

A PRACTICAL APPROACH TO FORMULATING GROWTH STRATEGIES

Dani Rodrik¹
Harvard University
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Introduction

The central economic paradox of our time is that “development” is working while “development policy” is not. What I mean by this is the following: on the one hand, the last quarter century has witnessed a tremendous and historically unprecedented improvement in the material conditions of hundreds of millions of people living in some of the poorest parts of the world; on the other hand, “development policy” as it is commonly understood and advocated by multilateral organizations, aid agencies, Northern academics, and Northern-trained technocrats has largely failed to live up to its promise. Hence we are faced with the confluence of two seemingly contradictory trends.

Let us start with the successes. According to the latest World Bank estimates, there were roughly 400 million fewer “poor” people in the world in 2001 compared to two decades earlier, when poverty is measured by the \$1 a day standard.² That represents a striking decline in the absolute number of the poor, not just in the relative incidence of poverty. What has made these gains possible is the sharp increase in economic growth in some of the poorest and most populous countries of the world, China and India in particular. China’s growth rate since 1978 has been nothing short of spectacular, bringing considerable poverty reduction in its wake. In fact, the reduction in poverty in China alone accounts for the full 400 million global reduction, with the gains and losses in the rest of the world canceling each other out. The number of people

¹ I thank Ricardo Hausmann, Lant Pritchett, Andres Rodriguez-Clare, Arvind Subramanian, and Andres Velasco, my co-authors on various research projects who contributed to the development of these ideas.

² Shaohua Chen and Martin Ravallion, “How Have the World’s Poor Fared since the Early 1980s,” World Bank, n.d.

below the \$1 a day line has fallen somewhat in South Asia, but increased sharply in Sub-Saharan Africa. In Latin America, poverty incidence has remained roughly constant, while the number of poor people has increased.

These regional disparities in performance match up very poorly against reform effort, when the latter is judged by the standard yardsticks of stabilization, liberalization, and privatization. The high performing economies have bucked conventional wisdom on what makes for good economic reform. China and Vietnam liberalized their economies in a partial, two-track manner, did not undertake ownership reform, and protected themselves from GATT/WTO rules (in the case of China until very recently). India reformed very gradually, and only after a decade of strong economic growth. By any conventional measure of structural reform, these economies would be considered laggards. Given the policies in place in China, Vietnam, and India, it is hardly an exaggeration to say that it would have been easier to explain their performance if these countries had failed abysmally instead of succeeding the way that they did.

Meanwhile, Latin America, which adopted the standard agenda with great enthusiasm and undertook a considerable amount of “structural reform” ended up growing slower not only relative to Asian countries but also relative to its own historical benchmarks. Reform in Sub-Saharan Africa may have been more halting than in Latin America, but still few can deny that this region now has much greater price stability than in the 1970s, is considerably more open to international trade, and gives much smaller role to parastatals and much greater role to markets. Yet the African successes have remained few, fleeting, and far in between. It is apparent that reform efforts have not directly targeted the public health, governance, and resource mobilization challenges to which the continent has fallen prey.

To downplay the importance of these disappointments requires us to go through a number of contortions, none of which is particularly convincing. One counter-argument is that countries in Latin America and Africa have simply not undertaken enough reform. What is “enough” is obviously in the eyes of the beholder, but this claim seems to me to be grossly unfair to the scores of leaders in Latin America and Africa who have spent considerable political capital in pursuit of Washington-Consensus-style reforms. The weakness of the claim is also evident from the ease with which temporary successes in these countries have been ascribed to the reforms being implemented. Remember for example Argentina in the first half of the 1990s and how the growth spurt there was broadcast as evidence that “reform pays off.”

A second counter-argument is that “the check is in the mail” (to use my colleague Ricardo Hausmann’s caricature of this position). That is, the payoffs from reform have yet to appear, but will surely do so if we do not give up. The trouble is that this is entirely inconsistent with everything we know about the empirics of reform and growth. Growth follows rather immediately when the right things are done; there is no evidence to suggest that the returns to reform tend to be delayed. A third, somewhat related counter-argument is that the first and second generation reforms were not enough, and that much more needs to be done to ensure growth will follow. Once again, this position is inconsistent with the evidence. As I have pointed out above, the countries that performed well are not those that undertook ambitious reform agendas--quite to the contrary. A fourth counter-argument is that the poor performance in the reforming countries was due to external circumstances, for example, the overall slowdown in industrial country growth. This is not convincing because other developing countries managed rapid growth in the same economic environment. In any case, economic convergence ought to be a function of the convergence gap—the difference with the level of income prevailing in rich

countries—which actually was larger in the case of Latin America and Africa in the 1990s compared to the 1970s.

Finally, there is the counter-argument that the contrast I have drawn above is false insofar as countries that did well were those in fact that did follow conventional advice. China did turn to markets and sought to integrate itself with the world economy. India did liberalize. Both of these countries, the argument goes, reformed at the maximum speed that their complicated politics allowed, and reaped the benefits. So what is the problem? For one thing, this line of thought overlooks the unconventional elements in these countries' successes (just as the focus on Korea's and Taiwan's outward orientation often obscured their active use of industrial policy). China did not simply liberalize and open up; it did so by grafting a market track on top of plan track, by relying on TVEs rather than private enterprise, and through special economic zones rather than across-the-board trade liberalization. Moreover, implicit (and sometimes explicit) in this line of argument is that the partial, heterodox reform efforts in these countries would have yielded even more fruit had they been more by the book. One commonly hears that India, for example, would in fact have grown faster had its government been able to reform more comprehensively and rapidly. The trouble is that one looks in vain for countries that did in fact reform more comprehensively and rapidly than India did and ended up with higher growth.

