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Growth and Policy Space in Historical Terms
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Macroeconomic Policy

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Chapter Two
Growth and Policy Space in Historical Terms
(with Maria Ángela Parra)

In this chapter, we take up the history of income growth in developing economies and the changes in the international environment in which they operate. Details about structural change in several dimensions are presented in the following two chapters.

Trends in Real Income Levels per capita

When one observes regional growth experiences in now rich and poor countries since the early nineteenth century, it is clear that there has been no overall convergence of per capita incomes. Instead, the income gap widened considerably in both relative and absolute terms. The growth rates of GDP per capita for the countries that were most advanced in 1820 were the highest throughout the nineteenth and twentieth centuries. According to Maddison (1995, 2001, 2007), in the “purchasing power parity” (PPP) terms that have become commonplace in making such comparisons, by 1992 Western Europe had a 13-fold increase in GDP per capita over its level in 1820. The Western Offshoots (United States, Canada, Australia and New Zealand) enjoyed a 17-fold increase, while Latin America and Asia respectively increased seven and six times compared to 1820. Figure 2.1 shows ratios of PPP per capita incomes in Maddison’s developing country regions to per capita income in the “old” OECD

(Western Europe and Western Offshoots but not Japan) for reference years during 1820-2003.¹

The generally negative slopes of the curves are disheartening. Over the long period, PPP per capita income ratios for Latin America and Eastern Europe fell by more than 50%, and the proportional loss for Africa was even greater. Toward the end of the twentieth century, the ratios for China and India began to go up from levels of less than 0.1 observed five decades earlier and which had continued to fall even during the third quarter of the century, the era of rapid growth worldwide generally referred to as the “golden age”. The “rest of Asia”, which includes about 12.5% of Asia’s population without Japan, China and India (with Indonesia as the most populous country followed by South Korea), moved gradually up since the mid-twentieth century, most remarkably in the case of the “Tigers”.

¹ For reasons discussed below, relative income ratios of poor to rich countries are significantly lower when calculated in terms of market prices as opposed to PPP.

