA, Group of Three (Colombia, Mexico, Venezuela) trading arrangements, and several bilateral agreements.

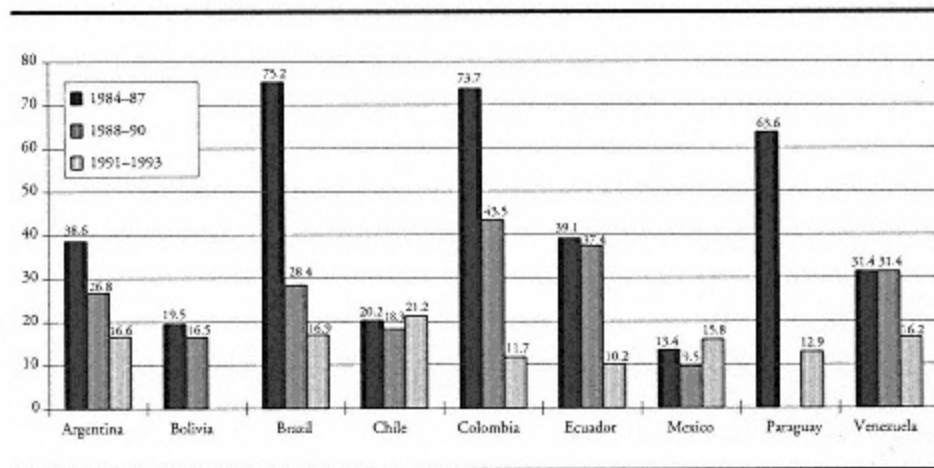


Figure 1

Weighted average import charges in LAC, 1984-1993  
(Weighted by a product's share of world trade flows)

Source: UNCTAD. Directory of Import Regimes. New York: UNCTAD Secretariat, 1994.

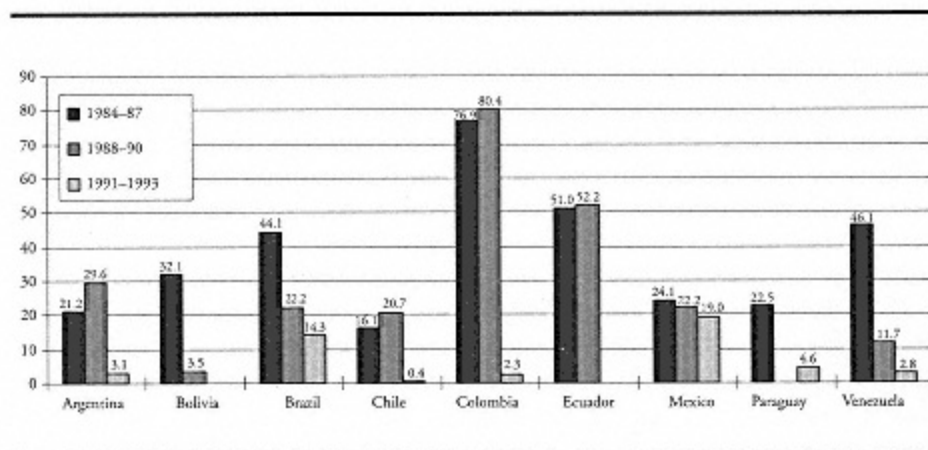


Figure 2

Weighted incidence of nontariff measures in LAC, 1984-1993  
(Percentages of product categories affected by NTMs, weighted by world trade flows)

Source: UNCTAD. Directory of Import Regimes. New York: UNCTAD Secretariat, 1994.





TABLE 1

Unilateral and regional trade liberalization in Mercosur  
(Average tariffs by country, percentages)

COUNTRY	1986	OURO PRETO OBJECTIVES
Argentina	41	12
Brazil	80	13
Paraguay	20	9
Uruguay	36	11
Mercosur	44	11

*Source:* Olarreaga, Marcelo, and Isidoro Soloaga. Endogenous Tariff Formation: The Case of Mercosur. Mimeo, International Trade Division, Development Economics Department, World Bank, Washington, D.C., March 1997.

TABLE 2

Net foreign direct investment as a share of gross domestic investment,  
1980-95

(Percentages, annual averages)

	1980-84	1985-89	1990-95
Argentina	2.4	4.5	6.7
Brazil	4.4	2.1	2.1
Chile	6.4	6.6	8.2
Colombia	5.3	8.0	9.9
Mexico	3.0	6.7	8.8
Peru	0.2	0.6	9.6
Venezuela	0.7	1.0	9.0

*Source:* World Bank World Development Indicators Database.

of the 1960s and the 1970s in most LAC countries. Table 2 shows that, in fact, FDI has become an important and increasing contributor to domestic investment. This is a second reason we talk of open regionalism in LAC today.

Moreover, the recent surge of regionalism has not promoted closed clubs, as some observers feared. On the contrary, we have observed a trend toward enlarging memberships and superimposing a host of free trade arrangements. Mercosur has signed trade agreements with Chile and Bolivia, and is busily negotiating new ones with the Andean Community and the European Union. Colombia and Venezuela signed a joint free trade agreement with Mexico (the so-called Group of Three); the fact that Mexico was a member of NAFTA and that Colombia and

Venezuela were members of the Andean Pact in 1994 did not deter this development.<sup>4</sup> These three countries have signed bilateral free trade agreements with Chile, irrespective of their other memberships. Finally, most LAC countries have expressed their willingness to participate in the construction of a hemispheric free trade zone and have been active, pro-liberalization members of the World Trade Organization (WTO). This is a third reason why we talk of open regionalism in LAC today.

Why has regionalism accompanied unilateral trade liberalization?

Although it is a legitimate intellectual exercise to ask if it would not have been more convenient to have had only unilateral liberalization, without the new RTAs, we think it is more interesting to ask why unilateral opening was accompanied by the revival of regionalism. Let me refer to a similar question posed by Professor Paul Krugman to free trade advocates. He asked why it is that free traders support WTO and GATT negotiations when, on purely theoretical grounds, they should oppose them.<sup>5</sup> In fact, trade theory suggests that countries should unilaterally liberalize to reap the benefits of freer trade, even if others do not do so. Why, then, doesn't this happen? Why don't we see unilateral trade liberalization taking place throughout the world? Why do we need an international organization like the WTO?

Of course, political economy considerations come into play. There are interests that oppose unilateral trade liberalization; there are those who think in mercantilistic terms (exports are good, imports are bad) even if economic theory would prove them wrong. When free traders support WTO negotiations, they are implicitly accepting these constraints.

Let me suggest that there may be similar motives driving the process of unilateral liberalization accompanied by RTAs. It is easier to have public opinion on your side, and to counteract opposing interests, in favor of integration with your neighbors and/or to secure access to foreign markets for exporters through reciprocity, than it is to undertake unilateral liberalization. A policy package that contains both unilateral liberalization and RTAs with your trading partners is likely to receive greater political support than one that is limited to unilateral liberalization.

4. The Andean Pact became the Andean Community of Nations in 1997.

5. Krugman, Paul. What Should Trade Negotiators Negotiate About?

*Journal of Economic Literature* 35 (March 1997):113-20.

But this is only one reason why policymakers may have chosen to engage in both processes simultaneously. Let me also suggest that securing access to crucial markets may indeed be worth some costs. Even if your trading partners liberalize today, they may change their minds in the future. To lock in access to export markets by imposing costs for exiting RTAs makes some sense. For example, investors in Mexico appreciate the more secure access that NAFTA provides to the U.S. market. Investors in Argentina, Uruguay, or Paraguay similarly appreciate the insurance the Mercosur treaty provides for the access they have gained to the Brazilian and each other's markets. The same goes for investors in Colombia and Venezuela, who benefit from the greater certainty about future access to their respective markets that is preserved in the Andean Community agreements. This consideration may provide an important motivation for many LAC countries to sign free trade treaties with the United States.. Even if the United States is generally open, once in a while protectionist impulses affect imports of particular products, some of which are precisely those in which LAC countries are more competitive. This reciprocal lock-in effect reduces uncertainty and risks, and may thus increase investment levels.

It also makes sense to lock *yourself* in. Making liberalization credible is often a necessary condition to ensure that sound economic policies yield their benefits. If investors fear that liberal policies may be reversed, they may invest less or nothing at all. Locking in through RTAs increases the credibility of trade and investment openings, because they raise the costs of policy reversals. Entry costs also enhance credibility, because the negotiations leading to RTAs and their implementation require the

use of public resources and political capital, which signal a government's commitment to trade and investment liberalization. Why would a government go through all these lengthy negotiations if it is not really committed to keeping the economy open? Notice that the arguments that emphasize locking in effects imply that the economic motivation behind RTAs is more related to their effects on investment than on trade itself.<sup>6</sup>

It should come as no surprise to anyone that the new RTAs have emerged at the same time as the new surge in FDI and other capital flows in a world of higher financial integration. Countries want to share in the bonanza by giving more credibility to their policies and more certainty to their access to foreign markets. Of course, the credibility of macroeconomic policies may rank higher in investor con-

6. These arguments are further elaborated in Fernández, Raquel. Returns to Regionalism: An Evaluation of Non-traditional Gains from RTAs. International Trade Division, Development Economics Department, World Bank, Washington, D.C., February 1997. Mimeographed.

cerns than the credibility of trade policies. But the latter may be a useful complement to credible stabilization and structural reforms.

In sum, there are both political economy and purely economic arguments that support the political decision to move forward with unilateral trade liberalization and regionalism. In any event, there is little doubt that they were part and parcel of the political decision to integrate LAC economies into the global economy, and we could even argue that one process would not have happened without the other in many LAC countries. There is, thus, a case to judge jointly the outcome of both processes, rather than attempt an artificial separation in the analysis.

There are other noneconomic reasons for joining RTAs. A well-known argument is that integration enhances the capacity to influence worldwide outcomes. Although it is doubtful that RTAs significantly strengthen the voice of less-developed countries in the WTO, it is a fact that a strong Mercosur has changed the landscape for future negotiations of a free trade zone in the Western Hemisphere.

A new argument is that RTAs may contribute to democratic consolidation if maintaining a democratic regime is a prerequisite for continued membership. This type of political lock-in consideration weighs heavily in today's efforts by Central European countries to join the European Union. While it may be less important in LAC, last year's events in Paraguay suggest that this may indeed be an important consideration for LAC countries. A less-publicized political consideration is that RTAs, by strengthening business links across countries, reduce the likelihood of conflicts between countries that have border disputes. A similar

peace lock-in effect has been a prime mover behind the European Economic Community initiative since the 1950s.

What about the results?

Coming back to hard economic facts, overall trade trends in the 1990s justify optimism. It is true that LAC intraregional imports and exports grew rapidly in the first half of the 1990s, but imports from the rest of the world grew even faster. Moreover, exports to the rest of the world grew somewhat less rapidly than intraregional trade, but still at faster rates than during the late 1980s (Table 3). When one looks at the data for each subregional grouping, it becomes evident that intraregional imports have grown more rapidly than imports from the world in all cases except CARICOM. However, trade with the rest of the world has in all cases grown at very high rates, certainly higher than in the late 1980s (Table 4).



TABLE 3

## Trade growth in LAC

(Growth rates of trade value in \$, exports f.o.b., imports c.i.f.)

	EXPORTS FROM LAC		IMPORTS TO LAC	
	198690	199195	198690	199195
World	6.4%	11.8%	9.3%	17.7%
LAC	11.3%	11.8%	8.6%	17.7%
Rest of world	5.7%	11.0%	9.5%	18.0%
Index	5.0%	4.0%	-1.0%	-1.0%

INDEX =  $[(1+\text{LAC})/(1+\text{ROW})]-1$ \*100; if INDEX > 0, intra-LAC trade growth was faster than trade with rest of world.

*Note:* LAC includes the developing countries of the Western Hemisphere (i.e., intra-LAC trade does not include trade between LAC countries and Canada and the United States). In principle, intra-LAC exports and imports should be equivalent, but the differences in data reflect the incidence of transportation costs and country coverage; hence the difference between the rate of growth of exports from LAC to LAC and the growth rate of imports from LAC to LAC.

*Source:* International Monetary Fund, Direction of Trade Statistics.

TABLE 4

## Intraregional import growth in LAC, 198690

(Growth rates of imports, value in \$ c.i.f.)

	198690	199195
Intra-Mercosur	18.5%	24.6%
From ROW (rest of world)	7.9%	19.7%
Index	9.9%	4.0%
Intra-ANDEAN	9.8%	34.6%
From ROW	2.7%	16.0%
Index	6.9%	16.0%
Intra-CACM	3.0%	20.8%
From ROW	5.7%	15.6%
Index	-2.5%	4.5%

Intra-CARICOM	6.7%	-8.0%
From ROW	0.4%	5.3%
Index	6.2%	-12.6%

INDEX =  $[(1+LAC)/(1+ROW)]-1$ \*100; when INDEX > 0, intra-LAC imports growing faster than imports from ROW.

Mercosur = Argentina, Brazil, Paraguay, and Uruguay.

ANDEAN = Bolivia, Colombia, Ecuador, Peru, and Venezuela.

CACM = Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua.

CARICOM = Bahamas, Barbados, Belize, Guyana, Jamaica, Suriname, and Trinidad and Tobago.

*Source:* International Monetary Fund, *Direction of Trade Statistics*.

These aggregate figures cannot be taken as definite proof that healthy trade creation has outweighed any inefficient trade diversion. It is true that we are concerned about inefficient trade diversion in some instances. Several studies, conducted at the World Bank and elsewhere, have produced evidence of this sort of effect for specific sectors in some regional groupings. Such cases are usually the outcome of exceptions to the general policy: They are remnants of trade distortions of the past that were designed to protect specific sectors. Such distortions do not promote economic efficiency, nor do they help the poor, and thus, as I have said before, we are all compelled to point them out, hoping that they will be corrected as soon as possible. Such may be the case with those sectors under special regimes or higher common external tariffs in Mercosur. We are well aware, of course, that in some instances there may be some room for gaining economies of scale and dynamic benefits that partly compensate for some of these short-term inefficiencies. In general, however, we would urge countries to accelerate convergence toward lower and more uniform tariff levels.

There are also other problems created by recent developments. The array of overlapping trading arrangements is creating distortions and difficulties, especially in the enforcement of rules of origin and other complex technicalities. Enrique Iglesias, one of the champions of regional integration in LAC, stated in his speech at the IDB's 1997 annual meeting that it is time to begin to tackle some of these problems in a systematic way. Also, it is particularly worrisome that some of the small economies, particularly in Central America and the Caribbean, have been left out, temporarily, of the action and have consequently suffered some

erosion of their previous preferential access to some markets without gaining new terrain.

What is the evidence on FDI flows? Mexico appears to have enjoyed a strong response to NAFTA in terms of FDI from non-NAFTA countries, but not from U.S. firms. The combination of geographic advantage and secure and preferential access to the U.S. market was a powerful incentive for non-U.S. firms to establish themselves in Mexico. Such access was naturally less important for U.S.-based FDI. Some of the latter now have fewer incentives to invest in Mexico as a means to gain access to its market: tariff-jumping incentives to invest in Mexico have disappeared. In fact, U.S.-based FDI reacted more vigorously to the deregulation of FDI in Mexico in the second half of the 1980s than they did to NAFTA.<sup>7</sup> Data published by the U.S. government show that U.S. direct investment in Mexico grew at a much slower pace than it did in other LAC countries during the early 1990s (Table 5).

7. See Blomstrom, Magnus, and Ari Kokko. Regional Integration and Foreign Direct Investment. Mimeo, International Trade Division, Development Economics Department, World Bank, Washington, D.C., March 1997.

There has been a distinctive jump in total FDI flows to the Andean Community, whose share of regional FDI flows increased substantially in the 1990s, possibly due to the vigorous market integration of Colombia and Venezuela. In contrast, there is no such evidence in the case of Mercosur (Table 6), although the 1996 figures looked promising. Changes in the composition of FDI in Mercosur countries seem more related to privatization efforts than to Mercosur itself. However, highly protected sectors in its member countries have attracted a higher proportion of that FDI investment, which in the end may prove undesirable. In other words, FDI flows motivated by the market expansion effects of RTAs tend to enhance welfare more than FDI flows driven by tariff jumping.

This said, we must acknowledge that the jury is still out in evaluating the outcomes of the recent revitalization of regionalism in LAC. Progress has been uneven, and varies according to the groups of countries and sectors involved. Trade in services and agricultural products has lagged, as has been the case at other latitudes, and even at the global level. Improving the infrastructure for integration remains a challenge. The case for harmonizing some trade-related policies, such as subsidies, indirect taxation, and competition policies, is becoming more compelling. There is also the difficult question as to how much macroeconomic policy coordination will be required as integration deepens. Finally, at some point conflicts may arise between deepening integration under current schemes, expanding memberships, and building a new free trade area in the Americas.

TABLE 5

Average annual growth rate of U.S. direct investment in LAC, 1991-95  
(Rate of change of dollar value of direct investment, measured at cost value)

	GROWTH RATE	1995 SHARES
To the world	11.1%	
Latin America and the Caribbean	12.2%	17.3% (of total)
South America	17.6%	38.3% (of total to LAC)
Argentina and Brazil	12.3%	25.7%
Chile	28.8%	4.5%
Andean Group		
(Colombia, Ecuador, Peru, Venezuela)	24.3%	7.2%
Mexico and Central America	7.0%	25.6%
Mexico	3.3%	11.4%
Caribbean	11.5%	36.2%

*Note:* Based on data on the direct investment position of the United States in LAC, which measures the value of the net accumulated stock of capital that U.S. parent companies provide to their foreign affiliates.

*Source:* U.S. Department of Commerce, *Survey of Current Business*, June 1996.

TABLE 6

Growth of net FDI flows to LAC groups  
(Average annual growth rates of \$ values)

REGION OR COUNTRY	1986-90	1991-95	SHARE OF TOTAL FDI TO LAC, 1995
Mercosur	37%	21%	25%
Andean	10%	55%	22%
CACM	19%	21%	2%
CARICOM	122%	13%	3%
Mexico	12%	38%	27%
Chile	58%	31%	7%

To all LDCs 32%

Mercosur = Argentina, Brazil, Paraguay, and Uruguay.

Andean = Bolivia, Colombia, Ecuador, Peru, and Venezuela.

CACM = Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua.

CARICOM = Antigua y Barbuda, Bahamas, Barbados, Belize, Dominica, Grenada, Jamaica, St. Kitts, St. Lucia, St. Vincent, and Trinidad and Tobago.

*Source:* International Monetary Fund, International Financial Statistics.

## PART II

# ALLEVIATING POVERTY



## PART II

### ALLEVIATING POVERTY

Progress in Alleviating Poverty has Probably Stalled in the latter part of the 1990s, and China is probably the only country with large numbers of poor people among its population to show significant improvement. Table 1 provides the most recent estimates of the incidence of poverty in large countries. There are nearly 2 billion people living in poverty in the countries that have the largest concentration of poverty.

Despite adopting the adjustment policies that go under the name of the Washington Consensus, poverty continues to persist in most countries of Latin America and the Caribbean. Nearly 20 percent of the population earns less than \$1 per day; another 15 percent earn \$1 to \$2. The majority of the poor live in urban areas, where most of them live in the shantytowns and favelas that dot the region's major cities. While the city poor live in grim circumstances, most of the absolute poor those with incomes of less than a dollar a day are still in the countryside. Many of them are indigenous people, such as the members of Indian communities that live in the southern states of Mexico, in the highlands of Central America, and in the uplands of Peru, Bolivia, and Ecuador.

TABLE 1  
Incidence of poverty in large countries, 1997

COUNTRY	POPULATION EARNING LESS THAN \$2 A DAY (MILLIONS)	TOTAL POPULATION (MILLIONS)	PERCENT OF POOR
India	854.6	962.4	88.8
China	709.3	1,227.2	57.8
Bangladesh	104.5	123.6	84.5

Indonesia	117.6	200.4	58.7
Brazil	71.2	163.7	43.5
Pakistan	73.2	128.5	57.0
Nigeria	70.6	117.9	59.9
Ethiopia	53.2	59.8	89.0
Philippines	47.4	73.5	64.5
Congo, Democratic Republic of	36.6	46.7	78.4
TOTAL	2138.2	3,003.7	71.2

*Source:* The World Bank, *World Development Report, 1998/99* (Washington, D.C., 1999), various tables.

Women and children suffer more from poverty than do men; they account for a far greater proportion of the poor population than their share in total population. Public policy aimed at poverty alleviation must focus a great deal of attention on these vulnerable groups. Perhaps the most important route toward the goal of poverty alleviation passes through education. As we see in Table 2, below, literacy among women remains a big factor in the lives lived by the poor in large countries.

Poverty was one of my major concerns as I guided our work in the region. I spoke about and also wrote about it on several occasions. Included in this collection are four pieces that deal with different aspects of the issue.

In a short statement I made as a lunchtime speaker at a conference organized by the World Bank Institute at Buenos Aires, I highlighted the importance of distinguishing between two groups of poor: those who are close to the poverty line and those who are well below it. Different sets of policies are needed to address the problem faced by the second group.<sup>1</sup>

In a speech given at a seminar at Yale, I picked up this subject again, but in the context of what governments could do to contain the impact of economic and financial crises on the poor.<sup>2</sup>

In a speech given in Rio de Janeiro in March 1997, I dwelt at length on the impact of crime and violence on development.<sup>3</sup> Since the poor are generally both perpetrators of crimes and also its greatest victims, this subject is of particular relevance for policies and programs aimed at helping them.

The fourth selection in this group of papers does not relate to the

Latin America and the Caribbean Region. It is about Pakistan, and its theme is the return of poverty to a country that had managed to reduce its incidence by a significant amount. The purpose of including this speech in the collection is to demonstrate that, for poverty to be successfully alleviated, governments must persevere with a consistent set of policies for a long time.

1. Speech delivered at the Latin American and Caribbean Forum on Poverty, Inequality and Vulnerability, Buenos Aires, October 1998, 1998.
2. Talk delivered at the seminar on Institutional Reform, Growth and Human Development in Latin America, Department of Economics, Yale University, New Haven, Conn., April 17, 1999.
3. This speech drew extensively on the work done by Robert Ayres at the World Bank and was delivered at a conference on Urban Crime and Violence, Rio de Janeiro, March 2, 1997.

TABLE 2

## Number of illiterate women, 1997

REGION OR COUNTRY	MILLIONS
Sub-Saharan Africa	87.9
India	184.0
China	112.1
Bangladesh	26.2
Pakistan	25.9
Nigeria	16.5
Indonesia	14.1
Ethiopia	11.3
Brazil	9.4
Congo, Democratic Republic of	5.5
Philippines	1.3

*Source:* The World Bank, *World Development Report, 1998/99*.  
(Washington, D.C., 1999), various tables.

## Chapter 4

### Global Economic Crisis and Poverty<sup>1</sup>

I am Delighted that the Group that will be Responsible for writing the 20002001 World Development Report on Poverty has started its consultation by touching base with a number of Latin American groups. These consultations are important, as they will help provide the context in which the WDR team will develop its thinking.

In the next few minutes I would like to focus on one aspect of the Latin American situation that needs to be looked at carefully as our thinking on poverty evolves. I am aware of the concerns associated with a highly skewed distribution of wealth and income in the countries of Latin America. I am also aware of the fact that a lack of homogeneity in particular, a lack of cultural homogeneity in Latin America contributes to the problem of inequality. I am also conscious of the fact that programs aimed at alleviating poverty really succeed when those who are being helped participate in designing, implementing, and evaluating them. And I accept that a well-functioning labor market is a more effective means than are wage increases to distribute the rewards of economic growth to the poor and disadvantaged. Most of these issues have been, or will be, discussed at this forum.

Notwithstanding all this, I would like to draw your attention to another aspect of the poverty equation. In seeking sustainable remedies to alleviate poverty and improve income distribution, we must factor in the consequences of globalization. Allow me to

explain.

The process of globalization, by which I mean the rapid integration of the industrializing world economies into the global economic system, has produced stresses with which we have not yet found ways to cope. Large sums of money can flow in and out of emerging markets at the click of a computer key. When foreign

1. Speech delivered at the Latin American and Caribbean Forum on Poverty, Inequality, and Vulnerability, organized by The World Bank, in Buenos Aires, October 1920, 1998.

capital enters and is invested in productive activities, it produces jobs and incomes. When it leaves and sometimes its departure may have nothing to do with the economic fundamentals of the country involved it produces stresses that affect the poor disproportionately.

The poor in most societies can be divided into two groups: the chronically poor, whose situation can be improved only with efforts that have to be sustained over a long time, and the poor who benefit quickly from economic upturns and sustained growth. We know from the experience of Asia that the second group can graduate out of poverty if a healthy rate of economic growth say two to three times the rate of increase in the population can be sustained for five to ten years. We also know from the experience of East Asia that it is equally easy for these poor to fall back below the poverty line when a shock to the economy slows the rate of growth significantly.

It appears to me that Latin America will escape the crisis that has engulfed most of East Asia. That notwithstanding, this escape from the crisis will be at the cost of lowered growth rates. The growth rates of Latin American economies will probably experience a 2 to 3 percentage point for the next few years. This slowdown will have serious consequences for the poor who are just above the poverty line that is to say, those who had recently graduated from poverty.

In view of this, it is extremely important to think in terms of developing safety nets that become operational during periods of economic stress, and to protect people from falling back into poverty. In developing our thinking for the next WDR on poverty, it is vital that we take a careful look at the effects of



globalization especially those that worsen instability and poverty. Globalization, volatility, vulnerability, and safety nets are the issues that need to be analyzed carefully. Given the unfolding of recent events, in which some global forces caused extreme volatility, which in turn gravely affected the vulnerable, we should think of creating interventions that can be used to take care of those likely to be affected.

Such interventions can take many different forms: grants to parents to keep their children in school, public works programs to provide employment, training programs to contribute to job switching, school feeding programs, etc. The fiscal adjustment measures that most countries have adopted to deal with crises should accommodate and protect these efforts.

I do not emphasize globalization and its consequences because we are living in difficult times. I do so because I believe that both the frequency and magnitude of disruptions will increase. We must prepare ourselves to deal with these situations.

## Chapter 5

### Protecting the Poor during Periods of Economic Crises<sup>1</sup>.

In Some Ways, My Lunchtime Talk Today Complements that given at the dinner last night by José Antonio Ocampo, Director General of the Economic Commission for Latin America and the Caribbean. He talked about managing economies during boom periods. His main point was that several Latin American countries made serious policy mistakes when times were good and resources were abundant. These mistakes compounded their problems when times turned sour. Instead of talking about boom times, I will speak about periods of crises, say a few words about the way serious economic downturns affect the poor, and outline what governments can do to keep the suffering of the underprivileged segments of society to a minimum.

I will not touch on the usual subjects that are discussed when poverty is the focus. Looking at the conference program, I see that there has been adequate coverage of subjects such as reforming educational, health, and social security systems; improving savings rates; the role of the government in providing social services; and partnerships between the public and private sectors to help the poor. There is, therefore, little point in dwelling any further on these subjects. I will instead spend a few minutes talking about the following four subjects:

Why the incidence of poverty and the extent of inequality are so much greater in Latin America and the Caribbean than in East Asia.

Why I believe that we should now change the language of our discourse from that of crisis management to the management of volatility.

Why one class of the poor is more vulnerable to volatility.

And, finally, what can be done to protect this class of the poor from losing all that they have gained during times when their economies are robust and resources are abundant.

1. Talk delivered at the seminar on Institutional Reform, Growth and Human Development in Latin America, Department of Economics, Yale University, New Haven, Conn., April 17, 1999.

## Comparing Latin America and the Caribbean with East Asia

I took up my assignment as Vice President for Latin America and the Caribbean (LAC) in January 1994, after having worked for nearly seven years managing the World Bank's large program in China. It was not surprising that I found the two regions very different. What intrigued me was the fact that, at about the same level of income per head, the LAC Region had a much higher incidence of poverty than East Asia. I searched for the reasons behind this difference, not only to satisfy my own curiosity. I believed that such an understanding would be helpful to those of us at the World Bank as we focused our programs and policy dialogue on alleviating poverty and improving the distribution of incomes in Latin America and the Caribbean.

In looking for an explanation, I focused on the same factors that had drawn the attention of so many other observers. East Asia had enjoyed a prolonged period of rapid economic growth compared to Latin America. There was now consensus among development economists that high rates of growth were important for alleviating poverty. It was also well known that the East Asians had invested large amounts of public funds in developing their educational systems and providing basic health coverage to all segments of the population. Whereas the Latin American and Caribbean countries, on average, had committed a slightly higher proportion of GDP to education and health, they had not achieved the standard of education quality that had been attained in East Asia. The Latin Americans had done about as well as the East Asians in public health. It was also well known that the East Asians had managed to achieve a better distribution of assets than the LAC Region,

particularly where land ownership was concerned. It was common knowledge that Brazil had one of the worst income distributions in the worldthe highest 10 percent of the population received 51 percent of total income, compared to 35 percent in East Asia.

Combining economic growth rates and income inequality data, it was possible to estimate the increase in incomes needed to make a difference in the incidence of poverty. Based on empirical evidence available at the World Bank, I had developed a rule of thumb that suggested that, when Brazilian-type income distribution prevailed, GDP growth had to take place at a pace three times greater than the rate in population increase to make a significant dent in poverty. For the East Asian countries, a growth rate twice the increase in population was sufficient to make significant inroads against the prevalence of poverty. This point can be well illustrated by looking at the marked differences in the growth experiences of two countries, one in Latin America, and the other in East Asia. Brazil's population

increased at the rate of 2.1 percent a year over 1965-97. By this way of reckoning, its gross domestic product had to grow 6.3 percent a year three times the increase in its population to make a significant difference in the incidence of poverty. Instead, the GDP increased only 4.4 percent a year over this period. It was not surprising, therefore, that Brazil did not register a perceptible change in the level of poverty.

On the other hand, Korea's population increased by only 1.5 percent a year over the same 32-year period. Given its much better income distribution, its gross domestic product had to increase by twice the rate of population growth 3.0 percent annually for Korea to reduce significantly the level of poverty. Instead, GDP increased by 8.2 percent a year.<sup>2</sup> By the late 1990s, more than two-fifths of the Brazilian population was classified as poor, compared to less than one-tenth of Korea's.

All this was well known, and equally well understood. However, there were two other reasons why the East Asians had done so much better in terms of poverty alleviation and income distribution than Latin America and the Caribbean. One, the East Asians had known not only a high rate of economic growth, they had also experienced great stability there was nothing comparable in East Asia to the cycles of boom and bust that had been such a prominent feature of the economic history of Latin America. Two, the political and social systems of East Asia showed little tolerance for large and persistent income and asset inequalities. There was much greater willingness on the part of the Latin Americans to live with great inequalities in both wealth and income. While I will return to the subject of crises and their impact on the poor, let me

say a word about social values and political systems and how they influence attitudes toward poverty and inequality.

Two Swiss economists recently did some pioneering work on understanding the determinants of satisfaction and happiness. The level of employment scores very highly in their method of accounting. But democracy, defined broadly as participation in decisionmaking, also rates highly. This is perhaps one reason why genuine democracies are not prepared to tolerate high inequalities in poverty and income distribution. East Asians may not have practiced the form of democracy we see in the West, but what has sometimes been called the system of Asian values puts a high premium on caring for the less privileged segments of the population. Fully participatory democracy is of recent vintage in Latin America and the Caribbean and, with time it, too, will begin to force policymakers to work for the economic welfare of those who exist at the margins of their societies. Once this

2. These data are from the World Bank, *World Development Indicators: 1999* (Washington, D.C: April 1999), Table 1.4, pp. 2425.

pressure develops, we should begin to see a palpable difference in the approach governments take toward the poor.

Volatility rather than recurrent crises: a change in our way of thinking

There is a rich and growing literature on the economic crises that have hit Latin America periodically. It is now suggested that economic and financial crises will come more frequently, and leave a deeper impact on the countries that experience them. My approach is different. I believe that what we are witnessing today are changes in the global economic order that will keep the entire global system—the economies of the developed, developing, and emerging countries—if not in a state of recurrent and deepening crises, then at least in a condition of perpetual volatility. What we should now get accustomed to is not crises that come along every few years, but a situation of constant unpredictability. There are good reasons for this change, including the sharp demographic shift in the industrial world, the state's withdrawal from providing social security coverage to most segments of the population, and the development of new financial instruments seeking high rates of return.

Although we are familiar with the sharp decline in human fertility in the West and Japan, we have not fully recognized its consequences for financial and capital markets. Fertility declines increase dependency ratios, and when they occur simultaneously with changes in public policy toward providing social security, they induce reactions in the capital and financial markets. The net result of these profound changes is that individuals and households in the West will have to manage on their own to secure



the resources they need for old age. The state will not provide the type of security that was central to the thinking of so many governments in the 1950s and 1960s. With the state pulling back, individuals will turn to such institutions as pension funds and mutual funds to augment their savings. These institutions will look for high rates of return which will likely not be available in the mature economies of the industrial world. They are more likely to be found in the industrializing countries and, perhaps, in countries in transition. It is inevitable, therefore, that large amounts of capital will flow from industrial to emerging markets. But the managers of capital will be very sensitive to policy stances in the capital-importing countries. Even a hint of a problem in politics, in economics, or generally in society will induce capital to leave and move to places in which the managers feel greater ease. For as long as the economies of the

developing world do not converge as they did at Maastricht, we can expect some volatility in capital flows. At any given point, we can expect some part of the globe to be in a state of crisis.

Yet and this is a positive development markets have now learned to differentiate among countries. They are now able to distinguish the countries that have problems of one sort or another from those that are relatively well managed. When I speak of a constant state of volatility, it is global volatility, not turbulence that is confined to one or a few countries.

### Volatility and the poor

It is well recognized that the world has made important strides in improving human welfare over the last half century. Nonetheless, many people still live in abject poverty. The fight against poverty suffers whenever there is a severe economic slowdown, as happened in most of the developing world in 1998. International development targets to halve the number of people living in poverty by the year 2015, cut infant mortality in poor countries by two-thirds, and enroll all children in primary education are now all at risk. They are in jeopardy because of volatility in the global economy.

In looking at the impact of volatility on the poor, it is useful to divide the poor into two groups: the indigent poor and the poor who move above and below the poverty line depending on the pace of economic activity. In Latin America, the indigent poor are defined as those earning less than \$1 a day, or \$360 a year. They account for some 20 percent of the population. The second category of poor earns \$1 to \$2 a day and makes up another 15

percent of the region's population. When we talk about a sharp rise in the level of poverty, it reflects the fact that this second category of poor has slipped below the poverty line. For instance, it has been estimated that Brazil's poverty rate fell dramatically from 40 to 25 percent over 1983-86, but increased to 30 percent and stayed at that level until 1993. It then declined to 20 percent in 1994 and 1995, but has increased significantly since then.<sup>3</sup>

Brazil also provides evidence of how rapidly the poor are affected by a downturn in economic activity. It is estimated that a 1 percent drop in GDP adds 2.5 million people—1.6 percent of the total population—to the pool of poverty.<sup>4</sup> The

3. World Bank. *Report and Recommendation on a Social Protection Special Sector Adjustment Loan to the Federal Republic of Brazil*, Report No. P7221BR, December 16, 1998, p. 9.

4. *Ibid.* p. 7

decline in the real incomes of this class of poor can be sudden and very severe. For instance, in the 1980s, real wages in Argentina and Mexico fell by nearly 40 percent, and unemployment rose by 9 percentage points within one year. In the 1995-96 crisis, real wages in Mexico fell by more than 30 percent.

