# Development Strategies for the 21st Century

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*The lesson of the 20th century is that successful development requires markets underpinned by solid public institutions—institutions that protect property rights, regulate market participants, maintain macroeconomic stability, provide social insurance, and manage conflict. A variety of institutional setups could serve these functions, but any imported blueprints should be filtered through local practice and needs. International rules and the loan conditionality imposed by international financial institutions ought to leave room for development policies to diverge from the dominant orthodoxies. Today's advanced industrial countries owe their success to having developed their own workable models of a mixed economy. Developing nations need to fashion their own brands. Economic development will ultimately derive from homegrown strategies, not imitation of U.S.-style capitalism.*

The idea of a mixed economy is possibly the most valuable heritage that the 20th century bequeathed to the 21st in the realm of economic policy. The 19th century discovered capitalism. The 20th learned how to tame it and render it more productive by supplying the institutional ingredients of a self-sustaining market economy: central banking, stabilizing fiscal policy, antitrust and regulation, social insurance, political democracy. It was during the 20th century that these elements of the mixed economy took root in today's advanced industrial countries. The simple idea that markets and the state are complements—recognized in practice if not always in principle—made possible the unprecedented prosperity that the United States, Western Europe, and parts of East Asia experienced during the second half of the century.

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The truism that private initiative and collective action are both required for economic success arrived in developing countries rather late. As most of them were becoming independent in the 1950s and 1960s, the apparently successful example of the Soviet Union and the antimarket ideology of national governing elites resulted in heavily state-centric development strategies. In Latin America, where countries had long been independent, the dominant "structuralist" view held that market incentives would fail to elicit much of a supply response. Throughout the developing world the private sector was regarded with skepticism, and private initiative was severely circumscribed.

These views underwent a radical transformation during the 1980s under the joint influence of a protracted debt crisis and the teachings of the Bretton Woods institutions. The "Washington consensus," emphasizing privatization, deregulation, and trade liberalization, was embraced enthusiastically by policymakers in Latin America and post-socialist Eastern Europe. The reception was more guarded and cautious in Africa and Asia, but there too policies took a decided swing toward markets. The market-oriented reforms at first paid little attention to institutions and the complementarity between the private and public spheres of the economy. The role assigned to the government did not go beyond that of maintaining macroeconomic stability and providing education. The priority was on rolling back the state, not on making it more effective.

A more balanced view began to emerge during the closing years of the 20th century as it became clearer that the Washington consensus would fail to deliver on its promise. The talk in Washington turned toward second-generation reforms, governance, and "reinvigorating the state's capability" (World Bank 1997, p. 27). And multilateral institutions began to take a considerably humbler view of conditionality. Several developments added fuel to the discontent over the orthodoxy. The first of these was the dismal failure in the Russian Federation of price reform and privatization in the absence of a supportive legal, regulatory, and political apparatus. The second was the widespread dissatisfaction with market-oriented reforms in Latin America and the growing realization that these reforms had paid too little attention to mechanisms of social insurance and to safety nets. The third and most recent was the East Asian financial crisis, which exposed the dangers of allowing financial liberalization to run ahead of adequate regulation.

So we enter the 21st century with a better understanding of the complementarity between markets and the state—a greater appreciation of the virtues of the mixed economy. That is the good news. The bad news is that the operational implications of this understanding for the design of development strategies are not that clear. There remains plenty of opportunity for mischief on the policy front. In particular, it is unlikely that an augmented Washington consensus strategy—appending to the old orthodoxy a new set of blueprints aimed at so-called second-generation reforms—will take us very far. As I argue below, the state and the market can be combined in diverse ways. There are many different models of a mixed economy. The major challenge facing developing nations in the first decades of the 21st century is to fashion their own brands of the mixed economy.

In what follows, I review some of the principles that should guide this quest. I begin by providing a capsule history of the post–World War II growth performance of developing countries. Since the reasons for the disappointing growth performance since the late 1970s are intricately linked with current policy prescriptions, I present my own interpretation of what went wrong. This interpretation underscores the importance of domestic institutions and downplays the role of microeconomic factors (including trade policy) in the post-1980 growth collapse.

In a more detailed analysis of market-supporting institutions, I discuss five functions that public institutions must serve for markets to work adequately: protection of property rights, market regulation, macroeconomic stabilization, social insurance, and conflict management. In principle, a large variety of institutional setups could serve these functions. We need to be skeptical of the notion that a specific institution observed in a country (the United States, say) is the type that is most compatible with a well-functioning market economy.

Partial and gradual reforms have often worked better because reform programs that are sensitive to institutional preconditions are more likely to be successful than those that assume that new institutions can be erected wholesale overnight. Learning and imitation from abroad are important elements of a successful development strategy. But imported blueprints need to be filtered through local experience and deliberation.

What are some of the implications of this for international governance? A key conclusion is that international rules and the conditionality imposed by international financial institutions ought to leave room for development policies that diverge from the dominant orthodoxies of the day. Trade and capital flows are important insofar as they allow developing countries access to cheaper capital goods. But the links between opening to trade and capital flows and subsequent growth are weak, uncertain, and mediated through domestic institutions.

## Some Lessons of Recent Economic History

Many developing countries experienced unprecedented rates of economic growth during the postwar period until the late 1970s.[1] More than 40 of these countries grew at annual per capita rates exceeding 2.5 percent until the first oil shock hit. At this rate of growth incomes double every 28 years or less—that is, every generation. The list of countries with this enviable record goes far beyond the handful of usual East Asian suspects and covers all parts of the globe: 12 countries in Latin America, 6 in the Middle East and North Africa, and even 15 in Sub-Saharan Africa (Rodrik 1999a, table 4.1). There can be little doubt that economic growth led to substantial improvements in the living conditions of the vast majority of households in these countries.

