

What Have We Learned About Development?

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In its early years -- and for many years after -- the main development recommendation of the World Bank was: adopt economic planning. Planning models were used to recommend policies and governments were encouraged to use these tools to choose investments.

The result was bureaucratic centralization of economic decision-making. This may have accorded with widely held views in many developing countries. Particularly in the academic profession, many believed planning was the best way to organize development.

Along with planning and directing allocation, and the use of planning models, there was a Keynesian belief in low interest rates. No country held that view more firmly or longer than India. India well represents the faults and consequences. With an investment rate of 20-25%, India was able to increase per capita income by 1-1/2 to 2% per year.

Some idea of how much thinking has now changed is shown by a series of recent studies done by the World Bank. Some might say the same World Bank that, under the influence of Hollis Chenery and his colleagues, promoted economic planning now promotes markets. I think it is a very different World Bank, one that has learned from experience and from research. Consider the principal conclusions of several studies:

- (1) Keep macro policy stable -- avoid inflation -- especially high and variable inflation; limit budget deficits to small percentage of GDP;
- (2) open the economy; get the exchange rate to the market rate and keep it there without exchange controls; free the current account and maintain convertibility; reduce tariffs and quotas.

- (3) Use micro policies to get incentives for efficient use of resources by deregulating, reducing subsidies and reducing tax rates.
- (4) Allow banks to pay and collect market interest rates. Reduce reserve requirement ratios. Avoid credit allocation.

This list of current policy prescriptions are general not specific. They emphasize the role of markets. The world planning or directing does not appear anywhere.

Looking back 20 years later, there is now a large literature with many summaries of development experience and even summaries of the summaries.

Some of the central issues are:

Does saving lead to growth or does growth lead to saving? Or, in everyday language does high saving cause growth or is it a result of growth?

Are there benefits from financial intermediation? Should government subsidize intermediation to increase development?

Do low interest rates increase development? Or, do they produce excess capital, inefficient allocation and waste?

India is an excellent example of mistaken policy. The investment rate was sustained at 22% of GDP, but growth was sluggish. Korea with about the same investment rate experienced much more growth. Korea was more market driven, open, with a market exchange rate.

India looked inward, favored import substitution, with no emphasis on exports. In 1950 Korea's manufacturing sector was 25% of India's. By 1981 it was up to 60% of India's. (Korea's population is 5% of India's.) By 1980 Korea's manufacturing exports were 4 times India's. India's failure was the inefficiency of its investment caused in part by an over large public sector, and in part by a regulated, protected, non-competitive, private sector.

This is not the whole story. It is incorrect to condemn all planning. Think of a country or countries that intervened in the allocation of saving and controlled interest rates yet grew rapidly - - Japan in the 1950s and 1960s, or China now. Now think of countries that followed similar programs and grew slowly - or not at all. Start with much of Africa below the Sahara or India with its sad history of wasted opportunities.

Next think of countries with market determined international rates and little interference in the allocation of credit. Try Hong Kong or Singapore

The first problem for any study of development policy is to get clean experiments. They are hard to design and rarely happen in practice.

Singapore and Hong Kong had open capital markets, but Singapore enforced policies that required households to save, and the Singapore government favored some types of investment over others. Does it matter that Korea or Japan relied more heavily on credit allocation while Singapore relied most heavily on other incentives and prohibitions?

Regulation, taxation, government spending, ``guidance" and allocation of financial resources all affect allocation. Differences in these effects are often more subtle than are captured by available data. The researcher's problem is difficult. The number of alternative methods of allocation or direction of investment is large relative to the number of countries. Interaction between different restrictions may be important quantitatively.

Interpretation is complicated by four additional problems. First, the time period over which the effects on growth of alternative policies are revealed may be measured in years or even decades. Stalinist policies industrialized the Soviet Union in the 1930s and the 1950s. Measured growth rates were comparatively high for a time, but living standards remained low and other measures of development such as life expectancy never reached the levels of the principal market economies. These longer-term effects were not known at the time. Governments can borrow externally and produce domestic growth for a considerable period before any effects of resource misallocation dominate the data. In the mid-1980s Poland and Yugoslavia claimed levels of per capita income about equal to Portugal and Argentina. Brazil, Mexico, and other Latin American countries also supported growth in the late 1970s by borrowing. These countries, and others in Latin America, grew rapidly for a time under policies of import substitution. The costs and inefficiencies of the governments' policies eventually slowed growth.

Second, a government may direct resources to efficient uses. There is no

economic law that says that all public resource allocations must fail or waste resources. Chance alone assures that some government investment will be productive and some private investments unproductive. Evidence of the superior outcome obtained from market allocation must come from comparison over many trials.

