5. DEVELOPMENT STRATEGIES: ASSESSMENTS AND RECOMMENDATIONS

5.1 Introduction

Although the international environment for development has been the main recurring theme of the TDR, since 1992 the Report has also paid greater attention to issues relating to national development strategies.[7] This has been in line with the growing interest in identifying the reasons for the widening discrepancies in the development experiences of different countries and regions. In analysing both success stories and failures, the TDR has pursued the objective of identifying ingredients for development strategies that have the potential to advance economic and social development in countries with widely varying characteristics.

Much of the discussion of the TDR was defined by its critical assessment of structural adjustment programmes (SAPs) and policy reforms based on the Washington Consensus and by a comparison of the development experiences of East Asia and other regions. More recently, the experience of China and the consequences of the Chinese development strategy for the options of other developing countries have received greater attention. This section first reviews the TDRs' analyses of the development strategies pursued by different countries and the lessons that can be drawn from various experiences. This is followed by a review of the TDRs' main recommendations for policies promoting industrialization, structural change and strategic integration into the world economy.

5.2 Lessons from three decades of development experience

5.2.1 Shortcomings of structural adjustment and the Washington Consensus

The 1980s and 1990s were shaped by a radical shift in development thinking and practice in the wake of the debt and development crisis of the 1980s. As the TDR put it, from the perspective of 1999, *for many, the crisis was final proof that inward-oriented growth strategies and interventionist policies could not extract developing countries from the mire of poverty and underdevelopment. Thus, in the second half of the decade, a powerful consensus was forged around "getting prices right"* (99: V).

The new policy approach looked to liberate enterprise from state intervention [in addition to correcting price distortions], *deferring to the invisible touch of global market forces* (03: I), thereby preparing the ground for a recovery led by private investment.

Trade liberalization was expected to improve resource allocation based on comparative advantage and boost export revenues. Financial liberalization was undertaken in order to attract foreign capital seeking high returns in capital-scarce countries. Moreover, it was hoped that *a bigger flow of foreign direct investment would further accelerate growth not only by supplementing domestic resources for capital accumulation, but also through transfer of technology and organizational skills* (99: V; also 93: IV). The swing to the free market philosophy took place *at an amazing speed* in Latin American countries that were especially hard hit by the debt crisis of the early 1980s, but it was also rapid in Africa (93: Part Two, chs. II and III).

The Bretton Woods institutions played a dominant role in the dissemination of this policy approach, both as lenders, imposing their policy conditionality on borrowing countries, and as "think tanks" with a major impact on the international policy debate. The Washington Consensus approach also shaped the economic thinking of elites in many developing countries, notably in Latin America. As a result, the principles underlying the reform agenda shaped development strategies in the 1980s, 1990s and into the new millennium in large parts of the world (06: ch. II).

From the beginning, the TDR adopted a critical attitude towards these reforms, grounded in the recognition that *practically no country that has modernized in recent decades has pursued purely market-oriented financial policies* (91: VI). The TDR was especially concerned with the drop in the share of investment in the first half of the 1980s – seen by the World Bank as an "investment pause" – and its slow and incomplete recovery thereafter (89: Part One, ch. IV; 93: Part Two, chs. II and III; 03: VI). It compared the new strategies with those chosen by several countries in East and South-East Asia that had been much less affected by the debt crisis of the early 1980s and did not embark on the new development paradigm with the same enthusiasm as others.

The recovery in Latin America in the early 1990s at a time of global recession was seen by many observers as an indication of the success of the reforms. However, TDR 1993 again warned against interpreting this as *proof that "root-and-branch market-orientation" provides a sure recipe for recovery and sustained growth regardless of the external trading and financial environment* (93: III). The Report observed that the recovery was *generally driven by consumption rather than investment*, and relied on large inflows of private foreign capital (93: V). It related the latter partly to the success of the Brady Plan (see also section 4.4.4 above), which had *opened the floodgates to foreign capital*, the return of flight capital, and increasing FDI in connection with privatization, which was a major element of SAPs.

The problem, according to TDR 1993, was that these capital inflows did not translate into sufficient new private investment for strengthening and upgrading production and export potential. It attributed this to an unfavourable *configuration of interest rates and exchange rates* and reduced public investment. It even went further by warning that *if the configuration is not improved in time there may be payments crisis later* (93: V), which indeed turned out to be the case a little more than a year later. Most observers and market participants were taken by surprise when new financial turbulence engulfed Latin America following a "shift of sentiment" in international financial markets after the collapse of the Mexican peso in December 1994. Since 1991, the TDR had frequently warned that the surge of capital flows to Latin America might be unsustainable and that the speculative character of much of those inflows made the region susceptible to a sudden reversal (91: Part One, ch. III; 92: annex II to Part Two; 93: Part Two, ch. III; 95: Part Two, ch. II). These predictions not only turned out to be correct, but the analysis of how fragility is created and how a crisis builds up also proved insightful by subsequent events: *An influx of capital in response to interest rate differentials shifts the mood of markets and encourages a further influx, which then acquires further momentum by putting upward pressure on the exchange rate, thus enlarging opportunities for profitable arbitrage* (93: V; also 94: II, 95: III).

While most observers believed the 1994-1995 crisis in Latin America (and several that were to follow in emerging markets) was due to "slippages in implementation of an outward-oriented strategy", the TDR asserted the crisis was due to *the economic strategy itself*, notwithstanding the fact that it *had received the blessing of the international community: 'big bang' liberalization of trade and of the capital account led to a sharp increase in their import propensity, but exports failed to keep pace, with the notable exception of China* (99: V–VII).