### *The Role of Import Substitution Policies*

Most of the countries that did well in this period followed import substitution policies. These policies spurred growth and created protected and therefore profitable

home markets for domestic entrepreneurs to invest in. Contrary to conventional wisdom, growth driven by import substitution did not produce tremendous inefficiencies on an economywide scale. In fact, the productivity performance of many Latin American and Middle Eastern countries was, in a comparative perspective, exemplary (Rodrik 1999a, table 4.2). In 1960–73 several countries in Latin America (for example, Brazil, the Dominican Republic, and Ecuador), the Middle East and North Africa (the Islamic Republic of Iran, Morocco, and Tunisia), and Sub-Saharan Africa (Côte d'Ivoire and Kenya) experienced more rapid growth in total factor productivity than any of the East Asian economies (with the possible exception of Hong Kong, for which comparable data are not available). Mexico, Bolivia, Panama, Egypt, Algeria, Tanzania, and Zaire experienced faster productivity growth than all but Taiwan, China. Productivity growth estimates of this type are not without serious problems, and one can quibble with the methodologies employed. Nevertheless, there is little reason to believe that the estimates of Collins and Bosworth (1996), from which these numbers are drawn, are seriously biased in the way that they rank different countries.

Thus as a strategy of industrialization, intended to raise domestic investment and enhance productivity, import substitution apparently worked pretty well in a broad range of countries until at least the mid-1970s. Despite its problems, import substitution achieved a more than respectable record. Had the world come to an end in 1973, the policy would not have acquired its dismal reputation, nor would East Asia have deserved its "miracle" appellation.

## *Collapse of Growth*

Following the oil shock of 1973, however, things began to look very different. The median growth rate for developing countries fell from 2.6 percent in 1960–73 to 0.9 percent in 1973–84 and to 0.8 percent in 1984–94. The dispersion in performance across developing countries increased sharply, with the coefficient of variation for national growth rates increasing threefold after 1973 (Rodrik 1999a, table 4.3). The Middle East and Latin America, which had led the developing world in total factor productivity growth before 1973, not only fell behind but experienced negative productivity growth on average thereafter. In Sub-Saharan Africa, where productivity growth had been undistinguished but still positive, it also turned negative. Only East Asia held its own in productivity growth, while South Asia actually improved its performance.

Were these economic downturns a result of the "exhaustion" of import substitution policies, whatever that term means? The common timing implicates instead the turbulence experienced in the world economy following 1973—the abandonment of the Bretton Woods system of fixed exchange rates, two major oil shocks, various other commodity boom-and-bust cycles, and the Volcker interest rate shock of the early 1980s. The fact that some of the most ardent followers of import substitution policies in South Asia—India and Pakistan in particular—managed to either hold on to their growth rates after 1973 (Pakistan) or increase them (India) also suggests that more than just import substitution was involved.

The actual story is straightforward. The proximate reason for the economic collapse was the inability to adjust macroeconomic policies appropriately in the wake of these external shocks. Macroeconomic maladjustment gave rise to a range of syndromes associated with macroeconomic instability—high or repressed inflation, foreign exchange scarcity and large black market premia, external payments imbalances, and debt crises—that greatly magnified the real costs of the shocks. Indeed, there was a strong association between inflation and black market premia and the magnitude of economic collapse experienced in different countries. The countries that suffered the most were those with the largest increases in inflation and black market premia for foreign currency (Rodrik 1999a, figure 4.1). The culprits were poor monetary and fiscal policies and inadequate adjustments in exchange rate policy, sometimes aggravated by shortsighted policies of creditors and the Bretton Woods institutions. Trade and industrial policies had very little to do with bringing on the crisis.

Why were some countries quicker to adjust their macroeconomic policies than others? The deeper determinants of growth performance after the 1970s are rooted in the ability of domestic institutions to manage the distributional conflicts triggered by the external shocks of the period.

Think of an economy that is suddenly and unexpectedly confronted with a drop in the price of its main export (or a sudden reversal of capital flows). The textbook prescription for this economy is a combination of expenditure-switching and expenditure-reducing policies—that is, a devaluation and fiscal retrenchment. But the precise manner in which these policy changes are administered can have significant distributional implications. Should the devaluation be accompanied by wage controls? Should import tariffs be raised? Should the fiscal retrenchment take place through spending cuts or tax increases? If spending is to be cut, what types of expenditures should bear the brunt of the cuts? Should interest rates be raised to rein in private spending as well?

In general, macroeconomic theory does not have a clear preference among the available options. But since each of the options has predictable distributional consequences, in practice much depends on the severity of the social conflicts that lie beneath the surface. If the appropriate adjustments can be undertaken without causing an outbreak of distributional conflict or upsetting prevailing social bargains, the shock can be managed with few long-lasting effects on the economy. If they cannot be, the economy could be paralyzed for years as inadequate adjustment condemns the country to foreign exchange bottlenecks, import compression, debt crises, and bouts of high inflation. Furthermore, deep social divisions provide an incentive to governments to delay needed adjustments and to take on excessive levels of foreign debt, in the expectation that other social groups can be made to pay the eventual costs.

In short, social conflicts and their management play a key role in transmitting the effects of external shocks to economic performance. Societies with deep social cleavages and poor institutions of conflict management tend not to be very good at handling shocks. In such societies the economic costs of exogenous shocks—such as deterioration in the terms of trade—are magnified by the distri-

butional conflicts that are triggered. Such conflicts diminish the productivity with which a society's resources are utilized—by delaying needed adjustments in fiscal policies and key relative prices (such as the real exchange rate or real wages) and by diverting activities away from the productive and entrepreneurial spheres. Cross-national evidence is supportive of this argument: macroeconomic disequilibrium and growth collapse have been more likely in countries with high degrees of income inequality and ethnolinguistic fragmentation, and less likely in countries with democratic institutions or high-quality public institutions (Rodrik 1999b).

### *Lessons in Conflict Management from the East Asian Financial Crisis*

The same logic played out in the recent East Asian financial crisis. One lesson of the crisis is that international capital markets do a poor job of discriminating between good and bad risks. It is hard to believe that there was much collective rationality in investor behavior before and during the crisis: financial markets got it badly wrong either in 1996, when they poured money into the region, or in 1997, when they pulled back en masse. The implication is that relying excessively on liquid, short-term capital (as all three of the worst affected countries did) is a dangerous strategy.

A second lesson is that trade orientation in itself has little to do with the propensity to be hit with severe liquidity problems. The Asian economies most affected by the reversal in capital flows were among the most outward-oriented economies in the world, routinely pointed out as examples for other countries to follow. The determinants of the crisis—as with the debt crisis of 1982 and the Mexican peso crisis of 1994—were financial and macroeconomic. Trade and industrial policies were, at best, secondary.[2]

A third lesson of the East Asian crisis is that domestic institutions of conflict management are critical in containing the adverse economic consequences of the initial shock. Indonesia, an ethnically divided society ruled by an autocracy, eventually descended into chaos. The democratic institutions of the Republic of Korea and Thailand, with their practices of consultation and cooperation among social partners, proved much more adept at generating the requisite policy adjustments. This recent experience has demonstrated once again the importance of institutions—particularly democratic institutions—in dealing with external shocks.