Programs and policies to protect the poor during economic busts

Public policy during economic busts must aim at a number of objectives, some of which may be contradictory. For instance, several programs whose purpose is to produce stability have focused on fiscal retrenchment. Restricting budgetary expenditures can affect public sector financing of human development. Declines in the public sector's support for health and education may produce short-term stability yet produce negative consequences for long-term development.

Governments face many challenges during periods of economic crisis. From the perspective of the poor, the two most important are how to buffer sharp falls in their incomes and how to shorten the period of economic distress.

There is now considerable experience from Latin America to suggest what governments can and should do to cushion the impact of economic crises on the poor. Of the many programs that have been adopted with some success in recent times, I would like to mention three: temporary employment programs, training programs to improve worker skills, and programs that focus on keeping children in school during difficult economic times.

Loss of employment is, of course, the main cause of income decline among the poor. Employment is first lost in the formal

sector, as enterprises either curtail their activities or close down altogether. The 1995 Mexican liquidity crisis produced by the near collapse of the banking sector had a devastating impact on enterprises in the formal sector. In Argentina in the same year, the tequila effect produced a credit squeeze, not because of the weakness of the banking sector but on account of capital flight. In both countries, there were sharp increases in formal sector unemployment. By the fall of 1995, unemployment in Argentina had increased to 18.5 percent of the labor force.

For the poor, the secondary impact of an economic slowdown is much more severe. This happens as a result of compression of demand when workers in the formal sector lose jobs. The second wave touches both the informal sector and the countryside. Much of the informal sector depends on the purchasing power of the poor; when it declines, jobs in this part of the economy may not be lost altogether, but incomes decline.

Public works programs in both urban and rural areas are the most effective way of providing employment to the poor. But these programs are hard to manage and can cause great waste. When they are run well, they provide relief to the poor, as they did in Chile in the 1980s and Argentina in the 1990s. One important feature of successful public works programs is that they provide employment at wages below those that would be paid by the market if jobs were available. This ensures that those seeking employment in public works programs stay for only as long as the markets are in recession.

Prolonged crises have a cleansing effect on economies. They close down enterprises that are poorly managed, are performing poorly, do not have a strong demand for their products, or have lost their competitive edge. Workers relieved of their jobs by these enterprises are not likely to go back to them once the economy recovers. Sometimes, entire lines of business may be affected. It is helpful, therefore, to include worker training programs as a part of a package of approaches adopted to help the poor deal with crises. The World Bank and other international financial institutions did this when they collaborated in helping the Mexican authorities to deal with the peso crisis of 1994-95.

Experience also teaches us that children often bear a heavy burden when economies come under stress. When the poor lose their jobs and their incomes drop dramatically, they have to do everything they can to protect themselves. Often their response is to pull children out of school and send them to work or to beg on street corners. This can happen even when schooling is free. In some of the recent programs it launched during periods of economic crisis,

the World Bank financed payments to families to compensate for the additional incomes they might lose by their keeping children in school. Such programs, if run well, can and do save societies from suffering the long-term damage that would result if children were indeed pulled out of school.

## Chapter 6

### Crime and Poverty

It is a Great Pleasure to Join You and to Have the Opportunity to speak briefly about a subject of great and growing importance in the countries of Latin America and the Caribbean. I hope you have had the occasion to read the paper prepared by World Bank staff for this conference. I shall not attempt to summarize it in great detail but simply highlight some of the main messages.

But first, a few words by way of introduction.

First, although the paper makes the point that the Latin America and Caribbean Region is now marked by a great deal of violence, it should be noted that a number of developments in recent years provide some grounds for optimism. I speak primarily of the end of violent civil wars in El Salvador, Guatemala, and Nicaragua, which has opened up windows of opportunity for development in those countries that did not previously exist. Guerrilla violence has generally declined elsewhere as well (although it remains a serious problem in a few countries).

Second, I will attempt to make some generalizations that are broadly relevant to the entire region. But I should acknowledge at the outset that the seriousness of the problems of crime and violence varies a great deal across the countries of the region, as do the manifestations that these problems assume from country to country. Indeed, one of the challenges ahead is to learn more about what accounts for the differences in crime and violence between countries of the region and what lessons can be learned from the



experience in some countries that can be applied in others.

Third, I wish to emphasize that the problems of crime and violence are not unique to Latin America and the Caribbean or to the developing world. Some of the advanced industrial countries likewise confront substantial problems in this regard. Indeed, the problems in Washington, D.C., headquarters of the World

Bank, look dramatically similar to many of the problems we will be discussing over the next several days. So there is no notion of any one country or group of countries having the right to preach to others about what to do concerning crime and violence. We all have a great deal to learn.

Fourth, and finally by way of introduction, permit me to refer to the problems of drugs and narcotrafficking. It may surprise some of you that the World Bank paper for this conference did not deal more extensively with these issues. This, however, was quite intentional. The view adopted in the paper is that the crime and violence problem is not primarily a drug problem. It is undoubtedly exacerbated by drugs and drug trafficking. But our view is that illegal drugs and narcotrafficking are part of a larger problem of economic and social decay, and not the prime mover. Having said that, it is undeniable that the increasing prevalence of illegal drugs and the perceived rewards from narcotrafficking make all efforts to combat crime and violence considerably more difficult.

Let me turn now to the central thesis of the paper. The main message I wish to leave you with this afternoon is that the World Bank regards the growing problems of crime and violence in Latin America and the Caribbean as a major threat to the sustained development of the region's economies. In our view, crime and violence threaten to reduce growth, increase poverty, and destroy the social fabric in much of the region. Therefore, as a development agency, the World Bank cannot and will not ignore the many ways in which crime and violence impede development. This does not mean that we can or will intervene directly to help

countries deal with their crime and violence problems. But it does mean that there are many steps we can take consistent with our development mandate which can make a substantial, if indirect, contribution toward preventing or mitigating crime and violence.

Having asserted that crime and violence are major threats to development in the region, I must immediately caution that it is very difficult to quantify their effects in this regard. In preparing our paper, we surveyed relevant materials produced within the Bank and a considerable body of literature produced by scholars and interested observers, both within the region and outside it. We were impressed by the lack of systematic knowledge on many key points and by the substantial research agenda that lies ahead if we are to comprehend more adequately the many issues raised by crime and violence. However, we came to the conclusion that the adverse effects of crime and violence on development stem principally from their effects on capital investments of various kinds. To summarize briefly:

Crime and violence adversely affect the stock of physical capital in several ways. The most obvious is the outright destruction of physical infrastructure

and the deterioration of neighborhoods that results. Beyond that, crime and violence have a negative impact on the overall investment climate and can contribute to reductions in investment in physical infrastructure. For example, a recent analysis of Colombia concluded that gross capital formation is about 38 percent lower today than it would be if homicide rates had remained at their 1970 level.

Crime and violence erode the development of human capital. The negative effects on women's health stemming from domestic violence are a clear example. In education, there are the direct costs stemming from the inability of children, especially girls, to attend school in a violent climate. A recent World Bank poverty assessment of Jamaica found that 30 percent of girls in the communities studied were afraid to go to school because of the threat of crime and violence. Moreover, educational quality suffers in an atmosphere of violence.

Crime and violence destroy social capital. The recent literature on development has given great emphasis to social capital to social networks and norms of trust and reciprocity that bind communities and nations together. Last year I chaired a World Bank Task Group on Social Development that concluded that social capital makes important independent contributions to economic growth and development. But crime and violence have devastating effects on social capital. For example, they prevent community members from associating with one another. This was a clear finding in the World Bank study of poverty in Jamaica I mentioned earlier. More fundamentally, crime and violence destroy interpersonal trust and reciprocity. Cooperation among individuals and community groups

suffers greatly.

Crime and violence have terrible effects on the capacity of governments. The resources that have to be spent on combating crime and violence are frequently very substantial and often must come at the expense of resources that should be spent for developmental purposes. In addition, crime and violence directly and indirectly contribute to corruption within agencies of the public sector. The legitimacy of the state is increasingly called into question as it is seen as ineffective in providing such basic services as public security.

These various effects of crime and violence have a negative effect on growth. Surprisingly, few efforts have been made to quantify this effect. However, one recent empirical study concluded that the high homicide rates persisting in Colombia since the late 1980s are costing the country about 2 percentage points annually in GDP growth. Expenditures on protection and the associated indirect

costs of crime and violence, plus the direct costs resulting from criminal activity, are estimated to be at least as high as 5 percent of GDP in Colombia.

What, then, is to be done?

Here again I would make a plea for modesty and humility. No one has definitive answers to this question. In part this is because we still do not possess an adequate understanding of the determinants of crime and violence. Without that, it is difficult to be precise about what actions to take to correct the problems. We lack agreement about the relative efficacy of different interventions and, thus, of where to allocate resources at the margin.

Nevertheless, the paper we have prepared for this meeting suggests a number of areas we call them policy domains in which we think actions can be taken that will have positive effects in reducing crime and violence in the region. The selection of these policy domains quite likely reveals something about how we conceptualize the crime and violence problem. I admit that we tend to come at the problem through the prism of poverty, inequality, and unemployment which is not surprising given that we are a development institution. We are not oblivious to the fact that poverty is not the only cause of crime and violence; one can undoubtedly find poor communities that are not violent (although finding rich ones that are may be more difficult). While recognizing that the determinants of crime and violence are many, complex, and imperfectly understood, we were searching for areas where evidence suggests that interventions including interventions supported by international institutions may prove helpful. With these caveats, let me put forth five propositions that in our view

could constitute a development agenda for dealing with crime and violence.

The first proposition is that we need to increase our efforts to combat urban poverty in Latin America and the Caribbean. I needn't remind this audience that the region is the most urbanized in the developing world, or that with the growth of cities has come the urbanization of poverty. Some three-fourths of the total regional population living in poverty now lives in cities. Yet, as the paper discusses, urban poverty has not received the attention it deserves, either from analysts or practitioners. Paradoxically, it received more attention in the 1970s, when it was less of a problem, than it does now.

The paper argues that this must change, and that a number of key interventions are required, which, in combating urban poverty, would make a dent in urban crime and violence as well. For example, we need to make greater efforts to provide basic infrastructure for the urban poor. Interventions to assist in making poor neighborhoods better places to live can improve people's sense of well-being and reduce levels of crime and violence. We need to revisit and build upon previous

efforts to upgrade slums and improve neighborhoods. I believe this is a propitious time to do so. Our paper discusses a number of innovative efforts being undertaken by nongovernmental and community-based organizations as well as governments (including the PROSANEAR project with World Bank assistance here in Brazil). The World Bank has concluded that the obstacles to providing basic urban services are not fundamentally financial. A study we did as background work for last year's Second United Nations Conference on Human Settlements in Istanbul concluded that addressing basic infrastructure needs would absorb only 0.1 to 0.5 percent of GDP in the developing world as a whole. As identified in the paper, the real challenges are those of replicating best practices, establishing effective partnerships among all the participants in the process, and strengthening political commitment.

In thinking of ways to address urban poverty, we also need to devote greater attention to issues of unemployment and underemployment. I am convinced that the depressed labor market in urban areas, particularly for less skilled men, has played a major role in the increase in crime and violence in the region. It is not surprising that studies of cities in the United States confirm that areas with high unemployment rates tend to have high crime rates. In addressing this problem in Latin America and the Caribbean, we need to sharpen our understanding of the urban informal sector and what can be done to assist it, enhance access to credit and support microenterprise development among the urban poor, and target social investment funds toward poor urban areas with high rates of crime and violence.



The second proposition is that we need to target programs toward vulnerable groups, especially at-risk adolescents and women. A number of developments in the region have had profound effects on youth. They include an increasing proportion living in single-headed households, mounting pressures to leave school early to supplement family incomes, and the declining socialization capacity of families, schools, and community institutions.

Dropping out of school has been identified as a crucial variable affecting the propensity, especially of adolescent males, to engage in criminal and violent behavior. Frequently, abuse of alcohol and drugs is part of the pattern.

We need to break the vicious cycle that traps youth, especially young males, in lives of crime and violence. The paper identifies a number of approaches derived from international experience that seem to work. Some of these have been undertaken in Latin America and the Caribbean and are already pointing the way toward effective approaches for assisting at-risk youth. The World Bank is currently working with the Colombian government and nongovernmental organiza-

tions to implement an innovative program to tackle the problems faced by at-risk youth that lead them to perpetrate criminal and violent acts.

I wish to stress that special efforts also will be required on behalf of women. We must recognize that violence against women, mainly in the home but not confined to it, is one of the truly major social ill with serious economic consequences of contemporary Latin American and Caribbean society. Two kinds of efforts for dealing with violence against women are required: preventive and ameliorative. Actions are required to empower women and increase their autonomy. Actions to expand and improve educational opportunities for women are an obvious example. In addition, a range of efforts is required to enhance the income-earning potential of women and, thus, their economic independence (including increased child care for working women and the expansion of credit to women to open their own businesses). Once violence occurs, we require a substantial expansion in efforts to enable women to cope with it. There are hundreds of organizations in Latin America and the Caribbean working to support female victims of violence. They include crisis centers, legal aid centers, and women's police stations. For the most part, however, these organizations function with inadequate budgets and with little external support. They could readily be strengthened with relatively modest investment of additional resources.

The third proposition is that we need to increase our efforts to build social capital or to rebuild it where it has been destroyed. Research indicates that where the social fabric is strong, poverty is

less likely to result in crime and violence. A strong social fabric is characterized by a dense network of intermediary organizations, including civic associations, churches, parent-teacher groups, amateur sports leagues, and social clubs. Other studies show that lack of social capital hinders young people from reaping the benefits of human capital investments. Youths from neighborhoods with low levels of social capital, for example, tend to perform more poorly in school.

Building social capital takes time, is not easy, and requires a diversity of economic and noneconomic expertise and inputs. But the payoffs, including the payoffs in reducing crime and violence, can be substantial. The World Bank is paying increasing attention to this dimension in its work. For example, the design of the recently approved World Bank-financed Social Investment Fund in Jamaica explicitly incorporates concerns for strengthening social capital in targeted communities. One of the most successful and innovative World Bank-financed projects in the educational sector the EDUCO project in El Salvador is noteworthy for its explicit incorporation of extensive parental and community involvement in the administration of schools. A number of other World Bank projects in

the region address the needs of preschool children under the age of five and seek to enhance parenting skills; in short, they seek to strengthen the family unit that is so vital to the maintenance of the social fabric.

The fourth proposition is that we should seek to strengthen the capacity of local governments to combat crime and violence, especially through community involvement and partnerships with civil society and the private sector.

The message here is that democracy and decentralization two of the great revolutions sweeping Latin America and the Caribbean can contribute to preventing or reducing crime and violence. The democratic opening in the region, together with improved local governance in many municipalities throughout the region, provide an opportunity for attacking crime and violence at the local level. Electoral politics is making local leaders more accountable and their actions more transparent. Since public opinion data now show that crime and violence are at or near the top of citizen concerns, such local leaders will increasingly be held accountable for dealing with them, as well as with the more traditional agenda of local government. Anti-crime partnerships are required, and they need to bring together local government, community-based organizations, and the private sector. Better knowledge is also needed about the concerns and desires of the communities in which crime and violence are problems, so that these partnerships can design and with sustained community involvement implement appropriately targeted programs. An excellent example of what can be done in the region is the DESEPAZ program in Cali, Colombia. The experience of recent years in New York City provides an

example from outside the region.

The fifth proposition is that we need to reform the criminal justice system and professionalize the forces of public order. As the paper points out, no treatment of the agenda for addressing crime and violence in the region would be complete without acknowledging the pressing need for reforms in the criminal justice system. The court systems civil and criminal in most countries of the region suffer from major inefficiencies, delays, and high costs. They lack transparency and are prone to widespread corruption, a lack of predictability in the outcome of cases, and, in some instances, political interference in judicial decisions. It is far from surprising that the criminal justice systems in almost all of the countries of the region are inefficient and time-consuming in the extreme, and that only a minuscule proportion of the perpetrators of crimes is ever brought to justice. It is also not surprising that large majorities in countries where surveys have been conducted manifest little confidence in the administration of justice.

This is an extremely serious situation that simply must be addressed urgently and effectively despite political and other constraints. A number of countries in

the region are implementing important initial efforts with international support. The Inter-American Development Bank began its program of support for judicial reform in late 1994, and has undertaken a wide-ranging program of assistance including both criminal and civil aspects. The World Bank has also been stepping up its lending for various aspects of judicial reform so far excluding, however, the criminal justice system. The United States Agency for International Development and the United Nations Latin American Institute for Crime Prevention and the Treatment of Offenders have also made major contributions. Considerably more remains to be done, however, including efforts to combat such white collar crimes as bribery, money laundering, and tax evasion.

The World Bank's paper also emphasizes the importance of reforming the police forces in the region. We note that this is not an area in which the World Bank possesses expertise or is likely to get involved; it is first and foremost a national responsibility, although here, too, some external agencies have done important work. But the professionalization of police forces is absolutely crucial for preventing or reducing crime and violence in the region. At a minimum, strong efforts are required to guarantee that agents of the state do not themselves become instruments of crime and violence or abusers of human rights.

Those are my five main elements of a development agenda to combat crime and violence in Latin America and the Caribbean. It is a formidable and demanding agenda. In each of these areas, there is much that we do not know from an analytical viewpoint. We also have much to learn about the effectiveness of different

kinds of operational interventions. Still, I believe we know enough to get started with pilot efforts that can prove cost effective, sustainable, and replicable. We really have no other choice. If we do not enhance our knowledge and take more effective actions soon, crime and violence threaten to overwhelm all our other efforts for promoting growth and development and reducing poverty in the region. That is why the World Bank and I personally attach such great importance to this conference and to a wide-ranging exchange of ideas and information on such a vital topic.

## Chapter 7

### Poverty Returns to Pakistan<sup>1</sup>

Is Poverty Returning to Pakistan? Some Will Say it Never Left. But for a while in fact for a fairly long while it appeared that Pakistan was well on its way to addressing the problem of poverty. From about 1965 to 1990, the incidence of absolute poverty declined considerably.<sup>2</sup> There was also a significant improvement in income distribution. But these trends do not seem to have continued, and the momentum that generated them may have been lost. Since the early 1990s, poverty appeared to be on the rise once again, and income distribution may also have begun to worsen. It is clear that unless the government acts quickly and decisively to address the problem, the situation will rapidly deteriorate with grim social and economic and perhaps also political consequences.

If these assertions are correct and they are basically assertions, since too little serious analytical work has been done recently on poverty in Pakistan to make profound statements about the situation at this time they lead to a number of important questions. However, before these questions are asked, two important points need to be underscored. First, redressing poverty and improving income distribution do not need urgent government attention merely because such policies make good economic sense. The government also must worry about the return of poverty because the country does not possess institutions that can absorb the economic and social shocks that would be felt in fact, are being felt as a result of this unhappy



1. Address at a seminar held by the Pakistan Institute of Development Economics, Islamabad, December 4, 1995.
2. That there was a significant decline in the level of poverty is borne out well by a recent study by the World Bank. The Bank's work covers the period 1972 to 1990 and analyzes the change in consumption poverty, which declined in this period from 44 million in 1984<sup>85</sup> to 39 million in 1990<sup>91</sup>. My own earlier work on poverty looks at a longer period, from about the mid-1960s to the late 1980s. See Burki, Shahid Javed. Poverty in Pakistan. In T. N. Srinivasan and Parnab Bardhan, editors, *Poverty in South Asia*, pp. 172-98. New York: Columbia University Press, 1986. For a synthesis of work done recently on poverty in Pakistan, see World Bank, *Pakistan: Poverty Assessment*, Report No. 14397\_PAK, Washington, D.C., September 25, 1995.

development. Two institutional weaknesses come to mind at this stage. Despite the initiation of the *zakat*, *ushr*, and *baitul-maal* programs, government support for the poor remains insignificant. And Pakistan has failed to erect a strong safety net that can catch people who fall into the trap of poverty as a result of economic and social changes.

The deteriorating situation in Karachi illustrates these points well. Conventional wisdom about Karachi focuses attention on the city's difficult and seemingly intractable ethnic situation. However, a deeper and more informed look at Karachi's socioeconomic development over the last few years indicates that some segments of the city's population have suffered extreme deprivation because of profound changes in the structure of the country's economy. To take only one example: for a decade and a half from 1975 to 1990 the Middle East offered a safety valve for thousands upon thousands of Karachi's educated unemployed. The escape valve's shutoff has seriously aggravated the economic situation of this segment of city's population. If we understand the reasons poverty is returning to Pakistan, we will also begin to understand why it has been so difficult to resolve the conflict in Karachi.

A second important point that needs to be emphasized is that, with one exception, Pakistan's governments have done little to address the problem of poverty directly. The administration of Prime Minister Zulfikar Ali Bhutto was the only exception. Its impressive electoral triumph in 1970 was largely the result of a powerful slogan *roti, kapra, and makan* (food, clothing and housing). Once in power, Bhutto sought to fulfill his electoral promise by extensively restructuring the economy and redefining the role of

the state. However, these policies did not yield the intended results. In fact, Bhutto's restructuring of the economy may have contributed to worsening poverty.

Let me now pose some of the important questions raised by Pakistan's experiences with poverty and income distribution since its birth nearly half a century ago. It is important to ask these questions for at least three reasons: to encourage academic interest in poverty alleviation and income distribution; in the hopes that their findings about the social, economic, and political causes and consequences of poverty and unequal income distribution will persuade policy makers to take urgent actions; and, finally, to highlight the areas in which policymakers need engage. At this point I would like to pose three questions.

3. *Zakat* is an Islamic tax on wealth, usually levied at the rate of 2.5 percent; *ushr* is also an Islamic tax but on agricultural output; *baitul-maal* is a fund maintained by the state to provide help to the poor.

One, what were the reasons for the significant declines in the incidence of poverty and equally significant improvements in income distribution in the two-and-a-half decades between 1965 and 1990?

Two, why was it difficult for Pakistan to sustain this momentum, and why has poverty returned to Pakistan in recent years, particularly after 1990?

Three, what policies could the government adopt to stop further deterioration in poverty and income distribution, and begin to bring about a permanent improvement in both?

Some answers to these questions are provided in the three sections of this presentation. The answers are tentative, as they are based not on deep analytical work but on a careful observation of the evolution of the Pakistani economy and society since the country's inception in 1947. The third substantive section of the paper provides what I consider a viable plan of action to prevent poverty from engulfing Pakistani society.

### Social revolution, 1965-90

From 1965 to about the late 1980s, Pakistan witnessed a social revolution of great import. A number of developments, both domestic and external, changed Pakistani society profoundly.<sup>4</sup> There was a significant decline in the incidence of poverty, and some improvement in income distribution. New social and economic classes emerged and began to claim a share in the space occupied by traditional groups, and, finally, new social and economic forces were unleashed that the weak institutional structures in the country found it difficult to absorb. It is no

exaggeration to employ the term revolution to describe what happened over 1965-85.

The green revolution that began to take hold in Pakistan in the late 1960s was the first important domestic development during the period. As I have argued in some earlier works,<sup>5</sup> small- and medium-sized farmers led the way in adopting the new technologies associated with the green revolution. They dug

4. I have written about this revolution in some earlier works such as *Pakistan under Bhutto, 1971-77*, 2nd ed. (London: Macmillan, 1988) and *Pakistan: The Continuing Search for Nationhood* (Boulder, Colo.: Westview, 1991). A good account of the way the society in Pakistan changed as a result of these developments is to be found in Duncan, Emma. *Breaking the Curfew: A Political Journey through Pakistan*. London: Michael Joseph, 1989.

5. In my contribution to a book published several years ago, I developed this argument at length. See Burki, Shahid Javed. The Development of Pakistan's Agriculture: An Interdisciplinary Explanation. In Robert Stevens, Hamza Alvi, and Peter Bertocci, editors, *Rural Development in Bangladesh and Pakistan*, pp. 156-86. Honolulu, Hawaii, 1976.

wells to augment the supply of irrigation water, began to use the high-yielding rice and wheat varieties that had been developed in laboratories in the Philippines and Mexico, and began to apply large amounts of chemicals to get the best results from the new seeds. Without Ayub Khan's system of Basic Democracies, it would not have been possible for these farmers to become the leaders in this revolution. The Basic Democracies system put these farming communities in close touch with the government bureaucracies that had been given the responsibility of bringing the green revolution to Pakistan.

By adopting green revolution technologies, small- and medium-sized farmers benefitted from an explosion in their marketable surpluses and a consequent increase in income. The result was a significant improvement in rural income distribution, as the income gap between the innovating farmers and the landed aristocracy began to close. The green revolution also brought prosperity to the small towns in areas in which the new technologies were introduced. These towns, in turn, provided farmers with the new inputs and helped market their surpluses. Most of these activities were labor intensive and, as a result, large numbers of new jobs were created to serve the agricultural sector.

The economic boom in the oil-producing countries of the Middle East was the second fortunate development for Pakistan's poor. Millions of them moved to Middle Eastern countries to help build infrastructure and staff the service sectors. A very large proportion of the incomes earned by the migrants was remitted back to their families in Pakistan. The migrants to the Middle East sent almost \$20 billion to Pakistan in the ten years between 1975 and 1985. The

flow of remittances reached its peak in 1982<sup>6</sup>, when the Pakistani expatriate community sent \$3.1 billion to their families equivalent to 10.7 percent of Pakistan's gross domestic product. In terms of the geographical distribution of these remittances, two areas were the principal beneficiaries: the poor districts of northern Punjab and southern Frontier Province on the one side, and Karachi on the other. While Punjab and the Frontier Province provided unskilled and semiskilled workers to the construction sites in the Middle East, Karachi sent highly trained and skilled people to staff the public and service sectors. The poor of Punjab and the Frontier Province benefited enormously from the flow of remittances, and the Middle East continued to provide support to the large economy of Karachi. It is not surprising that the areas not touched by migration to any significant extent such as the southern districts of Punjab are among the poorest in Pakistan today.<sup>6</sup>

6. The World Bank's study, *Pakistan: Poverty Assessment, op. cit.*, provides some information on the geographical distribution of poverty in the country.

## Poverty returns, 1990-95

By the late 1980s, the factors that had such an impact on the incidence of poverty and income distribution in the previous two decades had run their course. Increased agricultural productivity thanks to the green revolution had been achieved, and the country had to adopt an entirely different strategy for further improvements to take place. At the same time, the Middle East no longer provided a safety valve for Pakistan's rapidly growing labor force. By the end of the decade, a return flow had started from the Middle East to Pakistan, and there was, as a consequence, a significant decline in remittances. By 1993-94, remittances accounted for only 4.6 percent of GDP, compared to the peak of 10.7 percent in 1982-83.

Along with the loss in the momentum of the factors that had helped to mitigate poverty in Pakistan, circumstances that contribute to perpetuating poverty became more prominent. Four of these need to be underscored: the high rates population and labor force growth, a low level of social development, a sharp reduction in the rate of economic growth, and the appearance of macroeconomic instability.

Largely due to having a fertility rate that ranks among the highest in the world, Pakistan's population continues to grow rapidly. As with other weaknesses in the availability of data, it is difficult to be certain about the precise size of the country's population. For political reasons, Pakistan has not held a population census for the last 14 years; the count due in 1991 has been postponed several times. However, the government estimated the population of the country at 130 million in the middle of 1995 and its rate of growth



at 2.86 percent.<sup>7</sup> In August of 1997, 50 years after its birth, Pakistan will have a population of 138 million, almost four and a half times its population at the time of independence. At the turn of the century, the Pakistani population will cross the 150 million mark, nine times more than its population at the dawn of this century.

A rapidly growing population naturally translates into an equally rapidly growing labor force. The government estimates yearly growth in the labor force at 2.6 percent, but this rate will increase due to the increase in the rate of population growth in the 1980s. Today, Pakistan needs to create 4 million new jobs every year to accommodate new entrants into the labor force. This number is well beyond the economy's current capacity.

7. Government of Pakistan. *Pakistan Economic Survey 1994/95* (Islamabad: Ministry of Finance, 1995), p. 9 of the Statistical Appendix. The document provides an estimate for January 1995; I have extrapolated the figure to mid-1995 at the rate of growth suggested by the government.

The government's own estimates<sup>8</sup> suggest that the size of the formal work force grew from 30 million in 1990<sup>91</sup> to 34 million in 1994<sup>95</sup>, an increase of only 4 million over a period of four years. The labor force should have increased three times that much to provide productive employment to newcomers to the work force. It would appear, therefore, that some 8 million people entering the work force in the last four or five years are engaged in poorly paying jobs in the service sector.

The poor state of social development in Pakistan is by now a well-told story. Any of the commonly used indices reflecting the level of social development in a country, such as life expectancy at birth, total fertility rate, infant and maternal mortality rates, and the enrollment of children in schools, show that Pakistan's social situation is worse than that of other countries at its level of income. Poor social development translates directly into poverty. Take for instance, the enrollment of girls in schools. In 1992, only 31 percent of girls in the 5-11 age group were enrolled in primary schools. The rate for all poor countries (not counting India and China) was 66 percent; in India 90 percent of girls were in school, in Bangladesh, 71 percent.<sup>9</sup> These comparisons clearly underscore the enormous neglect of an extremely important determinant of poverty alleviation. It is now well established that educating girls pays handsome dividends not only in alleviating poverty, but also in increasing economic productivity and growth.

The link between economic growth and poverty alleviation is now well established in academic literature, and also is recognized by the practitioners of development. The assumption that the state can intervene to alleviate poverty and improve income distributiothe

assumption that guided economic policy making during the days of Jawaharlal Nehru in India and Zulfikar Ali Bhutto in Pakistan turned out to be misplaced. Economic growth is needed to create the fiscal space for governments to be able to work directly with the poor. Economic growth also translates into increases in the real wages of the working classes.

The World Bank has concluded that South Asian economies need a minimum 3.3 percent increase in aggregate consumption to achieve a reduction in the number of poor.<sup>10</sup> However, with a highly skewed income distribution, which has gotten worse in recent years, I would suggest that an economy that has the characteristics of Pakistan's needs its GDP to increase at twice the rate of the increase

8. Government of Pakistan, *Pakistan Economic Survey 1994/95*, *op. cit.*, pp. 67 of the Statistical Appendix.

9. World Bank. *World Development Report 1995: Workers in an Integrating World* (Washington, D.C., 1995), p. 216

10. World Bank, *Implementing the World Bank's Strategy to Reduce Poverty: Progress and Challenges* (Washington, D.C., 1993), p. 6.

in its population growth to make a serious difference in the incidence of poverty. For Pakistan, this means an annual growth rate of over 6 percent. Growth rates of this order were achieved in the 1960s and in the 1970s, Pakistan's GDP increased at a yearly rate of 6.8 percent, and its income per capita rose by 3.9 percent. In the 1980s, the GDP and per capita income growth rates were 6 and 3.2 percent a year, respectively. However, in the 1990s, GDP growth has averaged only 4.4 percent, and per capita incomes have increased only 1.6 percent a year. With these levels of growth, there must have been a significant increase in the incidence of poverty in recent years if a significant deterioration in income distribution occurred simultaneously.

Macroeconomic stability also helps the poor a lesson that has been driven home by the experience of several Latin American countries during the 1970s and 1980s. It is now recognized that inflation is an exceedingly regressive tax the impact on the poor is disproportionate to their share in the national income.

Hyperinflation in Argentina, Brazil, Chile, and Peru and even in smaller countries in Central America, such as Nicaragua had a devastating effect on the poor, in particular the urban poor. The rich not only were able to protect themselves from the ravages of inflation but, in many cases, benefitted from it tangibly. Of late, Pakistan has begun to experience a steady increase in prices, largely because of the government's failure to raise sufficient resources to finance its expenditures. The use of extensive domestic borrowing, at interest high rates, to finance public expenditures a practice begun in the early 1980s, when khas deposits were first introduced has left the country with a large domestic debt that has to be serviced at a tremendous cost to the

budget.

The increase in agricultural productivity has stalled for the time being, and the Middle East no longer offers a safety valve for the rapidly growing labor force. Pakistan today cannot achieve what it did between 1965 and 1990 in alleviating poverty. This situation has been compounded by the continued rapid growth of its large population, the dismal level of social development, the serious decline in economic growth, and growing macroeconomic instability. Is there a way to escape from this situation? Is there a way to prevent Pakistani society from slipping once more into extreme poverty? The answer to both questions is yes.

A ten-point action program

Pakistan has reached the point where the government needs to adopt an action program to stem the growth of poverty. I suggest a plan of action that touches ten

broad areas. First, the government must revive economic growth; it should aim to double the gross domestic product between now and the year 2005. This implies a rate of growth of 7 percent a year, slightly more than the growth achieved in the 1960s, and an annual increase in per capita income of over 4 percent. For this to happen, the rate of investment and, therefore, the rate of domestic savings must increase significantly. There must also be a significant improvement in the efficiency of investment.

We know from the experience of several developing countries that an increase in public savings contributes significantly to increasing domestic savings. Government revenues, and hence government savings, can only increase if the fiscal system, including the tax administration, is overhauled. We also now appreciate that a redefinition of the economic role of the government one that removes it from the management of the economy's productive asset contributes significantly to improving productivity.

Second, serious attention needs to be given to rebuilding the institutions that have either perished or are in a state of serious disrepair. Institutions and here I use the term in its broadest sense to include the system of administration, the legal and judicial systems, and political parties are needed to mediate between the rulers and the ruled. Institutions transmit information between different segments of the society and provide opportunities to settle disputes; in sum, institutions substitute the rule of law for the whims of politicians.

Third, Pakistan needs to revive the agriculture sector, which, despite all the developments that have taken place in the past, remains the mainstay of the economy. Pakistan's agriculture needs

another paradigm shift because the factors that contributed to its remarkable growth in the past have now been nearly exhausted. Not much land remains uncultivated, nor does there remain much new water to be channeled into irrigating the fields. Few new technologies are left to be adopted. What is required is a fundamental change in the incentives provided to farmers.<sup>11</sup> Pakistan needs a market-based agricultural system rather than a system in which, over a long period of time, price and tax distortions have piled up to the point that the real potential of the agricultural sector has been totally camouflaged. The time has come to do away with subsidies on such agricultural inputs as water, seeds, and chemicals; allow farmers to obtain full market prices for their outputs and gain access to the full options to trade in the domestic and international markets; and allow the state to tax agricultural incomes, as it does incomes from any other economic activity.

11. For a new development paradigm for agriculture in Pakistan, see Faruquee, Rashid. *Structural and Policy Reforms for Agricultural Growth*. Washington, D.C.: World Bank, 1995.

Fourth, the government must encourage the economic structure to move toward greater equality in the distribution of physical assets, land in particular. What is needed is not another land reform of the types attempted by Ayub Khan in 1959 and Zulfikar Ali Bhutto in 1974, but the development of efficient land markets. For that to happen, the *patwari* (an official responsible for maintaining records on land ownership) system will have to be replaced by a modern system of land administration. At the same time, a combination of property and urban land taxes can be designed to discourage the wasteful use of scarce land in the country's crowded cities.

Fifth, the functions of the government should be decentralized so that they respond effectively to the wishes and aspirations of the people. A viable system of local and city government should be built to provide people with such basic services as health and education, police protection, and an inexpensive system for the settlement of disputes.

Sixth, a comprehensive program needs to be formulated to help the women of Pakistan achieve their economic potential. Women's rights should not be judged inferior to general human rights. Women should be provided the opportunity to obtain an education and enter the work force. A society that condemns its women to servitude condemns itself to permanent backwardness.