In 1999, the TDR observed that *after more than a decade of liberal reforms in developing countries, their payments disorders remain as acute as ever and their economies depend even more on external financial resources*. It found that growth rates were even lower than before the radical policy change, while many countries' external deficits had worsened. Moreover, *where trade balances have improved, there has generally been a slowdown in economic growth* (99: VI). In 2003, the TDR noted that in Latin America this trend had been accompanied by a premature trend towards "deindustrialization", as indicated by a declining share of manufacturing value added in total output (03: VII).

The Report's criticism of SAPs in Africa, where investment and growth performance were also disappointing, was as harsh as that of the Latin American programmes, although with some nuances (98: Part Two). Since most African countries did not attract private capital flows, they were less affected by financial instability than Latin America. But, since the agricultural sector still plays a much greater role in African economies, the TDR signalled that any harm done to the functioning of this sector could have more far-reaching consequences than elsewhere, as was sadly confirmed with the food crisis in and after 2008. TDR 1993 also highlighted a deterioration in the external environment for African development, with falling commodity prices and insufficient official lending and ODA to compensate for the loss of foreign exchange earnings*: losses on the terms of trade have been a multiple of the aid increment* (93: VI).

The Report never left any doubts about its critical view of the standard policies undertaken under SAPs and, later, the Poverty Reduction Strategy Papers. The supply-side and "leave it to the markets" credo of these policies, in the TDR's opinion, overemphasized efficiency increases by altering resource "allocation" at the expense of "accumulation". The latter would have required a different macroeconomic policy stance altogether and greater intervention in favour of real productive investment, especially in potentially dynamic sectors (93: 110; 03: ch. IV).

The TDR even showed that the policy prescriptions of the new agenda undermined growth by rendering the macroeconomic and financial environment hostile to corporate investment. The liberalization of capital flows, a key element of the outward-oriented strategy, *led to currency appreciations and instability, thereby undermining trade performance*, while *a growing proportion of net private capital inflows is absorbed by activities which add little to productive capacity* (99: VII). [Moreover,] *the policy choices and institutional reforms designed to remove state-induced distortions have weakened long-term growth prospects. The policy reforms have been unsuccessful because the "creative" element of Schumpeter's process of "creative destruction" has failed to bring about real transformation of the productive structure through higher investment and technological change* (03: XI).

In 2003, the TDR conceded that Washington-Consensus-type policies were successful inasmuch as they brought inflation under control and led to greater monetary and fiscal discipline (03: ch. VI). However, it found that *the experience does not support the underlying logic of the new policy approach, namely that an import-substitution growth strategy could effectively be replaced by a market-driven, outward-oriented strategy simply by eliminating inflation, downsizing the public sector, and opening markets to foreign trade and capital* (03: XI). It maintained that the reform agenda had overlooked the importance of aggregate demand, real interest rates and real exchange rates.

TDR 2010 recalled that in the 1980s and 1990s, development strategies in most countries had relied heavily on exports to drive expansion of their formal modern sectors. These strategies were unsuccessful in many countries because the supply capacities and competitiveness of domestic producers on global markets were inadequate owing to insufficient capital accumulation. In other countries these strategies created pressure to keep wages low, so that the domestic labour force did not share in the productivity gains. To a large extent, these gains were passed on to lower prices in order to increase the competitiveness of the labour-intensive tradable goods sectors. However, as a consequence, domestic demand stagnated, employment problems persisted, or even worsened, and inequality increased (97: ch. III; 10: ch. IV).

The legacy of insufficient capital accumulation due to inconsistencies of macroeconomic, trade, FDI and financial policies continued to weigh on many countries even into the new millennium, although their performance in terms of exports, growth and employment creation improved after 2002. But rather than interpreting this improvement as a late harvest of the market-oriented policy reforms, the TDR suggested it was due to faster growth in the developed countries, especially rapidly rising net imports by the United States, and higher primary commodity prices.

Moreover, TDR 2010 considered *more accommodative monetary policies and an exchange-rate policy that aimed at preserving international competitiveness,* which it had been advocating for many years, as important factors for faster growth. It also pointed out that several countries took specific measures that represented a diversion from the paradigm of labour market flexibility, such as *sizeable rises in the minimum wage, the reactivation of collective bargaining bodies and the launching of public works programmes.* Such measures were found to have contributed to a significant fall in informal employment and unemployment, and poverty until 2008 (10: VII).

5.2.2 The East Asian development experience

In the 1980s and much of the 1990s East Asia stood out as the bright spot in the development landscape. But while many observers sought to interpret this success as the result of liberalization and market forces, the TDR focused on the policy strategy behind that success.

A study by the World Bank (1993) presented a distorted picture of the experiences of the newly industrializing economies (NIEs) of East Asia, explaining their success on the basis of traditional economics and market forces while overlooking the high degree of selective intervention by their governments, especially in the larger economies. Several issues of the TDR, on the other hand, identified various institutional and policy arrangements that had made the difference. They showed that the "East Asian miracle" was not due to market forces alone, but also to extremely effective government intervention (94: Part Two, ch. I; 96: Part Two, chs. I and II; 97: Part Two, ch. VI). The State had played a very active role in directing the process of structural change and industrial upgrading: *Government intervention in Japan, Republic of Korea and Taiwan province of China was designed to counteract a number of factors that typically limit the capacity and willingness of individual firms in developing countries to undertake long-term investments and modernize their methods of production and organization. It was directed at accelerating the pace of both growth and structural transformation, by changing the composition of industry through rapid capital accumulation, and by increasing the dynamism and efficiency of the industrialization process as a whole. It sought to make profitable sectors and activities which would not have been attractive to investors in a regime of laissez-faire, but which could be expected in due course to be able to withstand international competition. And it sought to stimulate the "animal spirits" of investors, strengthen their confidence, lengthen their time horizons, coordinate their expansion plans, and enlarge their command over resources* (94: VI, VII).