While democratic institutions are relatively recent in Korea and Thailand, they helped these two countries adjust to the crisis in several ways. First, they facilitated a smooth transfer of power from a discredited set of politicians to a new group of government leaders. Second, democracy imposed mechanisms of participation, consultation, and bargaining, enabling policymakers to fashion the consensus needed to undertake the necessary policy adjustments decisively. Third, because democracy provides for institutionalized mechanisms of "voice," the Korean and Thai institutions obviated the need for riots, protests, and other kinds of disruptive

actions by affected groups and reduced support for such behavior from other groups in society.

### *A Different Interpretation*

Many of the lessons that the development community has internalized from recent economic history are in need of revision. In my view the correct interpretation goes something like this. First, import substitution worked rather well for about two decades. It led to higher investment rates and unprecedented economic growth in scores of countries in Latin America, in the Middle East and North Africa, and even some in Sub-Saharan Africa. Second, when the economies of these same countries began to fall apart in the second half of the 1970s, the reasons had little to do with import substitution policies or the extent of government interventionism. The countries that weathered the storm were those in which governments undertook the appropriate macroeconomic adjustments (in fiscal, monetary, and exchange rate policy) rapidly and decisively. Third, and more fundamentally, success in adopting these macroeconomic adjustments was linked to deeper social determinants. It was the ability to manage the domestic social conflicts triggered by the turbulence of the world economy during the 1970s that made the difference between continued growth and economic collapse. Countries with deeper social divisions and weaker institutions (particularly of conflict management) experienced greater economic deterioration in response to the external shocks of the 1970s.

Taken together, these points provide an interpretation of recent economic history that differs from much current thinking. By emphasizing the importance of social conflicts and institutions—at the expense of trade strategy and industrial policies—they also suggest quite a different perspective on development policy. If I am right, the main difference between Latin American countries, say, and East Asian economies was not that those in the first group remained closed and isolated while those in the second integrated themselves with the world economy. The main difference was that Latin American countries did a much worse job of dealing with the turbulence emanating from the world economy. The countries that got into trouble were those that could not manage openness, not those that were insufficiently open.

## A Taxonomy of Market-Sustaining Public Institutions

Institutions do not figure prominently in the training of economists.[3] The standard Arrow-Debreu model, with its full set of complete and contingent markets extending indefinitely into the future, seems to require no assistance from nonmarket institutions. But of course this is quite misleading even in the context of that model. The standard model assumes a well-defined set of property rights. It also assumes that contracts are signed with no fear that they will be revoked when it suits one of the parties. So in the background there exist institutions that establish and protect property rights and enforce contracts. There has to be a system of laws and courts to make even "perfect" markets function.

Laws, in turn, have to be written, and they have to be backed by the use of sanctioned force. That implies a legislator and a police force. The legislator's authority may derive from religion, family lineage, or access to superior violence, but in each case she needs to ensure that she provides her subjects with the right mix of "ideology" (a belief system) and threat of violence to forestall rebellion from below. Or the legislator's authority may derive from the legitimacy provided by popular support, in which case she needs to be responsive to her constituency's (voters') needs. In either case we have the beginnings of a governmental structure that goes well beyond the narrow needs of the market.

One implication of all this is that the market economy is necessarily "embedded" in a set of nonmarket institutions. Another is that not all these institutions are there to serve the needs of the market economy first and foremost, even if their presence is required by the internal logic of private property and contract enforcement. The fact that a governance structure is needed to ensure that markets can do their work does not imply that the governance structure serves only that end. Nonmarket institutions will sometimes produce outcomes that are socially undesirable, such as the use of public office for private gain. They may also produce outcomes that restrict the free play of market forces in pursuit of larger goals, such as social stability and cohesiveness.

The rest of this section discusses five types of market-supporting institutions: property rights, regulatory institutions, institutions for macroeconomic stabilization, institutions for social insurance, and institutions of conflict management.

### Property Rights

It is possible to envisage a thriving socialist market economy in theory, as the famous debates of the 1920s established. But today's prosperous economies have all been built on the basis of private property. As North and Thomas (1973) and North and Weingast (1989), among many others, have argued, the establishment of secure and stable property rights was a key element in the rise of the West and the onset of modern economic growth. Entrepreneurs do not have the incentive to accumulate and innovate unless they have adequate control over the return to the assets that are thereby produced or improved.

Note that the key word is *control* rather than *ownership.* Formal property rights do not count for much if they do not confer control rights. By the same token, sufficiently strong control rights may work adequately even in the absence of formal property rights. Russia today represents a case where shareholders have property rights but often lack effective control over enterprises. Town and village enterprises in China are an example where control rights have spurred entrepreneurial activity despite the absence of clearly defined property rights. As these examples illustrate, establishing "property rights" is rarely a matter of just passing a piece of legislation. Legislation in itself is neither necessary nor sufficient for the provision of secure control rights. In practice, control rights are upheld by a combination of legislation, private enforcement, and custom and tradition. They may be distributed more nar-

rowly or more diffusely than property rights. Stakeholders can matter as much as shareholders.

Moreover, property rights are rarely absolute, even when set formally in the law. My right to keep my neighbor out of my orchard does not normally extend to a right to shoot him if he enters it. Other laws or norms—such as those against murder—may trump property rights. Each society decides for itself the scope of allowable property rights and the acceptable restrictions on their exercise. Intellectual property rights are protected assiduously in the United States and most other advanced societies, but are not in many developing countries. But zoning and environmental legislation restricts the ability of households and enterprises in the rich countries to do as they please with their "property" to a much greater extent than is the case in developing countries. All societies recognize that private property rights can be curbed if doing so serves a greater public purpose. It is the definition of what constitutes "greater public purpose" that varies.

## *Regulatory Institutions*

Markets fail when participants engage in fraudulent or anticompetitive behavior. They fail when transaction costs prevent the internalizing of technological and other nonpecuniary externalities. And they fail when incomplete information results in moral hazard and adverse selection. Economists recognize these failures and have developed the analytical tools required to think systematically about their consequences and about possible remedies. Theories of the second best, imperfect competition, agency, mechanism design, and many others offer an almost embarrassing choice of regulatory instruments to counter market failures. Theories of political economy and public choice offer cautions against unqualified reliance on these instruments.

