Introduction

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The Annual World Bank Conference on Development Economics is a global gathering of scholars and practitioners of development policy from academic life, government, and the private sector. The topics selected for the conference vary from year to year, but we seek to include new areas of concern and cutting edge research, together with areas we believe can benefit from exposure to recent knowledge and experience.

The 12th annual conference, held at the World Bank on April 18–20, 2000, focused primarily on four areas: new development thinking, crises and recovery, corporate governance and restructuring, and social security, public and private savings. In addition, there were three keynote addresses: "Development Thinking at the Millennium" by Joseph E. Stiglitz, "A New Global Consensus on Helping the Poorest of the Poor" by Jeffrey Sachs, and "Ten Years After *The Road to a Free Economy:* The Author's Self-Evaluation" by János Kornai.

Mats Karlsson in his opening address outlines a number of challenges for development. These include the intransigence of poverty in Africa, exacerbated by the ineffectiveness of the state and the widening AIDS crisis, and finding new ways of working with the private sector by establishing partnerships at the country and global levels.

Joseph E. Stiglitz, in his keynote address, identifies equilibrium and change as the twin foci of development economics. In describing and analyzing these two forces, the central question is, how do we know what we know or come to believe what we come to believe? Stiglitz's response? A blend of nature and nurture. As economists we believe that incentives play a central role. Thus as countries make decisions on the best available evidence, he encourages a healthy skepticism when weighing the merits of various sources of policy advice. Inevitably, both internal and external policy advice is driven by assorted incentive structures. Over time there has been a noticeable change in thinking about development economics. Experience has shown that there is more to development than privatization, liberalization, and stabilization. Long-term sustainable growth requires development of a consensus behind the reform policies; they cannot be

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Annual World Bank Conference on Development Economics 2000

imposed from the outside, which is part of the reason for the widespread failure of aid conditionality. He suggests that, contrary to the neoclassical model, institutions do matter, but so does the distribution of income. An alternative paradigm would include the role of imperfect and incomplete information. He favors a more comprehensive framework, including a greater sensitivity to the complexity of the development process. We should also show a greater sense of optimism about what the future might bring.

Jeffrey Sachs sets the tone for the discussion of crises and recovery in his keynote address on helping the poor, calling for a new consensus on economic development, to replace inadequate approaches to global poverty. He refers to the general failure to address the AIDS epidemic, malaria, and poverty, especially in the poorest parts of the world—Sub-Saharan Africa, parts of the Andean region, the Gangetic valley of India, and central Asia. He suggests that this failure is due primarily to inadequate funding and inappropriate structures to address the problem. The inadequate funding is due to lack of contributions from rich countries, especially the United States, while the International Monetary Fund (IMF) and, to a lesser extent, the World Bank are placing too much emphasis on economic reform and good governance, to the neglect of other key aspects. Sachs suggests that escape from poverty be based on economic reform, funding to address health and education needs, technology development, and structural adjustment, especially export diversification—which would require an industrial strategy and access to U.S. and European markets. To achieve these ends, he suggests a bipartisan approach. This would include many of the elements proposed by the Meltzer Commission. The IMF would get out of the poverty business and the World Bank would focus on the poorest countries. The World Bank should retreat from banking and refocus on knowledge creation.

The third keynote address, by **János Kornai,** provides a perspective on the recent history of transition economies. Drawing on experience in the Czech Republic, Hungary, Poland, and Russia, Kornai focuses on two issues: ownership reform with private sector development and macroeconomic stabilization. He argues that the choice between gradualism and shock therapy is a false dichotomy. While speed is important, it is not the primary indicator of success. Transformation of the economy and the society often proceeds in parallel, with many interactions. Thus it is essential to create favorable conditions for bottom-up development of the private sector. The shock tactics employed in the Czech Republic initially yielded some favorable political outcomes. They were less successful, however, looked at over a 10-year period than the more gradual reforms in Hungary and Poland. The shock approach in Russia was also a failure. One measure of success is change in labor productivity: over 10 years Hungary had gains of 36 percent and Poland of 29 percent, while the Czech Republic had a gain of 6 percent and Russia had a decline of 33 percent. He suggests emphasizing consolidation and stability, making growth sustainable, and not being overly concerned with speed.