Seventh, the state needs to provide for those who cannot meet their basic needs. With the initiation of the *zakat*, *ushr*, and *baitul-maal* programs, Pakistan has the makings of a comprehensive welfare system, but these programs need to be unified in a single, viable framework.



Eighth, given the increased emphasis on providing health care through forprofit clinics and hospitals, Pakistan needs a health insurance system that ensures access to these institutions even to those who cannot afford them. Such an insurance system can be combined with privately managed pension programs that guarantee that people will have incomes after their working lives are finished.

Ninth, a sturdy safety net should be erected to catch the people who are likely to fall into poverty as the economy restructures itself. Pakistan is unique, even among the poor countries of the world, in that it does not have any formal system to assist people who suffer the job losses or serious declines in income that are the inevitable consequences of economic transformation.

Tenth, and finally, Pakistan can no longer postpone the development of a comprehensive program to provide basic education, primary health care, and the opportunity to control family size to all its citizens. The Social Action Program is a step in the right direction, but the temptation must be resisted to politicize it by providing employment opportunities only to loyal political workers. A number of

Latin American countries have been able to shield such programs from perverse political encroachment by allowing active community participation in their design and implementation.

## Conclusion.

For the third time in its short history, the Pakistani nation has reached the point where its leaders or a leader need to make the big offer.<sup>12</sup> What I have in mind is one of those rare occasions in which nations make real revolutions, when a leader or group assume power on the strength of ideas that represent a fundamental shift from the status quo, to solve an exceptionally difficult problem. Twice in its brief history, the Pakistani nation has been galvanized by such big offers. The first opportunity was grasped by Muhammad Ali Jinnah, in 1940, when he suggested the idea of creating Pakistan to solve what the British called India's Musalman problem. Zulfikar Ali Bhutto made the second big offer in our history when, in 1971, he brought new life to a defeated nation by promising the poor, the disadvantaged, and the disenfranchised new opportunities in a restructured Pakistani society. Now is the time for another big offer, another revolution. Without it we are in the danger of losing Jinnah's legacy.

12. The term big offer is borrowed from a recent work on the American political system. See Pinkerton, James P. *What Comes Next: The End of Big Government and the New Paradigm Ahead*. New York: Hyperion, 1995.

PART III  
GLOBALIZATION, FINANCIAL CRISES, AND  
VOLATILITY

## PART III

### GLOBALIZATION, FINANCIAL CRISES, AND VOLATILITY

A Great Deal has Been Said and Written in Recent months about globalization and the benefits it brings to the countries that have become associated with the global system. But the growing body of literature has not dealt extensively with how developing countries are affected directly and indirectly by globalization. The speeches included in this section attempt to address some of the mixed consequences of globalization in the developing world.

Globalization is understood in many different ways. My own interpretation is simple: I view globalization as a process that guides exchanges among countries on the basis of global, rather than national, rules. Some of these rules such as those governing trade are formal. The most important achievement of the Uruguay Round was to set up a rules-based framework for trade among nations. Any infringement of the rules can lead to adjudication and the imposition of penalties. An elaborate system is being devised to develop organizations for enforcing this rule-based structure.

The field of global finance remains much less regulated, however, in part because of the rapid changes occurring in it. A call for better regulation of the system is issued whenever a major country or group of countries is thrown into crisis. In recent months, we have heard a great deal about the need to develop a new financial architecture. However, it seems extremely unlikely that world financial leaders will develop the political will needed to establish

a new set of rules and the supporting organizational structure to guide the flow of finance among nations. This is fortunate. Any set of rules and organizational structures crafted during a period of flux would be short-lived. And we are currently experiencing a phenomenal degree of change in the way global finance is evolving.

If a new system of rules cannot be devised, is there a way of protecting the developing world from the ill effects of globalization? I explore this question in the selection of seven speeches included in this section. The first one is based on a short address at the closing session of the Annual World Bank Conference on the Development of Latin America and the Caribbean (ABCD-LAC) held in El Salvador in June 1998. The conference focused on the need for institutional development. I suggested that the present situation in the developing world

could be described by drawing a two-by-two matrix that juxtaposed institutions (defined as sets of rules) with organizations that worked within the institutional framework. Looked at that way, we are able to define four quadrants: formal institutions and formal organizations, informal institutions and formal organizations, formal institutions and informal organizations, and, finally, informal institutions and informal organizations. I suggested that the task of development was to increase the area in society that is covered by the first quadrant.

This matrix served me well in attempting to understand the complexity in institutional development that was emerging as the world moved toward systematizing as many inter-country transactions as possible, including trade, capital flows, the exchange of information and technology, and the movement of people, within a clearly articulated framework of rules.

This section includes two other speeches. One, delivered in Budapest to an audience mostly from Eastern Europe, identifies a number of factors that contributed to both weaknesses and strengths in the economies of the countries in the Latin America and Caribbean Region. The other, delivered at the annual meeting on Latin America sponsored by *Business Week*, carried the story forward and focused on the fragility of market perceptions of the major economies of the developing world.

The final two speeches in this section were delivered while I was on my farewell visit to the region in June 1999. The first of these, given at Buenos Aires, suggested that we needed to change the language of our discourse in order to deal with the challenge posed by globalization. The second, given at Valdivia, Chile, inaugurated

the fifth Annual World Bank Conference on the Development of Latin America and the Caribbean.

## Chapter 8

### Globalization: Institutional and Organizational Imperatives for the Developing World

In These Few Pages, I Will Attempt to Provide A contextan analytical frameworkwithin which I hope we may begin to review the relations between developed and developing countries in the post-Cold War world. That context is globalization and the imperatives that it establishes, or reinforces, for institutional and organizational development in the developing world. A major part of what I want to do is look more closely at a number of much-used terms, namely: globalization, institutions, and organizations; and the developing world.

*Globalization.* The term globalization is used loosely: it has been employed to refer to a number of different phenomena, issues, and trends. For the present purposes, I want to propose a definition that encompasses three distinct elements:

First, I believe the term should include the extraordinarily broad consensus that has developed over the past decade and a half regarding the appropriate basic package of policies that countries should adopt to secure a sustainable pace of development. This agreement on a standard set of basic policies often goes under the label of the Washington Consensus. Since the collapse of the communist regimes in Eastern Europe, some analysts have indeed suggested that we can declare that history itself (defined as ideological polarization) has come to an end.

Second, this consensus on the content of policy reforms has



helped encourage the opening of the economies of the Third World to trade, capital flows, and technology transfer. This process of opening has occurred at a fast pace, although there are still constraints to a free flow of some of these factors. Constraints are most obvious where the flow of workers across international borders is concerned. While an easier movement of workers across borders is taking place in industrial countries (e.g., within the European Union), the movement of workers from developing to industrial countries is more likely to be illegal than legal.

The third element in the process of globalization is the consequence of changes occurring within the industrial countries. We need to underscore two of these

changes: first, demographic changes and, second, the redefinition of the role of the state. A profound demographic change in the developed world has brought about a sharp decline in its fertility rate over several decades, as well as an extension in life expectancy. These two trends make for aging populations and rising dependency ratios of retirees to active workers.

When this demographic change is read with the change in the way people now view the legitimate role of the state, we begin to see the relevance of these developments for understanding the phenomenon of globalization. It was not only under Margaret Thatcher and Ronald Reagan that the role of the state was so profoundly redefined. The reform of the welfare system has persisted under Bill Clinton and Tony Blair, putting much greater pressure on individuals and households to take care of their own financial future, including most specifically saving to pay for their own retirement, rather than expecting to rely on state-organized pay-as-you-go pension schemes. Today, a larger proportion of the gross domestic products of the industrial world is flowing into pension and mutual funds than ever before. Global assets of pension funds alone, for example, reportedly grew from \$4.3 trillion in 1989 to \$7.0 trillion in 1994 and their cross-border investments from \$302 billion to \$790 billion over the same period.

Institutional investors' search for high rates of return has taken a significant proportion of global savings to emerging markets largely because of the expectation that rates of return in the new markets in the developing world, even when weighted by risk, will be higher than in the industrial markets. Net private capital flows to

developing countries grew almost sixfold between 1990 and 1996, to exceed \$240 billion in the latter year. The term globalization is thus often used to describe this almost exponential growth in the flow of funds to the developing world.

We need to note three features of this flow of funds between developed and emerging markets. First, the speed of its growth, and the likelihood that notwithstanding what has happened in East Asia since mid-1997 this growth will, in time, resume. Second, its concentration among a few countries. While new destinations are being added gradually to the list of acceptable emerging markets, the fact remains that a dozen developing countries account for four-fifths of capital movements into the developing world, and a score of countries for 95 percent. Third, the ease with which capital can move in and out of emerging markets. This volatility is, in turn, the consequence of three things: the opening of financial markets in much of the developing world, the rapid development in technology and new financial instruments, and at times I would argue the

lack of sound knowledge among the players in the markets about the economic fundamentals of emerging countries. These three features have produced an extraordinary amount of volatility in the flow of funds. It should be pointed out, however, that while capital can move quickly in and out of developing countries, its exit does not necessarily mean that it goes back into the capital markets of the industrial countries. At times these flows go to and fro among different emerging markets.

*Institutions and Organizations:* It is useful to handle together the next two commonly used terms in today's lexicon: institutions and organizations. In so doing, I should be clear at the outset that I feel the underestimation of the importance of institutional aspects has proved to be one of the key missing elements of the original Washington Consensus. By institutions, I mean a set of rules and incentives that affect behavior. By organizations, I mean structures that apply these rules to transactions. Both institutions and organizations can take two different forms and shapes: they can be either formal or informal. Examples of formal institutions are constitutions, legal systems, government regulations, and international treaties. Cultural norms and traditions are examples of informal institutions. Examples of formal organizations are legislatures, courts, financial regulatory systems, and such international entities as the IMF, World Trade Organization, International Labor Office, and the International Atomic Energy Commission. Examples of informal organizations might include extended families, kinship groups, or networks of ex-classmates.

A two-by-two matrix, with institutions on the horizontal and organizations on the vertical axis (Figure 1), provides what I want

to call policy spaces. All four of these spaces are important. The interaction between formal institutions and formal organizations is the policy space in which the Washington Consensus was largely applied. It is also the space in which policy reforms are being introduced as the countries of East Asia deal with their ongoing financial crisis.

The interaction between formal institutions and informal organizations or between informal institutions and formal organizations are the two spaces or boxes where many of the problems relating to poor governance occur. The fourth box (of informal institutions and informal organizations) defines the informal economy in which many of the poorer inhabitants of large Latin American cities principally function, as well as some of the more traditional societies of great interest to anthropologists. The ways in which citizens relate to one another in those aspects of their lives where the formal apparatus of the state is largely absent have come to be defined in recent years by sociologists (and now many economists) as social capital.

		INSTITUTIONS	
		Formal	Informal
ORGANIZATIONS	Formal	Traditional space for undertaking reforms	Propensity for poor governance
	Informal	Propensity for poor governance	Self-regulating, "traditional" systems

Figure 1

Policy spaces defined by the interface between institutions and organizations

The space in the northwestern quadrant of the matrix in Figure 1 is occupied by systems of formal rules and structures at many different levels. In the environment presented by globalization, we should be interested in four of these:

The international level, where institutions such as IMF, WTO, Bank for International Settlements, ILO, the International Atomic Energy Commission, Global Environment Facility, and the still-evolving structures associated with the Kyoto agreement on reducing greenhouse gasses, apply internationally agreed norms and sets of rules.

The national level, at which governments operate structures such as tax and customs authorities, regulatory agencies, courts and legal systems to apply sets of rules and norms on which national consensus has been formed. One important aspect of the globalization phenomenon is that, in many areas, international

norms have begun to impinge on national discretion. There is now increasing consensus about the universality of many international sets of rules. Human rights, nonproliferation of nuclear weapons, and controlling the emission of greenhouse gases are examples of areas where outcomes from purely national dialogue now need to be constrained by the evolution of international norms.

The third level where formal structures apply formal rules is sectoral. This happens in a variety of ways: schools and universities impart formal education, hospitals and clinics provide known and accepted treatment, power companies distribute energy at certain voltages and frequencies, etc.

The fourth level constitutes the formal relationship between national and sub-national governments. National constitutions generally provide, in varying degrees of detail, the sets of rules that govern these relationships. In many cases, important formal structures (such as constitutional courts) exist to ensure that these rules are observed.

*The Developing World:* The term developing world is often used as if there is a homogenous part of the globe that can be clearly distinguished from the developed countries. I want to suggest that this is misleading. In fact, over the last several decades and in particular since the collapse of communism in Eastern Europe two significant developments have occurred. One, the developed world has become more homogenous and better integrated. This has happened for many reasons, among which perhaps the most important have been the rapid development of information and communications technology, travel and tourism, the rise of the global firm, and standardization of product lines. At the same time, though, the developing world has become more heterogeneous. This is partly because of the significant differences in the ways countries have integrated into the global economic system, and also is due to the increasing divergence among the rates of economic growth currently occurring in developing countries, compared to three or four decades ago. Conversely, developed



country growth rates have converged.

It may be useful to divide the developing world into three categories. First come those countries that are being increasingly incorporated into the global economic system. This group includes most of those in East Asia, several Latin American countries, and some in Eastern Europe. Countries in the second category are being increasingly marginalized. Most of the countries in Sub-Saharan Africa, some in East Asia, and also some in Central Asia belong to this group. The third group falls between the other two; this is where modernization and backwardness co-exist. Much of South Asia, North Africa, and the Middle East belong in this category.

Why draw this distinction among the countries of the Third World? This typology helps us to define the emerging relations between the industrial countries and the developing world. A schematic presentation (Figure 2) helps to identify the principal areas of focus in the relations that exist between the developed world and, in turn, each of the three groups of countries we identified above. By implication, it also underscores the remarkable change that has occurred in these relations since the collapse of communism in Eastern Europe and the Soviet Union.

FIGURE 2

Globalization and evolving relations between developed and developing countries

	NATIONAL	SUBNATIONAL
THE DEVELOPING WORLD		
	International financial markets	
	International financial regulatory systems	International finance (municipal finance)
Countries integrating in the global system	New world trading rules	Provincial/state reforms
	Global environmental regulations	
	Labor laws	
	Official capital flows	
	New world trading rules	
Intermediate countries	Labor laws	
	Nuclear nonproliferation	
	Concessional assistance	International nongovernment organizations
Marginalized countries	Capacity building	Social capital formation

Developed country governments and the private sector now look at the developing world not through the old ideological lenses, but through more pragmatic lenses that focus both on upside opportunities and downside apprehensions.

Finally, I want to point to another aspect of Figure 2 the fact that it

further subdivides issues into those that take place at the national level and those that occur at the sub-national level. It is important to view developing countries at these two levels since many national governments remain weak; some are even weakening. In India, for instance, many international players are ignoring the federal government and going to the subnational level. This is particularly true of the

software and information industries. If we move from the search for opportunities to the area of fears and apprehensions, we need to note as an illustration of the fear that, in extreme cases, collapse of the state can produce massive migration of people. The Western countries realize that a significant number of migrants would choose them as destinations. The United States' concern about developments in Haiti is motivated in part by this fear, which is why there is such a great deal of interest in working with nongovernmental organizations and building social capital to preserve social stability even in the presence of economic difficulties.

*Conclusion:* By way of conclusion, I would like to offer the following four assertions:

One, the process of globalization defined in the broad terms used in this presentation will continue at a rapid pace. However, it will not affect the developing world evenly. It will be of great significance for the first category of developing countries, while it will continue to increasingly marginalize the third.

Two, globalization is likely to continue to be associated with volatility in the developing world. The type of crisis we saw in Mexico in 1994-95, and are now witnessing in East Asia, will continue to occur with frequency unless the developing countries turn their attention to institutional and organizational reform. The big mistake made in the late 1980s and the early 1990s was to assume that policy change as implied by the Washington Consensus could produce positive results without much attention being given to institutional and organizational reform and restructuring.

Third, there are important synergies to be obtained by moving at the same time at all four levels of institutional and organizational reform: international, national, sectoral, and subnational. There is a tendency to address each crisis by looking at the institutional and organizational changes that seem most relevant at that time. As globalization proceeds, it is important to adopt a more comprehensive and holistic approach.

Fourth, I should point to a little noted trend in recent human history when looked at from the perspective of institutional and organizational development. As the global community has faced crises, it has sought institutional and organizational responses principally at the global and the national level. The creation of the United Nations, the Bretton Woods sisters, and the General Agreement on Tariffs and Trade constituted the international set of responses. The New Deal in the United States, the welfare state in the United Kingdom, and, much later, the adoption of the Washington Consensus are examples of national sets of responses. While the international and national levels may indeed be the right place to start, we should not forget the third level of response, namely the relationship between

subnational communities and the nation state, and the issues related to decentralization. This is a set of issues to which not much attention has been given. Yet, a recent article in the *Washington Review* reminded us that the global political system of some 180 states overlies another level of 500 or even 1,000 potential states among entities that possess some sort of distinctive regional identity. The danger that the pressures of globalization may encourage a process of fragmentation along these lines is one of the downside risks to which, arguably, too little attention has been paid.

## Chapter 9

### Latin American Economic Crises and Prospects<sup>1</sup>

Latin American and Caribbean Countries are Increasingly functioning in an open global economy. Globalization creates new opportunities, but also as we have seen over recent months new sources of risk and vulnerability.

Latin America's opening up occurred initially as a result of conscious decisions by policy makers to abandon earlier, discredited models of inward-looking development. The new model adopted by most countries of the region emphasized unilateral trade liberalization, opening up to foreign direct investment, and allowing foreign financial institutions to establish local operations. These decisions were sound. But once a country starts to open up to the global economy, the process develops a logic and momentum of its own. Not all of the implications of globalization were clear when the process of reform began. In today's presentation I will point out that, while globalization has many benefits, it also has costs. Benefits should be realized but, at the same time, the costs of globalization should be kept to a minimum.

Today, I will look at some of the key challenges facing Latin America as it functions in the new global economy. Let me address seven related subjects:

First is the continuing need to take advantage of globalization while protecting against volatility.

Second, the factors that contributed to the recent difficulties in Brazil, as an illustration of how globalization can throw a very glaring light on the faults in economic (as well as political) systems.

Third, the problems of poverty, income distribution, and the vulnerability of the poor to the shocks delivered by globalization.

Fourth is the need to reinforce the momentum toward growth.

1. Speech delivered at the conference on Integration Processes in Central Europe and Latin America and Prospects for Inter-Regional Links sponsored by the Inter-American Development Bank and the Hungarian Development Bank, Budapest, January 29, 1999.



Fifth is the importance of institutional change in the Latin American region.

Sixth, the need for a new development framework to design strategies that maximize growth while promoting social development.

Seventh, the long-term prospects of the region.

*The continuing need to take advantage of globalization while protecting against volatility:* Latin American economies began to open up in the 1980s in response to their debt crises. This change was part of a process that generally carries the title of the Washington Consensus, although most of the reforms undertaken were developed by Latin American policymakers themselves.

Reforms involved four things: reducing tariff rates on external trade, allowing financial institutions much greater freedom to operate without government interference, reducing the state's presence in asset management, and transparency in conducting economic policies, in particular those involving international markets. These policies brought macroeconomic stability to the countries that adopted them, including an end to hyperinflation. They also attracted great amounts of foreign capital an important development for a region that suffered from low rates of domestic savings. But globalization made the countries that failed to fully accommodate this new development paradigm vulnerable. There was an expectation that countries that wished to participate in the rapidly expanding global economy would play by the rules of the game, most of which were established by the markets. Developing countries should have recognized that their performance would be watched closely by the global markets, and that any major

departure from observance of the new development paradigm would be costly. This message was reinforced in the winter of 1994/95, when Mexico failed the market test spectacularly on three counts. It mismanaged its economy by allowing its balance of payments deficit to grow to unsustainable levels, financed the deficit in nontransparent ways, and allowed its financial sector to conduct its affairs without adequate oversight. The result was a severe loss of confidence in Mexico by the global financial markets, and Mexico was thrown into a deep economic crisis.

The Mexico crisis of 1994/95 was the first real indication of a new development: international markets would be exceedingly unforgiving if they spotted weaknesses in economic systems or had doubts about the way they were managed.

Latin American countries have done a great deal to shore up their economic defenses. In most countries, overall fiscal discipline has been substantially tightened. Financial systems have also been reinforced. This progress took place while the attention of the markets was focused on another part of the globe—East Asia. At the heart of the East Asian crisis was weakness in financial sectors that were responsive to the imperatives of the region. Analysts called it crony capitalism,

from which Mexico had also suffered. But the Latin American countries had learned their lesson from the Mexico crisis, which helped shield the region from the worst impacts of the Asian and Russian crises.

But, as the developments in early 1999 in Brazil reminded us, there is no room for complacency. In a world of volatile capital flows, the defenses built up to protect domestic economies need continued reinforcement. Weaknesses are noticed quickly. Once the markets begin to take active positions, they cannot be resisted: Brazil lost \$7 billion of its reserves in less than a week attempting to protect the value of its currency, the real. It was clear that the situation in Brazil, produced by a progressive loss of confidence on the part of the markets, could not be sustained for long. The government had to act and it did, and this brings me to my second point.

*What are the causes of the recent turbulence in Brazil?* This question is being asked largely because of what has happened in Brazil over the last few weeks. It is, therefore, useful to put the Brazilian story in its proper perspective. The Real Plan adopted by Brazil in the spring of 1994 was aimed at bringing hyperinflation under control by creating a new currency and pegging it to the U.S. dollar. The program was a spectacular success in that it brought down the rate of inflation from 50 percent a month in the spring of 1994 to a little more than 1 percent for all of 1998. In fact, as 1998 was drawing to a close, some analysts began to fear that Brazil might be moving toward deflation.

This success notwithstanding, the twin crises in East Asia and Russia created serious doubt in the markets regarding the viability

of fixed, or pegged, currencies. Most East Asian countries and Russia had attempted to keep their currencies firmly pegged to the dollar. The markets, having determined that these economies' fundamentals could not justify the rate at which their currencies were pegged, decided to test the resolve of the authorities. The markets won, and East Asia and Russia saw dramatic declines in the values of their currencies. The fate of the pegged currency systems in Russia and Asia focused attention on the exchange rate policy being pursued by Brazil. There were two perceptions: the markets saw the real as overvalued by some 25 to 30 percent; the Brazilian authorities saw it as appropriately priced within the band in which it was pegged. The markets' perception was grounded in the belief that large, open economies cannot operate fixed or crawling pegged exchange regimes especially those unable to control fiscal deficits or with large balance of payments deficits. Moreover, there was an impression that real wages in Brazil had continued to increase even when inflation had declined precipitously, and thus had resulted in the overvaluation of the exchange rate. The government's perception of the eco-

economic situation was quite different from that of the markets. It was believed that there had been an impressive increase in total factor productivity that could accommodate some increase in real wages without hurting the competitiveness of the economy. The clash of these two perceptions came to a head in the fall of 1998.

The international effort, led by the IMF and supported by the multilateral development banks and the BIS, was structured on the assumption that, with some augmentation of the Brazilian foreign exchange reserves, it should be possible to strengthen the main pillar of the country's stabilization program: a pegged currency. However, the additional resources put at the disposal of the government by the international community—some \$41.5 billion—could not possibly match those the markets were prepared to deploy once they became agitated about Brazil's situation. The markets were not so much disturbed by the country's deteriorating fiscal situation, as they had been aware of the Brazilian fundamentals for a long time. It was a series of political events that shook the confidence of international players. The markets' nervousness increased enormously with the decision by the governor of one of Brazil's largest states not to service his state's debt to the federal government. Also, the Congress defeated a bill designed to reduce the burden on the government for making generous pension payments to state employees. Nervous and agitated markets beat a hasty retreat from the Brazilian currency. In these circumstances it was wise for the government to abandon its exchange rate policy while the central bank still had sizeable reserves left on its books. In the four-month period preceding the decision to float the real, the central bank lost \$40 billion trying to defend the value of the currency, but it still had about as much left

when the float was initiated.

The situation Brazil faced did not necessarily result from endogenous economic factors, as had happened in East Asia and Russia. Brazil was dealing with foreign markets that had become extremely sensitive to negative developments. In Brazil, the negative developments that caused the markets to panic were almost entirely political: a state governor unwilling to work with the central authorities and a Congress still not prepared to abandon its narrow parochial interests. These events in Brazil underscored two important points about the consequences of globalization. First, in any clash between domestic perceptions and the perceptions of the global markets, the latter is bound to win. It is, therefore, extremely important for policymakers in developing countries to work aggressively and continuously to keep the markets fully informed. Second, operators in the markets are as sensitive to negative political developments as they are to poor economic fundamentals so it is as important to work against producing political surprises as it is to keep the economic fundamentals on track.

I draw one large comfort from the way events have unfolded in Brazil. For some time now, Brazil was an outlier in terms of adopting all the structural reforms associated with the Washington Consensus. Governments in the region have in the last decade moved toward open market systems, brought fiscal deficits under control, and begun to follow flexible exchange rate regimes. Some of the recent policy changes in Brazil, and some others being actively debated in the country's Congress, should create fiscal and monetary systems comparable to those being pursued, with some success, by other large economies in the region.

While Brazil is introducing a number of fundamental changes in the way it manages its economy, it must take cognizance of their impact on the poorest segments of the population. The evolving economic situation cannot cause unbearable pain for the poor and remain politically viable. This brings me to my third point.

*The problems of poverty, income distribution, and the vulnerability of the poor:* Volatility is one of the unhappy consequences of globalization, and volatility is particularly bad for the poor. Globalization gathered momentum just as Latin America was beginning to address the problems posed by persistent poverty. At the present time, something like 35 percent of Latin America's population lives on less than \$2 a day; about 20 percent are counted as the absolute poor, with incomes of less than \$1 a day. The region's income distribution is probably the most unequal in the world. Only recently have we seen indications that the incidence of poverty is starting to inch down, following its disastrous increase during the lost decade of the 1980s.

To comprehend how the poor are affected by the changes that

occur as a result of globalization, it is useful to divide disadvantaged people into two broad categories:

First, there are those who live on the edge, always vulnerable to moving into poverty at times of cyclical downturns. They constitute about a quarter of the total population. They suffer as a result of losing jobs or from loss of income from informal sector enterprises. But, correspondingly, they are likely to be lifted up out of poverty when the economy does well. A case in point is what happened in Mexico during the peso crisis of 1994-95, when millions of people who had graduated out of poverty became poor once again as the economy slowed down. It had taken half a dozen years of sustained growth to move these people out of poverty. It took a few months of economic crisis to throw them back into poverty.

Second, there are those suffering under longer-term structural handicaps. Economic literature identifies them as the absolute poor. Cyclical upturn by itself may do relatively little for these people. They may be members of indigenous



groups, or they may be of African descent. Often, they are women in poor households living in remote, resource-poor rural areas. Or they may be youth in areas of high crime. For this group of poor, it is only sustained growth and policies aimed at improving human resources that work to improve their well-being.

Globalization creates both opportunities and risks for the poor. There are farmers in parts of Central America, for example, who are finding new opportunities to diversify into high-value, nontraditional crops for export markets. But there are other poor people who may lose what they already have as a result of heightened shocks from the external economy. In the immediate short term, Latin American countries must strengthen their social safety nets. This needs to be done to help those living on the margin to get through the difficult times without losing everything; without for example taking their children out of school, when we know they may never go back.

Over the long run, however, only a high rate of sustained growth will reduce the levels of poverty and, at the same time, reduce economic volatility. This is my fourth point.

*The need to reinforce the momentum toward growth:* We now know that growth in gross domestic product is helped by two factors: growth-promoting policies and investment in human capital. Washington Consensus reforms have indeed raised growth, perhaps by about 2 percent a year, but nowhere in the region (with the sole exception of Chile) have we seen the sustained levels of growth needed to make a real dent in the incidence of poverty. We know from the experience of other developing countries, including those in East Asia, that growth rates two to three times the rate of

increase in population are required to tackle the problem of poverty on a sustainable basis. Why have the reforms adopted in Latin America not achieved a higher rate of growth?

A large part of the explanation can be found in the lack of effective attention to the development of human resources. Latin American countries have, it is true, devoted considerable resources to the social sectors, including education, and the level of resources committed is not necessarily less than in other regions, such as East Asia. But the results in the form of educational achievement do not reflect this. This is so in large part because of the intrusion of populist politics. A significant proportion of expenditures for education and health were used to provide employment for people who were not well trained to perform the jobs for which they were recruited, but who were hired because of the political benefits seen in their employment by the people and parties in power. We have been made familiar with the presence of hundreds of thousands of ghost teachers on the payroll of the Brazilian educational system. They were put there by politicians

eager to provide benefits to their constituents. That Brazil today faces a serious fiscal problem is in large part due to the inflated number of state workers. Also, generous politicians generous at the expense of the state were happy to pay these workers large pensions, creating another burden for the government's finances.

There are, therefore, many facets to reforms, not all of which were included in what has come to be labeled the first generation effort. The region must vigorously pursue second generation reforms, the most important of which is the reform of institutions.

These observations lead to my next point.

*The importance of institutional change:* Broadly, second generation reforms involve achieving effective institutions. There are several examples:

Schools that really deliver a modern education, equipping all children to function in a globally competitive economy.

Enforceable property rights and contracts: secure title to land for the small farmer or for the family living in a favela, who want to improve their home.

Affordable and transparent systems of justice and dispute resolution.

Government services that really serve the people instead of extracting bribes and wrapping small businesses in red tape.

Regulatory systems that cover a number of areas of economic activity: systems that ensure competition among participants and provide a reasonable amount of protection to consumers.

We know, again, from experience, that finding ways to deliver on these demands will not be easy. But there are some areas of promise:

In El Salvador, local communities, including parents, have been empowered to run the schools and hire and fire the teachers, with salutary results.

Brazil has instituted reforms to ensure that all states receive a minimum amount of support for education based on their population.

All across the region, power has been accruing to elected local governments; this can be a source of risk, but also of promise.

In Bolivia, the government is working to create an integrity system designed to improve standards in public life.

What these all have in common is that the basic political impetus for change must come domestically, from within the country. With that present, though, there is scope for outside partners to play a significant supporting role.

This brings me to my sixth point.

*Articulation of a new development framework:* One way of bringing all these developments together is to work in the context of what in the World Bank is now

being put forward as the New Development Framework. This was first enunciated by World Bank President James Wolfensohn, in his address to the 1998 annual meetings of the Bank and Fund. This framework aims to develop a vision over the long term, based on strengthening not only the finances of a country, but also its human capital and institutional base. It is also aimed at improving the instruments of governance. And it seeks to bring all actors operating on the development stage in a country to work from the same script. Working together in such a way, we should be able to take maximum advantage of the opportunities offered by the global markets, development finance institutions, open trading systems, the dynamism of the civil society, and the commitment of a new generation of leaders in Latin America. What is intended is an approach that builds upon globalizationthe rapid integration of the world economy. While it is appropriate to leave micro decisionswhere to invest, how much to invest for how long, and what rate of return to expectto the markets, macro decisions must still involve governments and the people they serve. It is only with this recognition of the linkages between the decisions people and their governments take, and those that motivate the markets, that we will be able to realize the full potential offered by the rapid changes that are occurring around us, which brings me to my concluding point:

*What are the region's long-term prospects?* I believe that most governmentsat least the governments in the large countries of the regionhave set in place policies that should produce sustainable growth rates that are sufficiently high to begin to make a significant dent in poverty. I will elaborate on this point in just a minute. I also believe in three other things: First, that crises offer

very good opportunities for undertaking reforms. They produce a sense of urgency and lower resistance to change, particularly when that resistance is to protect narrow and parochial interests. The fact that in January 1999, the Brazilian Congress moved so expeditiously and so sensibly in areas in which it had procrastinated for so long was precisely because of the apprehension that unless action was taken, the country might head toward an economic meltdown. Second, the weaknesses from which Brazil suffers today can be addressed quickly once there is the political will to act. Some of the structural weaknesses that have kept the Asian countries in crisis for such a long period are absent in the countries of Latin America. To take one example, Latin American companies are, on average, far less leveraged than their Asian counterparts. In fact, they are also considerably less leveraged than companies in Europe and the United States. The average debt-to-equity ratio for Latin America is of the order 35 percent. This is equivalent to a Standard & Poor's rating of AAA. By contrast, the ratio for Korea, Japan, and Thailand was in the 140 to 160 percent range, equivalent to a BB or B rating.

Third, as demonstrated by Mexico following the crisis of 1994-95, countries in Latin America have policy instruments in place that help them to recover quickly from crises of the type that are the result of globalization.

Largely as a result of these policy initiatives, growth rates had begun to pick up in Latin America before the region was visited by the shock waves produced by the crises in East Asia and Russia. There was a near doubling of the average growth rate in 1991-96 compared to 1980-90. In 1980-90, the average rate of growth (weighted by GDP) was only 1.8 percent a year—about equal to the rate of growth of population. In 1991-96, it rose to 3.5 percent a year. After dipping below 1 percent in 1995 because of the crisis in Mexico, growth picked up to 3.5 percent in 1996 and 5.6 percent in 1997. In fact, 1997 was the best year for the region in nearly two decades, and it appeared that Latin America was finally on the way to achieving high levels of growth performance. As I have already indicated while discussing the case of Brazil, a large part of the blame for the slowdown in Latin America's growth is not because of internal problems but is mostly due to developments outside its borders. In 1997, most fundamentals for the region looked good. For a region notorious for hyperinflation, the average rate of price increase had moderated to 11 percent in 1997 compared to an average of 700 percent a year over 1986-90. The average nonfinancial public sector deficit had declined to below 3 percent of GDP in 1997 compared to over 20 percent for 1986-90. There were palpable improvements in such public services as basic health and primary education. As a result, the incidence of poverty had begun to decline.

I believe that, after a pause of a year or two, the region will not only return to these trends but could significantly improve upon them. There is a good likelihood that we will see an improvement in several economic fundamentals in the first few years of the 21st century. In fact, with some of the recent initiatives taken by Brazil, it can be argued that the region's largest economy has joined the ranks of the rapidly reforming economies in the area. By tolerating high fiscal deficits while maintaining a pegged exchange rate, Brazil in recent years was not in line with other major economies of the region. It has now begun to close this policy gap.

Latin America also is actively engaged in implementing second generation reforms. These reforms concentrate on institutional improvement and development, with a view to improving the quality and effectiveness of educational, health, financial, judicial, and legal systems. The region also faces a highly favorable demographic transition in the next two decades as declining rates of fertility reduce dependency ratios. This should create the right environment for improving domestic savings rates. The first step toward this goal establishing pension



funds in the private sector has already been taken by a number of countries. In fact, in the area of providing social security through private initiative, Latin American is a pioneer. Many countries in the region are already working with the devices that were mentioned by President Bill Clinton in his 1999 State of the Union address as possible ways to cure the problems faced by the U.S. social security system. Taken together, these positive developments lead me to expect that Latin America may well be the fastest growing region in the world in the first decades of the next century.

## Chapter 10

### New Initiatives to Tackle International Financial Turmoil: A Comment<sup>1</sup>

It is a Great Honor to Be Asked to Provide Some Closing comments to this important seminar. I read with great interest the three papers prepared for this meeting. I listened with equal interest to the discussion among the two sets of panelists. The papers and the discussion underscored a number of important points, all of which are relevant to the situation we face today. If I were to pick some of the more critical themes from this morning's discussion and the papers prepared for the seminar, I would highlight the following five:

One, in a highly interdependent world in which large volumes of capital move across borders, even minor policy infractions can cause severe disturbances. These disturbances are usually caused by a sudden loss of confidence on the part of international financial markets in one, two, or several developing economies.