TDR 2003 summarized the reasons for the greater success of the strategies pursued in East Asia compared with the policies pursued in Africa and Latin America as follows: Opening-up to international trade took place in a more stable macroeconomic environment with a rising share of investment in GDP. *The regional peak of 30 per cent of GDP was surpassed in a number of countries, in some cases by a considerable margin. Investment in machinery and equipment along with expanding construction in physical infrastructure were important features of East Asian investment. This improvement in overall investment was in most cases associated with a stable or rising share of public investment with strong crowding-in effects* (03: VI). Whereas some interpretations of the East Asian experience highlighted the benefits of rapid liberalization of foreign trade and finance and deregulation of domestic markets, while reducing the role of the State, the TDR found: *No doubt, competition in foreign markets has exerted an important discipline over enterprises, thereby promoting efficiency. However, the principal rationale for the strategy of export-oriented industrialization that these countries pursued has been different. Initially they had no significant capital goods sector and produced mainly consumer goods. Exports, together with some limitation of imports of consumer goods, allowed domestic industry to expand without a corresponding growth in domestic consumption, and provided the foreign exchange needed for capital goods imports and access to advanced foreign technology. While success in raising investment depended crucially on export growth, export expansion in turn required new investment. Thus, rapid growth required mutually reinforcing dynamic interactions among savings, investment and exports* (96: VII).

In earlier issues, the TDR had already underlined the important role of strong government support to private business and exports: *Some of the most outstanding performers industrialized using a panoply of controls and subsidized credit in favour of activities picked by the Government as having a potential for rapid productivity gains, including heavy industries* (93: IV). Furthermore, through a selective approach to attracting FDI in support of infant industries and establishing close links with foreign firms, host countries gained access to the requisite technologies. Due to these policies, TDR 1996 commented, *successful export orientation was accompanied by structural changes, from resource-based to labour-intensive, and subsequently to technology-intensive, production and exports, especially to the fastest growing northern markets* (96: VII).

But the TDR also recognized problems that emerged in East and South-East Asia in the 1990s. It observed that these countries were running higher deficits in the 1990s than in the 1980s without achieving faster growth, and that they were not undertaking financial and capital-account liberalization in the same deliberate manner as trade liberalization before. As a result, they had become more vulnerable to external financial shocks. As early as 1994, the Report warned that East Asia was becoming a destination of *hot money* and that *a bandwagon in financial or currency markets might prompt a reversal of such capital flows* (94: II). Indeed, large inflows of speculative capital and overvaluation of the real exchange rates, with attendant effects on current-account balances, triggered what came to be known as the Asian financial crisis in 1997–1998. The crisis led to a dramatic fall in GDP growth rates in a number of countries, but it also prompted a rethinking of the policies that had led to the crisis and the policies that would be necessary to reduce their vulnerability to future external shocks (06: V).

5.3 TDR recommendations for development strategies

Many of the TDRs' recommendations have derived from lessons drawn from the successful experiences of several Asian countries that managed to catch up with the developed countries – and from experiences in these latter countries themselves. But at the same time, the TDRs have cautioned against simply replicating their development strategies. While certain principles underlying those strategies might be universally valid, in practice, each country would have to tailor its development strategy to its own specific historical, cultural and institutional background. For many countries, raising income levels and creating productive employment for a growing population would require them to reduce their reliance on primary commodities, while for others it would necessitate increasing the domestic value-added components in their manufacturing sectors. Thus, benefiting from the opportunities of participating in the international trading system requires different strategies at different stages of development (02: ch. III). The TDR also noted the diversity of experiences among the Asian countries themselves, in particular between the so-called first- and the second-tier NIEs, which demonstrates that there is no single, universally applicable model, but a range of options available to other developing countries (96: VI).

Moreover, the design of development strategies has to take account of the changing international context for development. On the one hand, developing countries have fewer policy options for outward-oriented strategies; on the other hand, new market opportunities have arisen.

Nevertheless, referring to historical experience, the TDR emphasized two elements that are common to practically all successful development strategies. First, *establishing a broad and robust domestic industrial base holds the key to successful development because of its potential for strong productivity and income growth* (03: VII). Key factors in this context are the establishment of a nexus between profits and investment, and exports and investment, along with government intervention in businesses in selected sectors in support of structural change. Second, an active management of integration into the global economy is indispensable for modern industrialization and development. This should be guided by a sense of pragmatism rather than ideology: liberalization of trade and international capital flows should not be considered as objectives in their own right, but as instruments for development that are part of a broader development and growth strategy. The two elements need to be linked through measures that channel capital inflows and profits from exports to domestic capital accumulation (96: VI; 06: VI).