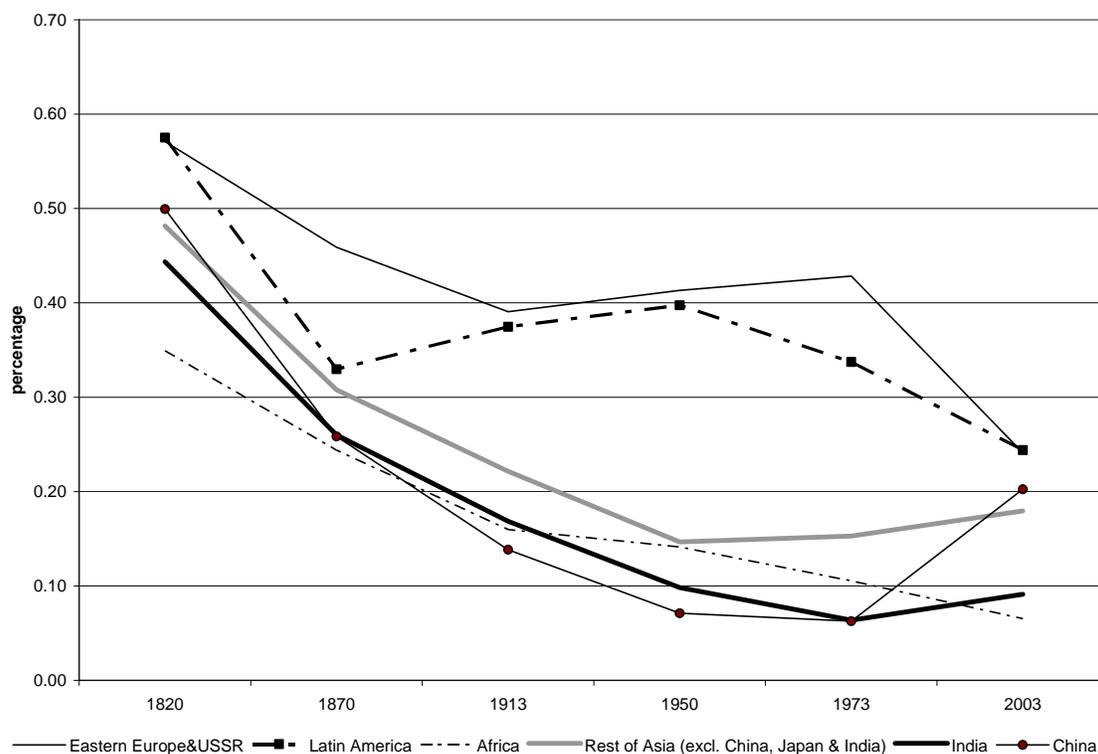
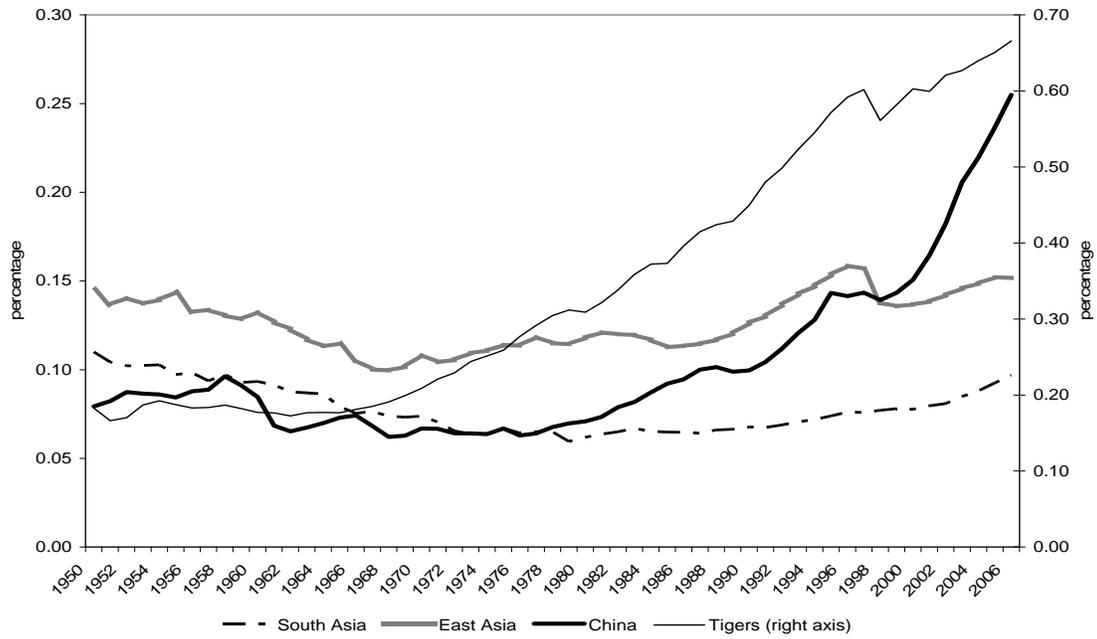


Figure 2.1: Ratios of GDP per capita (Developing countries/'old' OECD)
Source: GDP and Population levels from Maddison (2007).