Much of what passes for analysis of comparative performance consists of examples that do not support a general conclusion. Japan, guided by some ministry officials, invested in shipbuilding, steel mills, autos, and consumer electronics. Korea, using similar methods, invested in shipbuilding, textiles and steel. These are typically described as successes. But, the Japanese ministries later promoted investment in high definition television and the fifth generation computer, while Korea used lending and other subsidies to develop chemical and heavy industries. These decisions wasted resources.

Unless we measure all the gains and losses over decades and compare the returns to the returns in economies with much less direction, we learn little from these comparisons. No law of nature of man says that governments always misallocate or that private ownership always succeeds. If one or the other were always the case, either all investment would be done by governments or, apart from redistribution and political favors, only malevolent or misinformed governments would intervene.

Third, regulators can succeed for a time by investing in technologies that have worked well elsewhere. Korea's ministries kept their eyes on Japan. Japanese ministries looked to Europe and North America. Copying or adapting does not always work, but it does not always fail. When copying works, even an authoritarian, inefficient government can bring about a period of growth.

In the past forty years, we have had several different experiments about the role of government in development. Should we conclude that nothing can be said? Have we learned nothing? My answer is no. We have learned much. If this were not so, we would not have seen the enormous change in development policies and in the role of government in economic development. The experiments were not designed to test the effect on development of institutional and organizational differences. They are not,

therefore, experiments in the sense of the physical sciences. They are, nevertheless, about as close as we are likely to come to experimental evidence on some central propositions of economic development.

One set of comparisons is between countries that relied mainly on markets and property rights to allocate resources and countries that relied mainly on command and control. Financial repression or development is not the most important difference between these systems, but the World Bank now speaks of the "massive waste" of forced savings in command economies. Differences are not limited to savings. Comparison of market and command economies provide evidence on the role of markets in fostering development.

The examples of North and South Korea and East and West Germany are particularly relevant. Here we hold constant culture, language, and past history. Differences in resources in 1950 or at the end of World War II do not favor one system over the other. Probably North Korea and West Germany had an advantage at the start. After forty years, the market economies with private ownership achieved much higher living standards. Per capita incomes are difficult to compare across countries, but there is little doubt that the increase in the two market economies is at least 3 to 5 times greater than in the two socialist, command and control, economies. This is an impressive difference in favor of property rights and market economies, and the magnitude is probably understated.

Comparison of Hong Kong, Taiwan and China introduce differences in size as well as in political and economic systems. Again the comparison favors the market systems and private property. By 1990, Hong Kong was classified by the World Bank as a high income country; its per capita income was three times the income of China.

Although governments in Korea, Taiwan, and Hong Kong were authoritarian, not democratic, there were important differences in political rights between the citizens of these countries and those in China and North Korea. Citizens in the non-communist countries had more rights to speak, travel, or express opinions. They could own property. These freedoms affect growth. We cannot infer from the differences in growth rates that all of the differences in growth result from differences between the

market system and command economies or between private property and state control. Additional evidence is needed to separate political from economic factors.

The Chinese government conducted an unplanned experiment to separate political and economic factors at an early stage of development. They retained political control but changed the system of resource allocation. First in agriculture, and later in manufacturing and trade, they shifted toward increased reliance on private ownership (or long-term leases), free markets and individual or firm decision making. Growth rates rose and for several years have approached the best levels achieved in market economies.

A second experiment of the postwar years concerns the effect of trade policy on development. This is particularly relevant for India. Recognizing that GATT rules made a return to the protectionist policies of the interwar years unlikely, some countries adopted strategies of export led growth. Others chose import substitution as their trade policy. The early results were far from decisive; in the early postwar years, growth rates reached 8 to 10% in Brazil and Mexico and for 1965--80 growth under import substitution averaged 6% for Latin America as a whole. The rate under export led growth in East Asia was 7% for the same period. For 1965--90, however, growth of per capita income in East Asia averaged 5-1/2% while average growth in Latin America and the Caribbean was below 2%. Government financed, subsidized, or protected investment programs produced rising incomes at first, much as the statist, protectionist policies in the Soviet Union, Eastern Europe and China had done when they started. In many Latin countries, exchange rates overvalued the domestic currency, discouraging exports often to the disadvantage of the agricultural sectors.