In practice, every successful market economy is overseen by a panoply of regulatory institutions, regulating conduct in markets for goods, services, labor, assets, and finance. A few acronyms from the United States suffice to give a sense of the range of institutions involved: EPA, FAA, FCC, FDIC, FTC, OSHA, SEC. In fact, the freer are the markets, the greater is the burden on the regulatory institutions. It is no coincidence that the United States has the world's freest markets as well as its toughest antitrust enforcement. It is hard to envisage a hugely successful high-technology company like Microsoft being dragged through the courts for alleged anticompetitive practices in any country other than the United States.

The lesson that market freedom requires regulatory vigilance was driven home recently by the experience in East Asia. In Korea and Thailand, as in so many other developing countries, financial liberalization and capital account opening led to financial crisis precisely because of inadequate prudential regulation and supervision.[4]

Regulatory institutions may need to extend beyond the standard list covering antitrust, financial supervision, securities regulation, and a few others. This is true especially in developing countries, where market failures may be more pervasive and the requisite market regulations more extensive. Recent models of coordination

failure and capital market imperfections make it clear that strategic government interventions may often be required to get out of low-level traps and elicit desirable private investment responses (see Hoff and Stiglitz 2001 for a useful survey and discussion). The experience of Korea and Taiwan, China, in the 1960s and 1970s can be interpreted in that light. The extensive subsidization and government-led coordination of private investment in these two economies played a crucial role in setting the stage for self-sustaining growth (Rodrik 1995). Many other countries have tried and failed to replicate these institutional arrangements.

And even Korea may have taken a good thing too far by maintaining the cozy institutional links between the government and *chaebol* well into the 1990s, at which point these links may have become dysfunctional. Once again, the lesson is that desirable institutional arrangements vary and that they vary not only across countries but also within countries over time.

### *Institutions for Macroeconomic Stabilization*

Since Keynes, we have come to a better understanding of the reality that capitalist economies are not necessarily self-stabilizing. Keynes and his followers worried about shortfalls in aggregate demand and the resulting unemployment. More recent views of macroeconomic instability stress the inherent instability of financial markets and its transmission to the real economy. All advanced economies have come to acquire fiscal and monetary institutions that perform stabilizing functions, having learned the hard way about the consequences of not having them. Probably most important among these institutions is a lender of last resort—typically the central bank—which guards against self-fulfilling banking crises.

There is a strong current within macroeconomics thought, represented in its theoretically most sophisticated version by the real business cycles approach, that disputes the possibility or effectiveness of stabilizing the macroeconomy through monetary and fiscal policies. There is also a sense in policy circles, particularly in Latin America, that fiscal and monetary institutions—as currently configured—have added to macroeconomic instability, rather than reduced it, by following procyclical rather than anticyclical policies (Hausmann and Gavin 1996). These developments have spurred the trend toward central bank independence and helped open a new debate on designing more robust fiscal institutions.

Some countries—Argentina being the most significant example—have given up on a domestic lender of last resort altogether by replacing their central bank with a currency board. The Argentine calculation is that having a central bank that can occasionally stabilize the economy is not worth running the risk that the central bank will mostly *destabilize* it. Argentine history gives plenty of reason to think that this is not a bad bet. But can the same be said for Brazil or Mexico, or, for that matter, Indonesia or Turkey? A substantial real depreciation of the rupee, engineered through nominal devaluations, was a key ingredient of India's superlative economic performance during the 1990s. What might work for Argentina might not work for others. The debate over currency boards and dollarization illustrates the obvious,

but occasionally neglected, fact that the institutions needed by a country are not independent of that country's history.

### Institutions for Social Insurance

A modern market economy is one in which change is constant and idiosyncratic (individual-specific) risk to incomes and employment is pervasive. Modern economic growth entails a transition from a static economy to a dynamic one in which the tasks that workers perform are in constant evolution and movement up and down the income scale is frequent. One of the liberating effects of a dynamic market economy is that it frees individuals from their traditional entanglements—the kinship group, religious organizations, the village hierarchy. The flip side is that it uproots them from traditional support systems and risk-sharing institutions. Gift exchanges, the fiesta, and kinship ties—to cite just a few of the social arrangements for equalizing the distribution of resources in traditional societies—lose much of their social insurance function. And as markets spread, the risks that have to be insured against become much less manageable in the traditional manner.

The huge expansion of publicly provided social insurance programs during the 20th century is one of the most remarkable features of the evolution of advanced market economies. In the United States it was the trauma of the Great Depression that paved the way for the major institutional innovations in this area: social security, unemployment compensation, public works, public ownership, deposit insurance, and legislation favoring unions (see Bordo, Goldin, and White 1998). As Jacoby (1998) notes, before the Great Depression the middle classes were generally able to self-insure or to buy insurance from private intermediaries. As these private forms of insurance collapsed, the middle classes threw their considerable political weight behind the extension of social insurance and the creation of what would later be called the welfare state. In Europe the roots of the welfare state reach in some cases back to the tail end of the 19th century. But the striking expansion of social insurance programs, particularly in the smaller economies most open to foreign trade, was a post–World War II phenomenon (Rodrik 1998b). Despite considerable political backlash against the welfare state since the 1980s, neither the United States nor Europe has significantly scaled back these programs.

Social insurance need not always take the form of transfer programs paid for out of fiscal resources. The East Asian model, represented well by the Japanese case, is one in which social insurance is provided through a combination of enterprise practices (such as lifetime employment and enterprise-provided social benefits), sheltered and regulated sectors (mom-and-pop stores), and an incremental approach to liberalization and external opening. Certain aspects of Japanese society that seem inefficient to outside observers—such as the preference for small-scale retail stores or extensive regulation of product markets—can be viewed as substitutes for the transfer programs that would otherwise have to be provided by a welfare state (as they are in most European nations).

An important implication of such complementarities among different institutional arrangements in a society is that it is very difficult to alter national systems in

a piecemeal fashion. One cannot (or should not) ask the Japanese to get rid of their lifetime employment practices or inefficient retail arrangements without ensuring that alternative safety nets are in place. Another implication is that substantial institutional changes come only in the aftermath of large dislocations, such as those created by the Great Depression or World War II.

