WORLD BANK REGIONAL AND SECTORAL STUDIES

Striving for Growth after Adjustment

The Role of Capital Formation

EDITED BY

LUIS SERVEN

AND

ANDRES SOLIMANO

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The World Bank
Washington, D.C.

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Preface

This book presents the results of about three years of work finished in early 1992 in the area of private investment and macroeconomic adjustment. Its purpose is to explore the macroeconomic determinants of investment and the causes and cures for the gap between macroeconomic adjustment and stabilization and the resumption of economic growth in developing countries, a gap that even today—10 years after the debt crisis and the subsequent adjustment of the eighties—remains wide. This volume highlights the central role of capital formation (private and public) in the restoration of sustainable growth.

Most of the book's chapters were developed as part of a research project, "Private Investment and Macroeconomic Adjustment," financed by the Research Committee of the World Bank. They were presented in several seminars both within and outside the Bank. A conference was held at the World Bank in Washington, D.C. in March 1991, where the work in progress was presented. The panel discussion that closed the conference is contained in the final chapter of the book.

Three of the chapters contain previously published material, which is reproduced here with the kind permission of the copyright holders: chapter 2, by Luis Servén and Andrés Solimano, was originally published by *The World Bank Research Observer*. Chapter 3, by Robert Pindyck, was published by the *Journal of Economic Literature*. Chapter 6 by Luis Servén and Andrés Solimano, was published in *Adjustment Lending Revisited: Policies to Restore Growth*, edited by V. Corbo, S. Fischer and S. Webb.

In developing this work we benefited greatly from the encouragement and advice provided by many colleagues at the World Bank and elsewhere. Among them, our greatest debt is probably to Vittorio Corbo for his constant support from the early stages of this project. We are also grateful to Alan Gelb for his advice, to Anna Maranon and Sabah Moussa for their patient typing of our many revisions to the manuscript, and to Whitney Watriss for her careful editing. Special thanks go to Cecilia Guido-Spano and also Jenepher Moseley and Lauralee Wilson for their valuable assistance in the editorial process, and to Fernando Lefort and Raimundo Soto for assistance.

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Part A. Investment Theory and Adjustment Policies

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Introduction

Luis Servén
and
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Almost a decade ago, the debt crisis and the global shocks affecting developing countries set off a protracted period of macro instability and lack of external financing that led to a drastic decline in capital formation. This worrisome trend endangers the social sustainability of stabilization and reform programs in the developing world. In fact, the paradigm of adjustment *with* growth involves an apparent circularity: for adjustment policies to be followed by growth (that is, to be sustainable), a robust response by investment is required, particularly by the private sector, which is expected to play a key role in market-oriented reform. However, for that investment response to materialize, and for the private sector to engage in intrinsically irreversible investment decisions, it needs to perceive adjustment as sustainable. Lack of confidence in, or just mere skepticism about, the permanence of policy measures may be self-defeating and postpone the benefits of reform.

The study of different experiences with economic reform reveals that private investment follows a cycle during adjustment. In the initial phase of an adjustment program, private (and often public) investment falls, following which it reaches a "plateau" in which neither a substantial recovery (nor further decline) in private investment takes place. The implication is that private investors are adopting a "wait-and-see" attitude. Then, in economies where reform is consolidated and external factors improve, sustained private capital formation resumes, although this phase may not get underway for several years.

The questions

Important policy questions regarding the effects of macroeconomic adjustment on the recent performance of investment motivated the research covered in this volume. The questions below derive from important aspects

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