5.3.1 Domestic policies in support of industrialization and structural change

(a) Industrialization and the profit-investment nexus

Regarding the creation of a domestic industrial base, the TDR underlined the importance of *a strong and sustained investment drive by national elites, often from very low levels,* which *has been a defining feature of successful development episodes* (03: VI). In order to reach what the TDR suggested as a target threshold of investment – 20 per cent of GDP in poorer countries, rising to 25 per cent as countries climb the income ladder – it maintained that continuing efforts would be needed *to ensure a pro-investment policy regime through an appropriate mix of macroeconomic and market pressures and incentives* (02: XI). Several TDRs, in particular the 1997 issue (Part Two, chs. V and VI), have elaborated on the important role of profits for growth dynamics: *What distinguishes late industrializers from other developing countries is the high animal spirits of their business class, reflected in exceptionally high rates of saving and investments from profits*. The establishment of a profit-investment nexus was therefore considered key to successful structural transformation and output growth. However, TDR 1997 argued that such a nexus would not normally emerge spontaneously, even if basic conditions such as political stability were secured and property rights guaranteed: *Policies must be actively pursued that are designed to provide incentives to private firms to retain profits and invest them in the enhancement of productivity, capacity and employment. Fiscal instruments, both taxes and subsidies, can be important tools in this respect. But there is also an array of trade, financial and competition policies that can help raise profitability and investment in key industries above what might be attained under free market conditions. Closing unproductive channels of wealth accumulation and discouraging luxury consumption are essential ingredients of such a strategy* (97: VII).

In addition to favourable monetary and financial conditions, and pressures and incentives from market forces, the right interventions and well-targeted incentives by governments play a crucial role in influencing the pace and direction of diversification and industrial upgrading. Domestic and external environments conducive to increasing export earnings are important; but what matters even more in the industrialization process is the stimulation of a *dynamic interaction between exports and investment* (96: VI).

An export-investment nexus results when profits earned from exports lead to higher investment through (a) reinvestment of such profits, (b) stimulation of additional investment in the profitable export sectors, (c) stimulation of investment in other domestic industries through linkages with the exports sector, and (d) investment of fiscal revenues from export activities in education, health and infrastructure (02: XI; 05: IX). These, in turn, will enable higher and, over time, more sophisticated production for both export and domestic markets.

In this context, the distribution of commodity rents received increasing attention with the rise of primary commodity prices between 2003 and 2008. For many developing countries this rise led to considerably higher export earnings. However, the TDR found evidence that in many cases, especially in the oil and gas and mining sectors in Africa and Latin America, these higher earnings in the commodity sector did not translate into commensurate increases in domestic income and government revenues. According to the TDR, this was because of a *large share of the gains from the higher prices that have gone into profit remittances* and because of a policy, since the early 1990s, of attracting FDI through the provision of fiscal incentives (08: V; 05: IX). To the extent that commodity rents go into profit remittances *they are lost for capital accumulation in the country where they originate, unless they are reinvested by the foreign companies. But the latter may often not be in the interest of the exporting country either because,* *rather than contributing to diversification and industrial upgrading, such reinvestment in the same activities tends to perpetuate commodity dependence* (08: V).

Since it is not only the level of investment but also its structure that matters for the upgrading of economic activity, one of the distinctive features of the TDR has been its long-standing advocacy of proactive industrial policies adapted to different stages of development and to new opportunities for economic progress (92: VI; 03: XII). In this regard, the TDRs' view contrasted, at times sharply, with the view of other international organizations, especially the IMF and World Bank, regarding industrial policy. These other institutions asserted that, all government intervention that aims at directing the development of private economic activities leads to distortions and should be avoided because it prevents market forces from behaving in the way that abstract models suggest. But the divergent experiences of developing countries studied in the TDR had made it clear that *exclusive concentration on allocative efficiency implies a lack of sufficient attention to stimulating the dynamic forces of markets which underlie structural change and economic growth,* and that *industrial policies were an important supportive factor for East Asia's economic catch-up as well as for industrialization in today's mature economies* (06: X). Accordingly, the TDR advocated an industrial policy aimed at *strengthening the creative forces of markets and related capital formation* by helping private firms to *solve information and coordination problems arising in the process of capital formation* and by *translating cumulative production experience into productivity gains* (06: X, XI).

Several issues of the TDR discussed industrial policy in some detail. For example, TDR 1992 highlighted the importance of industrial policy to support the learning process of companies, especially where new products and markets are involved (92: VI). TDR 2009 summarized the discussions in earlier reports of elements of policy aimed at promoting innovative investment and achieving international competitiveness in increasingly sophisticated products: *A successful industrial policy may comprise, among other elements, public sector engagement in R&D, simplifying access to patents, fiscal and financial support for new production activities, information dissemination, and FDI policies that favour integration into international production chains. Government procurement can also have an important impact* (09: XV). New forms of industrial policy may include supporting private businesses in their efforts to engage in international trade by helping to identify the most promising ways and the most dynamic product groups, especially in connection with international production-sharing arrangements of transnational corporations (TNCs).

TDR 2002 examined the possibilities that had opened up for industrial latecomers through participation in labour-intensive segments of international production networks. Such networks had been established either within large TNCs, or through international subcontracting of groups of smaller enterprises. The TDR suggested that these had widened the possible range of sectors where industrialization could begin. Although participation in these segments may generate a relatively small increase in value added, it could *yield considerable benefits for countries in the early stages of industrialization.* It would generate employment for low-skilled surplus labour and allow the acquisition of *basic techniques and organizational skills, which are prerequisites for more broad-based growth* (02: VII).