Social insurance legitimizes a market economy because it renders it compatible with social stability and social cohesion. At the same time, the existing welfare states in Western Europe and the United States engender a number of economic and social costs—mounting fiscal outlays, an "entitlement" culture, long-term unemployment—which have become increasingly apparent. Partly because of that, developing countries, such as those in Latin America that adopted the market-oriented model following the debt crisis of the 1980s, have not paid sufficient attention to creating institutions of social insurance. The upshot has been economic insecurity and a backlash against the reforms. How these countries will maintain social cohesion in the face of large inequalities and volatile outcomes, both of which are being aggravated by the growing reliance on market forces, is a question without an obvious answer at the moment. But if Latin America and the other developing regions are to carve a different path in social insurance than that followed by Europe or North America, they will have to develop their own visions—and their own institutional innovations—to ease the tension between market forces and the yearning for economic security.

### *Institutions of Conflict Management*

Societies differ in their cleavages. Some are made up of an ethnically and linguistically homogenous population marked by a relatively egalitarian distribution of resources (Finland?). Others are characterized by deep cleavages along ethnic or income lines (Nigeria?). These divisions hamper social cooperation and prevent the undertaking of mutually beneficial projects. Social conflict is harmful both because it diverts resources from economically productive activities and because it discourages such activities through the uncertainty it generates. Economists have used models of social conflict to shed light on such questions as the following: Why do governments delay stabilization when delay imposes costs on all groups (Alesina and Drazen 1991)? Why do countries rich in natural resources often do worse than countries that are resource-poor (Tornell and Lane 1999)? Why do external shocks often lead to protracted economic crises that are out of proportion to the direct costs of the shocks themselves (Rodrik 1999b)?

All these can be thought of as instances of coordination failure, in which social factions fail to coordinate on outcomes that would be of mutual benefit. Healthy societies have a range of institutions that make such colossal coordination failures less likely. The rule of law, a high-quality judiciary, representative political institutions, free elections, independent trade unions, social partnerships, institutionalized representation of minority groups, and social insurance are examples of such institutions. What makes these arrangements function as institutions of conflict man-

agement is that they entail a double "commitment technology"—they warn the potential "winners" of social conflict that their gains will be limited and assure the "losers" that they will not be expropriated. These arrangements tend to increase the incentives for social groups to cooperate by reducing the payoff to socially uncooperative strategies.

## What Role for Institutional Diversity?

As the previous section shows, a market economy relies on a wide array of nonmarket institutions that perform regulatory, stabilizing, and legitimizing functions. Once these institutions are accepted as part and parcel of a market-based economy, traditional dichotomies between market and state or laissez-faire and interventionism begin to make less sense. These are not competing ways of organizing a society's economic affairs; they are complementary elements that render the system sustainable. Every well-functioning market economy is a mix of state and market, laissez-faire and interventionism.

Another implication of the discussion in the previous section is that the institutional basis for a market economy is not uniquely determined. Formally, there is no single mapping between the market and the set of nonmarket institutions required to sustain it. This finds reflection in the wide variety of regulatory, stabilizing, and legitimizing institutions that we observe in today's advanced industrial societies. The U.S. style of capitalism is very different from the Japanese style. Both differ from the European style. And even within Europe there are large differences between the institutional arrangements in, say, Germany and Sweden.

It is a common journalistic error to suppose that one set of institutional arrangements must dominate the others in overall performance. Thus the fads of the decade: With its low unemployment, high growth, and thriving culture, Europe was the continent to emulate throughout much of the 1970s. During the trade-conscious 1980s Japan became the exemplar of choice. And the 1990s were the decade of U.S.-style freewheeling capitalism. It is anybody's guess which set of countries will capture the imagination if and when a substantial correction hits the U.S. stock market.[5]

The point about institutional diversity has a more fundamental implication. The institutional arrangements that we observe in operation today, varied as they are, constitute a subset of the full range of institutional possibilities. This is a point that has been forcefully and usefully argued by Unger (1998). There is no reason to suppose that modern societies have already managed to exhaust all the useful institutional variations that could underpin healthy and vibrant economies. Even if we accept that market-based economies require certain types of institutions, as listed in the previous section,

> such imperatives do not select from a closed list of institutional possibilities. The possibilities do not come in the form of indivisible systems, standing or falling together. There are always alternative sets of arrangements capable of meeting the same practical tests. (Unger 1998, pp. 24–25)

We need to maintain a healthy skepticism toward the idea that a specific type of institution—a particular mode of corporate governance, social security system, or labor market legislation, for example—is the only one compatible with a well-functioning market economy.

## Market Incentives and Institutions

It is individual initiative that ultimately accounts for all economic progress. The market system is unparalleled in its efficacy in directing individual effort toward the goal of material advancement of society. Early thinking on development policy did not take sufficient account of this. Structuralists downplayed market incentives because they viewed them as ineffective in view of pervasive supply and other "structural" constraints. Socialists downplayed market incentives because they viewed them as inconsistent with the attainment of equity and other social goals.

Both fears have turned out to be groundless. Farmers, entrepreneurs, and investors all over the world, regardless of their income and education levels, have revealed themselves to be quite responsive to price incentives. In Korea and Taiwan, China, the private sector's strong response to the tax and credit incentives put in place during the early 1960s was a critical instigator of these economies' growth miracles (Rodrik 1995). In China the dual-track system that allowed farmers to sell their crops in free markets (once their quota obligations were fulfilled) resulted in a large increase in agricultural output and sparked the high growth that has continued to date. After India reformed its cumbersome industrial licensing system, reduced the cost of imported capital goods, and altered relative prices in favor of tradables in the early 1990s, it was rewarded with a sharp increase in investment, exports, and growth. While inequality has gotten worse in some of these economies, poverty levels have been reduced in all of them.

So market incentives work. If this were the entire story, the policy conclusion would be equally straightforward: liberalize all markets as fast as you can. This in fact was the message internalized by the advocates of the Washington consensus and the policymakers who listened to them.

But the experience with development during the past half century reveals another striking fact: the best performing countries were those that liberalized partially and gradually. China, of course, stands out in this respect, as its astonishing success since 1978 is due to a strategy based on dual tracks, gradualism, and experimentation. Save for Hong Kong, which has always been a laissez-faire haven, all the East Asian success cases have followed gradualist reform paths. India, which did very well in the 1990s, liberalized only partially. All these countries unleashed the energies of their private sector, but did so in a cautious, controlled manner.

