The Quest for Prosperity
How Developing Economies Can Take Off

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Overview of Presentation

• The needs for rethinking development economics

• The new structural economics as the third wave of development thinking

• The Growth Identification and Facilitation: A new approach for Industrial Policy

• Concluding remarks
WHY DO WE NEED TO RETHINK DEVELOPMENT ECONOMICS
Why Do We Need Rethinking?

Rethinking

Economic Theory

Failure to:

Explain Observed Economic Phenomena

Failure to:

Provide Recipes for Actions to Achieve Intended Goals
Old Recipes and the need for rethinking Development Economics

Development Economics 1.0
Structuralism
Focus on Market Failures
Recipe: Import Substitution Strategy
Disappointing results

Development Economics 2.0
Neoliberalism
Focus on Government Failures
Recipe: Washington Consensus
Lost decades

Successful East Asian Tigers: Export Promotion
Market based economies with proactive role for government

China, Vietnam and Mauritius: Dual-track approach to transition

Rethink Development

World Bank has been in the Process of Rethinking Economic Development

Export Orientation and Market-Friendly Government

(i) Openness and using available knowledge;
(ii) Macro stability;
(iii) High rates of saving & investment;
(iv) Market mechanism;
(v) Committed, credible & capable government

Michal Spence: These are ingredients but not a recipe
THE NEW STRUCTURAL ECONOMICS
Let’s go back to Adam Smith

• But not to *The Wealth of Nations*, which reflects findings of Adam Smith’s research on economic phenomena at his time

• Let’s go back to Adam Smith’s methodology, that is, *An Inquiry into the Nature and Causes of the Wealth of Nations*
The Nature of Modern Economic Growth

- Sustained income growth in the West is a modern phenomenon, appeared only after the Industrial Revolution in the late 18th century.
- The nature of modern income growth is a process of continuous changes in the structure of technologies, industries, and soft and hard infrastructure of the economy.
- The search for growth recipe should focus on the determinants of structure and causes of structural changes.
- The new structural economics attempts to provide a new growth recipe.
New Structural Economics

• An application of neoclassical economic approach to study the determinates of economic structure and its evolution in development, which is the nature of modern economic growth

• Why do I call this approach New Structural Economics?
  – By convention, it should be called structural economics
  – Add “new” to distinguish it from structuralism
What Determines Structure and its Change?

• **The main hypothesis.** Industrial structure is endogenous to endowment structure, which is given at any specific time and changeable over time

• **Initial endowments.** Determine the economy’s total budgets and relative factor prices at time t.
  – Comparative advantage
  – Optimal industrial structure (endogenous)

• **Dynamics.** Income growth depends on:
  – Upgrading industrial structure
  – Upgrading of endowments
  – Improvements in “hard” and “soft” infrastructure

• **The new recipe:** Following comparative advantage (determined by the endowment structure) to develop industries and tapping into the potential of advantage of backwardness is the best way to upgrade the endowment structure and to sustain industrial upgrading, income growth, and poverty reduction.
Institutional Conditions for the New Recipe

• Firms maximize profits...choice of technology and industries based on relative factor prices...

Need for a competitive market system

• Industrial upgrading and diversification needs to:
  – Address externalities
  – Solve coordination problems

Need for a facilitating state
The New Recipe and The Growth Commission’s Ingredients for Growth

• The new recipe: Following comparative advantage
• Institutional Preconditions
  • Market economy
  • Facilitating State
• The results:
  – Openness and advantage of backwardness
  – Competitiveness and strong external as well as fiscal accounts: fewer home-grown crises and larger scope for countercyclical fiscal policies.
  – Large economic surplus and high returns to investment: high rate of savings and investment.
• The NSE’s recommendations are consistent with the East Asian Miracle’s findings.

Growth Report
Ingredients:
#4
#5
#1
#2
#3
NSE and the Failure of Structuralism

• Structuralism advised governments to develop industries that were too far advanced compared to their countries’ level of development and went against their comparative advantages.

• The firms were non-viable in competitive markets and required government policy support for their initial investment and continuous operation.

• This led to rent-seeking, corruption, and political capture.