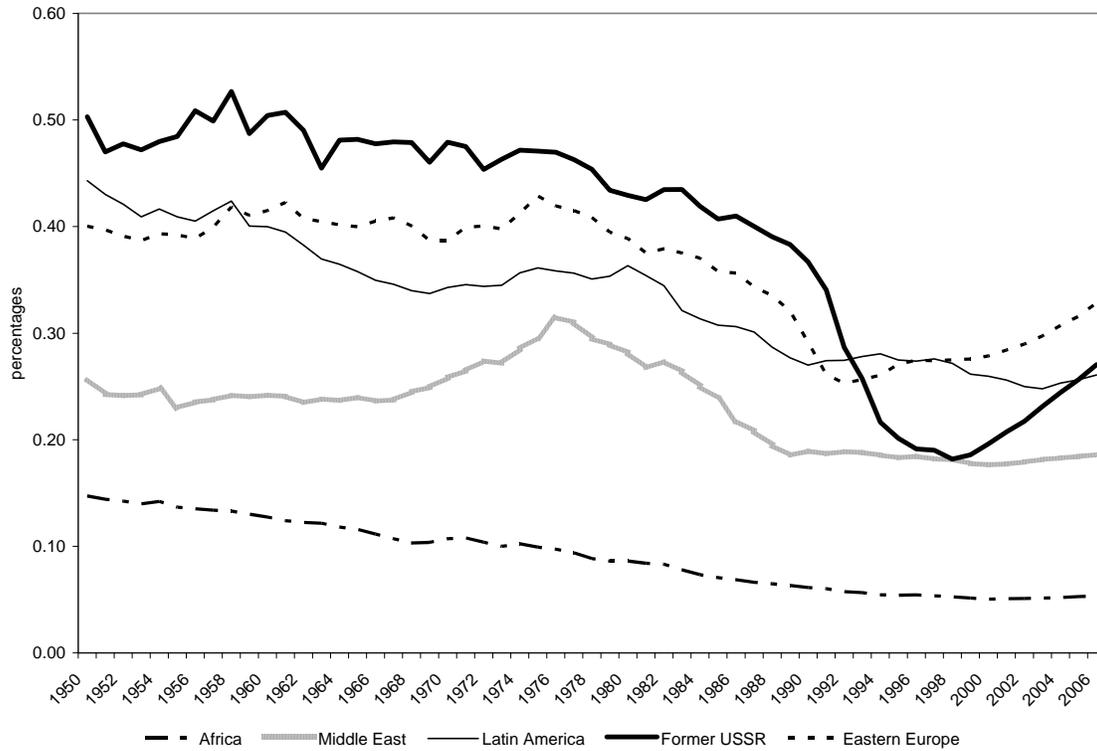
Figure 2.2 shows PPP ratios for selected regions in the second half of the twentieth century (the rich countries now include Japan).² The “Tigers” are the only group showing a sustained increase over most of the period, accelerating in the last quarter of the century to reach 70% of the level of income in the developed economies. There was modest catching-up on the part of the rest of

² The regions broadly follow the configuration used by the *World Bank Development Indicators 2007* for Latin America and the Caribbean, Middle East and North Africa, Sub-Saharan Africa and the high-income OECD countries. Eastern Europe in our analysis includes only Bulgaria, Czech Republic, Hungary, Poland, Romania and Slovakia. The Tigers region counts in South Korea, Malaysia, Singapore and Taiwan, while East Asia comprises Myanmar, Cambodia, Indonesia, Laos, Mongolia, Philippines, Thailand and Vietnam. Finally, South Asia includes Afghanistan, Bangladesh, India, Pakistan, Nepal and Sri Lanka. The detailed analysis of sources of growth undertaken in chapter 3 will be based on slightly different configurations for the selected regions compared to the current chapter.

the Asian regions in the last 25 years, and a remarkable one in the case of China.



2a



2b

Figure 2.2: Catching up: GDP per capita of developing countries vs OECD (1950-2006)

Source: Source: GDP and Population levels from Maddison (2007). World Bank World Development Indicators 2007 for GDP and population levels for 2003-2006.

During the “golden age”, the ratios for the other regions remained roughly constant with two major exceptions, sub-Saharan Africa and Latin America. However, Latin America had been the success story of the developing world from 1870 to 1950, so in 1973 the ratio of its income relative to that of industrial countries was still above that of the Tigers. The regional average during the third quarter of the twentieth century includes poor performances of some countries (notably Argentina) combined with very good performance of others (notably Brazil and Mexico). The Middle East was obviously a success story during the oil boom of the 1970s.