An important reason why gradualist strategies worked in these cases was that they were better tailored to preexisting institutions at home. They therefore economized on institution building (see Qian 2000 for an account of China's experience along these lines). Korea used a repressed, heavily controlled financial system to channel credit to industrial firms willing to undertake investments. The textbook alternative

of financial liberalization coupled with investment tax credits might have been more efficient on paper, but probably would not have worked as well in the Korea of the 1960s and 1970s nor have paid off so quickly. Rather than relying on dual-track pricing, China could have liberalized agricultural prices completely and then compensated urban dwellers and the treasury through tax reforms, but the new institutions would have taken years, if not decades, to build.

Compare these examples with the wholesale reforms implemented in Latin America and the formerly socialist countries. Because the formerly socialist countries were so radical and borrowed en masse from other countries, their success hinged on the herculean task of creating a wide range of new institutions in short order and, for most of them, from scratch. It is not surprising that the transition has proved more difficult than many economists had expected. The most successful cases, such as Poland, are those that had capitalist institutions that were not entirely destroyed or were recent enough to remember.

Market-oriented reform strategies must recognize not only that institutions matter, but also that altering existing institutions takes time and effort. The need for time and effort is both a constraint—because it implies that first-best price reforms may not be feasible—and an opportunity—because it allows imaginative policymakers to devise profitable alternatives such as the dual-track system or town and village enterprises in China. Development strategies that overlook possibilities for experimentation and local variation foreclose potentially successful paths for growth.

## Implications for International Governance and Conditionality

My argument so far can be summarized in four propositions:

- Market incentives are critical to economic development.
- Market incentives need to be underpinned by strong public institutions.
- Market economies are compatible with a diverse range of institutional arrangements.
- The greater is the fit between market-oriented reforms and preexisting institutional capabilities, the higher is the probability of success.

The first two propositions are now widely accepted, and they form the foundation of an augmented Washington consensus. According to the revised consensus, liberalization, privatization, and global integration are no less important, but they need to be supplemented and supported by reforms in governance. But the importance of the third and fourth propositions is not adequately recognized.

We see the new consensus in operation in a number of areas. In the aftermath of the East Asian crisis, for example, International Monetary Fund (IMF) programs in the region prescribed a long list of structural reforms in business-government relations, banking, corporate governance, bankruptcy laws, labor market institutions, and industrial policy. A key component of the new international financial architecture is a set of codes and standards—on fiscal transparency, monetary and financial policy, banking supervision, data dissemination, corporate governance and struc-

ture, and accounting standards—designed for application in all countries but targeted especially to developing countries. And ever since the Uruguay Round, global trade negotiations have resulted in a number of agreements—on subsidies, intellectual property rights, and investment-related measures—that harmonize practices in the developing countries with those in the more advanced countries.

Thus as the new view of development comes to be operationalized, it results in a ratcheting up of conditionality and a narrowing of the space within which policy can be conducted. In general, this is undesirable for several reasons. First, it is ironic that this is happening at precisely the moment when our comprehension of how the global economy works and what small countries need to do to prosper within it has been revealed to be sorely lacking. It was not so long ago that East Asia's export orientation and high investment rates were assumed to provide protection against the kind of external crisis that periodically rocks Latin America. A common exercise in the aftermath of the 1995 tequila crisis was to compare the two regions' current account deficits, real exchange rates, export-to-GDP ratios, and investment rates to show how East Asia, for the most part, looked "better." East Asia had its critics, of course, but what the critics had in mind was a gradual running out of steam, not the meltdown that transpired. Alan Greenspan was quoted in early 1999 as saying, "I have learned more about how this new international financial system works in the last 12 months than in the previous 20 years" (Friedman 1999, p. 71).

Second, as I have emphasized, market capitalism is compatible with a variety of institutional arrangements. The new consensus either rejects this view (the extreme "convergence" view) or underestimates its significance in practice. The new set of external disciplines comes hand-in-hand with a particular model of economic development that is untested even in the historical experience of today's advanced countries. These disciplines foreclose some development strategies that have worked in the past and others that could work in the future. The narrowing of national autonomy in the formulation of development strategies is a cost for which developing countries are unlikely to receive an adequate reward.

Third, the practical difficulties of implementing many of the institutional reforms under discussion are severely underestimated. Today's developed countries did not get their legal and regulatory institutions overnight. It would be nice if developing countries could somehow acquire developed country institutions, but the safe bet is that this will happen only when they are no longer developing countries. A strategy that tailors market-based reforms to existing institutional capabilities is more likely to bear fruit in the short run.

None of this is to suggest that the specific institutional reforms that dominate the agendas of the Bretton Woods institutions are without merit. No one can seriously oppose the introduction of proper accounting standards or improved prudential supervision of financial intermediaries. While some of the standards are likely to backfire in practice, the more serious concern is that the agendas focus too much on institutional reforms needed to make the world safe for capital flows and therefore necessarily divert political capital and attention from institutional reforms in other areas. The risk is that such an approach privileges freedom of international trade

and capital mobility in the name of "sound" economic policy and that it does so at the cost of neglecting other goals of development policy that might clash with free trade and capital flows.

In the real world, governments face choices: Should they devote education resources to training bank auditors or secondary school teachers? Should they focus on the grand corruption that deters foreign investment or on the petty corruption that most concerns the average household? Should politicians spend their political capital on removing obstacles to international integration or on improving administrative capabilities in the public sector? Should resources be spent on harmonizing legislation with international practice or on public health? Priorities matter when administrative, human, and political capital is scarce. The demands of global integration often imply a different weighting of priorities than that in an appropriately development-focused strategy. Whatever shape the evolving architecture of the international economy takes, therefore, an important goal should be to leave space for developing countries to experiment with their own strategies.

## How Important Is International Economic Integration?

The requirements of global economic integration have come to cast a long shadow over the design of development policies. Developing countries are incessantly lectured about the long list of requirements they have to fulfill to integrate into the world economy. The trouble with the current discourse on globalization is that it confuses ends with means. A truly development-oriented strategy requires a shift in emphasis. Integration into the world economy has to be viewed as an instrument for achieving economic growth and development, not as an ultimate goal. Maximizing trade and capital flows is not and should not be the objective of development policy.