Foreign direct investment can play a potentially important role in industrial strategy. In this regard, the TDR always emphasized that the actual benefits of FDI depend on how well the profit interests of TNCs are reconciled with public interest in developing countries. To be beneficial for the public, FDI needs to contribute to creating employment, raising domestic value added and export earnings, and broadly supporting domestic industrialization through the transfer of technology and organizational skills.

In the 1980s and 1990s many developing countries attracted FDI through fiscal incentives, and often through extensive privatization initiatives (93: ch. III). But in African and Latin American countries, the increase in FDI flows did not accelerate growth to the extent expected (99: ch. V). TDR 2003 pointed out that the strong growth of FDI flows to developing countries in the 1990s largely reflected mergers and acquisitions (rather than greenfield investments). *Much of this merger activity was in service sectors, and has the potential to add to payments difficulties* (99: VII). Another important share of FDI went into the mining sector, and thus *tended to shift the production structure away from sectors with the greatest potential for productivity growth* (03: IX).

Due to the mixed experience with FDI as a vehicle for development, the TDR favoured a selective approach to such investment, following the example of several successful NIEs (96: VII; 02: XI; 03: XII; 06:XI). It emphasized the need for *a well-devised approach to FDI* as part of *targeted trade and industrial policies* (02: XI; also 06: XI), and cautioned against placing too much emphasis on FDI in development strategies. Increased competition among developing countries to attract FDI in the labour-intensive segments of international production networks often leads them to offer ever greater fiscal incentives and other concessions to TNCs, resulting in a "race to the bottom". To avoid this, TDR 2005 suggested that potential host countries of FDI *cooperate in the formulation of some generally agreed principles relating to the fiscal treatment of foreign investors*. The Report saw the upward trend in world market prices of fuels and mining products as an *opportunity to review the existing fiscal and ownership regimes,* where there was evidence that incentives provided in the past may have been excessively generous or where they were no longer necessary for motivating FDI (05: IX).

The TDR clearly adopted a position favouring proactive State involvement in shaping the development process over a laissez-faire approach on the grounds that markets alone, especially in developing countries, are unable to produce outcomes that reflect the social and economic interests of development and structural change. It is, however, also important to note that the TDR, while insisting that markets alone could not be relied upon to promote faster growth and prosperity in developing countries, did not propagate a *false ideology of State infallibility*; rather, it acknowledged that in developing countries *instances of misdirected interventionism* had not been infrequent, and that intervention did not always lead to desirable outcomes (91: VI; 98: XV). But in such cases the challenge for governments, supported, where necessary, by international organizations, should be to improve intervention mechanisms rather than abandon them altogether, and adjust intervention in line with the maturing of markets.

(b) The role of monetary conditions and domestic finance

The TDR frequently stressed the need for particular attention to the conditions for the financing of investment in productive capacity, and for continuous upgrading in line with technological possibilities and market demand. The importance of strengthening domestic finance as a central element of any development strategy has been emphasized in various TDRs since the early 1990s. The Report considered it more important for developing countries to improve their own financial systems than to rely on external financing for investment, and to design appropriate monetary and financial policies in the context of integration into the international financial system. *Finance must serve industry and commerce – not vice versa. It must therefore not be allowed to become too costly or uncertain for business*. Reliable domestic sources of affordable long-term finance were seen as a precondition for promoting dynamic entrepreneurship and for enabling business firms to operate with longer time horizons that enable "learning by doing" (91: VI).

According to the TDR, domestic conditions for the financing of investment in productive capacity depend on three elements: first, a monetary policy that keeps the cost of finance low; second, strengthening the domestic banking system and the role of governments in the allocation of credit; and third, regulation of the domestic financial sector.

Regarding monetary conditions, the TDR observed that in the cases of successful industrialization in East Asia, policy interest rates in the 1980s and 1990s generally had been slightly higher than the rate of inflation but lower than real GDP growth rates. By contrast, they were higher than GDP growth rates in most African and Latin American countries, where investment ratios and growth rates remained low. As observed in TDR 2008: *When interest rates are too high, they have a negative impact on the most important sources of financing for investment: company profits and bank credit* (08: VIII).

Maintaining low and stable interest rates is facilitated when a high degree of flexibility of monetary policy is retained by appropriate exchange-rate arrangements and capital-account management, and by using additional instruments, such as fiscal and income policies, to ensure domestic stability.

TDR 2008 also noted that self-financing from retained earnings is the most important and most reliable source for financing private investment (08: VII; also 95: III), thereby reiterating the importance of establishing a profit-investment nexus, which had been discussed earlier in TDR 1994 (Part Two, ch. I).

It is very important that a substantial part of firms' earnings be reinvested in productive capacity, rather than being used, for example, for luxury consumption or speculative activities (08: VII). Therefore, measures that increase the liquidity of firms and encourage the retention of profits may help to spur investment (08: VIII). Such measures had played an important role in East Asia, as discussed in TDR 1997 (ch. IV).

In addition to financing from retained profits, bank financing is particularly important, since the banking system is the link between liquidity-creating monetary institutions and the real sector: *To the extent that investment can be financed by the banking system, which has the power to create credit, depending on the amount of liquidity provided by the central bank, the prior existence of savings balances in the financial system is not a prerequisite for investment* (08: VIII; see also section 3.2 above). However, in 1991 the TDR had remarked that in most developing countries private financial institutions cannot be relied upon for the financing of investment in productive capacities. They are mostly *weak or even absent, while business firms tend to be under-capitalized* (91: VI).