Two, I must differ with Angel Gurría, Mexico's very able finance minister, who suggested that, while markets can react quickly, moving large amounts of capital back and forth, they have not learned to be more discriminating. This was the case some time ago. The debt crisis of the early 1980s engulfed the entire developing world. Even the crisis caused by the devaluation of the Mexican peso in December 1994 produced waves that reached many shores. The markets now have more knowledge about the Third World and are able to differentiate among developing

economies. It is for this reason that we did not see contagion spreading in Latin America in early 1999. The markets punished only those countries they perceived as having weak fundamentals.

Third, the markets dislike disequilibria; they have reacted vigorously and punished heavily the countries that ran large fiscal or external imbalances while attempting to constrain exchange rate movements. Once the markets decided to move, no amount of reserves, even when they were augmented by relatively large

1. Comment made at a seminar on New Initiatives to Tackle International Financial Turmoil at the Annual Meeting of the Inter-American Development Bank, Paris, March 14, 1999.

international support packages, were able to turn the tide. This was the experience of Brazil, and it will happen again to those countries that stray seriously out of line.

Fourth, these crises and they seem to be coming more frequently and leaving a deeper impact on the affected economies take a heavy economic and social toll. Years of progress, especially in reducing the incidence of poverty, can be wiped out in a few weeks or months. Some people now argue that it is not certain whether the net benefit from easy access to foreign savings, when calculated over a number of years, is positive or negative for the countries that have lived through these crises. Implicit in this argument is the thought that the economic openings of the last dozen or so years may not have been entirely beneficial for the countries that opted for this approach.

Fifth, and finally, international financial turmoil cannot be allowed to persist. The cost of inaction is great, and governments around the globe must act in concert to erect a new financial architecture on a more solid and durable foundation.

These, then, were some of the more important arguments I picked up from reading the papers and listening to the views of the panelists. In response to them, I would like to offer five points of my own. First, I believe that there is little point in fretting that the new global economic system has created an environment in which emerging markets have become subject to crises that arrive at ever-increasing frequency. What the organizers of this seminar have termed the *international financial turmoil* is now a fact of life. It will persist for as long as the policies pursued by some countries especially such large economies as Brazil run counter to

those the markets perceive as rational and prudent. A new financial architecture cannot be erected upon a weak policy foundation; it cannot overcome the financial markets' aversion to risk.

Second, I would like to suggest that no amount of thinking by the governments, of whatever group of countries G-7, G-8, G-10, G-22, or G-whatever will be able to build a new architecture. The new structure will evolve more or less spontaneously, in response to the challenges posed by the rapid evolution of a highly integrated global economy.

The belief that the solution for the current turbulence in the global economic order must come from active deliberations among governments has, of course, many powerful antecedents. Those who advocate it are no doubt thinking of the days of the conference at Bretton Woods, when a few clever individuals, working overtime, were able to devise a new financial order for the postwar world. The Bretton Woods system worked well in bringing stability and growth. If it could be done then, goes the argument, why cannot it be done now? The same belief in the

ability of governments to fashion a new global economic order prompted a number of developing countries to agitate in the 1960s and 1970s for the establishment of a new international economic order (NIEO). Industrial countries were drawn into the NIEO dialogue largely because of the imperatives dictated by the Cold War. Eventually nothing came of it even the commitment by the industrial world to transfer 0.7 percent of their collective GNP as official development assistance did not prevent the precipitous decline in those flows in recent years.

My third observation builds on the second. Those of us who were active participants in the NIEO debate a quarter century ago should look around and notice that a new international economic order has in fact emerged. However, it was not produced by the political will of governments, but by the needs and perceptions of the marketplace. If I were to pick three groups of actors that have contributed more to the emergence of the new global order than any others, they would be central bankers, financial regulators, and credit agencies. They have already laid the foundation of a new financial architecture and will continue to build upon it, brick by brick, to meet market demands. If governments want to act, they should prompt and facilitate the work of these agents of change.

The fourth point I would like to underscore is the need to recognize that markets form judgment not only on economic fundamentals, but also on the political environments in which policy makers operate. A very good illustration of this is the recent developments in Brazil. It had been recognized, for a while, that Brazil was running fiscal deficits at a level at which they could not be sustained. However, President Fernando Henrique Cardoso's

decisive election victory in the fall of 1998 persuaded the markets that the Brazilian authorities had the political resolve to begin to address the structural problems that had kept deficits so high for so long. That confidence suddenly eroded in early 1999, when a governor from a large state declared that his state was unable to service its debt to the central government. The market's reaction to this unexpected development was swift and unforgiving.

I now come to the fifth, final, and more speculative point of my presentation. The debate about the most viable exchange rate regime in emerging markets is now intense. Earlier today, Ricardo Hausmann, the chief economist of the Inter-American Development Bank, summarized well the main points of this debate. Hausmann believes that empirical evidence shows that both fixed exchange and fluctuating exchange rate regimes are costly for the countries of the Latin America region. He is now in favor of dollarizationa regime in which local currencies are abandoned in favor of the U.S. dollar. The recent Brazilian move to abandon a tightly controlled rate for its currency has provided some more evidence for those

who believe that in today's global financial environment, maintenance of fixed rates is no longer an acceptable option. While policymakers in the developing world are agonizing over the question of the efficiency of various types of regimes, there is another development taking place that needs to be factored into this debate. I am referring to the move toward the formulation of large currency blocs. The success of the euro has demonstrated that it is possible for reasonably well-integrated, converging economies to adopt a common currency. Might not similar developments take place in the Western Hemisphere with the possible dollarization of Argentina, Ecuador, and Central America? If the countries of the Western Hemisphere succeed in meeting their goal of forming a free trade zone in the next few years, might that not be the first move toward adopting the dollar as the common currency by the entire region? If Europe and the Western Hemisphere move to adopt common currencies, would this not induce East Asia, including Japan, to adopt one as well? If the Asians move in that direction, would they favor the yen as the currency of choice, opt for the Chinese renminbi, or introduce an entirely new currency?

My guess at this point is that, in the next couple of decades, we will see a move toward fewer currencies and toward the formation of large currency blocs. By the year 2025, we might see much of the industrial and semi-industrial worlds organized into just three currency blocs—the dollar, the euro, and the yen/renminbi.

The best way to wrap up this discussion is to pick up some thoughts from the presentations made by the members of the first panel. The only practical and pragmatic way of dealing with the



profound changes taking place in the structure of the global economy is not to impose on it a new architecture. Instead, what is required is to balance the profound changes that have already occurred in the global economic and financial system with an equally profound restructuring of domestic economies. Examples of the successful adoption of this approach are to be found in Argentina and Chile. The policy reforms now being contemplated by Brazil will also build on the impressive structural changes that have already been put in place. The main point I wish underscore is that incremental changes should suffice to deal with rapid changes in global markets. A good illustration of this approach is the one highlighted by Pablo Guidotti of the Ministry of Economy, Argentina, in his presentation this morning. This approach saved Argentina from being buffeted by the turmoil in international financial markets in 199899. It is always tempting to contemplate revolution in response to revolutionary change. The need of the moment instead, I believe, is to devise a careful, incremental policy response aimed at maintaining domestic solvency and ensuring liquidity.

## Chapter 11

### Latin American Economies and the Global Economic Turmoil<sup>1</sup>

The Global Financial Markets' Reading of the Latin American situation in particular the economic prospects of the region's large countries changed significantly in the middle of March 1999, when the Inter-American Development Bank was holding its Annual Meeting in Paris. The change was most tangible in Brazil. For two days, the stock market in São Paulo advanced aggressively, while the value of the real gained by almost 15 percent against the dollar. Consensus quickly emerged among financial experts that Latin America had turned the corner, and that a better future lay ahead for most of its countries. Even the near collapse of the banking system in Ecuador and the assassination of Paraguay's vice president, followed by the resignation of its president, were not sufficient to sour the mood of the markets.

The change in the markets' perception of the region was as profound as the one that had occurred several weeks earlier, when a series of political events in Brazil generated a consensus that it was headed toward a deep economic and financial crisis. Brazil's economic fundamentals did not change in this eight-week period. What changed dramatically was the perception of market operators regarding the country's ability to handle its economic and financial problems. Earlier in the year, the markets saw political confusion; in March, they saw efficiency and competence in the way Brazil was conducting its economic policy. The markets also developed

considerable confidence in the person called upon to manage Brazil's central bank.

The change in the markets' mood about Brazil is no different from what we see in the major financial centers almost every day. Billions of dollars can be added to, or deleted from, the value of the markets depending on the pronouncements of the chairman of the U.S. Federal Reserve Bank, the resignation of Germany's finance minister, or a hiccup in the implementation of the Good Friday Agreement in Ireland. The main difference is that the industrial economies have the depth to take

1. Speech delivered at the 1999 *Business Week* Americas Summit, Bal Harbour, Fla. March 26, 1999.

these shocks. In the smaller and shallower markets of the developing world, the same shocks can produce catastrophic consequences.

This is why many in the developing world clamor for the erection of something commonly described as the new global financial architecture. I will return to this point a little later. For the moment, I would like to underscore the main conclusions that have been drawn by a number of people who have observed the recent economic crises in East Asia and Russia, and the near-crisis in Brazil and other Latin American countries.

If I were to pick some of the more critical themes from the literature that has emerged in early 1999, I would highlight the following four:

One, in a highly interdependent world in which large volumes of capital move across borders, even minor policy infractions can cause severe disturbances. These disturbances are usually caused by a sudden loss of confidence on the part of international financial markets in one, two, or several developing economies. The market's response is usually highly exaggerated. It is certainly not proportional to the event or series of events that may have caused the initial jolt. It has been argued that there is a need to protect the emerging markets from the extreme volatility they have experienced.

Two, while markets can react quickly, moving large amounts of capital back and forth, they have learned to be more discriminating. The much feared contagion has not materialized not in Asia and certainly not in Latin America. While a number of East Asian countries were deeply affected, there were good economic

reasons why the markets turned their backs on them. But they were not always so discriminating. Only a few years ago, market operators did not have the sophistication to tell one emerging market from another. If one was perceived to be a problem, the entire group of emerging economies was regarded with suspicion. The debt crisis of the early 1980s engulfed the entire developing world, good and poor performers alike. Even the crisis caused by the devaluation of the Mexican peso in December 1994 produced waves that reached many shores. The markets now have more knowledge about the Third World; they are able to differentiate among developing economies. It is for this reason that we did not see the difficulties that Brazil experienced spread to the rest of Latin America. The markets punished only those countries they perceived as having weak fundamentals, or faced with intractable political problems.

Third, the markets dislike disequilibria; they have reacted vigorously and punished heavily countries that ran large fiscal or external imbalances while attempting to constrain exchange rate movements. Once the markets decided to move, no amount of reserves, even when augmented by relatively large international support packages, was able to turn the tide. This was Brazil's experience when the

concerted effort launched under the leadership of the International Monetary Fund was unable to help it continue to manage its currency within a band even an expanded band. The IMF, working with the World Bank and the Inter-American Development Bank, had come up with new instruments to save countries from going into crises. These instruments were to be a part of a new approach that sought to prevent crises from happening, rather than dealing with them after they arrived. The markets were not impressed, and Brazil remained under pressure until it abandoned its exchange rate regime.

Fourth, these crises and they seem to be coming more frequently and having a deeper impact on the economies they affect take a very heavy economic and social toll. Years of progress, especially in reducing the incidence of poverty, can be wiped out in a few weeks or months. This happened in Mexico and Argentina in 1995, in East Asia in 1997-98, and was witnessed in Brazil in 1999. Some people now argue that it is not certain whether the net benefit from easy access to foreign savings, when calculated over a number of years, is positive or negative for countries that have lived through these crises. Implicit in this argument is the thought that the economic opening of the last dozen or so years may not have been entirely beneficial for the countries that opted to open their economies.

These, then, are some of the more important arguments I pick up from reading the copious amount of work that is now available analyzing the recent crises in Asia, Russia, and Latin America. In response to them, I would like to offer five points of my own.

First, I believe that there is little point in fretting about the new

global economic system having created an environment in which emerging markets are subject to ever more frequent crises. A turbulent international financial system is now a fact of life. It will persist as long as the policies pursued by some countries especially such large economies as Brazil run counter to those that the markets perceive as rational and prudent. A new financial architecture cannot be erected on weak policy foundations; it cannot overcome the financial markets' aversion to risk, real or perceived.

Second, I would like to suggest that no amount of thinking by governments, done by whichever group of countries G-7, G-8, G-10, G-22, or G-whatever will be able to build a new architecture. The new structure will evolve as it has begun to evolve over the last few years more or less spontaneously in response to the challenges posed by the rapid evolution of a highly integrated global economy.

The belief that the solution for the current turbulence in the global economic order must come from active deliberations among governments has, of course, many powerful antecedents. Those who advocate it are no doubt thinking of the

days of the conference at Bretton Woods, when a few clever individuals, working overtime, were able to devise a new financial order for the postwar world. The Bretton Woods system worked well in bringing stability and growth. If it could be done then, goes the argument, why can it not be done now? The same belief in the ability of governments to fashion a new global economic order prompted a number of Third World countries to agitate in the 1960s and 1970s for the establishment of a new international economic order (NIEO). Industrial countries were drawn into the NIEO dialogue largely because of the imperatives dictated by the Cold War. Eventually, nothing came of it even the commitment by the industrial world to transfer 0.7 percent of its collective GNP as official development assistance did not prevent a precipitous decline in those flows in recent years.

My third observation builds on the second one. Those of us who were active participants in the NIEO debate of a quarter century ago should look around and notice that a new international economic order has, in fact, begun to emerge. However, it was not produced by the political will of governments, but by the needs and perceptions of the marketplace. If I were to pick three groups of actors who have contributed more to the emergence of the new global order than any others, they would be central bankers, financial regulators, and credit agencies. They have already laid the foundation of a new financial architecture and will continue to build upon it, brick by brick, to meet market demands. If governments want to act, they should prompt and facilitate the work of these agents of change.

The fourth point worth underscoring is the need to recognize that



markets form judgments not only on economic fundamentals, but also on the political environments in which policymakers operate. A good illustration of this is the developments in Brazil in early 1999. It had been recognized for some time that Brazil was running fiscal deficits at a level that could not be sustained. However, President Fernando Henrique Cardoso's decisive reelection victory the previous autumn persuaded the markets that Brazilian authorities had the political resolve to begin to address the structural problems that had kept deficits so high for such a long period of time. That confidence was suddenly shattered when former President Itamar Franco, since elected governor of Minas Gerais, declared that large state's inability to service its debt to the central government. The market's reaction to this unexpected development was swift and unforgiving.

I now come to my fifth, final, and perhaps most speculative point. The debate about the most viable exchange rate regime in emerging markets is now intense. The recent Brazilian move to abandon a tightly controlled rate for its currency has provided more evidence for those who believe that in today's global financial environment, maintaining fixed rates is no longer an acceptable option.

While policy makers in the developing world are agonizing over the question of efficiency of various types of regimes, another development is taking place that needs to be factored into this debate. I am referring to the trend toward forming large currency blocs. The success of the euro albeit a bit tarnished by the early slide of the new currency against the U.S. dollar has demonstrated that it is possible for reasonably well-integrated and converging economies to adopt a common currency. Might not similar developments take place in the Western Hemisphere, with the possible dollarization of Argentina, Ecuador, and Central America? If the countries of the hemisphere succeed in meeting their goal of forming a free trade zone in the next few years, would that not be the first move toward the adoption of the dollar as the common currency by the entire region? If Europe and the Western Hemisphere move toward adopting common currencies, will this not induce East Asia, including Japan, to adopt one as well? If the Asians move in that direction, would they favor the yen as the currency of choice, opt for the Chinese renminbi, or introduce an entirely new currency, something patterned on the euro perhaps an asean?

My guess at this point is that, in the not too distant future, we will see a move toward fewer currencies and the formation of large currency blocs. By the end of the first decade of the 21st century, we might see much of the industrial and semi-industrial worlds organized into just three currency blocs: the dollar, the euro, and a common East Asian currency.

I will conclude my presentation by emphasizing that the only practical and pragmatic way of dealing with the profound changes

taking place in the structure of the global economy is not to impose on it a new architecture. Instead, what is required is to balance the profound changes that have already occurred in the global economic and financial system with an equally profound restructuring of domestic economies. Examples of the successful adoption of this approach are to be found in Argentina and Chile. The policy reforms contemplated by Brazil will also build on the impressive structural changes it has already put into place. While the emerging markets adopt what the financial markets perceive as sound policies, the global financial system itself will continue to evolve. The main point I wish underscore here is that incremental changes will suffice to deal with rapid changes in global markets. There is always the temptation to contemplate revolution in response to revolutionary change. Instead, the need of the moment is, I believe, to devise careful, incremental policy responses aimed at maintaining domestic solvency and ensuring liquidity, while adopting regulatory measures to constrain overreaction by global financial operators to unexpected changes in emerging markets.

## Chapter 12

### Volatility, Contagion, and Possible Dollarization<sup>1</sup>

There is Good News Coming out of Emerging Markets, in particular from the countries of Latin America. Brazilian inflation has not picked up as it was expected to do following the collapse of the Real Plan in December 1998. There was a very moderate price increase in April 1999. Argentina, Brazil, and Mexico have returned to the international financial markets with issues the size of which could not have been anticipated a few weeks ago. As the economies of large emerging markets stabilize, it is a good time to look back and review what happened in the last 18 months when, suddenly and unexpectedly, the currency of Thailand the baht came under intense speculative pressure. What happened? is a question that is not very difficult to answer, and I will spend some time describing the way the crisis developed. Why the crisis happened in particular why it spread from one country to another is a more difficult question. And could something like this happen again? is another question that takes us into the realm of speculation. But the question should be answered, as the answer to it will guide policymakers toward the construction of what is called the new financial architecture.

Let me begin by providing a quick overview of what happened over the last 18 months. The story behind the current turbulence should, perhaps, start with the wave of financial liberalization that began in a number of mature Third World economies, most of them in Latin America. One by one, these countries allowed the Washington Consensus to guide the formulation of domestic

economic policies. The adoption of these policies created tempting opportunities for investors in the industrial world who were looking for high rates of return on the capital available to them. In a period of seven years from 1990 to 1997 longterm private investment flows to developing countries increased sixfold, from \$42

1. Text of a speech delivered at Programa Iberalia 99: Encuentro de Economía Global Europeo Iberoamericano, Madrid, May 17-20, 1999.

billion to \$256 billion. They went mostly to East Asia in particular to China and Latin America, especially to Mexico, Brazil, and Argentina. China was attractive because it had a large market starved of basic manufactures. It was also attractive because it had a large pool of well-trained, highly disciplined, and low-wage workers who could staff export industries.

Things were going reasonably well when, suddenly and unexpectedly, international financial operators began to lose confidence in the emerging markets. The stampede out of the markets in the developing countries started in July 1997 in Thailand, where the baht lost 20 percent of its value against the dollar in one month. The IMF assembled a \$17.2 billion package, and the government was persuaded to float the baht. The pressure then shifted to Indonesia. Once again, after a failed attempt to protect the domestic currency, the Indonesian government floated the rupiah and the IMF came in with a package of \$42 billion. All eyes were now on the Republic of Korea, a country that had graduated from the status of an aid recipient to that of aid donor. Like Thailand and Indonesia before it, Korea drained its large foreign exchange reserves to protect its currency, the won. The IMF put together a \$58.4 billion package for the country in December 1997, the biggest such effort ever. Because of the speed with which the crisis spread in East Asia, the IMF came to the conclusion that it would impact other parts of the world. Accordingly, while in October it had predicted economic growth rates of 4.3 percent for 1998 and 4.4 percent for 1999, it revised them downward to 3.5 and 4.1 percent, respectively.

By March 1998, the Thai baht and Korean won had begun to firm

up, but by May, returning confidence was shattered once again, this time by political rather than economic events. Riots rocked Indonesia, killing at least 1,200 people and leaving large parts of Jakarta in ruins. President Suharto resigned after 32 years of uninterrupted rule. While currencies as far away as South Africa came under pressure, the IMF lowered its projection for global growth once again, to just 3.1 percent in 1998 and 3.7 percent in 1999.

In August, speculators turned their attention to Russia, which had seen a precipitous decline in oil revenue, caused by the severe economic slowdown in East Asia. In spite of a \$11.2 billion package put together by the IMF, Russia was unable to prevent a run on its currency. Russian authorities devalued the ruble, unilaterally restructured short-term debt, and imposed a 90-day moratorium on the private sector servicing its foreign obligations. Surprised by the move, the IMF, having disbursed \$4.8 billion, cut off further support to Russia.

The Russian turmoil spooked the markets, and investors began to pull out from all but the safest deals, hurting even the U.S. corporate sector. By

September 1998, there was a real threat of a global meltdown. According to the 1999 Economic Report of the U.S. President, the contagious spread of turmoil from Russia to Brazil and other Latin American countries arguably signaled a degree of financial panic as investors apparently withdrew capital indiscriminately from most emerging market economies regardless of their strength.

But by then the crisis was no longer confined to the emerging markets. Long-Term Capital Management, a prominent U.S. hedge fund built on an investment theory that had won two of its sponsors Nobel Prizes in economics, was saved by the U.S. Federal Reserve from near collapse. A group of large investors were persuaded to put in \$3.5 billion to save the fund from defaulting on its obligations and the Fed lowered its expectations for the performance of the global economy to 2 percent for 1998 and 2.5 percent in 1999. It should be noted that the IMF regards a 1 percent growth rate as global recession. Its repeated reassessment of the global economic situation was moving it to the point of declaring that the global economy was moving in that direction.

The closing months of 1998 brought about two developments. The first of these came in the form of several new initiatives by the major economies to prevent the spread of crisis from one country to another. The Group of Seven endorsed a U.S.-sponsored plan to allow the IMF to lend to countries before a full-blown crisis erupted. At the same time, the U.S. Congress acceded to President Clinton's request to provide the IMF with additional funding of \$18 billion. The U.S. contribution brought an additional \$72 billion from other countries. This additional liquidity in the Fund came in handy because of the second development—a sudden worsening of



international confidence in Brazil. This happened largely for political reasons. The markets had been aware of Brazil's fiscal problems, but had reached the conclusion that President Cardoso's decisive election victory in the fall would result in policies aimed to reduce the pressure on the budget. The decision by Itamar Franco, the newly elected governor of Minas Gerais, a large and important state, not to service his state's debt to Brasilia shook the confidence of international financial players. In handling this unexpected development, the Brazilian authorities made the same mistake their Mexican counterparts had committed four years earlier. For a few days, they thought that they could manage their way out of the pressure on the currency by widening the band within which it was being traded and increasing its slope. When that did not happen, they allowed the real to float and it promptly lost some 50 percent of its value. It took two months of international support and resolute action for Brazil to regain the respect and confidence of the international financial community.

I would like to draw the following five conclusions from the rapid unfolding of events in a period of some 18 months between the collapse of the Thai baht in July 1997 and the sharp devaluation of the Brazilian real in January 1999:

One, we are now undergoing an exceptionally volatile period, during which large amounts of unregulated finance can move into and out of countries.

Two, once markets become nervous, they lose the ability to distinguish among countries particularly among those that are known to have such economic problems as large fiscal and balance of payments deficits. This leads to contagion, as the loss of confidence in one market travels to another.

Three, once the markets lose confidence, it cannot be restored by large international packages of support. The IMF used \$170 billion of its resources in 18 months attempting to restore stability but confidence returned only with domestic action inspired mostly by internal dynamics.

Four, fixed currency regimes are very costly to manage when domestic economic systems are financially open but the markets have lost confidence in them.

Five, markets overreact in both directions, toward the negative as well as the positive. To take one example: the Brazilian economic fundamentals did not change so dramatically as to warrant the wide swing in market perception from highly negative to very positive over the last six months.

The crisis of the last 18 months, therefore, was the result of a combination of a number of developments. These include

emerging markets that had suddenly perhaps too suddenly opened themselves to outside influences and sought integration into a fast-changing global economy. That global economy itself was flushed with liquidity produced in part by demographic change in the developed world and a withdrawal of states from providing assured security to aging populations. The senior citizens in the industrial countries were now looking for returns on capital that were available only in the emerging markets. A number of new institutions hedge funds, investment funds, and the like stepped in to mediate between the returns on investment expected by the citizenry of the industrial world and the demand for capital in the emerging markets.

This brings me to the third question or set of questions that I asked at the outset. Could the type of crises that nearly brought a global financial meltdown last fall happen again? Can human ingenuity prevent the sort of crises that we witnessed in the last 18 months from reoccurring? Would protection against economic and financial crises come from the establishment of a new set of institutions that would become part of a new financial architecture? Would this architecture result from deliberations among the governments representing large economies of

the world? Or would a new set of rules for international transactions involving the flow of funds among nations evolve gradually, and mostly involve understandings among actors operating in the private sector?

Rather than answer these questions one by one, let me make a few suggestions about the way I see the future evolution of the global economy.

I believe that we should change the language of our discourse. It makes little sense to talk about recurrent crises if we agree that we are living in a rapidly evolving economic situation characterized by extreme and perpetual volatility. This volatility affects all financial transactions and not just the flows of funds among nations. It is not unusual anymore to see wide fluctuations in the stock markets of industrialized countries. But the markets in the developed world have the strength to absorb these ups and downs. They are basically resilient. If volatility is going to persist for a while for as long as we do not fully comprehend new economic relationships then how should developing economies protect themselves? They do not have the depth to sustain shocks equal to that of the industrial world.

Developing countries affected by the recent crisis handled it in three different ways. At least one of them, Malaysia, decided to buck the trend toward openness and withdraw into itself. This approach seems to have worked for the moment but it cannot be sustained, especially when other large emerging economies continue to move in the opposite direction. The second approach was to correct the fundamentals if they were seriously out of line with what is now considered to be the right way of managing

economies. What I call the right way also goes under the label of the Washington Consensus. Added to the original consensus is the further understanding that policymakers in the developing world must also adopt second generation reforms. These focus mostly on institutional development, to ensure that economic transactions are carried out within frameworks of rules accepted by all important segments of the society. We can now begin to talk of a third generation of reforms that will see a greater convergence of rules among nations.

The third approach to crisis management has been to let domestic currencies float. It is now recognized that fixed exchange rates will be tested in open economies whenever a perception develops that economic fundamentals are out of line with the expectations or tolerance of international financial markets. Argentina is the only large emerging economy that has chosen not to follow this rule. It has opted, instead, to adopt the currency board approach and let its monetary policy be determined strictly by the quantum of available foreign reserves.

The Argentine approach raises a question as to whether dollarization is the natural evolution of the policy it is following. At this point, the Argentine author-

ities are actively pursuing this idea, arguing that much of the Argentine economy is already dollarized. The uncertainty that remains the fear that, some day, the Argentines may be forced to devalue their peso would be removed if the peso itself were abolished. There are, of course, well-known problems with dollarization the absence of a lender of last resort, the loss of seignorage, the shocks that will be received as a result of changes in U.S. monetary policy which may be very costly for an economy that chooses to follow that approach.

Rather than selective dollarization selective in the sense that a few countries develop the nerve to do away with their own currency I believe we should move toward the creation of regional currencies. We are already at the start of a process that should eliminate a large number of national currencies, most of them floating freely in a fairly chaotic world of international finance. This system could be replaced by the emergence of three common currencies the dollar, the euro, and a common Asian currency. Currency unification has already occurred in Europe, but the process was slow and very deliberate. It could begin to happen in the Western Hemisphere with the expansion of two of the large trading blocs that are already operating there. It is not entirely inconceivable to imagine the move of the Mercosur countries toward a common currency, and then for NAFTA to go in a similar direction. Once these movements have taken place, the entire Western Hemisphere could move toward one common currency and the emergence of the free trade area already promised by the nations of the region for the year 2005. This promise was made at the 1994 Hemispheric Summit held in Miami in December 1994.

By underscoring these developments, I reach my final point. I believe that contagion is another word that may have to be dropped from the language of our discourse. What I described as the main features of the evolution of the 1997/99 crises was not strictly a contagion. It was the increased sensitivity of international financial operators to policy divergences from what they view as the norm. That is why I believe crises will be replaced by volatility, and volatility will be produced by policy lapses.

I conclude by emphasizing that those who are involved in building the new financial architecture for the global economy don't have to go for fancy designs. All they need to do is insist that a few basic rules be observed by all players in the system with the basic rules themselves being subject to change and adjustment as the global system continues its rapid transformation.

PART IV:  
COUNTRIES IN ECONOMIC CRISES



## PART IV

### COUNTRIES IN ECONOMIC CRISES

These Speeches Deal With Crises in Three Countries as well as a category of nations called the small states. By including the long speech on Pakistan, I want to underscore an important point: all developing countries cannot blame their problems on globalization or on the vagaries of the market place. As the piece on Pakistan stresses, the crisis of 1998 was the product of structural reforms that had been postponed for several decades.

The same is true for Mexico, the subject of the second piece in this section. In Mexico, however, the markets reacted with great vehemence once it came to light that the country had relied on short-term, dollar-denominated debt to finance a large and growing current account deficit. The deficit itself was the result of both political and economic policies. Once the markets reacted negatively, they exposed other structural weaknesses, particularly in the financial sector. The manner in which the Mexicans had privatized the banking sector, along with institutional weaknesses that allowed the banks to lend recklessly, exacerbated the problem created by the withdrawal of foreign funds. The Mexican crisis deepened because of the problems with its banks.

The third speech in this section concerns a different type of country crisisone that has been unfolding for a number of years. Cuba is an interesting example of a country that, for the moment, has opted to remain outside the global economic system. The Democratic People's Republic of Korea is the only other country

still going in this direction. This choice made by these countries raises two important questions. One, what will be the long-term consequences for the citizens of these two countries if they continue to stay outside the global system? Two, if they decide to join the global system, what approach should they adopt? I answer the second question in the context of Cuba, arguing that the Chinese model of introducing economic reform before political change is more appropriate for Cuba than is the Eastern European approach, in which the introduction of democracy proceeded at a pace with the adoption of economic reforms. It is my hunch that North Korea will have to choose the Eastern European model as the more appropriate one.

The fourth piece in this section concerns the small states more than 50 in all, with populations of less than 1.5 million each. My deep involvement with the small states understanding the challenge they faced as their external environment changed dramatically began in July 1998, when I was appointed cochair of the joint World Bank Commonwealth Secretariat Task Force on Small States. These countries had to contend with a sharp decline in flows of official development assistance and the unwillingness of major trading nations to grant them preferential access to their markets. The banana dispute between the United States and the European Union served as the backdrop for the deliberations of the task force. My speech to a large audience assembled by the task force in St. Lucia sought to provide an overview of the challenges faced by the small states due to their size, location, history, and the change in their external environments.

## Chapter 13

### The Language of Economic Discourse<sup>1</sup>

The Words and Phrases that are used in the Language of discourse have an enormous impact on the thinking of policymakers and, therefore, on policymaking. Take three words and phrases: contagion, crisis, and the need for a new financial architecture. Ever since the crisis in Mexico in 1994/95 and its effect on Argentina, the words contagion and crisis have been used freely in both academic literature and policy dialogue. The focus of policymakers, therefore, has been on three questions:

How can macroeconomic crises be prevented in emerging markets? The underlying assumption of this question is that emerging markets will continue to be afflicted by the type of crises that engulfed Mexico in 1994/95, East Asia in 1997/99, and Russia since 1997.

How can crises be stopped from spreading from one emerging market to another? In other words, how can contagion be prevented? Here the assumption is that once international financial markets become disillusioned with one country, their unhappiness spreads to most, if not all, emerging markets. In tarring all markets with the same brush, this assumption reveals ignorance of the differences that exist in the economic policy fundamentals in different countries.

What kind of international financial architecture should be erected to prevent crisis and contagion? The assumption here is that reforms in the international financial system could provide relief to

emerging markets that come under pressure. This assumption has an important historical precedent. Those who put a great deal of faith in the powers of a well-crafted international financial system are nostalgic about the 1944 Bretton Woods Conference that led to the creation of the International Monetary Fund and the World Bank.

1. Speech at the seminar on The World Bank/Universidad Torcuato di Tella Conference on Integration and Contagion, Buenos Aires, Argentina, June 17-18, 1999.

This line of reasoning, the questions to which it gives rise, and the assumptions on which it is based have directed a great deal of attention on the wrong thought path. We need to change the language of our discourse, drop words such as contagion and crisis from everyday discussion, and ask a different set of questions. We should focus on such words and phrases as *new global dynamics, a world of perpetual volatility, concentration of economic power among a few corporations, the role of the state in individual economies, and the role of corporations and private institutions as intermediaries among countries and economies.*

If we change our language and focus on a new set of issues, we will be better prepared to deal with the challenges we will face during the first decade of the next millennium, the years from 2000 to 2010. During that period, we are bound to see changes in the global economic system, the magnitude of which far exceeds current expectations. These changes demand a different focus on the part of policymakers, who must learn to deal with a highly integrated world of constant volatility, rather than preoccupy themselves with preventing the type of crises that have occurred in the past. We know from experience that crises seldom are repeated. The circumstances that produced the Latin American debt crisis of the early 1980s were very different from those that sent the Mexican economy into a nosedive in 1994/95. The East Asian crisis of 1997/99 was produced by developments that had deep roots in the economic history of that region. Russia plunged into a crisis, from which it has not yet recovered, for reasons that are mostly internal. Finally, the difficulties in Brazil in the winter of 1998/99 also stemmed from a combination of political and economic traits that were peculiar to that country.

If history and domestic policy play important roles in creating economic difficulties and crises, can changes in the international financial system really be expected to be effective in preventing or remedying them? Could governments acting in concert save emerging markets from the shocks of volatility? The answer to both questions is no. Emphasizing the need for a new financial infrastructure at the international level only deflects attention from the need for vigilance on the part of domestic policymakers as the world around them changes in significant ways. All of the recent economic crises were rooted in domestic events and domestic policies. They were exacerbated by the reaction-or overreaction of players in international finance. At the international level, policymakers must work with the private sector to devise regulations and systems of regulations that can protect all global players from being hurt badly by the volatility with which we must learn to live.

Five broad changes that can be expected in the near future stand out:

A new round of trade negotiations probably will be launched next year and will conclude in the first decade of the 21st century. Little remains to be

achieved in lowering tariffs on trade. This was accomplished in the Uruguay Round of trade negotiations. The current challenge is to introduce binding rules to exchanges in such sectors as services and agriculture, which are vital to developing countries and are still subject to government control

The rapid pace of the changes taking place in the world's demographic profile will accelerate. It will have profound and, at this point, unanticipated consequences for the industrial world.

The state will continue to redefine its role in the industrial world and, consequently, increase the space within which the private sector can and will operate.

In response to these developments, the private sector itself will become more consolidated in the developed world: larger and larger corporations will control an ever-greater share of global output.

Some, but not all, emerging economies will be better integrated into the rapidly evolving global economic system. Those that find accommodation through a better understanding of the evolving system will do very well. Those that are drawn into the system unprepared will reap some advantages, but they also will suffer from their lack of preparedness.