Later, and particularly in the last two decades of the twentieth century, income in all of these other regions declined, most notably for the Middle East and the formerly socialist countries which were parts of the Soviet Union. Central and Eastern Europe also experienced a decline during its transition to capitalism, but started to recover much earlier than the former members of the USSR. Even several successful Asian economies fell back for a while as a result of the 1997 Asian financial crisis.

This “great divergence” of the last quarter of the twentieth century is especially disturbing because the decline in the income ratios in several instances was due to stagnation or a decrease in the absolute value of GDP per capita of the follower countries. For example, by 1998, Africa’s GDP per capita

had decreased 14% with respect to the already low 1977 levels.³ The Middle East is another region with an absolute fall in income per capita at the end of the century – 10% between 1977 and 1998. Lastly, the former USSR lost ground in record time, with its per capita income collapsing by an astonishing 45% from 1989 to 1998 – a story that characterized in variable degrees most former socialist countries in Central and Eastern Europe during the first years of transition.

More recently, and until the collapse that took place since the third quarter of 2008, the rise in export prices of raw materials, oil and other basic commodities, mixed with favorable developments in international financial markets, helped the developing world recover some of the relative income lost since the mid-1970s. By 2003 (the last year for which the Maddison series are estimated), this trend was noticeable in most regions, with the major exceptions being Latin America and, to a lesser extent, Africa.⁴ The recovery from the Asian financial crisis was not uniform, and was clearly weaker in the rest of East Asia than in the Tigers.

However, although *all* developing country groups managed to grow faster than industrial countries during 2003-2007, which is an unprecedented historical development, all income ratios were still significantly lower at the end of this boom than in 1950, except for the East Asian regions (Tigers, East Asia and China). So, as this book went to press, the story for most of the developing world

³ We refer here to 1990 Geary-Khamis dollars, Maddison's preferred benchmark numeraire for computing PPP income levels.

⁴ We updated Figure 2.2 to 2006 from Maddison's series using data from the World Bank (2007).

continued to be that of “Divergence, Big Time”, to use Pritchett’s (1997) terminology.

Fluctuations in Growth

Another way of looking at this history is in terms of growth rates as opposed to levels. In the second half of the twentieth century, there was a pattern of growth successes and collapses at the country level. Numerical evidence is summarized in Table 2.1. Between two-fifths and one-half of developing countries experienced a decent rate of growth per capita (25% per decade or a bit over 2% per year) from the 1950s to the 1970s; this proportion fell to less than one-fifth during the lost decade of the 1980s. At the same time, the number of countries experiencing growth collapses increased sharply, reaching a peak during the lost decade, when about one-half of developing countries suffered a reduction in per capita GDP. A full one-third of them went through a severe growth collapse (fall in GDP per capita of over 10% in the decade).

As already discussed above, the situation reversed modestly during the 1990s when roughly a third of the developing countries managed to grow at more than 2% annually and the proportion of severe growth collapses fell to about one-fifth of the countries. During the early twenty-first century boom, the proportion of developing countries experiencing rapid growth reached levels comparable to those of the golden age, with about 64% growing at least at a rate of 2% per capita per year. However, negative growth experiences remained more frequent than before.

1950- 1960	1960- 1970	1970- 1980	1980- 1990	1990- 2000	2000- 2006
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Cumulative growth	>25%	44%	51%	46%	18%	34%	46%
of which	>50%	12%	19%	2%	1%	1%	18%
Cumulative growth	<0%	6%	8%	25%	53%	31%	12%
of which	<-10%	2%	3%	17%	33%	21%	3%

Table 2.1: Developing countries successes and collapses: Percentage of total number of countries with cumulative per capita GDP growth rate.

