

Rethinking Economic Development and Growth Identification and Facilitation

Seminar at

**German Development Institute /
Deutsches Institut für Entwicklungspolitik (DIE)**

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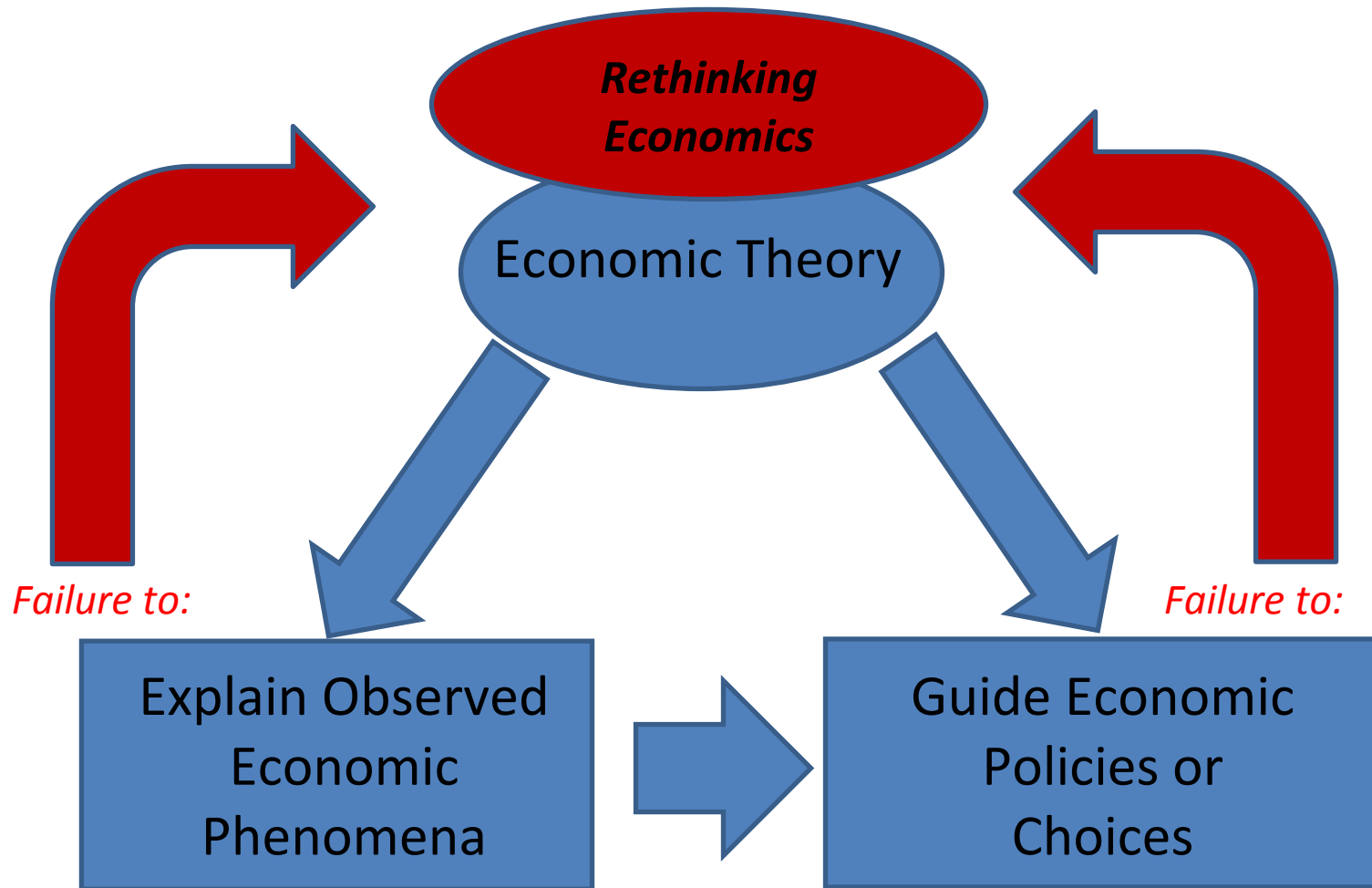
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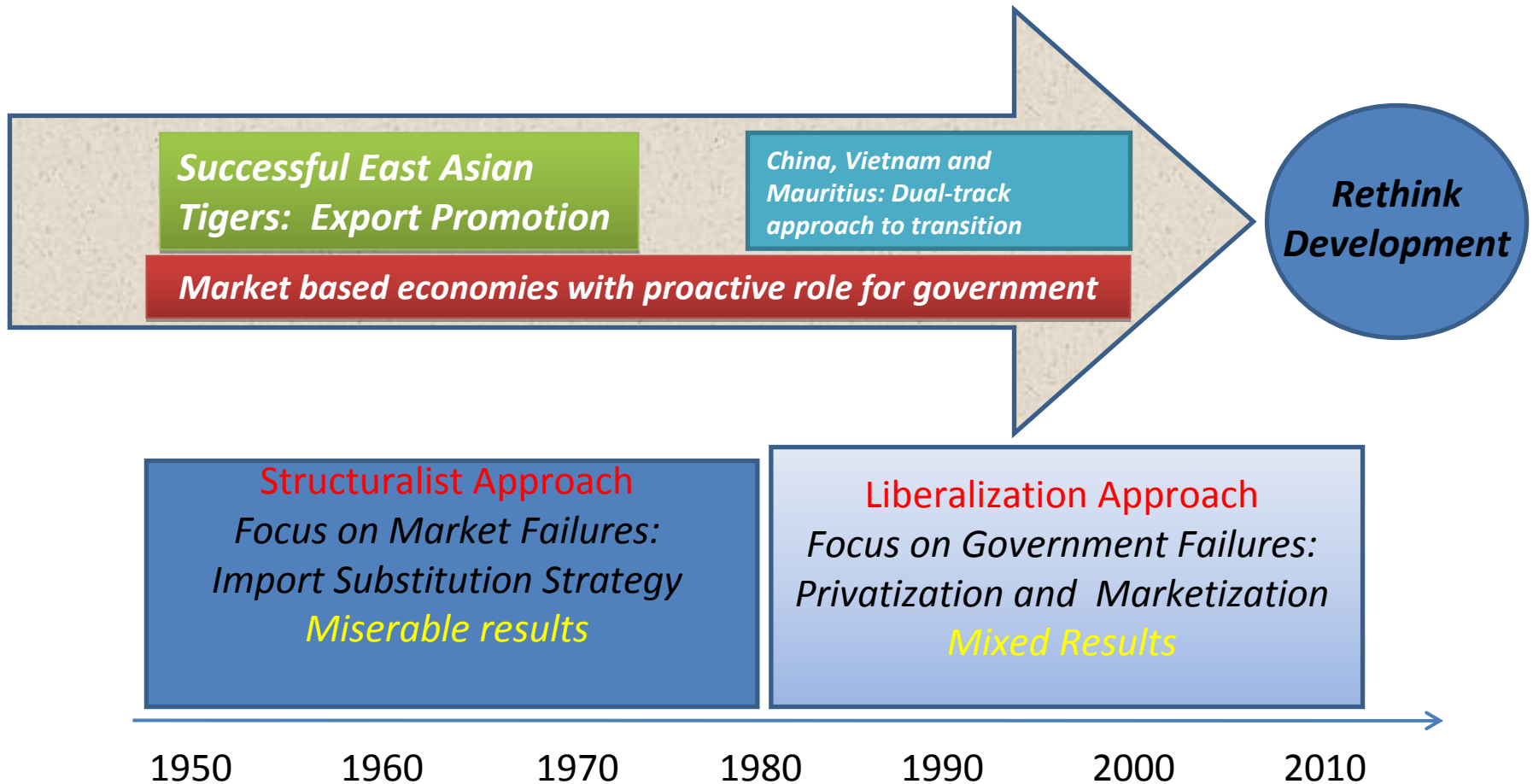
Overview of Presentation