In *trade*, for example, the next round of negotiations will address sectors not fully covered in the last round, including services and agriculture, in particular. A general opening of the global system in these two areas will help, not hurt, the developing world. In services, for example, large developing countries Brazil and India included have resisted the opening of the service sector, out of fear



that the more sophisticated firms in the industrial world will overwhelm their fledgling systems. There is an apprehension that the banking and insurance industries, air and shipping lines, construction companies, and firms operating in the retail trade would be overwhelmed by the more state-of-the-art operations available in the developed world. I believe that this defensive posture is erroneous. Most of these sectors rely heavily on a well-trained labor force and, this being the case, the developing world could turn its demographic situation into a great advantage. By improving the education and training of their work force, developing countries can obtain enormous benefits from opening the service sector. Instead of protecting their service sectors, the large and populous developing countries should instead seek to open them to the industrial world.

*Demographic changes* will have a major impact given that for the first time in human history, large segments of the world's population are declining in size. This is happening, not because of plague, pestilence, or war, but because fertility is declining sharply in most of the developed world. The population in several indus-

trial countries will drop dramatically during the 21st century, as has already begun to occur in Western Europe. In the next three or four decades, Japan's population is likely to decline from 120 to 65 million. Several European countries will also see a precipitous reduction in the size of their populations. Due to its more liberal attitude towards immigration, only the United States will maintain the size of its current population for many decades to come. I expect that the working population of industrial countries will decline from about 400 million today to some 300 million by 2060. This 100-million reduction naturally will have serious economic consequences, especially in those countries where compensating immigration is not encouraged. Only 70 to 80 million of this working population will be highly trained and equipped to staff the sophisticated service sectors that will dominate the global economy. Meanwhile, the developing world's population and work force will continue to grow. Five billion people now live in developing countries, and their numbers are increasing by 100 million every year. The proportion of young people in these populations also continues to rise. There are currently more than 2 billion persons under the age of 15 in the developing world. The trend in the industrial countries is in exactly the opposite direction: the proportion of older people in the population is increasing dramatically.

We are familiar with the problems associated with rapid population growth in the developing world. It perpetuates poverty and slows down modernization. However, not much can be done about people who already have been born, other than to make it possible for them to add value to domestic economies. For this to happen, education and training are vital. Developing countries can produce

a work force of high caliber on the order of 200 million.<sup>2</sup> We must turn this demographic advantage into an actual economic advantage.

The United States' recent response to growing demand for highly skilled workers in the information technology industry illustrates the opportunities available for well-trained people from the developing world. The 1999 quota of 120,000 workers allowed to enter the United States was already filled in the first five months of the year. Corporate managers from Silicon Valley are now pressing Congress to increase the quota to more than 200,000 immigrants a year.

The *role of the state* is being redefined, and this will affect international liquidity and resource availability. Since the governments of Ronald Reagan, in the United States, and Margaret Thatcher, in the United Kingdom, states have shown less willingness to provide the kind of security and welfare that has long been expected by citizens. People are responding to this challenge by assuming respon-

2. Author's back of the envelope estimates based on simple linear projections of variables such as fertility rates, enrollment rates in higher education, etc.

sibility for the costs themselves. This development has already had a remarkable impact on financial markets and institutions. For example, assets available to pension funds have been increasing enormously, particularly in the Anglo-Saxon world, which has taken the lead in reducing the presence of the state in the welfare system. World pension assets totaled \$11 trillion in 1998, of which Americans owned \$6.4 trillion, or nearly three-fifths of the total. As the state began to signal its intention not to provide extensive coverage to the country's aging population, people turned to privately managed pension funds to protect themselves during their golden years. U.S. pension assets increased by 76 percent in the five-year period between 1993 and 1998, contributing to the 63 percent increase in the holdings of pension funds worldwide. An increase of a similar magnitude was registered in the United Kingdom, where pension fund assets increased by 74 percent in 1993-1998, reaching \$1.4 trillion. The growth of such funds in other industrial countries was far less pronounced. In Japan, for instance, pension assets increased by only 11 percent in 1993-1998 but is likely to catch up with trends in the United States and the United Kingdom.

The pension industry expects that the overall growth rate will slow down somewhat in the next few years, but the total assets available to the funds is expected to increase by 40 percent between 1998 and 2003, to some \$15.4 trillion.

What do these developments mean for emerging markets? The growth of pension funds is adding enormous amounts of liquidity to the world's capital markets. Pension fund managers in the United States are looking for high rates of return, and these are

generally found in emerging markets. Even adjusted for risks, these markets offer better rewards, which is one reason why pension fund managers are picking up foreign assets. By 2003, pension funds are expected to hold 17 percent of their assets outside the countries in which they are located, up from 14 percent in 1998 and 10 percent in 1993. Of the \$2.6 trillion held abroad, one quarter, or \$655 billion, could be in emerging markets.

This discussion of the growth of pension funds in industrial countries seeks to illustrate two important points. Demographic changes and a redefinition of the role of the state in the industrial world are having a profound impact on emerging markets, which can now gain access to resources in amounts that previously were unimaginable. Yet, in attracting such resources, emerging markets also open themselves up to close scrutiny by the funds' owners. Resources will flow in and out of emerging markets, depending on how the financial markets perceive their performance and prospects.

Another critical factor is *institutional development in the developed world and the concentration of institutional capacity*. While governments debate the need for

a new institutional structure to manage changes in the global economy, important industrial world institutions are busy preparing for these changes. In the banking sector, for instance, new regulatory norms are being sought. Banks in the major money markets have been authorized to determine the level of risk entailed in the assets they hold and to institute the corresponding safeguards rather than simply follow a formula that is applied universally. In the United States, large banks have developed elaborate models to determine the quality of the assets on their books. If they deem the quality to be high, they are allowed to keep less than 8 percent of their total assets as nonremunerative capital. As a result of this regulatory change, large amounts of capital have been released for remunerative, hence profitable, use. At the same time, the capital adequacy ratios for the institutions of the developing countries will remain high, on the assumption that the assets on their books are riskier than those held by institutions in the industrial world. This change in regulation will give a tremendous advantage to the latter institutions. One way to deal with this imbalance is to opt for measures to consolidate the banking industry in the industrializing world, while fostering a closer association with counterparts in developed countries. This is one more reason why developing countries should not resist opening up their service sectors.

Finally, *greater preparedness of the developing world* for these dramatic global economic changes is essential. Part of the response to the challenges posed by globalization will have to come in the form of greater regionalism, as already has taken place in Latin America's Southern Cone and in East Asia, with the establishment of the Mercosur and ASEAN trading blocs, respectively. But

Mercosur and ASEAN must go beyond open regionalism and undertake a greater conversion of their of economic fundamentals. Once this takes place, we will see the more successful regional arrangements leading to common monetary arrangements and currencies.

One dayperhaps no more than a decade from nowthe global economy will be dominated by three regional arrangements: the European Union, the Western Hemisphere, and ASEAN, each with its own common currency. But the move toward such a configuration will require a great deal of preparation, as illustrated by the slow evolution of the European Common Market toward a more integrated European Union with its own currency, the euro. The lessons learned from the European Union could reduce the time it takes for the countries in the Western Hemisphere and East Asia to move toward the formation of similar economic unions.

Excessive concern with recurrent crises, contagion, and government-engineered changes in the global architecture have prevented us from thinking dynamically about the deep, dramatic, and swift changes that are occurring, to which we must

adjust positively rather than defensively. Our thinking must factor in the future rather than continue to dwell on the past. We should now leave the study of the Mexican crisis of 1994<sup>95,3</sup> the East Asian crisis of 1997<sup>99</sup>, and the ongoing crises in Russia to economic historians. Useful lessons already have been drawn from these episodes. None of these crises is likely to be repeated. The ground has now shifted; the situation has changed. Changing the language of our discourse accordingly will help us to focus policymakers on the future rather than on continuing to investigate the past.

3. See Chapter 14 in this book for my interpretation of the crisis in Mexico.



## Chapter 14

### From Globalization to Localization<sup>1</sup>

Much Has Been Written About the Global Economy and its impact on the developing world. The popular view of globalization is woven of several strands.

The first consists of what Marshall McLuhan once described as the global village, that is, the phenomenon of the media linking countries and the people who live in them so closely together that they seem to constitute one organic community. This has actually come to pass. Distances have shrunk not only because of the media, however. The information technology revolution has also made instant communication possible. The expansion of the Internet has led to the creation of chat rooms in which conversations can take place in real time among people in different parts of the world.

Second, many believe that the process of development, commonly referred to as globalization, is making a small number of huge corporations exceedingly powerful, with an influence that is exercised across the globe. A few global banks, a few global oil companies, a few combinations of airlines, one producer of software, and one manufacturer of microchips dominate their respective sectors of the economy.

Third, it is believed that the growth in the economic power of these entities has reduced the authority of governments. Governments now are seen as confining their energies to exhortation as they did at the G-8 summit in Cologne on June 20,

1999 rather than playing an effective role in erecting a new global economic and financial order. In other words, global governance lies more in the hands of global corporations than in the hands of individual governments.

Fourth, it is felt that many countries are being left so far behind in the race to provide citizens with basic needs that they may have been condemned per-

1. Speech delivered at the opening sessions of the Fifth Annual World Bank Conference on Development of the Latin American Region, Valdivia, Chile, June 21, 1999. The conference title was Decentralization and Accountability of the Public Sector.

manently to a state of perpetual impoverishment. In fact, it is no longer fitting to call these countries developing for they have not seen any development for several decades. A better description of their condition would be to call them perpetually weakening economies. Just one set of statistics illustrates this point. Of the children who die before their fifth birthday, 98 percent are in the developing world. Of people who are HIV positive, some 95 percent are in poor countries. Of the millions who die of tuberculosis, malaria, measles, tetanus, and whooping cough, all but a few thousand live in the poor world.<sup>2</sup>

Fifth, some people fear that these unfortunate developments are producing a backlash that may force governments to adopt negative policies that may appear to ameliorate the situation of the disadvantaged in the short term but will, in fact, eventually harm them.

There is some truth to all these assertions, or strands of argument. However, it would be dangerous to weave an entirely new fabric of policy reform from them. Such an attempt would set back all citizens of the world, including those who currently are being left behind by the rapidly globalizing world. It is important, therefore, to do three things: one, to understand the full meaning of the process of globalization; two, to understand the implications of globalization for different parts of the world; and three, to see how moving beyond the center by decentralizing the state would help all countries to reap benefits from the changes that are occurring all around us. The real challenge for the developing world is to turn the dynamics of globalization in favor of its citizens.

Let us first understand what we mean by globalization. It is a

phrase that we generally apply to the movement of large amounts of capital, to a greater exchange of goods and commodities among the world's nations, to a greater voluntary movement of people across established frontiers, to a greater integration of global output, and to the rapid exchange of information among people from all parts of the world. But people do not always realize that not all of this is new. Some of these events have happened before and to a greater degree, in fact, if we think in proportional, rather than absolute, terms. It is not well known that net financial flows made up a larger share of world savings before World War I than they did in the mid-1990s. It is also not generally recognized that world trade constituted a larger proportion of world output in 1913 than in 1975. For me, what is important about globalization is the speed at which information flows. It is this speed, and two other aspects of change, that will truly revolutionize and globalize the economy.

2. Helping the Poorest. *The Economist*, August 14, 1999, p. 11.

Apart from the flow of information, the other profound changes are taking place in the areas of demography and the role of the state. This is the first time in human history that large parts of the world are going through a period of demographic transition that is producing natural declines in national populations. Populations are declining in large areas of the industrial world because of plunging fertility rates and not because of plague or pestilence.

The decline in the size of the population will lead to a reduction in the size of the labor force. Will the industrial world be able to sustain economic activity at its present levellet alone at an increased levelwith this decline in the work force?3 The answer is no. At the same time, Europe and Japan, unlike the United States, will not permit compensating migration. The only way out for them will be to make use of the abundant labor in the developing world. This development alone would bring about a much greater integration of the global economic system. It may also help the developing world benefit from the emergence of a global economy.

The other change of great consequence is the redefinition in the role of the state. Over the last two decades, particularly since the time of Ronald Reagan and Margaret Thatcher, states have tended to reduce their risk-bearing responsibility. They are not prepared to provide as much economic protection to their citizens and to private institutions as they did in the past. The response to this dramatic change in political philosophy, from that of a caring state to a state that watches from some distance, has come quickly and will lay the groundwork for future relations among nations. Individuals have begun to plan for their own care in old age rather

than continue to depend on the state to provide them with security when they are no longer actively employed. Institutions have developed the means to help individuals in this quest. Pension funds and insurance companies are now expected to provide resources to people in their old age. One important manifestation of this change is the growth of liquidity in world capital markets. The assets of pension funds and insurance companies have grown at a fast clip. This has happened as people have turned to these institutions to protect their future earnings, as states withdraw from providing such security.<sup>4</sup>

This brings me to an important question, one that should receive a great deal of attention at this conference. How can the twin phenomena of globalization and localization be turned in favor of the poor in the developing world, to stop the perpetual widening of the gap between the world's poorest and its rich countries?

3. For a more detailed discussion of this subject, see Chapter 13 in this book.

4. This point is developed more fully in Chapter 13 in this book.

To answer this question, let us return to demography and the role of the state. A large share of the enormous resources available in the world's capital markets will go to countries that are able to educate and train their workers to provide the services the aging populations in the industrial countries will increasingly need. Large corporations based in developed countries will, no doubt, play the role of intermediaries between those who need services and those who provide them. These corporations have access to the technologies and management practices vital to progress in the developing world. One more set of numbers should help to underscore this point. The developing world accounts for more than 80 percent of the world's population but produces only 40 percent of global output and owns less than 0.5 percent of the patents granted in the world. Without access to the knowledge and technology easily available in the industrial world, developing countries will fall further behind. This is where large, developed-country corporations could help. These corporations are seeking new locations for their production facilities, favoring high-quality human resources, the ready availability of needed services, and the ability to research and improve the products they produce. To facilitate this, governments will need to come closer to the people by moving beyond the center toward both near and distant localities. Globalization will provide benefits to the developing world only if it is coupled with government localization.

Local governments in the industrial world understand the role they must play to attract private capital to their jurisdictions. The move from manufacturing to services, from factories that transformed commodities into products to enterprises that process information and improve technology, has already produced sea changes in the

world's mature economies. Local governments are active in developing corridors to attract these new industries. This is as true of the areas surrounding Dulles Airport, in Washington, as it is along Route 128, in Boston. The same developments will need to occur in the developing world. Greater authority and command over resources will have to be granted to local governments to help them take advantage of globalization. Local governments, in turn, must use their resources to build the requisite physical infrastructure and train and educate their people, to make their jurisdictions attractive for foreign investment. In localization, therefore, lie the seeds of change that could occur in the developing world and benefit all its citizens.

Localization can turn globalization into an asset rather than a liability, stop income disparities from widening, and involve billions of people all over the world as active participants in bringing about positive change. These discussions should help to mobilize the forces of globalization in favor of the billions of people who live in the world's developing countries.



## Chapter 15

### Pakistan in Crisis: A Diagnosis of its Causes and an Approach to Resolving it<sup>1</sup>.

#### I. Prologue

I am Grateful to the Pakistan Institute of Development Economics and its director, Dr. Sarfraz Qureshi, for giving me the opportunity to discuss a subject of such great concern today for the people of Pakistan. I have been asked to talk about the economic crisis the country faces today and how it can get out of it.<sup>2</sup> In requesting that I deal with this important subject, I presume the PIDE wanted me to draw upon my experience of working in two regions of the world East Asia and the Pacific and Latin America and the Caribbean. These two regions have dealt with, or now face, economic crises of considerable magnitude. Pakistan could draw many important lessons from their experience for handling a severe economic crisis of its own.

At the very outset, I would like to draw the following three lessons for Pakistan. The first, and perhaps most important lesson to be learned from these countries, is that something positive can come out of crisis management. Crises, although painful for almost all segments of the population, offer opportunities for undertaking reforms. There is good evidence that economic shocks change the way various groups perceive the benefits and costs of existing and potential policies and institutions. They open a window of opportunity for reform that can be exploit-

1. Lecture delivered at a function organized by the Pakistan Institute of Development Economics, Islamabad, November 19, 1998.

2. A number of individuals I met during my visit to Pakistan from November 4 to 24, 1998, provided me with important insights into the recent developments in the country. I am particularly grateful to Moeen Afzal, Khalid Ahmad, Sadiq Ahmad, Iqbal Ahsen, Syed Babar Ali, Kamal Azfar, Ijaz Butt, Shahid Hamid, Osman G. Isani, Ishaq Khakwani, Imran Khan, Farooq Ahmad Khan Leghari, Mian Muhammad Mansha, Hafiz Pasha, Naseem Saigol, Tariq Saigol, Jugnu Sethi, Najam Sethi, Suleman Shah, Mian Shabaz Sharif, Ahmad Mian Somme, Muhammad Mian Somme, and Hamid Yusuf for spending time with me and talking to me about the evolving situation in Pakistan. The analysis presented here is entirely mine and should not be attributed to any of these individuals.

ed by a well-intentioned leadership.<sup>3</sup> The second important lesson is that it takes time for deep crises to be fully resolved and for economies that have suffered the shocks of crisis to return to normalcy. It can be counterproductive to create the impression that quick remedies can be found, that the crises that are the product of policies followed over a long period of time can be quickly handled with the help of some form of external support. The third important lesson is that all successful reform efforts require the development of political consensus among most, if not all, important groups in society. Forming a consensus also takes time and requires educating the people about the nature of the crisis, its cost to society at large, and the potential benefits of policy and institutional reforms. In sum, the leadership groups in Pakistan can turn the crisis of today into an opportunity for tomorrow. This will require a painstaking effort. Much of this presentation will be devoted to developing some ideas as to how the leaders can reform the Pakistani economy and society in the coming months and years.

I will offer my arguments in five parts. In the first, I will provide some historical insights by discussing, one by one, what I call the defining years in Pakistan's 51-year history. By my reckoning there were seven such years, including 1998, and each of them left a deep imprint on Pakistan's economy and society, and the way the country manages itself politically. By looking closely at these links, we can begin to see what approaches will work in today's situation. A look at history will also help us to identify policies that would be difficult to implement as Pakistan prepares to deal with the crisis of 1998.

The second part of the presentation will focus on the current economic crisis in Pakistan. I will take the position that the present difficult situation is the consequence of the confluence of five distinct events. First, the global financial crisis has dramatically changed the external environment for all developing countries, including Pakistan. Second, a short-term liquidity crisis has made it difficult for Pakistan to service its foreign debt. Third, the economic system is seriously malfunctioning because of antiquated structures. These structures, left in place by several generations of leaders too timid to change and remodel them, have seriously exacerbated the situation caused by the liquidity problem. Fourth, Pakistan must also reckon with the crisis created by the severe social under-development of a large and growing population. Fifth, and finally, Pakistan must deal with a serious institutional crisis that is the consequence, once again, of a number of policy mistakes made by the political masters of the day.

3. See Burki, Shahid Javed, and Guillermo Perry. *Beyond the Washington Consensus: Institutions Matter*. Washington D.C.: World Bank, 1998 for a detailed description of the reform effort in the Latin America and Caribbean Region.

The second section of the presentation will present my thoughts on how the crisis could be resolved. Those of you who remember the way the Farooq Leghari Meraj Khalid caretaker administration of 1996-97 handled the crisis that contributed to the dismissal of the government of Prime Minister Benazir Bhutto will notice some significant differences in the approach adopted then and the approach I am now recommending.<sup>4</sup> I will put much greater emphasis in this presentation on the need for Pakistan to find itself a suitable place in the rapidly evolving global economic system. I will also emphasize far more today than the caretaker administration did in December 1996 the need for Pakistan to build and rebuild institutions for managing the economy.

In the third part of the presentation I will touch upon, albeit very briefly, the way some Western governments, the government of Pakistan itself, the people of Pakistan those living inside the country and those working abroad, and the press in Pakistan viewed the crisis of 1998. It is useful to touch on this, for experience tells us that in people's response to a crisis we can usually find the genesis of policy change. It is in this context that I will introduce the subject of the Pakistani diaspora the millions of people from this country who are now living and working abroad. This is a relatively a new group that has already begun to influence events in Pakistan and could, and, I believe, should play an important role in defining the country's future.

The fourth part will present two scenarios for the future. The first foresees a restoration in the rate of growth of the gross domestic product to levels achieved in the past; the second assumes a much slower growth rate equal to the average rate achieved in the last five

years and analyzes its economic and social consequences. In the fifth and final part, I will bring together the main arguments presented in this analysis.

Let me now deal with each of these five parts.

4. As adviser to the caretaker prime minister, I was in charge of the ministries of finance, planning, and economic affairs. I also chaired a number of cabinet subcommittees including the Economic Coordination Committee (ECC), the Executive Committee of the National Economic Council (ECNEC), the Cabinet Committee on Privatization (CCOP), and the National Finance Commission (NFC). Soon after joining the caretaker cabinet, I appointed 13 task forces to make recommendations on structural reforms in a number of areas. The suggestions made by the task forces were incorporated into an ambitious program of stabilization and structural reforms that was announced by President Farooq Ahmad Khan Leghari in a national TV and radio address on December 25, 1996. For a detailed description of the package of reforms adopted by the caretaker administration see Burki, Shahid Javed. Pakistan: Growth Set Back by Structural Rigidities. *The Pakistan Development Review*, 35:2. (winter 1996), pp. 315-39. The article cited above was based on the Quad-e-Azam memorial lecture I gave at the Twelfth Annual Meeting of the Pakistan Society for Development Economists on December 14, 1996. The comment on the lecture was made by S. M. Naseem and printed in the same issue of *The Pakistan Development Review*, pp. 340-42.

## II. Seven defining years<sup>5</sup>

By my count there have been seven defining years in Pakistan's history: 1947, the year Pakistan was born; 1958, the first time Pakistan witnessed intervention by the military in political affairs; 1970, the year Pakistan held its first general election on the basis of one man, one vote; 1972, when Pakistan launched a new experiment in economic management; 1983, the year Pakistan was recruited by the United States as an active partner in the struggle against the Soviet Union and communism; 1988, when Pakistan began to move hesitantly toward adopting democracy as a way of governance and reliance on the market to guide the economy, and finally, 1998, the year that several crises came together to create a really difficult situation for the country.

In choosing these years, I am conscious of the fact that I have ignored several others. I have not included 1949, when Pakistan fought its first trade war with India; or 1965, when the second Indo-Pakistan war was fought over the contested state of Kashmir; or 1971, when Pakistan broke into two parts; or 1977, when the military intervened in politics for the third time, inaugurating the second long military rule; or 1979, when the military rulers sent Zulfikar Ali Bhutto, the country's first elected prime minister, to the gallows; or 1990, 1993, and 1996, when three elected prime ministers were dismissed by two different presidents on charges of corruption and incompetence. Adding these eight to the seven I identified as defining years no doubt would make the telling of Pakistan's story more comprehensive. But the second group of years did not really define the future course of events; they did not leave an indelible imprint on the history of Pakistan. Even the

breakup of the country in 1971 and the execution of Bhutto did not leave deep and abiding impressions. These were, no doubt, traumatic events, but Pakistan recovered from them surprisingly quickly.

1998 will be a defining year for Pakistan, and I will have much more to say about it later. During the year, Pakistan had to deal with a number of problems. Some were of its own making and some were the consequence of events over which the country had no control. If the crisis Pakistan faced in 1998 is overcome successfully, it may well emerge stronger than ever before. On the other hand, if the leaders of today fail to address the problems expeditiously and comprehensively, Pakistan could quickly descend into a period of social and political chaos that could last for a long time. Pakistan truly stands at a crossroads today. It could go either way, toward developing a viable nation state with a functioning economy that can serve

5. A somewhat abbreviated version of this section appeared as an op-ed piece in a Pakistani newspaper in early 1999. See Burki, Shahid Javed. '98: When Crises Came Together. *Dawn*, January 9, 1999.



the people and deliver them the goods and services they need. Or the country could move into a situation in which the state becomes even more dysfunctional than it is today, unable to look after the people's welfare in any meaningful way.

Before launching into a discussion of the six defining years that preceded 1998, it is important to recognize that Pakistan did not suddenly arrive at 1998; it took 51 years to get to this point. On the way, it has crossed several landmarks, each of which left a lasting imprint. Before 1998, there were six other defining years. We need to look at each of them to fully understand where the country is now positioned.

*1947:* A great deal happened in 1947. The year saw the birth of Pakistan as an independent homeland for the Muslims of British India. It witnessed the arrival of millions of refugees from India. The newcomers had to be accommodated not only within the economy, but also within the social and political structure of the new state. Under Muhammad Ali Jinnah's stewardship, the new country began the task of developing instruments of governance. And, again under the leadership of Jinnah, Pakistan began the difficult task of defining with greater accuracy the boundaries within which it should live. Each of these was a daunting task; the way each was begun left a lasting impression on the country's future.

The creation of Pakistan resulted in ethnic cleansing of the sort not anticipated by the leaders who had fought for the creation of a separate homeland for the Muslims of British India. Some 8 million Muslims left India and moved into Pakistan, taking the place of 6 million Hindus and Sikhs who moved in the opposite

direction. By the time this movement of people was over, West Pakistan today's Pakistan was a country in which 95 percent of the people called themselves Muslims.

A significant number of the refugees from India settled in Karachi and other cities of Sindh. By and large, the newcomers were more educated and urbanized than the indigenous population of Pakistan. Their arrival brought a quantum jump in Pakistan's social development; suddenly, the population of Pakistan was more educated and urbanized than it had ever been before. It was natural for these new citizens of the country to come to hold important positions in government, industry, commerce, and all important professions. The refugees were also passionately committed to the idea of Pakistan. They had fought harder than any other group of Muslim India for the creation of Pakistan.

The arrival of millions of Muslims from India, who were better equipped to develop the economy and modernize the society, could have been turned into a great advantage for the new country. Pakistan was very short of the skills the refugees brought with them. Also, its political culture was dominated by people who were comfortable with a value system inimical to the development of new

instruments of governance. But a great deal of foresight was necessary to take advantage of the sudden infusion of people with skills and attitudes required for a modernizing society. The leaders of Pakistan could have brought the rest of the population to the level of social development represented by the refugees. Instead, by neglecting the provision of social services, it allowed the descendants of the original refugees to sink to the level of the indigenous population.

The leaders of Pakistan also should have created the conditions for the assimilation of the refugees into the evolving polity. Instead, they allowed the refugee community to become alienated from the rest of Pakistan. They began to call themselves *muhajirs* (refugees from India) and began to seek a separate identity for themselves in a society that became progressively factional and divided. Karachi would not have become Pakistan's problem city had the country's leadership groups taken full advantage of the remarkable opportunity that opened up in 1947 with the transfer of population between the successor states of British India.

The problem of unsettled frontiers was of a different nature. Dealing with it required more than foresight on the part of the leaders of Pakistan; Pakistan's new neighbors also needed to show willingness to accommodate the new country. The first definition of the geographical contours came shortly before Muhammad Ali Jinnah took the oath of office as Pakistan's first governor general. It came in the form of an award given by Cyril Radcliffe, by which Punjab was divided in two, one part Indian, the other Pakistani. To the surprise of many, the award gave the Muslim majority areas in Gurdaspur district to India, thereby providing Delhi with direct

access to the state of Kashmir. Radcliffe's one unforgettable gift, therefore, was the Kashmir problem that was to endure for more than 50 years and does not seem close to being resolved. The other unsettled frontiers were with Afghanistan and China. The first was settled in a way that was highly disruptive not only for Pakistan but also for the entire Central Asian region. Only the China-Pakistan border was demarcated in a manner that ensured steady good relations between the two countries for decades to come.

On August 14, 1947, some 72 million people became citizens of the new state of Pakistan. Of these, 24 million already lived in the country that we now call Pakistan and another 8 million were new arrivals from India. Together with another 40 million people who lived 1,000 miles across the territory of India in a country that now calls itself Bangladesh, these people began an experiment in nation building. They had been drawn to the dream of two extraordinary leaders of Muslim India, Muhammad Iqbal and Muhammad Ali Jinnah. Theirs was a simple dream that millions of people drawn from the Muslim diaspora of British India would come together within the borders of a Muslim state and live in social peace

and political harmony. Saved from doing constant battle with the Hindu majority of India, the citizens of this state would be able to devote their energies to improving their economic well-being. However, preoccupied with securing such a state from the departing British, Jinnah and his associates had little time to define the political and social shape of the country they had worked so hard to create.

Perforce, Jinnah left a number of questions unanswered. Did he create a state for the Muslims of British India, or an Islamic state to be guided by the Koran and Sunnah? Was Pakistan to be a federal state with a fair degree of autonomy for the provinces, or was it to have a unitary form of government ruled from the center? What was to be the role of the state in developing the economy and managing it? Was Pakistan to align itself with the West in the struggle that was shaping up between the United States and the Soviet Union? The leaders who succeeded Jinnah were to spend a great deal of their time finding answers to these and many other questions. The search goes on even today, as Pakistan enters the second half-century of its existence as an independent state.

These and other questions were to remain unanswered for a long time; for some of them, the search is still going on. In fact, Jinnah's dream did not come true. The country he had created was a geographical monstrosity made up of two wings stuck on either side of a large Indian body. The people who lived in the two wings of Pakistan did not find social peace, political tranquility, or a palpable improvement in their economic well being. Soon, they were quarreling among themselves, often bitterly, about the number of languages they should call national, about the role of

Islam in managing the affairs of the state, about who was entitled to call himself a Muslim and who should be designated non-Muslims, and about the extent of power that should devolve to the provinces. Pakistan broke up in 1971 largely because of the failure of its first and second generation leaders to take full advantage of the remarkable opportunities offered by the country's birth. Instead, they allowed themselves to be weighed down by problems that were created largely by the leadership's failure to act in a timely and decisive manner.

1958: The felt need for decisive action made 1958 the second defining year in the country's history. Half a dozen senior army officers concluded that Pakistan's politicians were neither fit to govern the country nor possessed of a mandate to do so.<sup>6</sup> They decided that, for Jinnah's dream to be realized, Pakistan needed an entirely different set of political institutions from those it had inherited from the

6. Two of the four generals directly involved in planning the takeover by the military in October 1958 provided the justification for their move in their autobiographies. See Ayub Khan, Mohammad, *Friends Not Masters: A Political Autobiography* (London: Oxford University Press, 1976), and Burki, Majid Ali, *Autobiography of an Army Doctor* (Rawalpindi: Burki House, 1988).

British Raj. Feudalism and the system of *baradaris* (clans) defined Pakistan's political landscape. Millions of politically ignorant people lacked the freedom and perspective to exercise democratic rights. A large proportion of these people owed their allegiance to individuals or communities. Democracy, declared General Ayub Khan, did not suit the genius of the Pakistani people. Ayub Khan was not only looking for a new political structure but also for a new economic paradigm to move Pakistan from deep economic backwardness to modernization and prosperity. The military officers' first impulse was to bring about a clean break with the past.

They broke from the past in many significant ways. The structure of local government devised by General Ayub Khan and his military associates they illadvisedly called it basic democracies and gave the impression that it was to substitute for the truly representative government the people wanted brought the government close to the people. It also deflected power away from the landed aristocracy, which, after having been discredited by its lukewarm support for the creation of Pakistan, was struggling to find its way back into the system. This was a serious effort at defeudalizing the state of Pakistan. The local government system also supported launching the green revolution, under which small and medium farmers were encouraged to adopt the new high-yielding wheat and rice technologies. Their adoption resulted in a quantum improvement in the productivity of agriculture and in raising rural incomes. With such positive outcomes, the president might have been able to win broad support for his system had he allowed more devolution of political and economic authority to the provinces and local government institutions. Instead, he allowed

the establishment to fight back. There were two strong legacies of this period, one positive, and one negative. During the Ayub Khan period, Pakistan was able to achieve economic growth well above the average for developing countries. The country demonstrated quite clearly that with the right set of economic policies, Pakistan could achieve the rates of growth that were later to be realized by the tiger economies of East Asia. It is no exaggeration to say that Pakistan blazed the trail that was later followed by East Asia.

The negative legacy was the creation of an environment that allowed the forces of tradition to beat back the forces of modernization. One by one, Ayub Khan surrendered his modernizing impulses to traditional forces, which, as we shall see presently, reasserted themselves quickly. The reason for the failure to modernize was that the reforms introduced were not placed within solid institutional contexts, so they were easy to attack once the president, their principal proponent, was weakened by politics.



What Ayub Khan put forward as a political philosophy in 1958 was akin to what later came to be called Asian values. These were put forth by a group of East Asian leaders Lee Kwan Yew of Singapore and Mahathir Mohammad of Malaysia being the most prominent who credited them for the remarkable economic success of the region. Whether Ayub Khan would have produced the same kind of economic and social results in Pakistan is a question that we briefly addressed above. To answer it fully would need a great deal of counterfactual analysis.

*1970:* 1970 is the third year that stands out as projecting a deep shadow on Pakistan's history. In December 1970, Pakistan held its first general elections. The rules for the elections were written by another military government, which had taken office following the demise of the Ayub Khan regime. In drafting the Legal Framework Order a quasi-constitution to be used for governing the country while a popularly elected assembly debated a new instrument the government of General Yahya Khan found no reason to question the genius of the people. The people, said the new military rulers, were perfectly capable of choosing their representatives. The representatives the people chose in the elections set into motion two developments that were of great consequence for Pakistan. The East Pakistanis gave an overwhelming mandate to the Awami League, which had let it be known that it favored a political system that gave most power of the state to the provincial governments, leaving the center with the responsibility only for defense and foreign affairs. The West Pakistani electorate focused its attention not on politics but on economics, resonating with considerable enthusiasm to the promise made by the Pakistan People's Party to provide *roti, kapra, and makan* (food, clothing, and housing) for

all citizens.

It was hoped that democracy would provide the right set of institutions for bringing the diverse people of Pakistan within the fold of one nation state. Instead, the two wings of Pakistan chose to move in two quite different directions. The Bengalis laid the ground for their eventual secession from the state Jinnah had founded, while the people of West Pakistan chose socialism as articulated by Zulfikar Ali Bhutto to take care of the poor and the underprivileged. A year after the elections of December 1970, Jinnah's Pakistan fell apart, broken into two halves. The separation occurred after tens of thousands of troops from West Pakistan, operating 1,000 miles from their home base and at times using a great deal of naked terror, failed to subjugate tens of millions of Bengalis. The military mission was as improbable as it was absurd. Following a humiliating surrender to a combined force of India and the Mukti Bahini, the Bengali freedom fighters, Pakistan's new boundaries

were drawn.<sup>7</sup> Having shed East Pakistan, Pakistan was somewhat more homogeneous. West Pakistan was no longer a wing, it was now geographically whole but remained ethnically and linguistically diverse.

*1972/73:* We depart here from our practice of identifying only one year as a defining moment in history. Now we use a slightly longer period of some 18 months, starting in January 1972 and concluding in August 1973. Zulfikar Ali Bhutto was the dominant figure during this period. Ambition alone would not have landed Bhutto in power. He was too vain to fully recognize that he reached the center of the political stage for the simple reason that the establishment wanted him there. Bhutto was brought to power by a group of interests his daughter, Benazir Bhutto, was later to label the Islamabad establishment. The senior leaders of the defeated military, equally senior civil bureaucrats, a sprinkling of landed families, and representatives of a few business and industrial houses made up the establishment. It was in the interest of this group to prevent the military defeat in East Pakistan and the dismemberment of Pakistan from unleashing social and political forces they would not be able to control. The establishment recognized instinctively that military defeat always disorients people and almost always results in social upheaval. Bhutto was one person who could step in to save what was left of Pakistan from meeting such a fate.