In the 1980s, East Asian countries adjusted more rapidly than the Latin Americans to the effects of higher real interest rates and reduced borrowing. Greater export growth, less regulation, more stable policies, exchange rates close to market values, and lower barriers to competition from abroad contributed to the better performance of these countries. As knowledge of the comparative experience spread through Latin America, a willingness to abandon import substitution and state direction spread. The results of Chile's policies of greater openness and reliance on markets

convinced several countries that East Asian successes could be achieved in Latin America. Mexico, Argentina, Peru and others adopted policies of stabilization, privatization, reduced regulation, and export-oriented growth.

One effect of large scale privatization is on efficiency of resource use. Another may be on national saving. State owned enterprises are often inefficient and overmanned, so they produce losses that are paid by the Treasury. The public deficit may reduce national saving. There is also an indirect effect. If selling the enterprises lowers the budget deficit, the pressure for inflation falls. Lower budget deficits, reduced inflation, privatization and deregulation encouraged nationals to invest at home instead of abroad and foreigners to invest in the country. Capital flowed in, augmenting domestic saving.

A third type of evidence comes from the comparison of countries in which governments have taken more and less active roles in directing or encouraging particular industries or firms. Although Korea and Singapore have operated market economies, the governments of these countries have encouraged and subsidized some activities as part of a development plan. Particularly in the 1950s and 1960s, the Japanese government also took a leading role in planning and encouraging some specific activities and discouraging others. On the opposite side, development of the Hong Kong economy relied almost entirely on investors' private decisions. Research shows that Hong Kong has generated much more growth per dollar invested than more interventionist Singapore and, needless to say, far more than India. The efficiency of investment counts heavily for long-term development. That's where Hong Kong was strongest.

The World Bank's (1993) study of the reasons for rapid growth in East Asia discusses the alternative policies. The principal conclusions I draw are (1) that intervention is not necessary for growth and development, and (2) that policies that produced macroeconomic stability contributed to growth. The Hong Kong economy, where government had almost no role, has one of the highest growth rates over a 25 or 30 year span. Singapore and Korea where government took a more active role in the investment or development process, have done about as well, perhaps at greater

cost in living standards. Many others have grown more slowly than Hong Kong. Government planning and directing is not necessary and is surely not sufficient to produce growth or sustain development. This is a principal and I believe firm conclusion.

Conclusion

When economists and development banks turned their attention to the mechanics of development in the 1950s, many believed that economic theory and planning models would provide a blueprint for growth. Looking back at forty years of experience, several recent studies by the World Bank conclude that we know very little about the details of the development process. Setting an institutional or political framework that encourages development seems more useful than any specific set of measures intended to promote growth.

In The Constitution of Liberty and elsewhere, Hayek stressed the role of search in economic development and human affairs. Innovations occur in myriad ways through chance, human intelligence, even planning. What matters for progress is that improvements are encouraged and sustained while mistakes are abandoned. Private ownership and secure property rights contribute to these outcomes.

Recent studies conclude that governments can contribute to economic development by providing a stable environment, avoiding high inflation, unstable exchange rates, and frequent changes in the rules of the game. Governments can encourage growth by supporting education, particularly basic education, avoiding restrictive regulation and protection, encouraging openness and competition, and keeping tax rates and redistribution low.

Development is a long-term process. Governments can stimulate demand, borrow abroad to finance development, and in other ways increase short-term expansion. For the long-term, however, efficient use of resources and continued innovation are more important.

What is true of development generally is also true of saving and financial intermediation. The evidence suggests that saving increases with development and

that the financial system develops as the economy develops. Development of the financial system appears to be driven by demand. Government can assist this development by providing a structure in which change and innovation are more likely to occur. Price stability or low inflation, stable economic policies, and avoidance of preferential lending programs, high reserve requirement ratios and other impediments to endogenous development of financial structure are important contributions that governments can make.

Countries with little intervention and no financial repression have grown relatively well. Intervention and financial repression are neither necessary nor sufficient for economic development. And often interventionist policies have proved to be anti-growth.

This lesson has been learned by the World Bank and, more importantly for present purposes, by the current government of India under the leadership of Prime Minister Rao and Finance Minister Singh. But it required a crisis to bring these lessons home.

Let me close with this summary of India's past and its future prospects. My summary comes from a lecture given by Professor Jagdish Bhagwati - a long-time student of India's development:

"The disenchantment with India's model of development has come from her inadequate performance and from the widely shared and justified perception that her policies have been wittingly foolish. In fact, since judgments are formed by most of us from our experience, encounters with these irrational policies have produced greater disenchantment than their deleterious consequences for growth and poverty which are understood only by a limited few."

India has now turned away from its past. That is why we have been discussing opportunities in India and with India. After 45 years, the principal lesson of development has sunk in. Government planning rarely works for long.