No country has developed successfully by turning its back on international trade and long-term capital flows. Very few countries have grown over long periods without experiencing an increase in the share of foreign trade in their national product. As Yamazawa (2000) puts it, "no developing economy can develop within its protected wall" (p. 2). In practice, the most compelling mechanism that links trade with growth in developing countries is that imported capital goods are likely to be significantly cheaper than those manufactured at home. Policies that restrict imports of capital equipment, raise the price of capital goods at home, and thereby reduce real investment levels have to be viewed as undesirable prima facie. Exports, in turn, are important because they are needed to purchase imported capital equipment.

But it is equally true that no country has developed simply by opening to foreign trade and investment. The trick in the successful cases has been to combine the opportunities offered by world markets with a domestic investment and institution building strategy to stimulate the animal spirits of domestic entrepreneurs. As mentioned, almost all the outstanding cases have involved partial and gradual opening to imports and foreign investment. Multilateral institutions such as the World Bank, International Monetary Fund, and Organisation for Economic Co-operation and Development regularly give advice predicated on the belief that openness generates

predictable and positive consequences for growth. Yet there is simply no credible evidence that across-the-board trade liberalization is systematically associated with higher growth rates.

### *The Evidence on Trade Liberalization*

Recently Francisco Rodríguez and I (1999) reviewed the extensive empirical literature on the relationship between trade policy and growth.6 We reached the conclusion that there is a significant gap between the message that the consumers of this literature have derived and the "facts" that the literature has actually demonstrated. The gap emerges from a number of factors. In many cases the indicators of "openness" used by researchers are problematic as measures of trade barriers or are highly correlated with other sources of poor economic performance. In other cases the empirical strategies used to ascertain the link between trade policy and growth have serious shortcomings, the removal of which results in significantly weaker findings.

Thus the nature of the relationship between trade policy and economic growth remains very much an open question. The issue is far from having been settled on empirical grounds. There are in fact reasons to be skeptical that there is a general, unambiguous relationship between trade openness and growth waiting to be discovered. The relationship is likely to be a contingent one, dependent on a host of country and external characteristics. The fact that practically all of today's advanced countries embarked on their growth behind tariff barriers, and reduced protection only subsequently, surely offers a clue of sorts. Moreover, the modern theory of endogenous growth yields an ambiguous answer to the question of whether trade liberalization promotes growth. The answer varies depending on whether the forces of comparative advantage push the economy's resources in the direction of activities that generate long-run growth (through externalities in research and development, expansion of product variety, upgrading of product quality, and so on) or divert them from such activities.

Indeed, the complementarity between market incentives and public institutions that I have repeatedly emphasized has been no less important in trade performance. In East Asia the role of governments in getting exports out during the early stages of growth has been studied and documented extensively (Amsden 1989; Wade 1990). Even in Chile, the exemplar of free market orientation, post-1985 export success has been dependent on a wide range of government policies, including subsidies, tax exemptions, duty drawback schemes, publicly provided market research, and public initiatives fostering scientific expertise. After listing some of the pre- and post-1973 public policies promoting the fruit, fishery, and forestry sectors in Chile, Maloney (1997) concludes that "it is fair to wonder if these, three of the most dynamic export sectors, could have responded to the play of market forces in the manner they have without the earlier and concurrent government support" (pp. 59–60).

The appropriate conclusion to draw from all this is not that trade protection should be preferred to trade liberalization as a rule. There is no evidence from the past 50 years that trade protection is systematically associated with faster growth.

The point is simply that the benefits of trade openness should not be oversold. When other worthwhile policy objectives compete for scarce administrative resources and political capital, deep trade liberalization often does not deserve the high priority it typically receives in development strategies. This is a lesson of particular importance to countries in the early stages of reform, such as those in Africa.

### The Evidence on Capital Account Liberalization

The evidence on the benefits of capital account liberalization is even weaker.7 On paper, the appeal of capital mobility is obvious. In the absence of market imperfections, freedom to trade enhances efficiency, and that is as true of trade in paper assets as it is of trade in widgets. But financial markets suffer from various syndromes—myopia, information asymmetries, agency problems, self-fulfilling expectations, and bubbles (rational and otherwise)—to an extent that makes their economic analysis inherently a second-best one. No amount of institutional tinkering is likely to make a significant difference to that basic fact of life.

The question of whether developing nations should be pushed to open their capital accounts (in an orderly and progressive manner, as is now recommended by the IMF) can ultimately be resolved only on the basis of empirical evidence. While there is plenty of evidence that financial crash often follows financial liberalization (see Williamson and Mahar 1998 for a survey), there is very little evidence that higher rates of economic growth follow capital account liberalization. Quinn (1997) reports a positive association between capital account liberalization and long-run growth, while Grilli and Milesi-Ferretti (1995), Rodrik (1998a), and Kraay (1998)—the last author using Quinn's (1997) indicator of capital account restrictions—find no relationship. Klein and Olivei (1999) report a positive relationship, but one driven largely by the experience of the developed countries in their sample. This is a field of inquiry that remains in its infancy, and there is clearly much more to be learned. The most that can be said at present is that convincing evidence on the benefits of capital account liberalization has yet to be produced.

Among all the arguments in favor of international capital mobility, perhaps the most appealing one is that such mobility serves a useful disciplining function for government policy. Governments that have to be responsive to investors cannot squander their society's resources as easily. As Summers (1998) puts it, "market discipline is the best means the world has found to ensure that capital is well used."

The idea is attractive, but once again one has to question its empirical relevance. When foreign creditors suffer from the syndromes noted above, a government intent on irresponsible spending finds it easier to finance its expenditures when it can borrow from abroad. Moreover, for such a government even domestic borrowing becomes politically less costly because in a world of free capital mobility there is no crowding out of private investors (since they can borrow from abroad). In both instances international financial markets allow reckless spending that might not have taken place in their absence. Conversely, the discipline that markets exert in the aftermath of crises can be excessive and arbitrary, as discussed previously. As Willett

(1998) points out, the appropriate characterization of market discipline is that it comes too late, and that when it comes it is typically too much.