Source: 118 countries for 1950-2000 based on Maddison (2007, 1990 Geary-Khamis dollars, PPP), 112 countries for 2000-2006 based on World Development Indicators (2007, constant 2005 international \$, PPP), The World Bank.

Note: For the last period the indicators on cumulative growth are based on the average annual growth rates for 2000-2006, which if maintained over a decade are equivalent to the specified decade growth rates.

Overall, growth successes and collapses tended to cluster in specific time periods. The outstanding difference between the golden age or the recent boom and the great divergence of the late twentieth century is the significant increase in the frequency of growth collapses and the much lower frequency of sustainable growth successes over the 1980s and 1990s.⁵

The clustering in time of successes and failures can also be seen in Figure 2.3. Abstracting from the regional differences noted above, rapid growth from the 1950s through the early 1970s was followed by a strong downward trend⁶ in average developing country growth between since the late 1970s, which reached its lowest point in the early 1980s. Average growth continued to be low until the early 1990s, but then was followed by a recovery, which was nonetheless interrupted for several years by the Asian and Russian crises of 1997 and 1998.

⁵ See a full analysis of this issue in Ocampo and Vos (2008), chapter I.

⁶ Or there was a “cycle” or “oscillation,” although whether or not the temporal pattern will recur as these words imply is an open question.

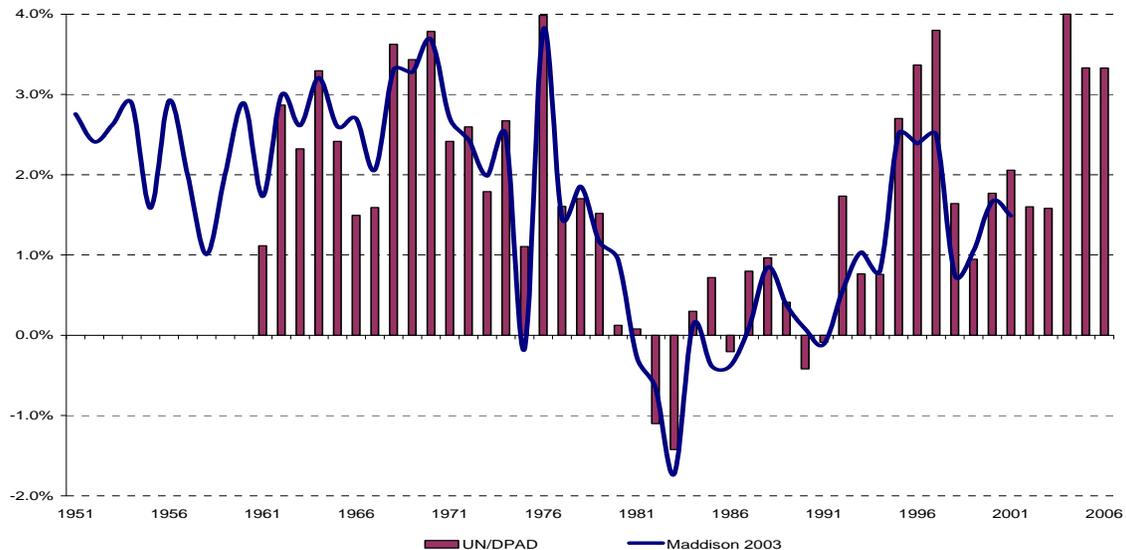


Figure 2.3: The Global Development Cycle

Source: Ocampo and Parra (2007), based on data from Maddison (2007) and World Bank Development Indicators 2007 database.

It is unlikely that domestic reasons alone can explain such a clustering in time of booms and growth collapses. Common external factors must have played a significant role, some with strong regional dimensions. It is not surprising that the end of the golden age of the industrial world also marked (with a lag) the end of the golden age of development. But the average performance of developing countries since then follows a different dynamics from that of industrial countries, reflecting the specific effects of the changing international environment.