Comparing the "Anglo-Saxon" and the German/Japanese model of financing, the 1991 Report concluded, that *most developing countries have more to gain by improving the banking system and by upgrading the quality of government intervention* in the allocation of finance than by creating equity markets (91: VII). In many countries, although it was hoped that opening up to foreign banks would lead to improvements in the banking sector, domestic financial systems mostly remained weak throughout the two subsequent decades. TDR 2008 observed that in most developing countries *new, innovative and small enterprises, in particular, often encounter severe financing constraints even when they are able to pay high real lending rates. Therefore, when developing countries with weak financial systems undertake domestic governance reforms, as frequently advocated, priority may need to be given to dealing with those institutional shortcomings that represent major obstacles to the provision of long-term credit for investment at reasonable interest rates* (08: IX).

Moreover, the 2008 report noted that *from the perspective of financing for development, it is not only the microeconomic profitability of an investment project that matters, but also the external benefits the project generates for the economy as a whole* (08: IX, X). It recalled an observation already made in 1991, that in most countries which had undergone a successful process of industrialization *governments have improvised techniques consciously to direct credit* to sectors and activities that are strategically important for the economy as a whole (91: VI). Moreover, *public sector banks, particularly development banks, could play an important role in ensuring access of firms to reliable sources for financing productive investment* (08: IX).

Recurrent financial crises in emerging economies have confirmed what had already been noted in the early 1990s, namely that managing financial markets in order to ensure that they serve the needs of the real economy is even more important in developing countries than in the industrialized countries (90: XII). Therefore, the Report stressed that the expansion of domestic finance in developing countries should be accompanied by strong prudential regulations and effective bank supervision (91: Part One, ch. III).

5.3.2 Strategic integration

TDR 1997 acknowledged that the quality and quantity of investment could be improved through closer linkages with the world economy through trade and capital flows, including FDI. But it also underlined that *these external linkages must be complementary to, and not a substitute for, the domestic forces of growth through capital accumulation and technological capacity building. This can be achieved only through a carefully managed and phased integration into the world economy, tailoring the process to the level of economic development in a country and capacity of existing institutions and industries. Such a strategy contrasts sharply with the "big bang" liberalization adopted by some countries in recent years* (97: VII).

(a) Export-led growth and its limits

Policy reforms in the 1980s aimed at replacing import-substitution strategies by export-led growth. Yet the early TDRs, apart from drawing attention to the potential for increased trade among developing countries (83: Part Two), noted that the economic performance of developing countries could be improved by measures promoting the supply of domestic manufactures as substitutes for imports

(81: 5; 85: 14). Such measures would temporarily support and protect nascent industries from the overwhelming competition of more efficient producers in the developed world. Subsequently, as the idea generally gained ground that growth in developing countries could be advanced by relying more than in the past on exports, the TDR paid increasing attention to how national industrialization efforts could benefit from the opportunities offered by the world market. Later, the limits to export-led growth became more obvious, and the TDR suggested that developing countries may be well advised to rely to a greater extent on domestic markets.

These propositions are not contradictory. First, while the earlier import-substitution strategy focused on foreign exchange constraints and policies influencing the supply side, recent recommendations relate to policies that support domestic demand, especially in the context of wage policy. Second, several TDRs in the late 1990s made it very clear that *it is wrong to see export expansion and import substitution as mutually exclusive strategies* (98: 219). In the successful industrialization of East Asia *both were integral parts of a single strategy which aimed to accelerate investment and productivity growth in the long run and enhance the pace of innovation* (96: 130).

This reasoning was elaborated further in TDR 1999: *The success of fast-growing developing economies shows that an export push often followed the build-up of domestic production capacity for the replacement of imports. In view of the evidence that the import content of growth in developing countries is now an even greater constraint on sustained economic growth than in the past, a rethinking of this issue is an urgent necessity in many developing countries. All trade and industrial policies must be designed and implemented so as to reflect differences in levels of economic development, resource endowments and macroeconomic circumstances. In both export orientation and import substitution there are easy and difficult stages, and Governments must be ready to make timely shifts in the incentive structure as their economies graduate through different stages of industrial and economic development* (99: 131–133).

In the view of the TDR, industrial policy should be *complemented by a trade policy designed to achieve international competitiveness in increasingly more sophisticated products* (06: X, XI). The TDR has always fully acknowledged the potential benefits of trade for growth, but it has also called into question *across-the-board opening up to international markets*, which it considers unnecessary to reap such benefits. In its concept of *strategic trade integration,* it believes some temporary protection of selected nascent industries can be a key element of policies aimed at structural change (06: XI; also 02: VI). *Which production should receive industrial and trade policy support and for how long will depend on many factors, which are likely to change in the course of economic development* (06: XI).

However, the potential for enhancing structural change and growth in developing countries through international trade depends not only on domestic policies but also on the international context. The latter is determined by the level and pattern of external demand, as well as by competition from producers in other countries and the industrialization strategies pursued in those countries.

TDR 1996 considered that *in the presence of slower expansion of global demand, the simultaneous attempt by a large number of developing countries to push up exports that they are able to produce – i.e. mainly low-skilled, labour-intensive manufactures – could flood the market and significantly reduce world prices* (96: IX; also 86: 128). In 2002, the TDR analysed this problem in greater detail. It found that *excessive competition among developing countries in world markets for labour-intensive products and for FDI* had led to a tendency for *the prices of manufactured exports from developing countries to weaken vis-à-vis those of the industrial countries in recent years. Competitive pressures are further compounded by the way labour markets in developing countries accommodate the additional supply of labour-intensive goods through flexible wages, allowing firms to compete on the basis of price without undermining profitability. Competition among firms, including international firms, in developing countries becomes competition among labour located in different countries* (02: VIII, IX).