A recent paper by Mukand (1998) develops the analytics of such situations nicely. Consider the following stylized setup suggested by Mukand's framework. Let there be two actors, a government (G) and a foreign investor (F), which have to decide what actions to pursue when the underlying state of the world is not observable. The state of the world can be either neat or messy. G receives a private signal about the state of the world and then chooses a policy, which is then observed by F. The policy can be either orthodox or heterodox. Assume that the orthodox policy produces a larger surplus in aggregate when the state of the world is neat, and the heterodox policy a larger surplus when the state of the world is messy. F wants to invest only when the policy and the expected state match (orthodox and neat or heterodox and messy). In addition, F believes (perhaps incorrectly) that the productivity of its investment will be higher in the orthodox-neat scenario than in the heterodox-messy one and will invest more when it expects the first scenario.

Mukand demonstrates that the government may have two reasons to follow the orthodox policy under these circumstances, even when it receives a signal that the underlying state of the world is messy (and therefore the heterodox policy would have been more appropriate). He calls the resulting biases "conformity bias" and "good-news bias":

> *Conformity bias:* Let F have a strong and unmovable prior belief that the state of the world is neat. Even if G's posterior belief that the state is messy is strong, G may want to follow orthodox policy anyway because it will not be able to sway F's (posterior) belief and may be better off having the investment and following the wrong policy than not having the investment and following the right (aggregate-surplus-maximizing) policy.
>
> *Good-news bias:* When F's posterior belief can be affected by G's choice of policy, G may want to follow orthodox policy to signal a neat state, because more investment will be forthcoming when F expects the neat state rather than the messy one (assuming that there is a match between the expected state of the world and policy in both cases).

For the good-news scenario to materialize, it is not necessary for the productivity of investment to be higher in the orthodox-neat scenario than in the heterodox-messy one. All that is needed is that the foreign investor believe so. In either case the government finds itself driven by "market sentiment" to follow policies that are inappropriate and fall short of the optimum.

Governments do need discipline, of course. However, in modern societies this discipline is provided by democratic institutions—elections, opposition parties, independent courts, parliamentary debate, a free press, and other civil liberties. Governments that mess up the economy are punished at the polls. Broad cross-national evidence suggests that democratic nations tend to be pretty good at maintaining responsible fiscal and monetary policies. Most significant cases of fiscal profligacy occur under authoritarian regimes rather than democratic ones. It was

military dictatorships that got Latin America into its debt crisis, and democracies that cleaned up the mess. In Asia democratic countries such as India and Sri Lanka have exemplary macroeconomic records by African or Latin American standards. Africa's only long-running democracies (Botswana and Mauritius) have done an excellent job of managing booms and busts in the prices of their main exports (diamonds and sugar). Among the transition economies, the most successful stabilizations have occurred in the most democratic countries. There is a strong negative association between the Freedom House index of democracy and the average inflation rate in a sample of more than 100 countries, after controlling for per capita income. The international-capital-mobility-as-discipline position embodies a view of politics that is at best partial, and at worst harmful to democracy.

Finally, the pursuit of the capital account liberalization agenda has the effect of crowding out policymakers' agenda and diverting their energies from national development efforts. A finance minister occupied with mollifying investor sentiment and marketing the economy to foreign bankers can spend no time on traditional development concerns: reducing poverty, mobilizing resources, and setting investment priorities. Global markets, not domestic priorities, end up dictating policy.

## Conclusion

The lesson of the 20th century is that successful development requires markets underpinned by solid public institutions. Today's advanced industrial countries—Japan, the United States, Western European nations—owe their success to having evolved their own workable models of a mixed economy. While these societies are alike in the emphasis they place on private property, sound money, and the rule of law, they are dissimilar in many other areas: their practices in labor market relations, social insurance, corporate governance, product market regulation, and taxation differ substantially.

All these models are in constant evolution, and none is without its problems. European-style welfare capitalism seemed especially appealing in the 1970s. Japan became the model to emulate during the 1980s. And the 1990s were clearly the decade of U.S.-style freewheeling capitalism. Evaluated in an appropriately historical perspective, all these models have been equally successful. The evidence from the second half of the 20th century is that none of these models clearly dominates the others. It would be a mistake to hold up U.S.-style capitalism as the model toward which the rest of the world must converge.

Of course, all successful societies are open to learning, especially from useful precedents in other societies. Japan is a good example of this. When Japan reformed and codified its legal system under the Meiji restoration, it used Germany's civil and commercial law as the primary model. So my emphasis on institutional diversity and nonconvergence should not be viewed as a rejection of institutional innovation through imitation. What is important is that imported "blueprints" be filtered through local practices and needs. Once again, Japan provides the example. As Berkowitz, Pistor, and Richard (1999) discuss, Japan's selection of the German legal system was an informed choice, not an imposition from

abroad: "extensive debates about the adoption of English or French law, and several drafts based on the French model, preceded the promulgation of codes that were largely based on the German model" (p. 11). In other words, Japanese reformers consciously selected from the codes that were available those that seemed most suited to their circumstances.

What is true of today's advanced countries is also true of developing countries. Economic development ultimately derives from a homegrown strategy, not from the world market. Policymakers in developing countries should avoid fads, put globalization in perspective, and focus on domestic institution building. They should have more confidence in themselves and in domestic institution building, and place less faith in the global economy and the blueprints that emanate from it.

## Notes

1. This section draws on Rodrik (1999a, chap. 4).
2. This point is disputed by many and goes against the official view of the International Monetary Fund (Fischer 1998). The argument that "structural" aspects of the East Asian model were not at the root of the crisis is put well by Stiglitz (1999) and Radelet and Sachs (2000). This is not to say that these economies did not have structural weaknesses, in particular, an overreliance on government steering of the economy that had probably outlived its usefulness. But as Stiglitz points out, financial crises break out with some regularity in economies ranging from those of Scandinavia to that of the United States, with very different types of economic management and standards of transparency.
3. This section borrows heavily from Rodrik (forthcoming).
4. Glaeser, Johnson, and Shleifer (1999) attribute the more impressive development of equity markets in Poland compared with those in the Czech Republic to Poland's stronger regulations upholding minority shareholder rights and guarding against fraud.
5. Perhaps Europe will come back into fashion. The *New York Times* recently published a major feature article with the title "Sweden, the Welfare State, Basks in a New Prosperity" (Andrews 1999).
6. Our detailed analysis covers the five papers that are probably the best known in the field: Dollar (1992), Sachs and Warner (1995), Ben-David (1993), Edwards (1998), and Frankel and Romer (1999).
7. This discussion on capital account convertibility is based on Rodrik (2000).

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