- Why do we need to rethink development?
- How has economic development theory and Practice evolved?
- The New Structural Economics
- Growth Identification and Facilitation: An Application

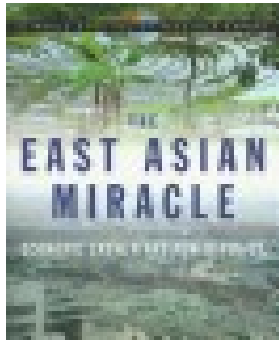
Economic Crisis and Crisis in Economics



How has economic development theory evolved?



World Bank has been in the process of rethinking economic development



Export
Orientation and
Market Friendly
Government



No one-size fits all



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

Introducing...

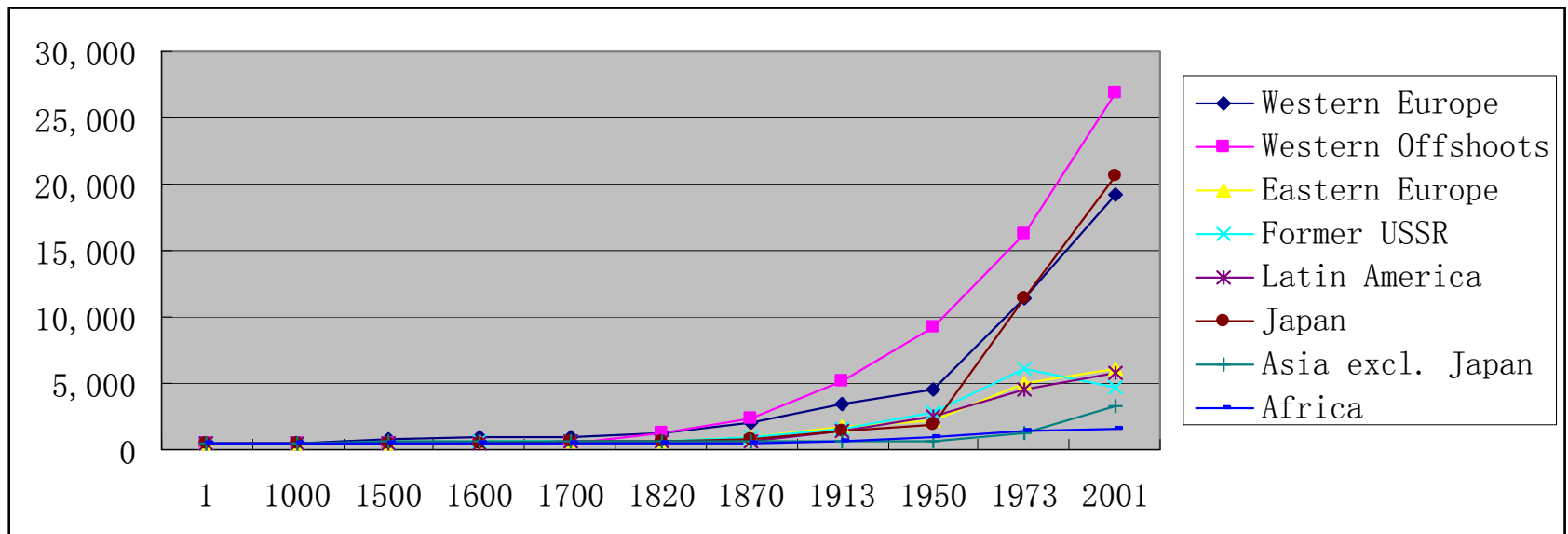
New Structural Economics

- Application of neoclassical economic approach to understand changing **economic structure** in development
- Provides a consistent framework for the **five stylized facts** of *Growth Report* as well as the findings from the *East Asian Miracle* and *Lessons from the 1990s*
- Contributes to **new theoretical and policy insights** for economic development

Introducing...