New Development Thinking

Paul Collier argues that poverty reduction on a grand scale is now possible. He suggests this goal can be achieved if governments and donors can establish the policy and institutional changes needed for broad-based growth. He attributes the older, pessimistic analysis of mass poverty to an undeservedly hostile response to progrowth policies and the failure to make such policies sufficiently broad based. Providing information and building consensus need to be treated as functional parts of the business of development. Attempts by donors to reduce poverty have met with only limited success, for a number of reasons. Like Stiglitz, Collier is skeptical that conditionality imposed from outside can succeed. Flexibility is needed to determine the most appropriate institutional design for each country. Governments should initiate institutional experiments and competitions to discover which institutions work best. A social consensus behind these experiments would speed these processes and enhance their credibility.

Dani Rodrik, in exploring development strategies for the 21st century, emphasizes the importance of markets underpinned by solid public institutions. While the idea of a mixed economy is a valuable heritage of the 20th century, the key lesson is that today's advanced industrial countries owe much of their success to having evolved their own workable models of a mixed economy. He places considerable importance on ownership of reform. Institutions are essential to protect property rights, regulate market participants, maintain macroeconomic stability, provide social stability, and manage conflict. These institutions can take many forms. They can also continue to evolve and to benefit from useful precedents in other societies. Developing countries should use available information to adapt institutional innovation to suit their own local practices and needs and not place undue emphasis on the global economy and the blueprints that emanate from it.

Jan Willem Gunning reviews the recent debate on aid's role in three areas: providing finance, changing policies in recipient countries, and transmitting knowledge. Providing finance, he argues, is a questionable way of accelerating growth rates except in a good policy environment. However, aid could play an insurance role in moderating the impact of negative external shocks on growth. As do other participants, Gunning argues that evidence confirms that aid cannot achieve sustainable policy reform. In particular, he feels that donor promotion of tax efforts in poor countries may be misguided. Rather, aid might be used for tax relief to avoid the high cost of taxation in the early growth stages. He proposes that donors consider ex post conditionality. He also suggests that transfers of knowledge need not be bundled with the provision of aid.

In the final article on new development thinking, **Karla Hoff** examines coordination problems in development. She offers a historical overview of how development economics has dealt with spillovers (externalities) over the past 30 years. Modern economic theory has broadened our view of the sources of spillovers that could lead to underdevelopment as an equilibrium. A critical determinant of action is the environment, including the behavior of other agents in that environment. Externalities that matter for welfare are not just direct interdependencies but rather many classes of systemic externalities. Initial differences in circumstances or beliefs may not only persist, but may be magnified over time. The basic lesson is that coordination failures abound, and neither the market alone nor government alone can solve them.

Crises and Recovery

William Easterly, Roumeen Islam, and Joseph E. Stiglitz look at volatility and growth, providing fresh insights into their relationship. They suggest that in explaining this relation traditional factors such as wage and price rigidities may have been overemphasized and factors relating to the financial system have been underemphasized. While recognizing the potential impact of a variety of microeconomic variables that could not be included in their analysis, the authors suggest that their findings, if correct, would have strong policy implications. Real wage flexibility may have little effect on volatility since the lowering of real wages may be offset by adverse demand effects. It is not evident that opening the capital account will help stability. They suggest the need to devise strategies to hedge against the risks of sudden outflows. Their analysis confirms that financial institutions play a central role in volatility—financial depth reduces volatility up to a point. They also note that too much private credit can increase volatility.

Ricardo J. Caballero and Mohamad L. Hammour examine a different aspect of the effect of crises on development. They focus on what Schumpeter termed "creative destruction." This was considered to be at the core of economic growth, as it provided the means for technology to combine with opportunities to upgrade the production structure. An index of restructuring can be developed based on a variety of reallocation measures. One of the more successful reallocation measures is labor reallocation. The authors provide a theoretical framework, backed by some limited empirical work, to focus on potential obstacles to creative destruction. They find that the adverse effect of crises on restructuring is even costlier than the immediate impact on unemployment and other aggregate indicators might suggest. This freezing of the restructuring process and resulting stagnation in productivity comes primarily from financial constraints. Crises are also likely to result in a significant amount of liquidations that may be privately inefficient, leading to large job losses and liquidations of organizational capital.

Eisuke Sakakibara outlines the circumstances surrounding the East Asian crisis and then presents some of the choices warranting consideration by policymakers, if a repeat crisis is to be avoided. Perplexingly, macroeconomic indicators were strong among East Asian countries hit by the crisis. Market rate spreads and country risk ratings did not suggest macroeconomic weakness. At the same time many of the structural weaknesses in corporate and national governance had existed for decades. The immediate cause of the crisis can be attributed to a number of factors: liberalizing a weak banking sector and at the same time opening capital accounts, amassing aggregate short-term debt in excess of foreign reserves, and defending unsustainable pegs. While it is important for countries to strengthen their financial systems, the author argues that there is also a need for a lender of last resort to help prevent future currency crises. Since the current political situation precludes having a single institutional lender with free capital movement, he suggests an Asian Monetary Fund as a second-best solution. This would be preceded by cooperation in the real sector, including on free trade and direct investment. In the meantime policymakers could focus on developing well functioning capital markets. The

Japanese government could engage in regionwide efforts to stimulate primary markets for international bonds and upgrade the regional secondary markets.