With Bhutto's ascent to power Pakistan saw the launching of yet another political and economic experiment. Bhutto was a man of many worlds, two of which were needed for minding Pakistan's difficult situation in 1972. Since leaving the government of Ayub

Khan in 1967, he had successfully transformed himself into a champion of the poor. In the elections of 1970, he adopted a populist program promising all citizens of the country jobs, access to basic health and education and *roti, kapra, and makan*. While empathizing with the poor and stepping into their world, he did not abandon the class to which he belonged or pull up his roots from the soil of feudal Pakistan. The establishment could not have found a better bridge builder. An extraordinarily clever, almost Machiavellian politician, with no strong beliefs but an enormous lust for power, Bhutto went to work with great speed and energy as soon as he was installed in power. His ambition was not to remold Pakistan and make it into a better place for the poor, as he claimed time and again. If the experiment to remold Pakistan also helped the people and, to be fair to him, he believed that would indeed be the outcome it was a bonus, an

7. The passage of time has made it possible for the people of Pakistan to view dispassionately the circumstances that led to the breakup of their country in 1971 and the emergence of Bangladesh as an independent country. For a sober analysis of the situation that led to the breakup, see Zaheer, Hasan. *The Separation of East Pakistan: The Rise of and Realization of Bengali Muslim Nationalism*. Karachi: Oxford University Press, 1994.

incidental development. His main objective was to keep Pakistan in his grip for a long time to come. Bhutto had accepted the invitation of the establishment not only to acquire power, but also to remain in control for as long as possible.

In January 1972, Bhutto introduced socialism into the management of the economy. His government nationalized all large industries and commercial houses, brought all financial institutions under the control of the government, nationalized privately managed colleges, and, eventually, brought all agribusinesses under government control. The economic philosophy guiding these actions was a simple one: Bhutto believed that the private sector could not be counted upon to serve the common citizens, provide them with basic services, or meet their basic needs. That could be done only by the state. But the state needed resources, and these would not be willingly provided by people of wealth. Accordingly, the state had to acquire the assets owned by the rich, generate surpluses from them, and then redistribute them to the less privileged segments of the population.

Economics was at the heart of Bhutto's experiment. Unfortunately for him and the country, it was a subject about which he knew very little. He brought in statism—the belief that the state's direct intervention was needed to get an economy to grow and distribute the fruits of growth in a reasonably equitable way. For such an approach to work required strong institutions. Bhutto never realized that it had worked in China and possibly also in Vietnam because they had very strong institutional bases. The invisible hand of the marketplace could only be replaced by the hand of an exceptionally well-educated, well-trained, greatly

experienced, and honestly motivated bureaucracy working within a sound institutional framework. These conditions did not exist in Pakistan; the few that did, Bhutto took care to destroy. What Bhutto set in motion in 1972 was to result in the total destruction of the country's institutional base.

Under Bhutto, Pakistan once again tried parliamentary democracy. His own preference was to introduce a presidential form of government not too different from the one operated by Ayub Khan. But the country's smaller provinces were as suspicious of such a system as were the people of East Pakistan in the 1960s. There was a fear that a presidential form of government would be quickly dominated by one of the two large provinces, Punjab or Sindh. Bhutto knew that he would have to obtain agreement with the smaller provinces to build a consensus around a new constitutional arrangement. The 1973 constitution was a product of this compromise. This, the third constitution in the country's history, in which all diverse interests were provided with a reasonable amount of protection, might have worked had Bhutto not begun to subvert it the moment it was promulgated. The constitution and the political system it sought to introduce fell victim to Bhutto's

inability to tolerate any form of dissent and his ambition to create a state dominated by one party.

Under Bhutto, therefore, the old system returned with a vengeance. There was hope, initially, when the electorate in West Pakistan gave overwhelming support to the Pakistan People's Party, a new organization that had loudly committed itself to developing a new social order. The elections of 1970 eventually led to the breakup of Pakistan and the redefinition of the role of the state in a way that could not have been foretold by the people who brought the PPP to power.

As prime minister, Bhutto had an opportunity to redefine the political system by bringing into it the social groups that powerful vested interests had kept out. Instead, Bhutto gave a different feudal meaning to the state. Under Bhutto and those who followed him, the state chose not to listen, but to dictate. It allowed personal will and whim to override prudence in handling the finances of the state.

*1983:* We do not identify 1977, the year Bhutto was deposed by the military, or 1979 when he was executed, as defining years in Pakistan's history, as they did not greatly influence the future course of events. The next defining moment for Pakistan came in 1983, following Ronald Reagan's 1982 victory in the U.S. presidential elections. By the time Reagan took office, the Soviet Union had occupied Afghanistan for more than three years. Jimmy Carter, Reagan's frugal predecessor, had offered Pakistan some help to counter the Soviet presence in Afghanistan. The offer was a modest one, and President Zia ul-Haq turned it down as peanuts. President Reagan, however, was prepared to go to extravagant

limits to embarrass the Soviet Union. Under his direction, a program of assistance was formulated that would ultimately pour billions of dollars into Pakistan to help the *mujahideen* fighting in Afghanistan. The Soviet Union was humiliated and withdrew its forces in 1989, but the war in Afghanistan had a lasting effect on Pakistan.

The campaign in Afghanistan was conducted in the name of Islam: it was a struggle between believers and the nonbelievers. It was a hideous civil war that even by 1987 had claimed the lives of perhaps 1.24 million people, mostly civilians.<sup>8</sup> Ultimately the believers triumphed, but their success created a problem that remains to be remedied to this day and is likely to visit Pakistan. It was easy to define believers when the enemy could be recognized readily as nonbelievers, as infidels. Yet once the infidel was gone, it was inevitable that the forces that fought the Soviet Union in Afghanistan would turn upon one another. The factions that had joined ranks against the occupying forces from the Soviet Union now turned their guns on one another in the name of Islam. This process of

8. George Washington Rides Again. *The Economist*, November 21, 1998, p. 18.



deconstructing the meaning of a true Islamic believer led to the emergence of the Taliban as an almost invincible force that imposed its rule on those who resisted it with striking viciousness, even by Afghan standards. In August 1998, Taliban forces captured the northern city of Mazar-e-Sharif and methodically executed between 2,000 and 5,000 civilians in one of the deadliest mass killings of civilians in two decades of warfare in Afghanistan. According to one account, Refugees reported that the Taliban were accompanied by Pakistani fighters [from] a Muslim fundamentalist party aligned with the Taliban.<sup>9</sup> While the United States succeeded spectacularly in Afghanistan, Pakistan is still living with the consequences of the American success. The war in Afghanistan brought sectarian violence to Pakistan. It contributed to the rise of the Taliban in Afghanistan. And it led to the use by Islamic militant forces of the training facilities initially built by the U.S. Central Intelligence Agency for training the *mujahideen*. Out of the war in Afghanistan emerged a battle-hardened breed of Muslim fanatic, the Afghans, who are now blamed for most acts of international terrorism carried out against Americans.<sup>10</sup> This chapter is still not fully written for Pakistan, and the Afghan contagion is likely to take a heavy toll, especially if the economy stumbles badly.

1988: Zia's death, in an air crash on August 17, 1988, that has yet to be explained, was another defining moment for Pakistan. It was to lead to a hesitant experiment with returning to democracy and the withdrawal of the state from active management of the economy. In the event, the old feudal structure now fully installed was not prepared to be guided by any other set of rules than its own. To paraphrase V. S. Naipaul's recent provocative work, in an extraordinary way in Pakistan where time beyond people's memory

is an unmeasured and unmeasurable flow, and serf structures untouched during the British time were reasserted with national Independence the country was approaching the 14th century.

Had Zia lived, he would have definitely taken the country in the opposite direction. At the time of his death, he was working on a constitutional arrangement that would have introduced much greater decentralization into the way Pakistan was politically managed under the constitution of 1973. The eighth amendment he introduced into the constitution had created a system of dyarchy that the British had once tried in their Indian domain. The constitution as amended by Zia divided executive authority between a prime minister responsible to a directly elected parliament and an indirectly elected president responsible only to himself or, at best, to the Islamabad establishment.

9. Cooper, Kenneth J. Taliban Massacre Based on Ethnicity. *The Washington Post*, November 28, 1998, pp. A1, A19.

10. George Washington Rides Again, *op. cit.*, p. 18.

The president had the power to dismiss the prime minister and dissolve the national assembly if he was convinced that the prime minister's conduct was inimical to the loosely defined strategic interests of the country. Zia exercised this power in May 1988, when he dismissed Prime Minister Muhammad Khan Junejo, but he was not fully satisfied with the outcome. Even the amended constitution gave him only 90 days of direct rule, after which he was obligated to hold general elections and transfer power to a person who could gain the support of a majority in the national assembly. He let it be known that instead of preparing for the promised elections, he was working on a new constitutional arrangement that would divide the country, not into four provinces as was done under the constitution of 1973, but into 20 or so states, each ruled by a governor. Under this scheme, which was still evolving in Zia's mind when he died, the governors and the state assemblies would be elected directly. The center would be governed by the president with the help of a *majlis-e-shura* (nominated assembly). He had not decided about the form of elections for the president and the *shura*.<sup>11</sup>

In 1983, Zia also sought a close relationship with the United States and found that President Reagan, a committed enemy of communism, was happy to recruit Pakistan to the cause. The billions of dollars of help that arrived in Pakistan from Washington and other supporters of the Afghan *mujahideen* could have been turned into a great opportunity for Pakistan. They provided some relief for the country to finance its perennial budgetary and external deficits. Pakistan could have begun restructuring its economy with the purpose of depending on internal rather than external resources for development. Instead, the leaders used the

money to continue with old habits: living well beyond the country's means.

The crisis in Afghanistan, and Pakistan's support for it, left the latter with a number of legacies, including resorting to armed conflict to resolve domestic political disputes, the inflow of drugs and the associated increase in the number of addicts, and the ascendance of the religious schools known as *madrassas*. The last development was to prove particularly critical. In the early 1990s, the *madrassas* launched the Taliban into Afghanistan. They also brought a new force into politics in Pakistan: the well-armed religious militia.

Had Zia lived, he would have certainly put an end to the experiment in democracy he had himself launched, albeit reluctantly, in 1985. He would have also gone back to reintroducing the state into the direct management of the economy. Dictatorships, even in their more benign form, do not easily coexist with market-

11. Some of these details were provided to me by President Zia ul-Haq in a conversation I had with him on July 28, 1988. See Burki, Shahid Javed. Zia's Eleven Years. In Shahid Javed Burki and Craig Baxter, editors, *Pakistan Under the Military: Eleven Years of Zia ul-Haq*, pp. 126. Boulder, Colo.: Westview Press, 1991.

based economies. Markets wrest a great deal of power from those who wield political authority. Zia's death, therefore, turned 1988 into a defining year in the sense that it made possible Pakistan's return to democracy and a market economy.

*1998:* 1998 proved a difficult year for Pakistan. This was the year that a number of crises, each with deep roots in the country's history, came together.

This crisis year arrived with a great deal of historical burden. 1947 left the country with the challenge of accommodating the *muhajir* community into the mainstream of politics and imaginatively dealing with the grievances of the people whose parents and grandparents had sacrificed all they had to help create Pakistan. 1958 set the stage for the return of Pakistan's traditional culture to the center of politics. This trend was reinforced by the arrival of a leadership ironically with the support of the poor and underprivileged that established a feudal state in the country. This state not only operated within a framework of rules totally different from the one that guides liberal democracies, but intruded into areas from which it had been precluded previously. This expanded, intrusive, and feudal state inevitably became extremely corrupt. These trends were reinforced further by the conflict in Afghanistan, in which Pakistan became a willing partner with the United States in 1983. But the Afghan conflict turned Pakistan further away from the path of modernization and took it toward obscurantism.

The ten years between 1988 the year President Zia ul-Haq died and Pakistan resumed its experiment with democracy and a market-based economy and 1998 were busy ones, in which four elections

and four administrations succeeded each other. Three prime ministers were dismissed (by two different presidents) on charges of corruption and incompetence. A struggle between the judiciary and the executive led to the dismissal of one prime minister and the resignations of one president and one chief justice of the Supreme Court. Finally, in October, the military made a half-hearted attempt to reinsert itself into politics, which led, instead, to the resignation of the serving chief of army staff. During this ten-year period, some half-dozen arrangements between Pakistan and the International Monetary Fund were signed, none of which was fully implemented. The crowding of so many events into such a short period is confusing. By identifying 1998 as a defining year in our history, we begin to disentangle these events and bring into focus the forces at work in the country. Some, if not all, of these forces are the result of past developments.

The year started reasonably well. At the annual meetings of the World Bank and International Monetary Fund in the fall of 1997, Pakistan made reasonable progress in negotiating a program with the Fund. These discussions advanced to the point where it seemed that the IMF was prepared to allow Pakistan access to

a significant amount of resources twice the amount of the reserves held by the country at the time in return for carrying out long-postponed structural reforms. Pakistan committed itself to the reforms that usually are included in Fund programs. The government undertook to expand its tax base, increase tax revenues by rationalizing the General Sales Tax, improve tax collection by modernizing tax administration, and reduce the average tariff rate and rely on tariffs rather than quantitative restrictions to provide some protection to local industries. It also promised to improve the efficiency of public sector corporations, in particular the Water and Power Development Authority (WAPDA); reform the banking system by reducing its burden of nonperforming loans and improving bank supervision and regulation; and reorder public sector expenditures to create more space for outlays on social sectors, in particular primary education, basic health care, and population planning. Finally an old Fund favorite it agreed to reduce fiscal deficits.

The Fund could have asked for tougher conditions: it could have forced Pakistan to produce a larger fiscal adjustment, a sharper exchange rate alignment, a more significant reordering of public sector expenditures, and faster privatization of public sector banks and utilities. From the perspective of the Fund in fact, even from the perspective of its previous agreements with Pakistan this was a relatively mild program. The government had argued that it needed time and a much larger cushion of foreign exchange reserves to implement structural reforms. At the same time, the Fund was anxious to avoid another failed program. The fact that the Fund was prepared to offer Pakistan the cheaper, larger, and longer-term Extended Structural Adjustment Facility (ESAF), rather than the

Standby Arrangements it had concluded with the government of Benazir Bhutto and the caretaker administration that succeeded it, reflected a profound change in the institution's attitude. The ESAF arrangement prepared the ground for large commitments by the Asian Development Bank, the World Bank (including the International Development Association, its window for concessional finance), and Japan, Pakistan's largest bilateral donor in the banking, power, irrigation, education, and health sectors. In the spring of 1998, it appeared that Pakistan might have begun to move on the road to economic recovery. But then five things happened.

The government's campaign against corruption by the leaders and officials of the previous regime persuaded it to open a new front against independent power producers (IPPs) that had invested hundreds of millions of dollars in a score of private sector electricity projects over the previous two to three years. In fact, Pakistan stood out as the largest developing country to receive this type of financing. The



IPPs had responded to a power policy formulated during the second Benazir Bhutto administration. It was a generous policy that allowed for large rates of return on invested capital. The guarantees provided by the government included take-or-pay arrangements that committed WAPDA to take, at a set price (in U.S. dollars), either the bulk of the power produced or pay the producers for the power the Authority was not able to use. The producers also were guaranteed a certain supply of fuel and full repatriation of profits in foreign exchange. The government of Prime Minister Nawaz Sharif inherited this policy, but did not find it overly generous. It also maintained that, if it were obligated to live with the negotiated contracts, it would bankrupt the already financially strapped WAPDA and create a serious, perpetual burden for the government. The government's *Ehtesab* (accountability) commission suspected that large amounts of money had passed under the table between sponsors of the private sector power projects and those who had the authority to sanction them, or could influence their acceptance by the government.

There was some substance to the government's case, but the way it was handled landed the country in a serious bind. In today's global market, in which countries and corporations actively compete for capital for investment, there must be an absence of surprises and the sanctity of contracts must be ensured. By violating both principles, Pakistan may have managed to scare off potential foreign investment for a long time to come. This is unfortunate, as the government today is a net spender; it does not collect enough in taxes and revenues to meet even its current expenditures, let alone pay for long-term development. Moreover, the economic turmoil of the last several years has left Pakistan an antiquated

asset base that must be renewed and updated if the country is to compete effectively in the increasingly competitive global market. Not having resources of its own, the country is more dependent on direct foreign investment than most of its real or potential competitors. It cannot afford to be unpleasant to foreign investors.

While the government's dispute with the foreign power producers was heating up, on May 11 and 13, India chose to explode five nuclear devices at a desert site close to the Pakistani border. The nuclear gauntlet had been thrown to the ground. Pakistan had two choices: let it remain there for the world to see, and reflect on the difficult situation in which Pakistan had been placed through no fault of its own, or pick it up and join the nuclear race. Pakistan agonized over this choice for several weeks, clearly disappointed with the West's condemnation of the Indian move as well as with the level of assistance it promised Pakistan. Then Pakistan chose the second option and exploded its own nuclear devices on May 28 and 30, quickly inviting the same set of sanctions that had been applied to India. Pakistan's

economy, however, was much more vulnerable to external pressures, largely because of its dependence of foreign capital flows. It suffered far more from the imposition of the sanctions than had its rival, India.

The decision in mid-May to freeze foreign exchange accounts, which amounted to nearly \$11 billion, or about 16 percent of the gross domestic product, may have prevented capital flight. However, it exacerbated Pakistan's reputation as an untrustworthy partner, which could not be relied on to honor the contracts it signed. Freezing the accounts may have solved a short-term problem, but it exacted a heavy toll in loss of trust. Trust is a fragile commodity; it takes a long time to build, and it can erode quickly.

The next unpleasant event of 1998 was beyond Pakistan's control. In July, a decision by Russia to devalue the ruble and default on its domestic debt jolted the global economy, which is still in the process of recovering. One immediate consequence was the total shutdown of global financial markets to all forms of developing country debt. Even creditworthy countries, like Argentina and Chile, were required to pay a four- to fivefold increase in the spreads over LIBOR, the amount of interest a borrower must pay over the London rate. The signal given by this increase in spreads was a simple one: developing countries were no longer welcome borrowers.

The fifth unhappy development stemmed from Pakistan's response to these events in the global markets. Unable to borrow to roll over its maturing short-term debt not a sound practice but one in which Pakistan had indulged in for a long time several senior officials

began to talk openly of possibly defaulting on foreign obligations. If there is anything the markets despise more than uncertainty, it is open defiance. Inability to pay is one thing. To make a virtue of it is correctly viewed by the markets as opportunistic. The markets responded predictably: all major credit rating agencies lowered the rating of Pakistan's sovereign debt to the lowest level granted to any country. Consequently, Pakistan is now completely shut out of all formal financial markets. No loan committee of any respectable institution will now lend to it, even at today's astronomical spreads.

What happens if the leaders fail? This was our second question, and the answer to it needs to be clearly understood. If Pakistan postpones the much-needed structural reforms, it will condemn itself to a rate of growth in its gross domestic product of between 3.5 and 4.0 percent. With the population increasing at some 2.8 percent a year, this translates into a per capita increase of only 1.3 to 1.8 percent per annum. Experience in Pakistan has shown that the gross domestic product needs to increase by 2.5 to 3 times the increase in population to make a significant dent in the level of poverty. At the forecast low rates, the pool of poverty will

double over the dozen years between 1998 and 2010; from some 40 million now, to 80 million 12 years hence. By adding nearly 40 million to the pool of poverty, we will be inviting social and economic and ultimately political tensions that the country cannot handle. It does not have the institutional strength to deal with that situation. The result will be unimaginable chaos.

Some relief came in November and early December. The United States announced that it was lifting some of the sanctions imposed following the May nuclear bombs testing incident. Nevertheless, in a speech delivered in Washington on November 12, Strobe Talbott, Deputy Secretary in the State Department, made it clear that the leash on which Pakistan was being kept was not very long. He spelled out five conditions that will have to be met by both Pakistan and India before his country would be prepared to restore normal economic relations. These conditions, he said, were crucial and immutable guideline of U.S. policy, [or else] we would break faith with the states that forswear a capability they could have acquired and we would inadvertently provide an incentive for any country to blast its way into the ranks of the nuclear-weapon states we are not simply going to give India and Pakistan the shoulder until they take that step.<sup>12</sup>

Following the easing of sanctions, the IMF began to renegotiate its suspended program and an agency mission worked in Islamabad for several weeks in November. In December, following a visit to Washington by Prime Minister Nawaz Sharif, the United States announced the release of \$324.6 million in cash to reimburse Pakistan for payments it had made for the purchase of F-16 planes that it never received. The total compensation amounted to \$463.7

million, of which \$60 million was to be paid in the form of wheat exports. The United States also was willing to provide export credit to Pakistan for Pakistan International Airlines to purchase Boeing airliners.

Despite these encouraging events, Pakistan continues to face a deep economic crisis. A new IMF arrangement, followed by new lending by the multilateral banks and agreements with the Paris and London Clubs, would certainly pull the country away from economic disaster. But the relief provided would not last long. The country's leadership must move quickly and resolutely on a number of fronts to secure a better future. How it responds to the present crisis will determine the course of economic development not only in 1999, but for many years to come.

12. Strobe Talbott's conditions included signing and ratifying the Comprehensive Test Ban Treaty, halting production of fissile material, limiting development and deployment of missiles and aircraft capable of carrying nuclear weapons, tightening export controls on sensitive materials and technologies, and resolving the conflicts between the countries that have kept them on the brink of war for such a long time. See Zamir, Roshan. IMF Package Not to Solve Pakistan Problems. *The Nation* (Lahore), November 13, 1998, p. 1.

Whether Pakistan succeeds in dealing with the problems it faces depends on the ability of its leaders to tackle its historical legacy.

Two questions arise from this analysis. First, do the leaders have the wherewithal the courage, will, and imagination to dismantle the feudal state they have inherited from the past? And, second, what will happen if the leaders fail to resolve the current crisis?

In answering the first question, we must realize that dismantling the feudal state would take more than reducing the political power of the landlords. More important, it would mean adopting a new mindset, in which leaders make decisions within a broad strategic framework developed in partnership with the people. It means moving from personal whims and wishes, and operating within a framework defined by a clearly articulated set of rules. It means, moreover, that the leaders must subject themselves to controls operated and overseen by those who are vested with the power to see that all citizens follow rules. It is only such altered behavior which may not come easily, given the country's history that our leaders will be able to pull Pakistan back from the abyss and set it on the path of economic and social recovery.

### III. The present crisis: its genesis and resolution

The economy and state of Pakistan are in crisis. It is a great temptation for a person such as myself, who has been involved for some three decades in analyzing developments in Pakistan, to talk about these crises, diagnose their causes, and offer suggestions to remedy them. Although I can claim some understanding of Pakistan and the dynamics that propelled it forward, albeit haltingly, for some 50 years, my perspective is necessarily different

from that of those who live and work here. Except for a brief 100 days, when I joined the 1996-97 caretaker administration and was placed in charge of the ministries of finance, planning, and economic affairs, I have spent the last 31 years outside Pakistan. I am a member of Pakistan's diaspora, which is developing its own point of view about the situation at home. It is an important perspective, as Pakistanis living abroad are in much closer contact with the rapid changes taking place in the global economic, social, and political systems. All these changes have an extremely important bearing on Pakistan's future as a nation state.

I do not think I exaggerate when I say that Pakistan has not faced a crisis of this magnitude in its entire 50-year history—not in 1947-48, when 8 million refugees arrived from India and had to be settled; not in 1965, when Pakistan fought its



first direct war with India over Kashmir; not in 1971, when East Pakistan seceded from Pakistan to become the independent state of Bangladesh; not in 1979, when a military president ordered the execution of the civilian prime minister he had deposed two years earlier; not even in the ten-year period that followed the occupation of Afghanistan by the Soviet Union. The economic crises that led to the dismissal of the first Nawaz Sharif government, in April 1993, and of the second administration of Prime Minister Benazir Bhutto, in November 1996, were severe, but they were not as acute as the one the country faces now.

The situation is considerably worse today because five different crises have coalesced to produce a situation that seems hopeless to many. I refer here to the global financial crisis, the short-term liquidity problem Pakistan currently faces, the structural problems in the economy that should have been dealt with a long time ago, the severe social backwardness of a large and rapidly growing population, and, finally, the crisis of governance posed by an almost total collapse of modern institutions. I will say a few words about each of these five problems.

*The global financial crisis:* The global financial crisis began in July 1997, with the sudden and unexpected collapse of Thailand's currency and then its economy. Within a few months, the crisis had engulfed most tiger economies of East Asia. It took the special intervention of international financial institutions in December 1997 to save the Republic of Korea from defaulting on its debt. In July 1998, exactly a year after Thailand's economic weaknesses were exposed by operators in the global capital markets, Russia came under heavy pressure. It responded by defaulting on its

domestic debt and devaluing the ruble. These actions delivered severe jolts to the already weakened financial markets. In late September and early October, as Brazil was preparing for elections, it appeared that the crisis would reach Latin America. By then, Wall Street had also received a severe shock. In October, the capitalization of the American stock markets had declined by one-fifth and it appeared that a severe compression in demand would follow. By the early fall of 1998, the crisis had approached a point at which it threatened the entire global economic system, leading to action by the U.S. Federal Reserve to lower short-term interest rates. The first positive turn came on October 28, when the G-7 ministers issued a joint statement announcing a new framework within which to address the types of problems that had brought about the collapse, or near collapse, of several economies in East Asia and Russia.

One important consequence of the G-7 plan of action will be to involve international financial system much more closely in directing the economies of the developing world. Developing countries will have to accept new norms of behavior, including greater transparency in the way they manage their economies, in

particular those aspects that are now becoming integrated into the evolving global economic and financial system. The Pakistani press and intelligentsia have always been deeply resentful of the role the international institutions have played in the past. They have regarded them as highly intrusive and unconcerned with the interests of the developing world. A couple of random pickings from a number of recent articles in the press should illustrate this point. According to one, The multilateral agencies have assumed the role of economic management in the absence of domestic effectiveness on this score. They are, therefore, ruffled if Pakistan's government assumes more economic authority than these agencies would like to vest in it.<sup>13</sup> Another commented on the way the IMF dealt with the problems in East Asia and Russia and how it might respond to the situation in Pakistan: At the same time, [the] IMF, bent upon extracting its own pound of flesh, set conditions guaranteed to make the common man come out in the streets in violent protest. Such harsh terms would be unacceptable to any self-respecting government in Pakistan.<sup>14</sup>

The Western countries and Japan don't look at the role of the international financial institutions this way. They are of the view that they have every right to lay the ground rules for the operations of these institutions, as the bulk of their funding comes from the pockets of their taxpayers. A new concern also exists: that economic, social, and political crises in the developing world can no longer be treated as isolated events. They now affect all parts of the globe. Political upheavals and social turmoil can generate streams of refugees that invariably head toward Europe or North America in search of sanctuaries and asylum. Serious economic troubles in the developing countries, as was vividly demonstrated

by the effect of the developments in East Asia and Russia, can have uncomfortable repercussions in industrial countries. The world has become too small a place for large and rich countries to totally ignore what is happening in smaller and poorer nations and economies.

Without digressing too much from the present subject, it is important to underscore that we are at this time seeing the emergence of a new global order. It is ironic that the demand for a new international economic order was first raised by the left in the developing world in the early 1970s and went largely unrealized. A quarter of a century later, we are witnessing the emergence of a new global order that is the product of the confluence of a number of forces operating in the industrial world. The left in the developed world is busy writing new international rules

13. Fatima, Mahnaz. As IMF and Pakistan Muddle Through. *Dawn Economic and Business Review*, November 915, 1998, p. vi.

14. Sehgal, Ikram. Balancing the Costs. *The Nation* (Lahore), November 14, 1998, p. 6.

and treaties that seek adherence to universally accepted norms of behavior in such diverse areas as human rights, child labor, the use of land mines, and environmental pollution. The governments in the West have begun to craft policies that would keep the spread of weapons of mass destruction to a minimum, even if some countries in the developing world consider it highly inequitable that a few industrial countries should maintain a monopoly over their development and stockpiling. The West also has shed its inhibition against putting pressure on groups within countries to resolve political differences among themselves even when these groups are working within the boundaries of sovereign states. Such involvement in what used to be called the internal affairs of sovereign states has received the approval of most nations when the conflict being addressed involves grave violations of human rights.

Operators in the global financial system are working with central banks in the industrial world to ensure that financial institutions all over the globe adhere to international norms. New surveillance mechanisms are being developed to ensure this. Multilateral development banks have announced that they want to see significant improvements in the quality of governance before committing large amounts of their funds, most of which either come from the budgets of the industrial world or are obtained from their financial markets. What we are seeing today, therefore, is the development of rules of behavior that curtail the degrees of freedom for governments. Developing countries may resent this intrusion, but they should recognize that many of their own citizens subscribe to most of these rules of behavior.

The global crisis is affecting Pakistan in many different ways over the short term and will continue to do so in the longer run. The most profound impact has been the creation of a short-term liquidity crisis.

*Short-term liquidity crisis:* The year-old global financial crisis has produced an environment that has already created serious difficulties for Pakistan. The most obvious of these is the lack of access to the global financial markets not only it, but most other emerging markets, are encountering. While other developing countries may regain market access within a year or so, Pakistan has so badly hurt its credibility that it will have to wait much longer. The closure of the markets to Pakistan has seriously exacerbated its situation because it is unable to roll over its maturing debt. This has made the country entirely dependent on official capital funds from the International Monetary Fund, multilateral development banks, and bilateral development institutions. Without official flows, Pakistan will not be able to service its short-and long-term foreign obligations. The press has reported that Pakistan is already in serious arrears to some multilateral institutions. One account

holds that Pakistan defaulted in late 1998 on a payment of \$25 million to the Islamic Development Bank, as a result of which the IDB is refusing to issue a letter of credit for \$35 million for fertilizer imports.<sup>15</sup> In the parlance of international finance, international financial institutions, including all multilateral banks, are called preferred creditors in the sense that all borrowers are obligated to put them at the head of the queue as loans are serviced and payments are made. The failure to service these obligations can lead to serious consequences.

While a new program with the IMF would certainly provide relief to Pakistan, this will be for the short term. The amounts being negotiated will help the country finance its obligations for about a year and reschedule some of its obligations to external creditors. Beyond that, the country will have to find other resources. Three of these a sharp increase in the level of remittances, the revival of foreign direct investment, and a significant increase in export earnings are contingent on the country's ability to implement a number of long-postponed reforms.

*Antiquated economic structures:* The depth of the crisis Pakistan faces today can be laid at the door of a series of policymakers who failed to adopt structural reforms. The list of postponed reforms is long and familiar. Of vital importance are the reforms aimed at improving the rate of domestic savings. Although economists do not fully agree on what motivates societies and people to save more, there is now recognition that countries with low levels of aggregate savings must begin their efforts in the public sector. This is especially true for countries, such as Pakistan, that have consistently run large budgetary deficits. A reduction in budgetary

deficits helps increase investments and improve the economy's rate of growth. There is a positive correlation between growth rates and private savings, with the causality running from growth to savings. Thus, once a high level of growth has been achieved, it can be made to sustain itself. That was East Asia's experience before the countries of the region succumbed to the 1997/98 crisis. It is also the reason why, when the process of restructuring that has been put in place in East Asia is complete, these countries will return to high rates of economic growth.

A reduction in budgetary deficits has been the aim of a number of failed IMF programs. Policymakers in Pakistan understand that the deficit has to be reduced to a level at which it can be sustained. There are really two issues: the size of adjustment and the time span over which it should be achieved. The experience of the countries in Latin America has some relevance in this regard. Brazil, for instance, announced a fiscal package in late October that aimed to reduce the deficit from its

15. Haider, Hasseeb. IDB to Confirm \$35 M L/C for Fertilizer Import. *The Nation* (Lahore), November 11, 1998.



then unsustainable level of 8 per cent of GDP to 4.2 percent within one year, an adjustment equivalent to nearly 4 percentage points of the country's gross domestic product. This package won the Brazilians the support of the international community, which put together an assistance program worth nearly \$42 billion. In 1991, the highly successful effort made by Argentina involved a fiscal adjustment that was even larger in scope than the one being made by Brazil. I, therefore, find it difficult to accept the argument that an adjustment of 2 to 3 percentage points of GDP within a year is beyond Pakistan's ability. I find it hard to agree with the conclusions reached by Parvez Hasan in his recent impressive work on Pakistan's economic history. He maintains that even though the ratio of taxes to GDP in Pakistan is low, compared to other countries, it is not realistic to expect dramatic improvements in the near future.<sup>16</sup> A large effort, of course, would require sacrifices by a number of groups, in particular those who have managed to avoid the tax net altogether. It will also require a significant improvement in the management of the tax administration and a reduction in leakage due to corruption.

Despite efforts made on several occasions, why has Pakistan found it so difficult to set its fiscal house in order? This is an important question, which calls for a moment of reflection. Among the many reasons for Pakistan's lack of success in this area, two in particular are worth noting. The country's political leaders have not been able to develop a consensus around which a viable system of tax administration could be built. It has often been suggested that the tax administration system requires greater coercive powers. While it is essential that those who fail to pay taxes, and thus cheat the government, must be punished, we should also recall what

Lord Canning, the first Viceroy of India, said about this matter: I would rather govern India with 40,000 British troops without an income tax than govern it with 100,000 British troops with such a tax.<sup>17</sup>

The second reason for the persistence of country's fiscal problems can be traced back to Zulfikar Ali Bhutto's administrative reforms. Because of these reforms, Pakistan lost a system of administrative management that was deeply conservative in its outlook on state finances. As Sunil Khilnani, an astute Indian observer, put it recently in reference to his own country, The British Raj left its successor one narrow but for any state, essential practical legacy. Its commitment to cheap government became entrenched as a finicky administrative concern about sound finances: a tropicalized Gladstonian rectitude that sus-

16. The most cogent presentation of this argument is in Hasan, Parvez. *Pakistan's Economy at the Crossroads: Past Policies and Present Imperatives*, pp. 331-35. Karachi: Oxford University Press, 1998.

17. Tomlinson, B. R. *The Economy of Modern India*, pp. 151-52. Cambridge: Cambridge University Press, 1993.

tained fiscal conservatism.<sup>18</sup> This rectitude was exercised by the administrations in Pakistan until Bhutto eliminated the possibility of the civil service remaining outside the realm of politics.

Following Bhutto's reforms, civil servants became increasingly beholden to the political bosses of the day and were subject to political demands that had to be accommodated even within the shrinking resources available to the state. Ghulam Ishaq Khan was the only person in the last quarter-century able to persevere with fiscal conservatism.

In sum, structural reforms aimed at increasing public revenues and subjecting public sector development expenditures to prudent and conservative tests will require a strong political commitment, a drastic overhaul of civil administration, and, circumstances permitting, a reduction in military expenditure. And it will mean a profound change in the economic role of the state.

In redefining the role of the state, it is important to take a second look at the way reform of the commercial and investment banks is currently being handled. It will be recalled, perhaps, that the caretaker government of 1996/97 established a Resolution Trust Corporation to take over the nonperforming loans in the banks before offering the banks for privatization. The RTC was expected only to not only collect a significant proportion of the debt owed the banks, but also to restructure industries that were either closed or grossly inefficient. The perennial problem of sick units was, thus, to be addressed by restructuring them, rather than providing them subsidies. This policy was not followed by the present government, which hoped that, by changing the management of the banks, it would be possible to first clean them up before

offering them up for sale. While the new, professional bank managers have done an impressive job in improving the management of these institutions, this approach has slowed down the privatization of nationalized banks and industrial restructuring. It is interesting that the Japanese government is following the line adopted by the caretakers in handling its own banking crisis.