<table>
<thead>
<tr>
<th>Country</th>
<th>Industry</th>
<th>Time</th>
<th>Main producer at Time</th>
<th>Real GDP pc Latecomer Country</th>
<th>Real GDP pc Leading Country</th>
<th>Income Ratio Follower versus Leader</th>
</tr>
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<tbody>
<tr>
<td>China</td>
<td>Automobile</td>
<td>1950s</td>
<td>USA</td>
<td>577</td>
<td>10,897</td>
<td>5%</td>
</tr>
<tr>
<td>DRC</td>
<td>Automobile</td>
<td>1970s</td>
<td>USA</td>
<td>761</td>
<td>16,284</td>
<td>5%</td>
</tr>
<tr>
<td>Egypt</td>
<td>Iron, Steel, Chemicals</td>
<td>1950s</td>
<td>USA</td>
<td>885</td>
<td>10,897</td>
<td>8%</td>
</tr>
<tr>
<td>India</td>
<td>Automobile</td>
<td>1950s</td>
<td>USA</td>
<td>676</td>
<td>10,897</td>
<td>6%</td>
</tr>
<tr>
<td>Indonesia</td>
<td>Ships</td>
<td>1960s</td>
<td>Netherlands</td>
<td>983</td>
<td>9,798</td>
<td>10%</td>
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<tr>
<td>Senegal</td>
<td>Trucks</td>
<td>1960s</td>
<td>USA</td>
<td>1,511</td>
<td>13,419</td>
<td>11%</td>
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<tr>
<td>Turkey</td>
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<td>1950s</td>
<td>USA</td>
<td>2,093</td>
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<td>19%</td>
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<tr>
<td>Zambia</td>
<td>Automobile</td>
<td>1970s</td>
<td>USA</td>
<td>1,041</td>
<td>16,284</td>
<td>6%</td>
</tr>
</tbody>
</table>

Source: Author's calculations based on data from Maddison (1995).
NSE and the Failure of the Washington Consensus

• All transitional economies started with many nonviable firms in their old priority sectors due to their **comparative advantage-defying development strategy**.

• The Washington Consensus **failed to recognize that the distortions were endogenous** when advocating for the protection of nonviable firms in the priority sectors and advised the government to eliminate all distortions immediately, which caused **the collapse of old priority sectors**.

• The Washington Consensus also **opposed that government play a proactive role in facilitating firm entry** into sectors consistent with the country’s comparative advantages.

• The dynamically growing transitional economies adopted a **dual-track approach**:
  
  – The government continued to provide transitional support to nonviable firms in the old priority sectors and removed distortions only when firms in those sectors became viable or the sectors become very small.
  
  – The government facilitated private firms’ entry to sectors that were consistent with the country’s comparative advantage, which were repressed before the transition.
THE GROWTH IDENTIFICATION AND FACILITATION: A NEW FRAME FOR INDUSTRIAL POLICY
Industrial Policy and Facilitating State

• Industrial Policy is a useful tool for a facilitating state in a market economy for implementing the new recipe
  – Contents of coordination may be different, depending on industries
  – The government’s resources and capacities are limited and need to be used strategically

• Historically, all the successful countries, their government used industrial policies to play the facilitating role in the process of industrial upgrading. The governments in developed countries continue to play that role through patents, supports for basic research, procurements and mandates.

• However, most industrial policies in developing countries failed.

• The governments in developing countries continue to adopt industrial policies no matter we like it or that.

• It is crucial to help the developing countries to have right industrial policies.
Latent Comparative Advantage and Picking Winners

• For an industrial policy to be successful, it should target sectors that conform to the economy’s latent comparative advantage:
  – The latent comparative advantage refers to an industry that the economy has low factor costs of production determined by its factor endowments but the transaction costs are too high to be competitive in domestic and international markets
  – Firms will be viable and the sectors will be competitive once the government helps the firms overcome coordination and externality issues to reduce the risk and transaction costs.

• But how can the government pick the sectors that are in line with the economy’s latent comparative advantages?
What Can Be Learned From History?