This reasoning was pursued further in subsequent Reports: *In any case, a strategy of export-led growth based on wage compression, which makes countries overly dependent on foreign demand growth, may not be sustainable for a large number of countries and over a long period of time. This is because not all countries can successfully pursue this strategy simultaneously, and because there are limits to how* *far the share of labour in total income can be reduced* (10: IX).

Moreover, the TDR warned that between 2000 and 2008 export-oriented strategies had benefited from relatively fast growth in the industrialized countries, which in some of them (especially the United States) was connected with a growing trade deficit, as well as the emergence of China as a large importer from world markets. But owing to adjustments in the level and structure of demand that are likely to occur in these two large economies in connection with the rebalancing of the global economy, the outlook tends *to darken even for those developing and emerging-market economies that in the past successfully based their growth on an expansion of exports rather than domestic demand* (10: IX).

Against this background, the most recent issues of the TDR, pointing to limits on the potential of primarily export-oriented development strategies, have recommended *a rethinking of the paradigm of export-led development based on keeping labour costs low. Past experience and theoretical considerations suggest that a sustainable growth strategy requires a greater reliance on domestic demand than has been the case in many countries over the past 30 years* (10: I). Strengthening domestic forces of growth would require greater emphasis on raising domestic mass incomes through wage adaptation in line with productivity gains, rather than using productivity gains for lowering export prices to increase market shares on export markets. In this context, TDR 2010 emphasized that wages must not only be considered from the point of view of costs at the firm level but also from a macroeconomic perspective: they are the most important source for consumer demand and, ideally, should grow in line with productivity to create dynamic domestic demand (see section 3.8 above). In many developing countries, *productivity-enhancing and income-protection measures in agriculture* [are] *equally important*. TDR 2010 remarked that such measures have been used *in practically all developed countries for decades to enable agricultural producers and workers to participate in economy-wide productivity and income growth. This will require a revitalization of agricultural support institutions and measures to reduce the impact on farmers' incomes of highly subsidized agricultural products imported from developed countries* (10: XII). Such measures, it noted, can also help strengthen the capacity of small-scale entrepreneurs or the self-employed to invest in productivity-enhancing equipment.

(b) Integration into the global financial system

The TDR always recognized the importance of stable capital flows to developing countries as an instrument that could be useful for accelerating development and structural change. It enables countries to import more capital goods, and thus to boost domestic investment in real productive capacity. But it also expressed concerns about an excessive reliance on private capital flows because the behaviour of financial markets is strongly influenced by policies in the industrialized countries and by unpredictable changes in "market sentiment". Financial liberalization can bring benefits *provided that considerable industrial advance has already been achieved, and strong institutions and markets and competitive industries are in place*. It should be *undertaken gradually and without preventing the Government from pursuing an active industrial policy* (91: VII).

A rapid opening up of the capital account and overdependence on private capital inflows not only increases the vulnerability of the domestic economy to external shocks transmitted via the capital account; it also implies a number of important constraints on the autonomy of developing countries in the conduct of macroeconomic policy (see section 5.3.3).

With the accumulation of experience which demonstrated that higher inflows of private capital were not necessarily followed by higher rates of investment and faster growth, the TDR became ever more sceptical about external financing. In 2008 it argued that, *financing of domestic investment does not always require a current-account deficit – that is, a net capital inflow – provided that domestic monetary policy and the local financial system offer a favourable environment for long-term financing of private firms* (08: I; also 04: IX; 06: XVI).

In the wake of the Asian financial crisis in the late 1990s governments of many emerging-market economies were no longer convinced that *domestic monetary policies have to be geared to generating confidence in international financial markets* (06: V). This implied a change in policy objectives, with an emphasis on avoiding trade deficits and dependence on international capital markets and on IMF assistance when payments problems arose. Governments also aimed at preventing an overvaluation of their exchange rates resulting from capital inflows and, through currency market intervention, they accumulated large amounts of foreign exchange reserves. Trade surpluses and private capital inflows that exceeded their external financing needs were used to repay outstanding debt or to accumulate foreign exchange reserves, which amounts to increasing official capital outflows. This change in strategy was very much in line with the scepticism expressed by the TDR in previous years regarding the potential benefits of opening up to private international capital markets and the unreliability of private capital flows as a source of development finance.

Reserve accumulation not only provided a cushion against the vagaries of international financial markets; it also avoided currency overvaluation and resulting current-account deficits, excessive credit expansion for consumption and speculation. TDR 1998 considered the "problems of cost and feasibility" of accumulating reserves for this purpose. It pointed to the possible costs for the economy as a whole, resulting from the fact that the rate of interest on foreign loans usually exceeds the return on foreign reserves. It also alluded to fiscal costs resulting from the sterilization of the monetary impact of reserve accumulation since the real interest on government debt typically also exceeds the return on reserves (98: 86).

However, later TDRs also recognized that these costs may need to be seen in comparison with the possibly much larger macroeconomic costs that could have resulted from the exchange-rate appreciation that would have occurred in the absence of currency market intervention (09: 123). According to the TDR, this strategy, which implied a more expansionary monetary policy, contributed to better growth performance in many emerging economies, especially in Asia and Latin America. It served not only to prevent a loss of competitiveness of domestic producers in the markets for internationally traded goods, but also to make the domestic financial sector more resilient to external financial disturbances, as evidenced before and during the global financial crisis that erupted in 2008 (08: VI; 09: II).