While reforming the banking sector has a high priority, the government should also recognize that it is vital to develop other institutions in the financial sector. After making some impressive strides in developing a capital market during the days of President Ayub Khan, Pakistan today lags way behind most large developing countries. Financial and capital reforms also are essential to provide new instruments for potential savers and new sources of finance for private businesses.

Zulfikar Ali Bhutto's nationalization not only left the government in ownership of commercial banks, it also added to the number of public corporations operat-

18. Khilnani, Sunil. *The Idea of India*, p. 66. New York: Farrar, Straus & Giroux, 1998.

ing in the economy. These entities offered excellent opportunities for graft and granting political favors. They were required to finance projects with low or negative rates of return and were ordered to employ people who could not find jobs elsewhere in the economy. Consequently, none of these corporations is working efficiently today; most, if not all, of them are bankrupt. WAPDA is the most vivid and also the most depressing example of this development. The agency's management was handed over to the army in November, and a lieutenant general was appointed chairman. In his first news conference on November 13, the new chairman informed the nation that WAPDA had accumulated a debt of Rs.50 billion, slightly less than 2 per cent of the gross domestic product.

The only way out for the insolvent public sector corporations seems to be to adopt the resolution trust approach. Creating a public sector agency to take over the debts of these bodies, remedy their indebtedness with the help of assistance from multilateral agencies, and then offer them for privatization, appears to be the most logical way to proceed.

Pakistan must look to international trade for a lasting means to correct its longenduring macro imbalances. Put another way, it is only with a sharp increase in export earnings that Pakistan can find a reliable way to close its external payments gap. It is well known that, for most of its history, Pakistan has followed an import substitution policy rather than an approach favoring exports. As a result, strong vested interests have developed that continue to act vigorously against attempts to liberalize the trade regime by adjusting it in favor of exporters.

A long list of reforms, some of which are structural, needs to be implemented to eliminate the strong import substitution bias in policymaking. First, a serious effort has to be made to modernize the industrial asset base. Some of this should be made possible by the industrial restructuring of the sick units mentioned above. Second, incentives may need to be provided to bring investments, both local and foreign, into sectors with high export growth potential. Upgrading the large textile industry toward higher value-added products could provide a boost to export earnings, particularly in light of the forthcoming changes in the Multi-Fiber Arrangement. Also, Islamabad should give serious thought to attracting the expatriate Pakistani community to invest in their homeland. This group of potential investors could draw disillusioned foreign investors back into Pakistan. The expatriates could play the same role for their country that the overseas Chinese played in the 1980s for China, and is now being exercised by the nonresident Indians for India. Although there is some disagreement in the academic community about the contribution that export promotion zones can play in increasing exports, Pakistan may wish to borrow a page

from the Chinese experience and set up such zones aimed especially at the Pakistani diaspora.

Third, decisionmakers in Islamabad still do not appreciate sufficiently that investors do not like surprises. There is now a well-established practice and an ingrained habit of using SROs (statutory regulatory orders that amend the rules under which trade is conducted) to respond to ad hoc demands from different pressure groups. This approach constantly introduces changes in the trade regime. Other than providing additional opportunities for corruption, as SROs increase the discretion available to those who enforce them, this way of handling the trade regime also introduces enormous uncertainty for investors. Pakistan now needs a clear and simple strategic approach to an export-oriented trade regime that is kept in place without endless tinkering.

Fourth, it is important to recognize that price ultimately motivates action and no price is more important to an export promotion strategy than the exchange rate. There is now an emotional debate going on in the country on the issue of the exchange rate, with those who oppose devaluation pointing to its disadvantages while those who are in favor extol its virtues. Those who do not wish to adjust the rate of exchange have created the impression that, somehow, Pakistan's sovereignty would be compromised if it allowed the rupee to devalue with respect to the dollar. Some concerns about devaluation are legitimate: it could result in cost-push inflation, the structure of the economy is such that lowering the value of the rupee would not generate a strong supply response, devaluation increases income disparities. Despite these objections, there is enough evidence on the movement of the

exchange rate in the last several years to show that the rupee has lost competitiveness. Large devaluations by the countries of East Asia will hurt Pakistani exporters if the country fails to make adjustments of its own. According to one estimate, the index of the nominal effective exchange rate has moved from 144 in late 1985 (with 1990=100) to only 65 in mid-1997.<sup>19</sup> In other words, the rupee is twice as expensive today as it was 12 years ago. It is not surprising, therefore, that exports are performing so poorly these days.

In sum, Pakistan must make a determined effort to solve the problems created by large external imbalances by improving its earnings from exports. Such an effort calls for deep structural reforms to reorient the thrust of government policies from favoring an import substitution strategy to promoting exports.

*Social backwardness:* It is now well recognized that the Pakistani state has failed spectacularly in the area of social development, and that the situation has been dete-

19. Hasan, Parvez. *Pakistan's Economy at the Crossroads*, *op. cit.*, Table 7.2, p. 339.



riorating over time. In 1998, Pakistan ranked 138th of 174 countries in terms of the Human Development Index<sup>20</sup> estimated by the United Nations Development Programme.<sup>21</sup> The HDI is a composite measure that includes GDP, life expectancy, adult literacy, and school enrollment. In 1990, when the UNDP did its first estimation of the index, Pakistan was ranked 94th. In other words, while in 1990 there were 93 countries ahead of Pakistan in human development, in 1998, the number of countries doing better than Pakistan had increased to 137. Within eight years, 44 countries had surpassed Pakistan in the development of human resources.

There are some other ways to illustrate Pakistan's failure in social development. For instance, Table 1 provides information on public sector expenditures for education and levels of illiteracy in the countries of South Asia. The latest information indicates that Pakistan spends only 2.0 percent of its gross national product on public sector education, compared to an average of 3.4 percent for low-income countries and 4.1 percent for middle-income countries. The levels of public sector expenditure in other South Asian states are much higher: 3.8 percent for India, 2.3 percent for Bangladesh, and 3.1 percent for Sri Lanka. It is not surprising, therefore, that the adult literacy rate for Pakistan is so much lower than the average for low-income countries and the other countries of South Asia.

The situation is particularly worrisome for women. In 1995, Pakistan had the highest illiteracy rate for women in South Asia. Less than one quarter of Pakistani

TABLE 1

Public sector expenditures and levels of illiteracy in South Asia

PUBLIC SECTOR EXPENDITURE ON ADULT ILLITERACY RATE

COUNTRY	EDUCATION	(%)	
	(% OF GNP)	MALES	FEMALES
Bangladesh	2.3	51	74
India	3.5	35	62
Pakistan	2.0	50	76
Sri Lanka	3.1	7	13
Low-income countries	5.5	35	59
Middle-income countries	4.5	12	25

*Source:* The World Bank, *World Development Report: Knowledge for Development 1998* Tables 2, 6; pp. 192-93, 200201. Washington, D.C.: 1998.

20. There is an irony in this since the HDI was originally thought of by a Pakistani economist, Mahbub ul Haq, when he was hired by the UNDP to start the *Human Development Report* series.

21. United Nations Development Programme, *Human Development Report 1998*. New York.

women could be counted as literate, as compared to 38 percent for India, 87 percent for Sri Lanka, and 41 percent for all poor countries. This is, indeed, a worrying trend. It is now recognized by all development experts—economists, sociologists, anthropologists, political scientists—that an illiterate female population is a serious drag on growth, development, and modernization. Female illiteracy usually results in a high fertility rate—a correlation that has been confirmed only too well in the case of Pakistan. Low levels of female education also slow economic growth and hamper modernization. It is indeed of great concern that administration after administration in Pakistan has paid so little attention to educating the country's women. A society that condemns its women to backwardness is choosing backwardness for itself. Perhaps the most vivid example of this attitude toward women and its impact on the society at large is to be found in the Taliban-controlled area of Afghanistan.

As with so many other things that went wrong with Pakistan's society and economy, the near collapse of public education can be traced to the ill-advised and ill-conceived actions of the administration of Prime Minister Zulfikar Ali Bhutto in the early and mid-1970s. Some quarter of a century ago, the Bhutto administration destroyed fledgling private interest in education by nationalizing the few privately run institutions. Most of these institutions were managed by foreign missionaries and offered a high-quality education to those families who could afford it. Protesting that the private institutions were introducing a high level of inequity in the educational system, Bhutto brought them under government control.

Bhutto followed up the nationalization of private schools by establishing a textbook board that had the responsibility for and a monopoly on producing instructional materials for schools, colleges, and universities. The result was both obvious and predictable. Today, Pakistan has some of the poorest-quality textbooks anywhere in the world. However, the damage done by the Bhutto administration did not stop there. In response to the slowdown in economic growth and the rising rate of unemployment among the educated young, his administration allowed a massive expansion of the work force employed in the education sector. The result also could have been predicted. Today, Pakistani children who attend public schools are being taught by a corps of teachers of which the overwhelming majority is itself barely literate.

These moves proved disastrous for education. There was a precipitous decline in quality. With private schools no longer able to provide a safety valve for those willing to pay substantial sums for a good education, the only remaining option was to send their children to foreign schools, mostly in the United States. At one point in the late 1980s, the aggregate expenditure on students studying abroad

more than 17,000, spending an average of \$20,000 a year, or some \$340 million was only slightly less than 1 percent of GNP. In other words, Pakistani parents were spending an amount equal to one-half of the total public sector education expenditure on educating only a few thousand boys and girls in British and North American universities.

Zulfikar Ali Bhutto was gone in 1977. Zia ul-Haq, his successor, was prepared to allow the private sector to move back into education. But he did it in a way that was to have and will continue to have a profound impact on Pakistani society. Beginning in the early 1980s, two very different sets of operators moved into the gap left by the poor performance of the public sector. The private sector, motivated both by the revealed preference of a growing segment of the population for quality education and the opportunity to make handsome profits, invested heavily in education. Hundreds of educational entrepreneurs set up hundreds if not thousands of institutions to provide instruction at all levels, in many subjects. However, a different type of private initiative has also filled the gap created by the dysfunctional state sector. *Madrasas* (religious schools) again in the hundreds, if not thousands have been established all over the country over the last decade and a half. The establishment of these *madrasas* was helped by a little noticed decision of President Zia ul-Haq in the early 1980s that allowed religious foundations to access *zakat* (Islamic wealth tax) funds for establishing religious schools. Following this decision, the number of *madrasas* and the number of students enrolled in them increased exponentially. The *madrasas* flourished in the areas in which the public sector had a weak presence.

These developments in education pose a number of serious problems for Pakistan. The virtual collapse of the state as a provider and the active participation of the private sector at two different levels institutions providing Western-style education, mostly using English as the language of instruction, and *madrasas* focusing mostly on religious instruction in Urdu and Arabic may have sown the seeds of immense social instability. In developing a highly modern, privately managed educational sector, we may have laid the ground for the nurturing of two different cultures, encouraged by two different sets of beliefs inculcated by two conflicting approaches to education, and motivated by two entirely different and contradictory sets of social and personal goals. A clash between these two cultures could occur if the economy fails especially if it is unable to accommodate the graduates from the religious schools. If such a clash takes place, its consequences could be enormous.

What has happened in education has also occurred in other social sectors. Another way of demonstrating the crisis of social development in Pakistan is to

compare Pakistan's demographic situation with that of Bangladesh, which was once part of Pakistan and was considerably less developed at the time of its secession. In the 16 years between 1980 and 1996, total fertility in Bangladesh declined by 44 percent, from 6.1 births per woman to only 3.4. Consequently, the rate of population increase has declined by a third, from an average of 2.4 percent over 1980-90 to 1.6 percent for 1990-97. Pakistan has done significantly less well. While its total fertility rate has also dropped by 27 percent, from 7.0 in 1980 to 5.1 in 1996, it remains high, one of the highest in the world. A high fertility rate produces a rate of population growth that Pakistan does not have the space or the resources to sustain over time. At 2.9 percent a year, the growth of Pakistan's population is 81 percent higher than in Bangladesh. In 1971, the year in which East Pakistan seceded, few people would have imagined that, only a quarter of a century later, Bangladesh would compare so favorably to what was once part of the same country.

Another aspect of the government's failure to address social development is the highly skewed distribution of services provided by the state. According to a well-informed Pakistani observer, In fact, there are only three other countries which are worse off than us in terms of distribution. They are Morocco, Oman and Algeria.<sup>22</sup> For growth rates to translate into increased incomes for the poor, there has to be an improvement in income inequality.<sup>23</sup> A move toward a more equitable distribution of income will require a considerably improved distribution of land, something that was attempted half-heartedly in 1959 and again in the 1970s. It will also require a fiscal system that does not discriminate against the poor. And, finally, it would benefit from an intensive state-led effort in

social development, particularly in the provision of basic education and primary health care to the poor.

What policy options are available to the state at this time? To begin with education, the state's role in providing education has become so dysfunctional over the last quarter century that the obligation has shifted to the private sector to fill the gap. The private sector will continue to be needed at all levels, especially the higher levels, so that the meager amount of resources the state is committing can be concentrated on the primary sector, especially providing basic education to girls. In entering the arena of higher education, the private sector should be mindful to use curricula and pedagogic methods that are relevant to the rapidly changing

22. Mustafa, Zubeida. Cost of Neglect of the Social Sectors. *Dawn*, November 12, 1998, p. 19.

23. For an analysis of the impact of growth on income distribution in the context of Pakistan, see Papanek, Gustav F. Pakistan's Development and Asian Experience. *The Pakistan Development Review* 35:4 (winter 1996), pp. 343-78.



global economy in which Pakistan should attempt to find a suitable place for itself. Private institutions should arrange financing for capable students from poor families and should also accept certification by institutions of accreditation to guide parental choice. The state should encourage private industry and corporations to augment the resources flowing into private education, particularly in science and technology.

The general thrust suggested for education also applies to healthcare. A partnership between the public and private sectors must be forged, in which the private sector takes responsibility for high-cost health care for those who can afford to pay, while the public sector provides basic coverage to the poorer segments of the population.

*Destruction of institutions and persistence of poor governance:* It is now generally recognized that Pakistan faces a serious institutional crisis. What we see today did not happen suddenly. The process of the willful destruction of institutions and organizations began a quarter of a century ago, when Zulfikar Ali Bhutto removed everything he found in his way. Some argue that this style of governance began even earlier, in the late 1950s, when the military first intervened in the political affairs of the country. No matter which date we choose, Pakistan's history is full of developments in which the leaders of the day were prepared to destroy institutions to deal with immediate political, social, or economic problems. Looked at it this way, we could peg the beginning of the process of institutional destruction at an even earlier date: 1954, when Governor General Ghulam Muhammad dismissed Prime Minister Khawaja Nazimuddin and dissolved the

Constituent Assembly and the Supreme Court, citing the doctrine of necessity, to justify his moves.

For the purposes of this presentation, it is useful to answer the following questions. First, how do we define institutions and organizations, and why are they necessary for sustained economic and social development? Second, why have modern institutions failed to take root in the soil of Pakistan? Third, what should be done to provide the country and society with a solid institutional foundation?

The new institutional economics literature defines institutions as informal and formal rules and their enforcement mechanisms that shape the behavior of individuals and organizations in society. By contrast, organizations are entities composed of people who act collectively in pursuit of shared objectives. Thus, organizations and individuals pursue their interests within an institutional structure defined by formal rules (constitutions, laws, regulations, contracts) and informal rules (ethics, trust, religious precepts, and other implicit codes of conduct). Organizations, in turn, can be formal (legislative chambers, political parties, government agencies, the judiciary) or informal (*baradaris*, savings clubs, or com-

mittees run by housewives).<sup>24</sup> Modern institutions and organizations are needed to modernize an economy. They introduce transparency, credibility, and predictability in the way economic decisions are made. Of all the agents working in an economy, none is more important than the state. If the weakening of institutions and the destruction of organizations has created a situation in which the decisions made are mostly opaque, subject to whimsical change, and seen to be motivated not by social concerns but to advance narrow interests, responses by agents in the marketplace will be uncertain. This situation prevails in Pakistan today. One example is the continuing and excessive resort to SROs to manage the trade regime. As discussed above, an SRO-based regime introduces uncertainty, unpredictability, and opaqueness, with all their negative consequences.

Perhaps the best way to estimate the damage done by institutional and organizational weaknesses is to separate transformation costs from transaction costs. Institutional economics has highlighted the importance of transaction costs in economic decisionmaking. These include the costs of obtaining and verifying information about the quantity and quality of goods and services, transaction partners (verifying their reputations, records etc.), and the quality of property rights to be transferred, including the legal and contractual frameworks and the costs of designing, monitoring, and enforcing contracts, including those entailed in litigation and dispute resolution. For some transactions, such as shopping for groceries or procuring cooked food from small, roadside restaurants, these costs may be small. The reason why small grocery stores and roadside restaurants tend to cluster together is to reduce transaction costs by allowing customers the opportunity to

shop around easily. A visit to Lahore's *Gowalmandia* busy market in the middle of the city where dozens of small restaurants sell fish provides vivid testimony of the power of transaction costs in helping economic agents make decisions.

For some other activities, transaction costs can be very high. An example in Pakistan is the private sector's investment in power generation. The way the government has handled IPP contracts has increased transaction costs enormously for individual investors. These will be factored into the real costs of making new investments by all future investors. Including these costs in total outlays could make Pakistan an unattractive destination for foreign investors.

Transaction costs can be high even in highly developed economies where institutions and organizations work well. Two researchers, John Wallis and Douglas

24. This definition draws upon the works of Douglas North, *Institutions, Institutional Change and Economic Performance* (New York: Cambridge University Press, 1994), and Oliver Williamson, *The Economic Institutions of Capitalism: Firms, Markets, Related Contracting*, (New York: Free Press, 1985).

North, estimated the share of transaction costs in the United States in 1970 at 40 percent of the country's gross domestic product.<sup>25</sup> A country such as Pakistan must move factors of production from the informal sector to the formal sector, from the small and medium scales to the large scale. An increase in transaction costs in the modern parts of the economy, as is happening now, will produce the opposite movement, from the modern to the traditional, from the large to small. Some observers have commented on the process of deindustrialization of the Pakistani economy. If that is indeed happening, much of the blame can be placed at the doorstep of institutional and organizational collapse.

What can be done about this situation? The answer to this question is simple at the general level, but gets more complex when we begin to deal with specifics. At the general level, leaders must begin to change the culture of a society that likes to see transactions made as individual contacts rather than with the help of organizational mediation. As I have argued in some of my earlier works,<sup>26</sup> the landlord-based culture of Pakistan puts emphasis on the give and take among individuals, rather than on transactions supported by a system of laws, rules, and regulations. The more traditional system encourages corruption; the modern system provides a way to counter it.

#### IV. How the crisis of 1998 is perceived

Now for a word about the way the crisis of 1998 has been perceived by various groups: foreign governments, the Islamabad establishment, the intelligentsia in Pakistan, the Pakistani press, and the Pakistani diaspora. Perceptions forge policy, and they will forge Pakistan's response to the exceptionally difficult situation it

faces today.

The West's in particular the United States' concern about the situation in Pakistan was indicated clearly in a statement by a senior Washington official, when he announced his government's decision to lift some of the sanctions it had imposed following the nuclear tests in May. The one-time economic bailout plan for Pakistan had been approved by the G-8 countries, as nobody wanted Pakistan to collapse economically, he is reported to have said.<sup>27</sup> In other words, at least the

25. Wallis, John J., and Douglas C. North. Measuring the Transaction Sector in the American Economy, 1870-1970. In S. L. Engerman and R. E. Gallman, editors, *Long-Term Factors in American Economic Growth*. Chicago: University of Chicago Press, 1986.

26. See Burki, Shahid Javed. *Pakistan under Bhutto, 1971-77*. London: Macmillan, 1980, and Burki, Shahid Javed. *Pakistan: First Half Century of a Nation*. Boulder, Colo.: Westview Press, 1999.

27. Sebhahi, Shaheen. Clinton Withdraws Sanctions Partially. *Dawn*, November 8, 1998, p. 1.

governments of the group of G-8 countries seemed very worried about the economic situation in Pakistan.

If Islamabad shares this sense of urgency, it seems to have done a good job of keeping its worries to itself. The statements made by senior government officials in the summer and fall of 1998 did not give the impression that they fully recognized the seriousness of the situation. Good cotton and wheat crops may have produced a sense of complacency. Or government functionaries may be concerned that, by communicating to the public their fears about the economy, they might further disturb the already disturbed currency and stock markets. The fact that the prime minister changed the entire economic team on November 7, a few days before negotiations began with the IMF and World Bank, indicated that at least he felt that the country was faced with a serious enough situation to merit forming an economic team that had his full confidence.

The intelligentsia seem anxious about the country's worsening economic situation, but do not know exactly what has gone wrong. They know that Pakistan has a serious balance of payments problem and realize that, unless help arrives soon, the country may not be able to meet all its foreign debt-servicing obligations. Even now, despite the visible efforts of the *Ehetasab* Commission under the direction of a close confidant of the prime minister, there remains great concern about the persistence of corruption. The people also worry about poor governance, ethnic and sectarian strife, deteriorating law and order in large cities, a number of high-profile murders in Karachi, and the dismissal of the provincial government in Sindh. There is a great deal of talk in living rooms

in Islamabad and Lahore about the political consequences of increasing unhappiness about the perception of Punjab's domination of all important instruments of state.

The domestic and foreign press share these views and have contributed to their spread and prevalence. For instance, the London-based magazine, *The Economist*, which has kept a watchful eye on Pakistan since its inception, carried a story in early October titled The Crumbling of Pakistan. Pakistan is more likely to crumble than to explode. A good harvest this year has so far kept the country's economy tribulations from being a catastrophe for most Pakistanis, wrote the magazine's Asia editor.<sup>28</sup> Hundreds of newspaper columnists have written about these matters in the local press in recent weeks and months, urging the government to take urgent action to remedy the situation. However, at least to the extent I have been able to follow the press, I see no clear message about the type of measures the government is supposed to adopt. The debate is

28. The Crumbling of Pakistan. *The Economist*, October 7, 1998, p. 45.



not very helpful if the policymakers are looking to the press for some ideas on how to proceed.

And, finally, there is the Pakistani diaspora the 4 million or so Pakistanis who live and work abroad. Most of them reside in three separate communities, the Middle East, Great Britain, and North America. Their combined income is now worth \$60 billion, almost equal to the gross national product of Pakistan. The economic muscle of this group has been recognized by the leaders of Pakistan for the last two decades. All presidents and prime ministers in the last 25 years have visited the communities of overseas Pakistanis in search of political and financial support. These communities have, in turn, begun to exert their influence by increasing or holding back the remittances they send home, choosing the channels for sending back money, and organizing nongovernmental organizations to work in the areas in which Pakistan's government has become dysfunctional. These communities claim that they also have been able to influence the politics in the countries where they reside, and it appears that Pakistanis living in North America have been successful in affecting the results of some elections involving individuals who had worked openly against Pakistan's interests. Pakistani communities played a critical role in the defeat of Senator Larry Pressler in the 1996 U.S. elections. There are stories in the Pakistani press that Pakistanis living in New York also contributed significantly to the success of the Democratic Party's Charles Schumer against Senator Alfonse D'Amato, a senator who had been vocal in his criticism of Pakistan.

The diaspora community observes the evolving situation in

Pakistan with great interest. Like all communities of immigrants, it maintains close ties to its homeland. Easy access to the Internet makes it possible for its members to read the Pakistani press daily. They seek good news, but not much was forthcoming in most of 1998. Even in cricket and squash, where the country had gained international prominence, the news has not been encouraging. One concrete demonstration of the Pakistani diaspora community's negative reaction to recent developments in the homeland has been a significant drop in remittances. Some recent estimates put the magnitude of this decline at 30 percent, compared to those of 1997. Even this estimate may be optimistic, as some of what is being recorded as remittances may just be the amounts that are being deposited in banks following their redemption from frozen foreign exchange accounts. Remittances have not only declined; they are increasingly bypassing official channels and flowing into the country via the *hundi* (nonformal banking) system. The increasing reliance on informal financial channels instead of the formal banking system is yet another manifestation of the erosion of the institutional structure.

What are the policy implications of these responses to the economic crisis? Two conclusions stand out. First, all important groups are worried about the situation, but they are not fully aware of the nature or magnitude of the crisis. Second, none of the groups understand that, unless it is addressed resolutely and promptly, the crisis of 1998 may last much longer than previous crises and may exact a heavy social, political, and economic price before it is finally overcome.

#### V. Pakistan's economic future

The reason I consider 1998 the defining year for Pakistan's future is that it has brought the country to a crossroads. We can go in one of two directions. By taking resolute actions, many of which are admittedly difficult and possibly politically risky, we could prepare the ground for a significant increase in the economic welfare of the citizens of Pakistan and create an attractive place for the country in the rapidly evolving global economic system. Conversely, today's leaders could adopt the politically less difficult approach of just tinkering at the margin which would reduce Pakistan to a place on the fringes of the global system. I should emphasize that, when I refer to the leaders, I speak not only of those who govern, but also of those who oppose, since it is the interaction between the two that creates the space within which policy is eventually made. It is precisely for this reason that I have devoted an entire section of this presentation to the way people are responding to unfolding current events. If the leaders have the courage to look beyond their immediate interests and adopt the policies that would take us on the high road, they could save the integrity of Pakistan and ensure a better future for the generations to come. If the leaders send the

country down the low road, they will condemn tens of millions of people to lives of absolute poverty and create an environment for political and social chaos.

The choices Pakistan faces can be illustrated with the help of the two scenarios shown in Table 2. In the first, GNP increases at 4 percent a year, the rate achieved in the 1990s. This rate of growth is not much higher than the rate of population increase, and would ensure an increase of only 1.3 percent a year in per capita income. Given the way income is distributed in the country, very little of this growth would be received by the poor bottom 40 percent of the population. While the average income at this rate of GNP growth would increase to \$570 by 2010, there would nevertheless be a significant increase in the incidence of poverty. In 2010, some 82 million people, or 42 percent of the population, would be living in absolute poverty. In other words, at this rate of growth, Pakistan will have

TABLE 2

Two scenarios for Pakistan's economic future

	1997	2000	2010(A)	2010(B)
Population (million)	137	149	196	196
GNP (billion)	67.2	75.4	111.6	141.5
GNP (per capita)	490	506	570	725
Poverty (% of population)	34	36	42	25
Poverty (millions of poor)	47	54	82	49

*Note:* The estimates for 2010 (A) are based on the assumption that the population increases 2.8 percent a year, while GNP increases 4.0 percent a year between 2000 and 2010. For 2010(B), the rate of population increase is estimated at 2.8 percent, while GNP increases 6.5 percent.

*Source:* Author's estimate using the population and GNP estimates in the World Bank's *World Development Report 1998/99*.

increased the number of people living in poverty by 35 million, from 47 million in 1997 to 82 million in 2010.

Pakistan does not have the institutional strength to absorb a poverty shock of this magnitude without causing major social and political disturbances. Some of the law and order problems of recent years, usually attributed to ethnic, provincial, and sectarian rivalries, are also the consequence of the increase in poverty.

The second scenario illustrated in Table 2 projects a GNP growth of 6.5 percent a year, more than twice the rate of population increase and equal to the rates achieved in the 1960s and 1980s. This growth path can be realized only by a determined effort on the part of policymakers. If they are able to muster enough political will to overcome the opposition of the groups that would be initially hurt because of the needed structural changes, Pakistan could reach 2010 close to the threshold that separates poor from

middle-income countries. Its gross domestic product could increase to \$141.5 billion and income per capita to \$725. At this rate of GNP growth, Pakistan would once again be able to make a dramatic difference in the level of absolute poverty. By 2010, the number of people living in absolute poverty could be 49 million, 2 million more than in 1997, but a considerably lower proportion of the total population. The proportion of the population living in poverty could decline from the 34 percent estimated for 1997 to 25 percent in 2010. An added benefit of this acceleration in the rate of growth would be to reduce the rate of fertility to manageable levels.

It should be clear from the analysis above that Pakistan's ability to overcome its many social and political problems depends on its ability to restore economic growth to the level achieved in the first four decades following independence, but with a considerably lower increase in population. However, restoring a high level

of growth depends, in turn, on the ability of leadership groups to bring about deep structural changes. These changes have been postponed for a long time, when the country was still able to secure sizable external flows. That option is no longer available. Pakistan now faces an external environment that will support its development efforts only if the country including its leaders and its people is prepared to make some difficult decisions to set their house in order.

## VI. Conclusion

Given the extensive ground I have covered in this presentation, it may be useful to recapitulate the main arguments in one place. In this concluding section, I will focus on the areas that require either the government's greater focus and improved understanding, or urgent and resolute action.

One, the economic crisis that afflicts Pakistan today is not entirely the result of the actions taken or policies adopted in recent months. It also is the consequence of developments that occurred over a long time. It is wrong to attribute the crisis to the sanctions imposed by the Western countries following the testing of nuclear devices in May of this year. Once this is recognized, government officials should be able to dispense with some of their defensive behavior and approach the problems Pakistan faces with the realization that overcoming them will require a great deal of serious and strategic thought.

Two, the current crisis is much deeper than is realized by most people in the country. There will be no easy and quick resolution; it will certainly not come to an end following the easing of

sanctions or the successful negotiation of a new package of support with the International Monetary Fund. It will take many years of hard work to get the economy back on track and to set it on the course toward a high level of sustainable growth.

Three, in addition to reaching agreements with the IMF and other multilateral financial institutions, it is important to restore the confidence of foreign investors in the economy. This confidence was shattered as a result of a number of actions taken in recent months. To restore it will take time; a start could be made by working with Pakistani expatriates who have the resources to invest in the homeland provided they have some assurance of reliable and reasonable longterm rates of return. In fact, the government should use the expatriate community to bring foreign direct investment back into the country.

Four, the time is gone when Pakistan could rely on large flows of external capital to augment poor domestic savings. Even Pakistanis living and working abroad



are cutting down on the remittances sent through formal financial channels. Among the many measures that need to be adopted immediately, the most important are those aimed at increasing domestic savings. This will require fiscal reforms aimed at a drastic reduction in budgetary deficits. Financial reforms in the insurance and capital markets should help to stimulate private savings by providing new instruments. Over the long run, a pickup in economic growth rates should help increase private savings and reduce the economy's dependence on external capital flows.

Five, decisionmakers must recognize that the only viable way for Pakistan to restore a sustainable balance in its external account is to increase export earnings significantly. This will not happen unless exporters are given adequate incentives, the most important of which is an adjustment in the value of the rupee. It is understandable why the leadership has resisted further devaluation, but ultimately an adjustment will have to be made. However, for an adjustment in relative prices to succeed, it must produce an adequate supply response, which, in turn, requires a significant amount of industrial restructuring including that of the sick units.

Six, it is extremely important to invest time, effort, and resources in improving human development. This will require a comprehensive plan of action aimed at forming a partnership between the public and private sectors. Education of girls and providing health coverage to women should receive high priority.

Seven, it is equally important to develop and strengthen institutions. Given past neglect, this task also will take a long time, but the effort in this area cannot be postponed. Financial sector reform, reform of the legal and judicial systems, public

administration reform, and reforming public sector management of social development are among the areas that must receive urgent and sustained attention. Without these reforms, transaction costs for economic agents will continue to remain high or even increase, which would perpetuate the environment in which corruption flourishes.

Eight, the locus of economic decisionmaking should be brought as close to the people as possible. This will involve vesting more powers in the provinces, municipal corporations, local bodies, and agencies working directly with communities.

Nine, both the people and the country's leaders must recognize that to remain within the international community of nations, full cognizance must be taken of the fact that the emergence of a new global order will involve some constraints on sovereignty. The country will have to abide by international rules as formulated and must receive the sanction of the global community.

Ten, unless Pakistan makes a serious effort to both stabilize an economy currently experiencing serious macroeconomic imbalances and bring about structur-

al changes that modernize the economy's antiquated systems, the country will continue to grow at a rate not much higher than the rate of increase in its population. At that rate, Pakistan will see a massive increase in the incidence of poverty, with 3 to 4 million people being added every year to the already large poverty pool. I do not believe Pakistan has the political and social strength to accommodate this large a pool of poverty. It is more likely to experience social and political turmoil.

Conversely, Pakistan could achieve a sustainable rate of growth in the next ten years or so that would ensure no further additions to the poverty pool. This more hopeful outcome will be possible only if policymakers are able to induce fundamental changes in the structure of the economy. For policymakers to move in that direction, they will have to encourage the development of political consensus that allows sacrifices to be made today in return for a better tomorrow. The choice is Pakistan's to make.

## Chapter 16

### A Fate Foretold: The World Bank and the Mexican Crisis<sup>1</sup>

#### Introduction

The Mexico Crisis Was a Pivotal Event for the World Bank. The Bank was rightly seen as intimately involved in the Mexican reform effort and, therefore, as implicated when the financial crisis struck. I will focus here on the economic dialogue between the Bank and Mexico in the period leading up to and including the crisis, to illustrate the difficulties and dilemmas that necessarily arise in handling sensitive relationships with governments on the one hand, and with the public and financial markets on the other. I hope this narrative will also shed light on the range of instruments and resources the World Bank uses in its intellectual interaction with countries—a process that is not always well understood.

To summarize the conclusions of the paper, I believe that the Bank's analysts clearly identified the medium-term financial risks facing Mexico and successfully mobilized the institution to communicate their concerns to the Mexicans. But the Bank was not able to persuade the authorities to change course, nor were we willing to risk destabilizing financial markets through a forthright, public critique of Mexican policy. The Bank's guarded public attempts to point out the vulnerability in the Mexican situation were largely ignored by both the markets and the Mexicans.

These comments are not intended to imply that the Bank's analyses

were perfect. As did many others, we missed the full implications of some developments in 1994: the increasing use of *tesobonos* (treasury debt indexed to the U.S. dollar), the expansion of credit, and the sharp loss of reserves at the end of the year.

1. This paper draws on an unpublished review undertaken by Sebastian Edwards while he was chief economist for the Latin America and the Caribbean Regional Office of the World Bank. My interpretations are, however, entirely mine, and should not be attributed in any manner to the World Bank or its affiliated organizations, or to members of its Board of Executive Directors or the countries they represent.

I have come to call the Bank's behavior during the pre-crisis period speaking with two voices. With its first voice, the Bank was strong and clear in communicating its concerns to the Mexican authorities; of this I have no doubt. With its more muted second voice, the Bank aimed to reassure financial markets by stressing Mexico's very real accomplishments, in an attempt to buy time for Mexico to complete the adjustment process on which it had embarked. Even with the benefit of hindsight, it is difficult to see how these two voices could have become more unified, desirable though this might have been.

### The reform effort

The World Bank was involved with the Mexican reform effort essentially from the beginning. From the mid-1980s on, Bank staff maintained a fruitful and frank dialogue with the Mexican authorities and assisted them in a number of programs, including the trade reform process. By assigning some of its strongest professionals to work on Mexico, the Bank signaled its degree of commitment to the reform program. This was clearly appreciated by the authorities during the de la Madrid administration and, after 1988, by the Salinas government.

Despite a vigorous reform effort and the benefits of debt reduction under the Brady Plan, the actual performance of the Mexican economy was rather modest. Real growth between 1988 and 1994 averaged 2.8 percent, significantly lower than that of Chile (7.1 percent) or Colombia (4.1 percent). Productivity growth was almost flat until 1993; export expansion was not overly impressive; real wages, while increasing, barely regained their 1980 level; the real exchange rate appreciated significantly; private savings

experienced a major decline; and poverty and income distribution continued to be serious problems. On the positive side, fiscal balance was attained in 1992, inflation was reduced to single digits, and the reforms dismantled successive layers of protection and regulation.