Changes in the International Environment

As discussed in Chapter 1, the end of the golden age also coincided with a major shift in the orientation of development policy. The transition was traumatic in several parts of the developing world, as the evidence from the previous section indicates.

Besides the change in policy, two major and largely unexpected shocks hit in the late 1970s. They were the interest rate shock of 1979, illustrated in Figure 2.4, which was triggered by stagflation (slow growth combined with rising inflation) during the 1970s in advanced economies and a structural downward shift of the terms of trade of commodities (see Figure 4.3 in Chapter 4).

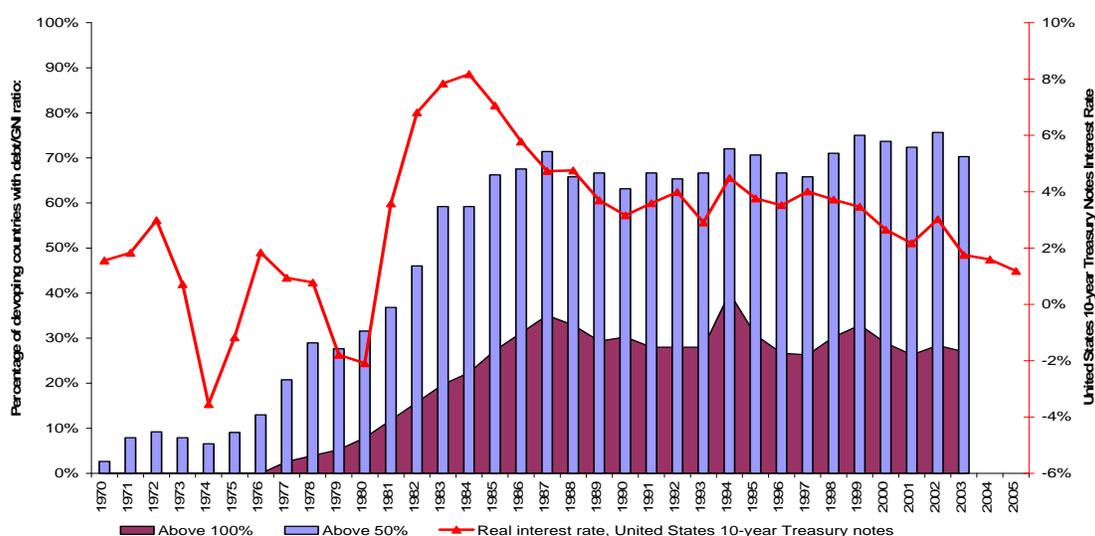


Figure 2.4: Debt/GNI ratio and US real interest rate

Source: Ocampo and Parra (2007) based on World Bank Global Development Finance database.

The worldwide interest rate shock had no historical precedents. After it was imposed by explicit policy decisions (notably by the US Federal Reserve Bank), inflation in the rich countries promptly receded but real interest rates stayed high. Using the 10-year US Treasury note as a benchmark, the real rate increased from -1.8% per year in 1979 to 3.6% in 1981, reaching a peak of 8.2% in 1984. The rate increase faced by developing countries was far higher, from 2.5% in 1979 to 22% in 1981 in real terms, as the average risk premia added to

LIBOR that they paid simultaneously rose.⁷ After having benefited from the recycling of petrodollars, developing countries suffered a substantial shock that implied, for many of them, significant balance of payments distress.

The non-oil commodity terms of trade shock did have precedents, but only in the distant past (in the 1920s). Real non-oil commodity prices went through a structural downward shift of over 30%, breaking the long stretch since the 1920s when they had been essentially trendless (Ocampo and Parra, 2003). The price index of manufactures exported by developing countries, relative to manufactures exported by developed countries, experienced a simultaneous downturn (Akyüz, 2003, chapter 2).

The unprecedented character of the interest rate shock and the distant memory of a comparable terms-of-trade shock explain the unexpectedly large magnitude of ex-post risks that the developing world had to confront.