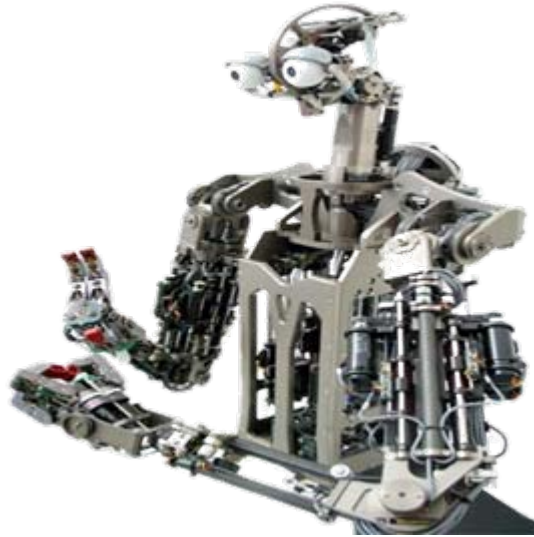
New Structural Economics

- *Sustainable income growth is the foundation for poverty reduction and development*
- *Sustainable income growth is a recent phenomenon*



- *The sustainable income growth is a result of continuous technological innovation as well as structural change*

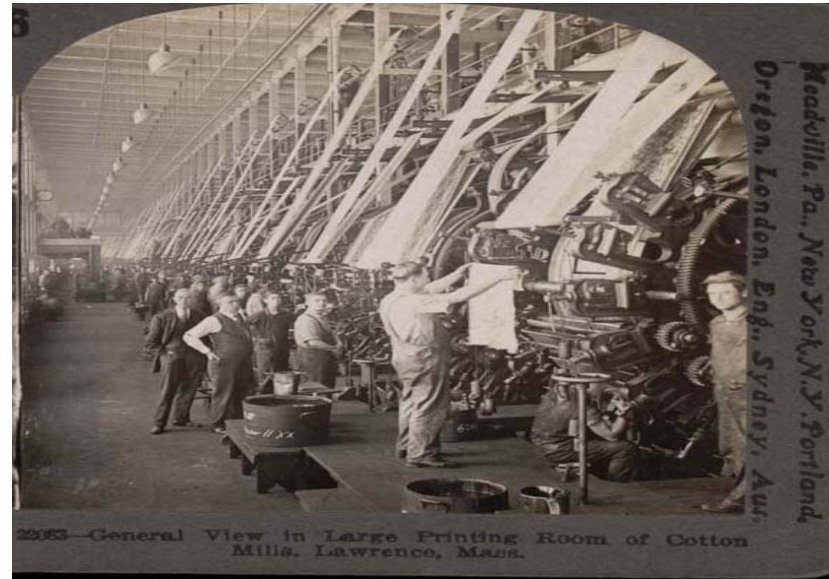
Example: USA, Now



USA in 1600s



USA in 1800s



SPECIALTIES.
is light, fine shod manufactured by the
SHOE MANUFACTURING COMPANY

Wholesale line of goods manufactured by this Company has received
international, or almost better the quality of "Boston" goods.
The amount of their shipments, they are all packed in cartons.

<p>Men's LIGHT RESISTANT. <i>Black Upper, Wood Sole.</i></p> <p><i>The shoe represents the line of work</i> <i>most satisfying, without above made</i> <i>for the very best. See the inside</i> <i>and you, see for sure.</i></p>	<p>Men's LIGHT RESISTANT. <i>Black Upper, Rubber Sole.</i></p> <p><i>A beautiful, well-balanced shoe</i> <i>which affords excellent protection in</i> <i>rainy weather. For the</i> <i>highest class, see below.</i></p>		
			
			
<p>Pringle</p>	<p>Montclair</p>	<p>Yonkers</p>	<p>Brooklyn</p>

The names below these shoes represent the names of the several
light shoes that are made in both men's and women's styles, and their
upper, rubber sole. The name of these shoes are shown above.