Despite this disparity between Mexico's achievements in terms of reform *policies* and economic *results*, Mexico was consistently praised as a major success by the media, financial experts, academics, and the multilateral institutions. It is sometimes suggested that a Mexican miracle was, at least in part, invented by these institutions. Their enthusiasm was the consequence of a number of factors. The most important, perhaps, was the tremendous faith that many analysts had in market-oriented reforms; if results were not visible, many argued, they were just around the corner. Paul Krugman has commented that much of the hoopla on Mexico's prospects represented a leap of faith, rather than a conclusion based on

hard evidence.<sup>2</sup> The U.S. administration's efforts to persuade the public and Congress of the benefits of the North American Free Trade Agreement (NAFTA) also contributed to the popular notion that there was a Mexican miracle.<sup>3</sup>

The buildup to the crisis: 1990-1993.

In analyzing the Mexican crisis, it is useful to distinguish between two periods: 1990 to 1993, when the economy became increasingly vulnerable, and 1994, when external and domestic political shocks precipitated the collapse of the peso. Mexico was, in fact, seen to be growing vulnerable to unfavorable external developments as far back as the early 1990s. Among the factors at play, the most important were the real appreciation of the peso, the large current account deficit financed by massive portfolio capital inflows, the slow growth of productivity, and the decline in private savings. Starting in 1992, a debate began to take place both outside and inside the World Bank regarding the possible consequences of the real appreciation that had occurred since 1988. Partly at the request of the Mexicans, the Bank's macroeconomic work from 1992 to 1994 focused on the exchange rate regime and associated issues of monetary and financial management, using a combination of Bank staff and expert external consultants.

In mid-1992, the Bank sent a team led by a senior World Bank economist and including a respected international consultant to review the macroeconomic situation and analyze the sustainability of the exchange rate system and the widening current account imbalance. A confidential report was prepared and passed on to the Mexican authorities in early October of that year. It suggested that the time had come for Mexico to introduce a more flexible



exchange rate regime. The report acknowledged the existence of potential tradeoffs between a more flexible exchange rate regime and other objectives of the program, notably reducing inflation. The report argued, however, on the basis of the experiences of Chile and Israel, that as long as fiscal and monetary policies were prudent, there was no reason to expect greater nominal exchange rate flexibility to generate an acceleration in inflation. A more flexible exchange rate regime would probably slow the speed at which inflation was being reduced. This potential shortcoming had to be weighed against the increased degrees of freedom that a more flexible system pro-

2. Krugman (1995), p. 33.

3. The Mexican experience was often cited as an example that it is possible to undertake successful structural reforms within a democratic regime. Mexico was often contrasted with Chile, where the most radical reforms had been undertaken by an authoritarian regime.

vided, as well as the potentially positive effect on economic activity and growth. Although the specifics of this suggestion were not followed by the authorities, the rate of daily devaluation was increased from 20 to 40 (old) pesos in mid-October 1992.

This measure proved insufficient. During the remainder of 1992, the real appreciation of the peso deepened, while the current account deficit remained remarkably large. The Bank's staff continued to be concerned. A private sector assessment mission that visited Mexico in January 1993 was clear as to the risks being run. It noted that the economy was dependent on high levels of foreign capital inflows, which were subject to rapid shifts in expectations. If flows were to fall, this would provoke a sharp rise in interest rates.

The mission drew attention to the banking sector's vulnerability due to the high real interest rates needed to attract foreign capital and high failure rates among firms rendered uncompetitive by the mix of an appreciated real exchange rate and high real interest rates. It also highlighted another channel of vulnerability: high domestic interest rates resulting from this macro policy stance were leading many of the larger firms to shift their borrowing abroad, exposing even these firms to significant cross-currency risk. If a crash landing was to be avoided, it was important for Mexico to start moving toward greater exchange rate flexibility and a reduction in the current account deficit from the existing levels of 6.5 to 7.0 percent of GDP to about half that amount.

While the Mexican authorities appreciated the Bank's concerns and technical analysis, they argued that widening the exchange rate band had already provided enough flexibility, that the private

character of capital inflows evidenced confidence in Mexican policies, and that they would review any further changes in exchange rate policy later, in the light of experience. The authorities also pointed out that the impending approval of NAFTA would result in a major change in Mexico's external conditions, allowing it to continue to attract large volumes of foreign funds.

### Developments in 1994

The Bank's analytic and policy work on monetary management, the exchange rate policy, and the banking system (and a range of other policy issues, including poverty, infrastructure, and the environment) continued through the approval of NAFTA in the fall of 1993 and the inauguration of the Zedillo government in the fall of 1994. An active dialogue with the Mexican authorities was maintained on

all these issues. In 1994, after the Mexican parliament enacted legislation giving the central bank full legal independence, the Mexicans asked the World Bank to assist the central bank in developing a policy framework to guide its macroeconomic management. As before, the method of work was for World Bank staff to identify issues and maintain a dialogue with the Mexicans while mobilizing international experts (often at the specific request of the Mexicans) to provide additional depth and credibility.

There was consensus between the outside experts and the Bank's staff that the exchange rate anchor had fulfilled its purpose of reducing inflation. However, having brought about a substantial real appreciation, and a concurrent trade deficit that required increasing amounts of uncertain and volatile foreign capital, it was time to introduce additional exchange rate flexibility. The World Bank's repeated counsel was, accordingly, that the central bank anchor its monetary policy to an inflation rate target rather than an exchange rate target, thereby leaving the nominal exchange rate available as an instrument to absorb external shocks. Bank staff members were also successful in drawing the government's attention to the mounting risks in the banking system, resulting from inadequate supervision and heightened currency risk. At the government's request, the Bank prepared an action plan for the consolidated supervision of financial groups (later supported by World Bank lending), and the Bank's analyses also probably influenced measures taken by the authorities to limit the open foreign exchange positions of banks.

These concerns regarding macroeconomic policy were communicated to the Bank's Executive Board in May 1994, in the

context of an overall review of the Bank's strategy toward Mexico. The Board was advised of the risks posed by shifts in the supply of capital, and also that the authorities were aware of these risks.

In 1994, the World Bank and the Mexican authorities at every level maintained an active and continuous dialogue on macroeconomic and exchange rate policy. In the early part of that year, on my first visit to Mexico as the Bank's incoming Regional Vice President, my predecessor and I met with members of the cabinet and with President Carlos Salinas de Gortari. We raised our concerns with regard to the vulnerability of the external sector to the overvaluation of the exchange rate. I again raised the issue when I met with Secretary of Finance Pedro Aspe in April 1994, on the occasion of the Inter-American Development Bank (IDB) annual meeting in Guadalajara.

The Mexican response was polite but firm: they appreciated the Bank's concerns, but did not agree with our conclusions and recommendations. They advanced three arguments. First, the system had enough built-in flexibility, in the form of flexible interest rates and the exchange rate band, to deal with disequilib-

ria. Second, in their view, a rapid increase in productivity was about to take place, generating a major export expansion that would help close the current account gap. Third, they argued, the long-term fundamentals remained healthy, especially in light of NAFTA's ratification. As evidence that the economy was under control, the authorities maintained that nontraditional exports were doing fine, although lagging considerably behind the growth in imports. A senior Mexican official argued that the question of the peso's overvaluation depend[ed] on the equilibrium real exchange rate. The appreciation process is a natural, and not necessarily a negative, consequence of the reform process in Mexico.<sup>4</sup> The governor of the Bank of Mexico told *The Economist* in January 1994 that the current account deficit was not a problem because it was associated with the inflow of foreign funds rather than with expansionary fiscal or monetary policy.<sup>5</sup>

In 1994, with the elections a few months away, and at the request of the government, the Bank prepared a set of 18 papers on basic policy issues including education, labor, environment, exchange rate, fiscal, and macroeconomic policies that the new administration would need to face. The overview on macroeconomics stated that the fight to maintain the current exchange rate regime had contributed to sluggish economic growth, surging imports and sustained large current account deficits, financial distress and bankruptcy in many otherwise healthy companies, and the banks' growing portfolio of non-performing loans. It went on to suggest that *moderate* economic growth (of 34 percent) could only be attained in the context of a positive macroeconomic environment, consisting of a lower real interest rate, a more depreciated exchange rate, tight fiscal policy, and sustained recovery of the

international economy.

The Bank's advice on exchange rate policy was not acted upon, after some internal debate among high-level Mexican officials, and the *Pacto* renewal basically maintained the exchange rate regime and overall macroeconomic policy. At the same time, Bank staff and the financial community were not aware of the day-to-day behavior of international reserves. In October, the issue of exchange rate policy and current account sustainability was again brought up with the Mexicans at the highest level, at the World Bank Group's Annual Meetings in Madrid. The reply was, once again, along prior lines: The country had been subjected to a series of political shocks, but productivity was increasing; exchange rate flexibility was

4. Ortíz (1994).

5. Although Mexico's remarkable fiscal adjustment following the debt crisis is impressive, it is also important to note that the stance in terms of fiscal policy started to shift as early as 1989. This can only be appreciated when the traditional fiscal accounts are corrected to exclude from public expenditure the inflationary component of interest payments. In any event, it is still the case that a significant shift in the fiscal stance took place only beginning in the second semester of 1993. See Leidermen and Thorne (1995).

available, and the existence of a \$6 billion currency stabilization fund set by NAFTA in early 1994 was additional insurance.

As the final months of 1994 unfolded, the Bank's concerns did not dissipate. In early December, the staff suggested that a high-level meeting on macroeconomics and exchange rate policy be held between the incoming economic authorities and senior officials of the World Bank and the International Monetary Fund, including the Bank's Chief Economist and the IMF's First Deputy Managing Director. The Mexican authorities agreed with the suggestion and proposed that the meeting be held during the week between Christmas and the New Year. In mid-December, however, they requested a postponement until February.

During most of 1994, the Bank's macroeconomic advice to Mexico was strategic in nature; it dealt mostly with exchange rate issues and the need to introduce greater flexibility. Little was said, however, about the dangers associated with the rapid substitution of *tesobonos* for *cetes*. This reflected two factors. First, staff quite simply missed the significance of the rapid accumulation of dollar-linked debt. Second, in the absence of timely data on international reserves, it was thought that a currency collapse although a clear risk at some point if policies were not changed was not imminent.

Several contacts were made during December with Mexican senior authorities, mostly from the Bank of Mexico, regarding the strength of Mexico's external position. Despite the long tradition of frank dialogue and World Bank support for the program, its staff had no access to precise information on Mexico's reserves (although government officials did indicate privately that reserves had been falling rapidly since mid-November), nor was World



Bank staff informed in advance of the decision announced on December 20 to widen the band.

### The Bank's second voice: the external arena

While these discussions were taking place internally, some outside commentators, though still a minority, were also raising alarms about the increasing external vulnerability of the Mexican economy. As early as November 1992, Rudiger Dornbusch argued in a newspaper article that the daily devaluation rate should be tripled in 1993, to 120 centavos per day. Sebastian Edwards subsequently pointed out that the rapid real appreciation of the peso in the last few months has contributed to [a] widening trade imbalance, affecting overall credibility.<sup>6</sup>

6. Dornbusch (1992, November 23) and Edwards (1994), p. 39, respectively.

Cautiously, the Bank began to share its internal misgivings with a broader audience. In a public document issued in November 1992, the Bank noted, Opening its capital account also exposes Mexico to the volatility of short-term capital movements that can transmit destabilizing external shocks to the economy even if domestic policies are right.<sup>7</sup> That report went on to say that Mexico could adjust to these risks [of volatile capital movements] through higher interest rates and, possibly, depreciating the peso.<sup>8</sup> In the World Bank's *Trends in Developing Economies 1993*, Bank staff expressed their apprehension in more vivid terms, stating that In 1992 about two thirds of the widening of the current account deficit can be ascribed to lower private savings. If this trend continues, it could renew fears about Mexico's inability to generate enough foreign exchange to service debt or remit dividends.<sup>9</sup>

After 1993, as fiscal policy was relaxed and public savings also experienced a decline, the drop in savings became more serious. Yet as of the end of 1993, and despite this vulnerability, international capital markets had high expectations for Mexico. The Mexican authorities, for their part, believed that the decline in savings was a temporary phenomenon, not unlike the impact on savings that had occurred during other rapid adjustments. The authorities were also convinced that the current account deficit would be remedied through productivity increases and that, because of access to NAFTA markets, capital inflows would continue at the 1992<sup>93</sup> rate, providing time to adjust the external accounts. The increase in capital inflows exacerbated the real exchange rate appreciation that the rigid exchange rate regime had generated. For the transfer of resources implied by the higher capital inflows to become effective, a real appreciation was

*required*. This was indeed the position taken by the Mexican authorities. However, the rate at which capital was flowing in clearly was *not* sustainable in the long run.<sup>10</sup> At those rates, the volume of Mexican securities held by foreigners as a proportion of the country's GDP grew continuously and without limits. This clearly was a short-term phenomenon that would have to be partially reversed.<sup>11</sup>

7. World Bank (1992), p. 359.

8. *Ibid.*, p. 359.

9. World Bank (1993), p. 330.

10. Given the rate of growth of the economy during this period, sustainable inflows were closer to the 2 to 4 percent of GDP range than to the 7 percent observed during 1992-93.

11. In 1993, Oks and van Wijnbergen (1995) recognized the temporary nature of the expansion of capital inflows and argued that the key question was: once capital stops flowing, should we expect the current account to improve, or is Mexico heading for a major [balance of payments] crisis? (p. 174). It should be noted that Oks was at the time the World Bank's country economist for Mexico, and that van Wijnbergen had been the Bank's lead economist for Mexico until early 1992.

## The Bank's role in retrospect

In providing an overall assessment of the Bank's role as an advisor to the Mexican government, it is useful to address the following three questions: Was the message the correct one? Was the message backed by technically sound analysis? And, were the messengers the appropriate ones?

*Was the message the correct one?* There is no doubt that, very early on, the Bank's staff was aware of the increasing vulnerability of the Mexican economy and the need to regain competitiveness by abandoning the exchange rate as the nominal anchor. The staff was aware of the implicit tradeoffs involved in allowing the exchange rate to depreciate. As was documented above, on the fundamental topics of exchange rate overvaluation and unsustainable current account deficits, the Bank issued several warning signals as early as the end of 1992.

However, as events in 1994 unfolded, Mexico's already weak external position became even more so. Increased use of *tesobonos* and a rapid decline in reserves made Mexico even more vulnerable to changed perceptions in the markets about its creditworthiness. The Mexican authorities did not provide information on reserves, nor did the Bank fully track changes in short-term obligations. The lack of complete information throughout most of 1994 greatly affected the nature of the Bank's message during that year. In fact, crucial policy decisions—the relaxation of fiscal policy in late 1993, the sterilization of the reserves decline in late March 1994, and the switch to short-term, dollar-indexed domestic debt—were not identified as matters of extreme concern by the Bank.

*Was the message based on sound technical analysis?* This is a difficult question. What is sound analysis for some may be weak analysis for others. Yet the World Bank clearly made a significant effort to engage some of its most experienced analysts in studying the Mexican economy. Moreover, the Bank consistently used consultants held in high esteem internationally and by the Mexican authorities as evidenced by the decision of the Mexicans to retain some of the same consultants for an independent review of their macro policies.

*Was the message conveyed by the appropriate messenger to the appropriate interlocutor?* The World Bank's position was transmitted to the Mexican authorities at different levels. The economists in charge of Mexico repeatedly had the opportunity to express their opinion to the technical staff on the Mexican economic team. The World Bank department director responsible for Mexico and the vice president for Latin America and the Caribbean conveyed the staff's misgivings at the subcabinet and cabinet levels. On more than one occasion, the Bank's president discussed the need for greater exchange rate flexibility and pointed out

to top-level Mexican authorities the dangers of very large current account deficits. For the most part, the World Bank's message was appreciated, but did not bring about changes in the government's policies. It is fair to say, then, that the message was transmitted by the right messengers. In fact, the Bank used its complete battery of interlocutors to convey its views to the Mexican authorities at every level.

If the message was largely correct, the analysis sound, and the right intermediaries were used, why wasn't the World Bank's advice accepted? The answer to this lies in genuine differences of opinion. While the Bank staff believed that the Mexican external sector was increasingly vulnerable, and that adjustment had to be undertaken as early as late 1992, the Mexican authorities were convinced that the situation was under control and that NAFTA would provide them with sufficient time to engineer an eventual correction in the external accounts. Until the first quarter of 1994, the financial markets seemed to back up the Mexican perspective, making the Bank's position appear unduly pessimistic. As the 1994 events unfolded, the Mexican authorities reacted time and again as if these were temporary shocks, not realizing that they were rapidly running out of time to correct the real exchange rate overvaluation and reduce their dependence on capital inflows. In a paper presented at the 1995 Brookings Panel on Economic Activity, Rudiger Dornbusch and collaborators argued that differences of opinion between different actors including the Mexican authorities, financial analysts, academics, and the multilateral institutions were at the heart of any explanation of the course that Mexico's crisis took.<sup>12</sup> In the absence of a Bank-financed adjustment program, such differences of opinion between the Bank's staff and the

Mexican authorities persisted, with no immediate consequences for the country's economic policy.

In retrospect, were there ways for the World Bank to be more effective in influencing Mexican decisionmaking? Some have argued that, if the Bank had gone public with its concerns early on, the Mexican authorities would have been forced to react in a timely fashion. Although this may appear superficially to be an attractive option, it would have been a highly risky course to follow. There is little doubt that, if the World Bank were to make public its assessment that a country's balance of payments is unsustainable, this in itself would help precipitate a crisis. In most cases, the Bank cannot persuade by withholding disbursements, as such an action only makes matters worse. The test of providing good and especially useful advice is not always whether a country follows it. What really matters is whether the message is clear, sound, and appropriately delivered. In some

12. Dornbusch, Goldfajn, and Valdés (1995).

cases, the Bank's advice will be accepted. In others, genuine differences of opinion will prevent its being adopted.

One final point should be made: The Bank came to be closely identified with the Mexican reforms enacted from 1987 to 1991, through the series of large, policy-based adjustment operations, culminating in the financial support provided to the Brady Plan commercial bank debt agreement. As part of this support, the Bank publicly provided high praise for the Mexican reforms, and it was partly on the basis of these statements of support that the commercial banks accepted the debt reduction agreement. The Mexican authorities welcomed these expressions of public endorsement and were keen to maintain a highly positive public image of the Bank's support. The image did remain positive, and led to capital inflows at a rate of almost \$30 billion per year.

However, with the Bank in this role it often was difficult for staff at the working level, who saw directly the problems that still existed in Mexico, to make themselves heard. The results were clearly unfortunate. A primary lesson the Bank may draw from what happened in Mexico is that, while there is no problem with public expressions of our positive assessment of the situation in a country (and Mexico *did* do much that was positive over 1987-91, taking major steps forward, even if they were not all that was required), we need to ensure that such statements are accurate and complete, and that they do not hinder the expression of concerns that develop later.

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## Chapter 17

### The Relevance of the Chinese Model for Bringing Cuba into the International Economic System<sup>1</sup>

I Find Myself in Some Disagreement With Bernard Aronson<sup>2</sup> about the model of reform that could be used to bring about change in Cuba and end its 40 years of economic isolation. He suggested the route that Poland followed. He was of the view a view also held by a number of people about China in the late 1980s that it was much more important to focus on the democratization of the political system. With democracy would come the right set of economic policies, as happened in most countries of Eastern Europe. My view is that the Chinese model is more appropriate.

I am skeptical about the relevance of the Eastern European model, as communism was imposed from the outside and did not take deep roots in the political, social, and economic soils of the region. On the other hand, Chinese communism was the result of a reaction against centuries of exploitation of the masses by those who had political and social power and economic wealth. I think it was naïve on the part of those who thought that the demise of communism in Eastern Europe in the late 1980s and 1990s would induce a similar move in China. It did not happen, and I do not believe that we will see a rapid loosening of the grip the Chinese Communist Party has on China.

Is the same true for Cuba? It appears to me but I should emphasize that my knowledge of Cuba is considerably shallower than my

familiarity with China that the Cubans will not easily forsake the Communist Party. The revolution in Cuba was also the consequence of a reaction against decades of exploitation.

If this parallel were correct, what would be the correct approach to adopt? What is the relevance of the Chinese experience for bringing about change in Cuba? To

1. Talk given at a luncheon organized by the Inter-American Dialogue, May 8, 1999, Washington, D.C.
2. Bernard W. Aronson also spoke at the lunch. He is currently with Acon Investments, LLC. He served in the Jimmy Carter White House and is the author with William D. Rogers of *U.S.-Cuban Relations in the 21st Century*. (New York: Council on Foreign Relations, 1999).

answer these questions, let me say a few words about the developments in China since the communists took power in Beijing on October 1, 1949.

I see four phases in China's economic transformation. The first lasted for 30 years and ended with the Second Coming of Deng Xiaoping. By 1979, Deng and his colleagues had finally established their control over the Communist Party and over China by eliminating the influence of the gang of four. In the 30 years before Deng became China's supreme leader, the country had undergone a social revolution of unprecedented proportion. The Chinese government had succeeded in bringing education and health to the masses. When measured in terms of gains in indices such as infant mortality, maternal mortality, life expectancy at birth, school enrollment for boys and girls, and adult literacy, China had made gains that were extraordinary. Such a transformation of such a large number of people was without precedence in human history.

This transformation was not cost-free. They made many mistakes. Two episodes in particular the Great Leap Forward of the late 1950s and the Cultural Revolution launched in 1965 took a very heavy toll. Nobody knows the exact human cost of these ill-advised moves, both ordered by Mao Zedong, the Great Helmsman. There is little doubt that scores of millions of Chinese died of starvation during these periods. Nor is it an exaggeration to say that the Chinese sacrificed a generation or two to build a better future for the generations to come.

Could the Chinese have brought about the unprecedented social revolution of 1949-79 without these upheavals? The answer to this question is an obvious yes, but this is not the time or the place to

speculate about an important counterfactual of this century to answer the following question. Where would China be today had Mao and his colleagues not launched the Great Leap Forward and the Cultural Revolution?

Still a poor country in mid-1980, with a per capita income estimated by the World Bank at only \$290 (in 1980 dollars), China had reached a level of social development comparable to that of middle-income countries. Its population was estimated at 978 million, the adult literacy rate was 66 percent, and life expectancy was 64 years. The total fertility rate had declined to 2.9 per woman, the birth rate to 21 per 1,000 people, and the death rate to 8 per 1,000. In the 20 years between 1960 and 1980, the Chinese had succeeded in reducing both the birth and death rates by one half; from 40 to 21 per 1,000 of the population for the birth rate, and from 14 to 8 for the death rate.<sup>3</sup> Comparable information for India and the middle-income countries is presented in Table 1.

3. These data are from World Bank, *World Development Report 1982* (Washington, D.C.: 1982), Tables 1 and 18, pp. 110 and 144.

TABLE 1

## China's social transformation

	CHINA	INDIA	MIDDLE-INCOME COUNTRIES
Population, 1980 (millions)	978	673	1,139
Rate of population increase			
196070	1.9	2.3	2.5
197080	1.8	2.1	2.4
GNP per capita (1980 dollars)	290	240	1,400
Life expectancy at birth (years)	64	52	60
Adult literacy, 1977 (%)	66	36	65
Crude birth rate (per 1,000 population)			
1960	40	44	43
1980	21	36	35
Crude death rate (per 1,000 population)			
1960	14	22	17
1980	8	14	11
Total fertility fate			
1980	2.9	4.9	4.8

*Source:* World Bank, *World Development Report, 1982* (Washington, D.C.: 1982), Tables 1, 17, and 18; pp. 110, 142, and 144

Having achieved this level of human development, China launched another revolution in the late 1970s, this time in the agriculture sector. It carried out the privatization of agriculture quickly by handing over the ownership of land to the families who were cultivating it. This could be done quickly, as the Chinese, unlike the Soviet Union, had not fully collectivized agricultural land. Family farms had been preserved although under the ownership of the state.<sup>4</sup> This ownership was

4. I first visited China in the summer of 1965 to study the commune system. Our three-man delegation spent six weeks in the country. We

visited 13 communes in six provinces. Our impressions were recorded in a report presented by the government of Pakistan to the government of China. Our main conclusion was that the communization of land had not reduced inter-regional inequality in the country. However, we suggested that the system of local government, of which communes were a part, helped to improve human development and lay the ground for the alleviation of mass poverty. Later, while a graduate student at Harvard, I used the data I had collected during this visit to write a monograph on the system of communes. See Burki, Shahid Javed. *A Study of Chinese Communes, 1965* (Cambridge, Mass.: Harvard University Press, 1969).



transferred back to the families living and working on the farms. Thus began the second phase of the transformation of the Chinese economy.

Healthier and better educated, the Chinese peasantry responded with palpable enthusiasm to the stimulus of privatization. Between 1970 and 1988, value added in agriculture increased nearly fourfold, from \$36 billion to \$121 billion (both in current dollars). Consumption of fertilizer increased nearly sixfold, from 41 kilograms per hectare of arable land to 236 kilograms. Over 1987-88, when Chinese farmers were applying more than a quarter of a ton of fertilizer per hectare of arable land, their counterparts in India the other major Asian agricultural economy were using only 52 kilograms. From 1979-81, the period during which this revolution in agriculture took hold in the Chinese countryside, to 1986-88, the index of food production per capita increased by 32 percent. During the same period, the Indian index increased by only 5 percent. From 1980 to 1988, agricultural output in China increased at the annual rate of 6.8 percent compared to only 2.8 a year in the 15-year period between 1965 and 1980. The comparable figures for India were 2.3 percent and 2.5 percent a year, respectively.<sup>5</sup>

In a few years, the Chinese farmers saw an enormous increase in their earnings. Given that the Chinese save a significant proportion of their income the World Bank's estimate for 1988 was 37 percent<sup>6</sup> the Chinese peasantry was flush with liquidity. Once again the response of the Chinese leadership was highly pragmatic. The peasants were allowed to use their accumulated savings and invest them in small enterprises in commerce, small-scale manufacturing,

and transport. With this decision a momentous development, as it turned out the Chinese process of economic transition entered its third phase. During this phase, China developed a parallel economy in nonagricultural sectors an economy parallel to the one operated by the state. It was during this period that the township and village enterprises (TVEs) began to grow rapidly. Over 1985-95, the output of this sector of the economy increased by an astounding 20 percent a year, doubling every three and a half years. Employment increased by 15 percent, picking up the slack in the growth of the state sector.

China's TVEs were a unique institution in the communist world. The TVEs were not strictly privately owned; they were collectives with many different forms of ownership. They started out from the base that had already been created by the system of communes since the communes were allowed to set up small-scale enterprises to process their agricultural output, repair the equipment they owned, pro-

5. These data are from World Bank, *World Development Report 1990: Poverty* (Washington, D.C.: 1990), Tables 2 and 4, pp. 180 and 184.

6. *Ibid.*, Table 9, p. 194.

vide employment to women in textile production and handicrafts, etc. But the sector was to expand rapidly once the peasantry was allowed to invest its savings in nonagricultural activities.

What distinguished the TVEs from the enterprises owned by the state was that they were not obligated to follow the complex regulatory environment in which the latter operated. The state-owned enterprises were compelled to keep their workers employed whether there was demand for their output or not. They were also required to provide workers with health and recreational facilities and pensions when they reached mandatory retirement age, run facilities for educating the children of workers, and provide workers with housing and transport from home to the place of work. The state-owned enterprises were central to China's intensive social security system.

By the mid-1990s, the nonstate sector mostly the TVEs employed about the same number of people as did the state sector: 100 million each. The nonstate sector was creating 1.5 million jobs a year, which provided some space for the reorganization of state enterprises. It was possible for some to close down and for their workers to move over to the TVEs. Although this adjustment process was slow, it was not disruptive.

China has now entered the fourth phase of the effort to reform and modernize its economy and integrate it with the global economic, financial, and trading system. This phase involves reforms in a number of areas, in particular the state enterprises. China is also seeking to gain admission to the World Trade Organization, the only international body from which it is still excluded.

## The Chinese model and its relevance for Cuba

Could Cuba follow the Chinese reform model? Or posing the same question from a different perspective is it in the interest of the international community to attempt to persuade the Cuban authorities to take the Chinese route? My answer to both questions is in the affirmative. While the adoption of the Chinese model would not result in the immediate democratization of Cuba, it would be less disruptive.

As shown in Table 2, Cuba has achieved impressive successes in human development. In terms of various health indicators and life expectancy at birth, Cuba's record is now better than that of countries with per capita incomes three times higher. If its human development index (HDI) ranking is lower, it is because the HDI is a composite index that includes political freedom as one of its components.

TABLE 2

Human development in Cuba compared to some Latin American countries

	ARGENTINA	CUBA	CHILE	DOMINICAN REPUBLIC
Population (millions)	36	11	15	8
GDP per capita (dollars)	8,500	3,100	9,930	3,900
HDI rank <sup>1</sup>	36	85	31	88
Life expectancy	73	76	75	70
Adult literacy	96	96	95	82
Enrollment rate	79	66	73	73
Gender-related HDI	48	85	46	88
Life expectancy				
Male	69	74	72	72
Female	76	78	78	68
Adult literacy rate				
Male		96		82
Female		95		82
Share of earned income				
Male	78	68	78	76
Female	22	32	22	24
Gender empowerment measure (rank)		25	61	58

1. Human Development Index

*Source:* United Nations Development Programme, *Human Development Report 1998*.

There is one interesting feature of the Cuban experience in human development that is even better than China's record. This is with respect to the advances made by women in Cuba. Women's share of income in Cuba is about a third of the total, compared to slightly over one-fifth for Argentina and China, two countries considerably richer than Cuba.

It appears to me, therefore, that the stage is set for Cuba to provide

the kind of incentives to agricultural producers that revolutionized China's agriculture in the 1980s. In fact, Cuba could compress China's second and third phase of reforms into one phase. Instead of waiting for the peasants to accumulate savings, it could open up small-scale manufacturing, commerce, and transport immediately for private and collective investment. Using the experience of China, Cuba very quickly could leapfrog to the point where it begins to worry about reforming the large and inefficient state sector.

Before concluding, I should underscore my belief that, as Cuba opens up and begins to integrate itself in the global economy, its economy will develop a strong service sector. In that way it would be very different from China, where light manufacturing led the way. In Cuba, tourism and telecommunications may provide the lead. This is likely to happen, not only because of Cuba's proximity to the United States the world's largest economy but also because the better economic and social situation of Cuban women may provide valuable human resources for the growth and development of these sectors.

## Chapter 18

### Integrating Small States in a Fast-Changing Global Economy<sup>1</sup>

Let me Spend a Few Minutes Providing the Audience with some information on the reasons that led to the establishment of a joint World Bank-Commonwealth Task Force on Small States. I will then provide a brief overview of the work that has already been done by the task force. I will also spend a few minutes discussing what I think has emerged from the papers prepared, and I will pose a few questions for us to keep in mind during this meeting in St. Lucia.

The Commonwealth's interest in assisting the development of small states goes back a long time. The Commonwealth Secretariat has done some pioneering work in understanding the economic and social characteristics that distinguish small states. We at the World Bank have also been concerned with the development problems of small states. In the late 1970s, for instance, the Bank proposed a small states bias in allocating International Development Association resourcesa proposal that was accepted by the IDA deputies in negotiating the fifth replenishment.

It is not surprising, therefore, that when a delegation headed by Prime Minister Owen Arthur visited the World Bank in July 1998, his proposal to establish a joint World Bank- Commonwealth Task Force on Small States was quickly accepted by our president, James Wolfensohn. Prime Minister Arthur spoke, in particular, about three problems faced by small states: economic vulnerability,



a sharp decline in official development assistance, and increasing pressures as a result of the rapidly evolving global trading system under the aegis of the World Trade Organization (WTO).

The Task Force met for the first time in Washington in October 1998; Sir Humphrey Maud and I were its joint chairmen. At this meeting, we decided to

1. Opening Remarks at the World Bank-Commonwealth Conference on Small States, St. Lucia, West Indies, February 18, 1999.

organize an advisory group drawn from people who have special expertise in small states, and international institutions to which the small states must look for help. We also decided to commission a series of papers that would help the task force's work. The terms of reference for these papers were discussed at the second meeting of the task force, held in London in December 1998. Following the London meeting, I visited Geneva to discuss the work of the task force with the senior officials of the WTO and United Nations Conference of Trade and Development.

As a sequel to the St. Lucia deliberations, it is our intention to write a short paper to be presented to the Development Committee's April 1999 meeting. Further discussions will be held during the summer with a number of international institutions, before this report is finalized for submission to the Commonwealth ministers and to the Development Committee this fall.

The background papers prepared for this conference provide a useful background for our deliberations. I identified at least eight conclusions, or threads. Namely:

1. The economic work done by the World Bank staff suggests that small states have higher per capita incomes and higher income volatility than large states. This does not suggest that small size does not pose a disadvantage. Small size implies high per capita costs of providing public goods and limits the possibility of exploiting economies of scale within the domestic economy. This disadvantage has been compensated by the advantages of greater trade openness in small states.
2. The paper by the Commonwealth Secretariat suggests that the trade advantages enjoyed by small states may have resulted in part

from preferential access they have been granted under various arrangements. There is a problem, however. The evolving trading system threatens to erode the preferences that have worked in favor of small states. These states are now vulnerable to the adverse consequences of trade opening as this new trading system evolves.

3. The paper on vulnerability establishes convincingly that in looking at the small states we have to look beyond conventional indices of development such as GNP/GDP measurements. A vulnerability index of the type developed in the paper should guide the international community in two ways: GNP-based thresholds need to be reinforced by a vulnerability index to establish access to official finance by small states. Moreover, in applying trading rules, the international community must take cognizance of the vulnerability of small states.

4. A theme that runs through most of the papers for this conference sometimes explicitly, at other times, implicitly is that developing countries, including those that are small states, must take full advantage of the rapid globalization of trade and finance. They cannot opt out of the system or expect long-term preferential support from the industrial world. That notwithstanding, as the current debate on the banana regime demonstrates, it would be both imprudent and irresponsible to force adjustments on small states without recognizing that there are large costs associated with making this transition. One of the unexplored areas from the perspective of small states is how long transitions should last and how their costs should be met. I hope this conference will help us to find some answers to these important questions.

5. An example of the globalization of finance, and how small states could benefit from it, is provided in the World Bank paper on disaster insurance. It suggests that rapid developments in global finance have made it possible to think in terms of developing new instruments that would bring together the public and private sectors to cope with the natural disasters to which small states are especially vulnerable. The purpose of this financial instrument engineering is to spread risks, reduce the volatility in risk premiums, and improve disaster management. The World Bank is working on identifying a role for itself in this important area.

6. I hope one product of the work done by the task force will be to challenge other international institutions of great consequence for the small states to develop responses similar to those that are being worked on in the World Bank. These responses should not only address the problems of transition to which I have already

referred. They should also take cognizance of the special circumstances of small states.

7. It would be helpful to recognize that, ultimately, it is the strength of domestic policies that counts in promoting development. This is the main conclusion of another World Bank paper. While the paper acknowledges that, for a variety of reasons, foreign aid does not reward those that have followed good policies, I would like to suggest that the future may well be different. There has been a precipitous decline in the level of aid in recent years. On average, 21 OECD countries devoted 0.22 percent of their GNP to development assistance in 1997, down from 0.25 percent a year earlier. Total overseas aid dropped from \$55 billion in 1996 to \$48 billion in 1997. Aid from the G-7 group of large rich countries has dropped by almost 30 percent in real terms since 1992. The United States now donates less than 0.1