Debt dynamics turned explosive after the interest rate shock, with both short- and long-term effects. The proportion of developing countries with moderate debt ratios (over 50% of GDP) had been rising from the mid-1970s but was still low prior to the shock, whereas the proportion with critical debt ratios (over 100% of GDP) was very low (Figure 2.4). Both increased sharply and remained at high levels for the next quarter century, for three basic reasons.

The first is that real interest rates remained high: over 4.5% for almost twenty years for the 10-year US Treasury rate. They only returned to low real levels in the early 2000s.

⁷ LIBOR stands for “London interbank offered rate,” an index of rates quoted by London banks. It serves as an international reference interest rate.

The second reason was a lack of international institutions to manage debt overhangs, in sharp contrast to the 1930s when one such “institution” was available: broad based moratoria. A few means to deal with overhangs emerged, but had only weak effects: the Brady Plan of the late 1980s and the Heavily Indebted Poor Countries (HIPC) Initiative of the mid-1990s followed by the Multilateral Debt Relief (MDR) Initiative launched after the Gleneagles meeting of the G8 economies in 2005.

Finally, alongside the hike in interest rates, net financial flows to developing economies became negative, indeed highly negative until the early 1990s for many of them. The early 1990s saw a recovery in such flows, but the succession of the Asian and Russian crises of the late 1990s and their contagion effects on other developing countries interrupted this recovery. These events had, nonetheless, weaker and more temporary repercussions than the debt crisis of the 1980s.

After 2003, capital flows to developing countries began again to boom. This factor, together with low real interest rates and the HIPC/MDR initiatives finally broke the long-term debt overhangs of many developing countries. At the same time, commodity prices boomed from 2004 until the first half of 2008 (see again Figure 4.3 in Chapter 4). Therefore, the two shocks that generated the “lost decade” waned or lost strength, leading to the 2003-2007 developing country recovery. However, favorable financial conditions weakened since the outbreak of the US financial crises in mid-2007 and came to a halt with the global financial

meltdown of September 2008. In turn, the commodity price boom weakened after mid-2008 and was followed by a free price fall during the financial meltdown.

The favorable trends that took place in 2003-2007 are part of a broader set that reflects striking changes that have occurred in the global economy. One important factor is the growing weight of China and, to a lesser extent, of India and other East Asian economies, which contributed until 2008 to the overall demand for raw materials exported by other developing countries.

Financial flows and Chinese investment in the developing world were also substantial. A set of Third World multinational enterprises took off, investing in other developing countries, and even in the industrial world. Countries with surpluses in their balance of payments (primarily oil-exporting countries and high savers in East Asia) created or capitalized sovereign wealth funds, and a larger group of developing countries accumulated large amounts of foreign exchange reserves.

These developments led to the expectation that economic downturn and financial events taking place in the US and Europe since mid-2007 could be counteracted by self-propelling growth in the developing world. In this view, the economic rise of China, India and of the East Asian countries could for the first time allow the developing world to “de-couple” from adverse trends in the industrial world, by acting as an autonomous engine of growth and as a significant source of finance.

However, as this book went to press, it was already evident that the developing countries had been strongly hit by the world financial crisis and that

the “de-coupling” story had been no more than a dream. Many developing countries may, nonetheless, manage to avoid recession, and in this sense they would continue to “converge” towards the income of industrial countries, but for the immediate future this will be a reflection of regression in the industrial world, not of a broad based dynamic growth experienced by developing countries.

On a more positive note, to the extent that official development assistance to the poorest countries of the world continues to increase, based on the commitments made in recent years (and only partly realized as of 2008), it would help the poorest countries of the world maintain part of their growth momentum. The following section describes an important example -- the effects that commodity prices, foreign aid, and other factors have had on economic performance in parts of Sub-Saharan Africa (SSA) over the current decade.