Daniel Lederman, Ana María Menéndez, Guillermo Perry, and Joseph E. Stiglitz, in exploring the Mexico crisis and its aftermath, find a number of salient features similar to those in the East Asia crisis. Their focus is on the real economy. They conclude that a sharp depreciation of the currency in 1995 resulted in a precipitous fall in fixed investment as a result of a negative income effect and higher cost of capital. The authors also note the important role of credit availability, both in quantity and cost. A third of loans to Mexican firms were denominated in foreign currency, and most had been extended to firms without sources of foreign income. This availability of dollar loans together with the change in relative prices resulted in a shift toward tradable goods and a sharp rise in exports. In Mexico, as in Indonesia, the Republic of Korea, and Thailand, fixed investment growth fell during the crisis. The authors attribute the decline and subsequent rise in GDP growth primarily to the behavior of fixed investment. Depreciation of the currency can have adverse consequences for investment in the short run as a result of the effect on the relative price of capital. However, they argue that in the medium term a real depreciation is healthy because it stimulates growth in exports, increases the share of the tradable sector, and has a large multiplier effect on investment.

Corporate Governance and Restructuring: Lessons from Transition and Crises

I. J. Alexander Dyck provides a functional framework rather than an institutional or neoclassical economic perspective for examining governance. He draws on a wide variety of theoretical and empirical evidence to study the effect on governance of legal protections and the ownership structure of firms. The primary function of corporate governance, he argues, is to facilitate investment. Among the many findings the evidence suggests that the extent of legal protections for financiers is correlated with the depth of equity markets and the rate of initial public offering activity. Corporate governance is a major concern for policymakers. When it is not functioning effectively, resources for new projects dry up, slowing national growth and development. However, reforms that focus only on legal rules have limits. The effectiveness of legal protections depends on complementary institutions that provide enforcement and information for investors.

Gérard Roland also looks at the role of corporate governance, but he focuses on transition economies. He emphasizes the implications for efficiency, the heterogeneity of managers' skills, the diversity of firms' restructuring tasks and financial situations, and political constraints. He argues that corporate governance is even more important in transition economies, where the initial situation was state governance and the approach chosen will affect overall economic performance. He generally favors more gradual privatization. Under mass privatization incumbent managers get control, and this can lead to asset stripping. It may also lead to a sudden and strong concentration of economic power in the hands of insider managers.

Gradual sales, by contrast, yield a lower initial concentration of economic power, produce new entrepreneurs, and promote the emergence of a strong middle class. This in turn helps foster further reform and stable democracy.

Social Security, Public and Private Savings

J. Michael Orszag and Peter R. Orszag examine the implications of flexible funding for pension reform in an uncertain world. How much pressure pensions will exert on government budgets in the future is unclear because of substantial uncertainty surrounding estimates of pension costs over coming decades. The authors use a simplified model to analyze several questions. What are the likely implications of uncertainty? How should reform be undertaken, especially decisions on prefunding? They argue for the importance of taking into account not only best guesses about the future but also best assessments of the uncertainty surrounding these guesses. Changing circumstances may warrant a change in the degree of funding. They note that achieving some degree of reversibility may be easier in a public approach to prefunding. It may therefore be unwise to commit to the up-front costs associated with moving from a pay as you go to a prefunded system without any assurance that the costs can be recaptured if the reform turns out to be less beneficial than expected.

Orazio P. Attanasio and Miguel Székely explore household savings behavior at the microeconomic level in Mexico, Peru, Taiwan (China), and Thailand. They analyzed disaggregated groups by education level to see the relation of savings behavior to income distribution. They also test the relevance of the life-cycle model for explaining differences in savings behavior. They find large differences across economies and across education groups within each economy. East Asian households, especially younger households, have had greater capacity to save because of higher income growth, lower fertility rates, and a more advanced demographic transition. Household savings are generated by a wide range of households in East Asia, whereas in Latin America almost all household savings are generated by the richest 20 percent of the population. The authors find no strong evidence of negative saving in the last part of the life cycle in any of the four economies. Their results suggest that the demographic trends now being projected are unlikely by themselves to generate large increases in savings rates under current circumstances.

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