• Historical experience shows that successful countries’ industrial policies, in general, targeted industries in countries with a similar endowment structure and somewhat higher per capita income:
  – Britain targeted the Netherlands’ industries in the 16\textsuperscript{th} and 17\textsuperscript{th} centuries; its per capita GDP was about 70\% of the Netherlands’.
  – Germany, France, and the USA targeted Britain’s industries in the late 19\textsuperscript{th} century; their per capita incomes were about 60\% to 75\% of Britain’s.
  – In Meiji restoration, Japan targeted Prussia’s industries; its per capita GDP was about 40\% of Prussia’s. In the 1960s, Japan targeted the USA’s industries; its per capita GDP was about 40\% of the USA’s.
  – In the 1960s-80s, Korea, Taiwan, Hong Kong, and Singapore targeted Japan’s industries; their per capita incomes were about 30\% of Japan’s.
  – In the 1970s, Mauritius targeted Hong Kong’s textile and garment industries; its per capita income was about 50\% of Hong Kong’s.
  – In the late 1980s, Ireland targeted US’s chemical, pharmaceutical, electronic and information industries and its per capita income was about 45\% of the US’s.
  – In the 1990s, Costa Rica targeted the memory chip packaging and testing industry; its per capita GDP was about 40\% of Taiwan’s, which was the main economy in this sector.

• Unsuccessful industrial policies, in general, targeted industries target industries in countries where their per capita GDPs were less than 20\% of the targeted countries
Growth Identification and Facilitation

**Step 1**
Find fast growing countries with similar endowment structures and with about 100% higher per capita income. Identify dynamically growing, tradable industries that have performed well in those countries over the last 20 years.

**Step 2**
See if some private domestic firms are already in those industries (existing or nascent). Identify constraints to quality upgrading or further firm entry. Take action to remove constraints.

Avoid the government doing the wrong things or being captured by vested groups for rent seeking.

Incorporate the idea of tacit knowledge.
Growth Identification and Facilitation

**Step 3**
In industries where no domestic firms are currently present, **seek FDI from countries examined in step 1, or organize new firm incubation programs.**

**Step 4**
In addition to the industries identified in step 1, the government should also pay attention to **spontaneous self discovery** by private enterprises and give support to **scale up successful private innovations** in new industries.

- **Import or cultivate tacit knowledge**
- **Benefit from opportunities arising from new technologies**
Growth Identification and Facilitation

**Step 5**
In countries with poor infrastructure and bad business environments, **special economic zones or industrial parks** may be used to overcome barriers to firm entry, attract FDI, and encourage industrial clusters.

**Play the coordination function in a pragmatic way**

**Step 6**
The government may **compensate pioneer firms** identified above with:
- Tax incentives for a limited period
- Direct credits for investments
- Access to foreign exchange

**Address the externality issue**
Two additional points

• Agricultural development is crucial for developing countries:
  – For poverty reduction, and
  – For providing capital and a market for industrial products.
  – Agricultural development also requires structural change in technology and product composition

• A resource-abundant country’s resources will be a blessing if:
  – It has a good management of resources. (E.g., some of it must be saved for future generations, and enclave rent capture avoided.)
  – It uses (part of) the wealth generated from resources to facilitate structural transformation.
Concluding Remarks

• Every developing country has the potential to grow continuously at 8% or more for several decades, and to become a middle-income or even a high-income country in one or two generations, as long as the government adopts the new growth recipe and has the right policy framework to facilitate the development of the private sector along the lines of the country’s comparative advantages and taps into the latecomer advantages.

• A change in the development thinking is required for the government to adopt the new recipe and play the right facilitating role

  – In the past, developing thinking advised the governments in developing countries to use high-income countries as references and develop what they did not have but high-income had (advanced industries in development economics 1.0) or improve what they could not do well but high-income countries could do relatively well (Washington consensus in development economics 2.0)

  – The new development thinking (development economics 3.0) proposes the governments in developing countries to develop what the developing countries can do well now (that is, their comparative advantages) based on what they have (that is their endowments)
This book can be downloaded for free from the World Bank: http://go.worldbank.org/QZK6IM4GO0

The book was published by the Princeton University Press in September and is available on Amazon.com.