Sub-Saharan Africa During the Current Decade

At the continent-wide level, growth post-2000 until 2007-08 in SSA was largely an oil-driven phenomenon.⁸ Merchandise exports from three major oil exporters (Nigeria, Equatorial Guinea, and Angola) increased from \$30 billion in 2000 to \$114.7 billion in 2007 or roughly a 21% compound rate over the seven-year period. Oil made up the bulk of merchandise export dynamism for SSA as a whole, as the three countries' exports rose from 47.4% to 59.8 of the regional total (excluding South Africa's). Both price and quantity changes

⁸ Thanks to Howard Stein for discussion of the issues considered in this section.

contributed to this outcome. The average barter terms of trade for the three countries increased by 78% between 2000 and 2006.

In turn, growth rates of oil producers have all been above the average regional rate. Angola averaged GDP growth of 13.1% for 2001-07, Equatorial Guinea 22.0%, and Nigeria 5.4% (6.7% 2003-07), Sudan 7.7%, Chad 10.9%, etc. compared to an average of 5.2% for all of SSA. Some non-oil producers showed more moderate growth increases in the last few years, again driven by recovery in the terms of trade. Zambia went from 3.3% growth in 2002 to a peak of 6.2% in 2006 when terms of trade increased by 100% due largely to the rise in copper prices.

There are some moderate growth improvements without a rise in the terms of trade. Kenya had stagnant terms of trade but used an export processing zone and AGOA (the US African Growth and Opportunity Act of 2000) access to increase textile exports to the US, leading to a modest increase in the proportion of manufacturing exports from 21 to 26% in 2000-2004. However, such export growth through diversification is a rare exception in Africa with broad indexes of diversification falling in recent years. Nor have there been significant private capital inflows.

Although conflicting opinions remain on the table, aid-driven economic expansion also seems to have taken place in several cases. Minoiu and Reddy (2007) argue that aid can be effective in promoting growth in the long run if it is directed towards sectors such as infrastructure, education, or health. They

suggest that harmonization of donor's intentions and the targeted use of aid for developmental goals is essential in determining aid effectiveness.

The recent positive shift in the industrialized world's commitment to provide Official Development Assistance (ODA) to poor countries, especially in Sub-Saharan Africa, emerged as a result of two UN-sponsored initiatives: the MDGs and the Monterrey Consensus. The 2008 *Economic Report on Africa* (UNECA 2008) reports that, while net ODA flows to Africa have increased in the post-Monterrey period, from about \$16 billion in 1998-2001 to \$28 billion in recent years, progress on aid effectiveness⁹ – promoting growth and development – lags in many cases. An exception is Mozambique which has seen a significant improvement in its ability to disburse aid for developmental projects, and consequently has seen solid growth in the recent years. For other countries such as Kenya, Malawi, or Ghana, the relation between aid and economic growth has been undermined by the unpredictability of aid flows, bureaucratic bottlenecks on both donor and recipient's sides, and overall misalignments between the conditions attached by donors and countries' developmental strategies. As discussed in Chapter 7, much more work has to be done so that aid can promote dynamic economic growth and not just alleviate temporary economic hardship.

⁹ The Paris Declaration on Aid Effectiveness was adopted in 2005. It comprises several principles that attempt to enhance aid effectiveness, including ownership of the development strategies by recipient countries, harmonization of donor practices, and alignment of such practices with the recipient countries' strategies. Although some advance has been made, much remains to be done and indeed significant disagreement remains about the precise meaning of these principles and the way to their implementation.

Economic changes and shocks related to trade or financial markets are not the only factors affecting economic performance in the region. The African continent overwhelmingly has led developing countries in terms of armed conflicts, especially during the 1980s and 1990s (Cramer 2002). In this area, advance has also been made, though significant conflicts remain in the continent. While we do not examine in this book the disruptive effects that wars and violence have had on economic activity or their causes, we acknowledge that they have worsened the weak economic performance and, particularly, the frequency of growth collapses in SSA in recent decades.