For the Complete List of Styles of These on Men's and Women's Shoes, see page 11 and 12.

New Structural Economics (NSE): Key Concepts

- The main hypothesis: Industrial structure is endogenous to endowment structure
- 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 of endowments → Upgrading industrial structure → “hard” and “soft” infrastructure
- *Following comparative advantage is the best way to upgrade endowment structure and to sustain industrial upgrading, income growth and poverty reduction.*

New Structural Economics (NSE): Key Concepts (2)

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

 *Need for competitive market system*

- Industrial upgrading needs to
 - Solve coordination problems
 - Address externalities

 *Need for a facilitating state*

NSE and The Growth Commission's Stylized Facts

Growth Report

Stylized Facts:

- Policy Recommendation from NSE
 - Following comparative advantage : Conditions
 - Market economy #4
 - Facilitating State #5
- The results:
 - Openness and advantage of backwardness #1
 - Competitiveness and strong external as well as fiscal accounts: fewer home-grown crises and larger scope for countercyclical fiscal policies. #2
 - Large economic surplus and high returns to investment: high rate of savings and investment. #3
- The NSE's recommendations are consistent with the *East Asian Miracle's* findings.

NSE and Failures of Industrial Policy in the Past

- Attempt to develop industries that went against comparative advantage
- The firms in the industrial policy's targeted sectors were non-viable in competitive markets and required government policy supports for their initial investment and continuous operations. Types of support:
 - Direct subsidy
 - Preferential tax treatment, trade barrier, and monopoly
 - Interest rate and foreign exchange rate distortions
- The supports were implemented through price distortions. As a result, planning and administrative allocations were required.
- This led to rent-seeking, directly unproductive profit seeking, and soft budget constraints.

NSE and Conditions for dynamic growth

- Market economy
 - Necessary Condition for efficient resource allocation and following comparative advantage
- Facilitating state
 - Necessary condition for smooth industrial upgrading and diversification to industries that the economy has comparative advantage
- Historically, all the successful countries were market economies and their governments played the facilitating role in the process of industrial upgrading. The governments in developed countries continue to play that role.
- However, the governments in developing countries all attempted to play the facilitating role but failed.
- The governments in developing countries will continue to try to play the facilitating role no matter we like it or that.
- **The key issue is how to help them play the role right?**

The existing practices and suggested new approach

- The existing practices:
 - Business environment
 - The goal is to introduce a whole set of the first-best institutions
 - The issues are:
 - The government may not have the capacity to introduce all those changes
 - The first-best institutions may be different at different stage of development
 - No identification of industries with latent comparative advantages and no compensation for the first movers
 - Growth Diagnostics
 - The goal is to remove binding constraints
 - The issues are:
 - Binding constraints are endogenous to industries
 - It relies on survey of existing firms. Many of them may be in industries where the country has no comparative advantages.
 - No firms will be in the new industries that the countries have latent comparative advantage
- The new approach based on NSE:
 - *Growth Identification and facilitation*

Growth Identification and Facilitation

Step 1:

Find *dynamic growing countries* with a similar endowment structure and with about 100% higher per capita income. *Identify tradable industries* that have grown well in those countries for the last 20 years. References for Lao may include Vietnam, Thailand, Indonesia, and China now and Finland in the 1950s.

Step 2:

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

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 the successful private innovations in new industries

Growth Identification and Facilitation

Step 5

In countries with poor infrastructure and bad business environment, special economic zones or industrial parks may be used to overcome these barriers to firm entry and FDI and encourage industrial clusters.

Step 6:

The government may compensate pioneer firms in the listed identified above with

- Tax incentives for a limited period,
- Direct credits for investments,
- Access to foreign exchanges

Thank you