Since the early 1990s the TDR has also advocated active capital-account management in order to reduce the risk of speculative bubbles in domestic markets and to provide governments with greater flexibility for domestic macroeconomic policies (92: VII; 95: III; 98: X). Although in recent years capital controls generally have come to be viewed more positively, in the early 1990s the TDR went against the received wisdom in reviewing measures to discourage capital flows that were not related to real investment or to trade transactions but were motivated by short-term gains (94: II; 93: ch. III; 95: ch. II).

In 2009, the TDR supported its earlier recommendations for proactive capital-account management. It showed how emerging market economies had succeeded in limiting undesirable capital inflows through a variety of instruments, ranging from outright bans or minimum-stay requirements, to the imposition of non-interest-bearing reserve requirements or taxes on foreign loans that are designed to offset interest rate differentials (93: VIII; also 98: VIII; 09: X).

In the second half of the 1990s discussions concentrated on the pros and cons of fixed or floating exchange-rate regimes for developing countries, and the macroeconomic policies that were consistent with one or other of these "corner solutions" (01: VII, VIII). Following the experience of the Asian financial crisis, the TDR perceived *a growing consensus that developing countries should target real exchange rates in combination with the control and regulation of destabilizing capital flows. This offers a viable alternative to free floating or to ceding completely monetary authority to a foreign central bank. Successful examples of control over inflows and outflows abound, from Chile to China, India and Malaysia, and provide a rich arsenal of tools for better management of the capital account and exchange rates* (99: X).

The 2008 Report showed that overvaluation of exchange rates had been the most frequent and the most "reliable" predictor of financial crises in developing countries over the past 15 years: *Current-account reversals in developing countries with a high share of manufactures in their total trade are primarily driven by large real-exchange-rate changes, whereas for commodity-dependent economies, terms-of-trade shocks are the major factor. An increase in the current-account deficit as a result of an appreciation of the real exchange rate and a concomitant loss of competitiveness of domestic producers may be temporarily financed by a net capital inflow, but it will sooner or later require some form of adjustment, normally a real depreciation. Indeed, overvaluation has been* *the most frequent and the most "reliable" predictor of financial crises in developing countries* (08: VI).

5.3.3 The problem of policy space

It is often argued that some of the key elements of the East Asian development strategy cannot be replicated because national policy autonomy has diminished as a consequence of the conclusion of the Uruguay Round. Agreements made under that Round closed or narrowed some of the earlier policy options available to countries, such as the scope for lengthy periods of protection or resort to extensive trade-related subsidies (96: ch. III; also 02: ch. II). But TDR 1996 also indicated that, despite the narrowing of policy space as a result of WTO rules, in many areas, *such as investment and savings, research and development, and regional policies, there remains ample room for active policy measures* (96: X). After several more years under the new trade regime that had emerged from the Uruguay Round, TDR 2003 found that governments still had a considerable range of options for proactive policies for nurturing competitive enterprises and promoting technological upgrading, *particularly on such matters as industrial support, technological progress and public infrastructure* (03: XII).

TDR 2006 examined this issue of policy autonomy in more depth, confirming that governments can support the creation of *new productive capacity and new areas of comparative advantage by the provision of public funds in support of R&D and innovation activities*. However, it cautioned that *the eventual outcome of the Doha Round may well further reduce flexibility in policy-making by developing countries, particularly in the area of industrial tariffs* (06: XIV).

TDR 2006 pointed out that a reduction of policy autonomy was not only the result of commitments undertaken by countries in multilateral trade and investment agreements; policy-making was also constrained by the loan conditionalities of international financial institutions. Those loan conditionalities had proliferated since the early 1980s, and increasingly *extended into structural and even non-economic areas without taking sufficient account of country-specific factors* (06: IX).

Moreover, apart from these "*de jure*" constraints on policy autonomy, *there are a number of important constraints that result "de facto" from policy decisions relating to the form and degree of a country's integration into the international economy*. TDR 2006 considered these constraints on macroeconomic policies potentially even more serious than those on trade policies. A number of important limits on policy space resulted from too much reliance on private capital inflows to finance trade deficits following the opening up of the capital account. With the progressive liberalization of international capital markets and developing countries' increasing financial openness, those countries experienced more frequent impacts from external shocks via their capital account than via the trade account of their balance of payments. At the same time, their reliance on private capital inflows restricted their autonomy in the conduct of macroeconomic policy. *Most notable among these is the loss of the ability to use the exchange rate as an effective instrument for external adjustment, or the interest rate as an instrument for influencing domestic demand and credit conditions, because of a reliance on private capital inflows to finance trade deficits following the opening up of the capital account* (06: IX, see also 90: XII).

Given the reduced ability to employ traditional instruments of economic policy, TDR 2006 saw the need for policy innovation (i.e. the use of policy instruments that were less subject to restrictions on policy space). With respect to macroeconomic management, it discussed, in particular, the merits of "heterodox", non-monetary, instruments, such as an *incomes policy or direct intervention in the goods and labour markets* as measures for maintaining price stability: *Without a sufficient number of policy instruments that can be used effectively to dampen inflationary risks, the attempt to boost development through expansionary macroeconomic policies is likely to fail, as inflation will rapidly flare up. Conversely, countries that successfully use heterodox instruments to achieve price stability have more room to employ macroeconomic policy to spur an investment-led development process* (06: XVI; also 7: XVII).