Nonetheless, the fact that there is enough in the successful heterodox approaches to give some comfort to the adherents of the orthodox agenda does indicate something. What it indicates is that there are indeed some broad principles which all successful countries have adhered to. Hence, all high-performing economies have managed to maintain macroeconomic stability; they have relied on market forces to varying extents and sought to integrate into the world economy; they have protected property rights of investors and entrepreneurs to some

extent and enforced contracts; they have maintained a semblance of social cohesion and political stability; they have ensured adequate standards of prudential regulation and avoided financial crises; they have maintained productive dynamism and encouraged economic diversification; and perhaps a few others. Note however that these commonalities can be articulated only at a sufficiently high level of generality, and in a manner that yields scant guidelines for operationalization. Take for example the objective of integration into the world economy. What is missing from the list is the specification of what specific policies would best serve that objective. It is tempting to say that the requisite policies are low policy barriers to foreign trade and investment, but then again the evidence hardly points to a straightforward relationship between trade and/or capital-account liberalization and economic growth. The countries that most successfully integrated into the world economy (Korea and Taiwan in the 1960s and 1970s; China and Vietnam in the 1980s and 1990s) had highly protected home markets, and achieved integration through other means (export subsidies in the former, and special economic zones in the latter). The bottom line is that these common elements do not map into unique, well-defined policy recommendations.

One conclusion one could take from this is that our ability as economists to design and recommend growth strategies is extremely limited. Basically, anything goes, and it is up to imaginative politicians to come up with recipes that will work. We have very limited advice to give them *ex ante*, even though we are in the possession of many tools to evaluate the consequences of their policy decisions *ex post*.

I think we can do better than adopt this kind of nihilistic attitude towards policy advice, If the original Washington Consensus erred in being too detailed and specific, and in assuming that the same set of policies work the same everywhere, policy nihilism goes too far in undervaluing

the benefit of economic reasoning. I would like to outline here a way of thinking about growth strategies that avoids these two extremes. This approach consists of three elements. First, we need to undertake a diagnostic analysis to figure out where the most significant constraints on economic growth are. Second, we need creative and imaginative policy design to target the identified constraints appropriately. Third, we need to institutionalize the process of diagnosis and policy response to ensure that the economy remains dynamic and growth does not peter out. I will say a few words about each of these in what follows.

Step 1: Growth diagnostics

An important reason why the Washington Consensus, and its subsequent variant, Second-Generation Reforms have failed to produce the desired outcome is that they were never targeted on what may have been the most important constraints blocking economic growth. The fact that poor economies are poor indicates that they suffer from a variety of afflictions: they are poorly endowed with human capital, make ineffective use of capital and other resources, have poor institutions, have unstable fiscal and monetary policies, provide inadequate private incentives for investment and technology adoption, have poor access to credit, are cut off from world markets, and so on. To say that one has to overcome all these disadvantages in order to develop is at once a tautology and quite unhelpful. If Chad did not have these problems, it would look like Sweden, and then it would not need to know the answer to the question: how can a country rise out of poverty? The trick is to find those areas where reform will yield the greatest return, or where we can get the biggest bang for the reform buck. What we need to know, in other words, is where the most binding constraint on growth lies. Otherwise, we are condemned to a spray-gun approach: we shoot our reform gun on as many potential targets as possible, hoping that some

will turn out to be the real live ones. That is in effect what the Augmented Washington Consensus does. While there is nothing wrong in principle with any of the recommendations on this laundry list of reforms, there is also no guarantee that the really serious constraints are targeted in a priority fashion. A successful growth strategy, by contrast, begins by identifying the most binding constraints.

But can this be done? Is it possible to figure out where the most binding constraints are? In a longer paper that is summarized elsewhere in this volume, my co-authors Ricardo Hausmann, Andres Velasco and I develop a framework that we believe suggests a positive answer.

We begin with a basic but powerful taxonomy. In a low-income economy, economic activity must be constrained by at least one of the following three factors: the cost of financing economic activity may be too high, the economic (social) return to economic activity may be too low, or the private appropriability of the (social) returns may be too low. The first step in the diagnostic analysis is to figure out which of these conditions more accurately characterizes the economy in question. At first sight, this may seem like a hopeless task. But fortunately, it is possible to make progress because each of these syndromes throws out different sets of diagnostic signals or generate different patterns of co-movements in economic variables. For example, in an economy that is constrained by cost of finance we would expect real interest rates to be high, borrowers to be chasing lenders, the current account deficit to be as high as foreign borrowing constraints will allow, and for entrepreneurs to be full of investment ideas. In such an economy, an exogenous increase in investible funds, such as foreign aid and remittances, will spur primarily investment and other productive economic activities rather than consumption or investment in real estate. This description comes pretty close to capturing the situation of Brazil,

for example. By contrast, in an economy where economic activity is constrained by low private returns, interest rates will be low, banks will be flush in liquidity, lenders will be chasing after borrowers, the current account will be near balance or in surplus, and entrepreneurs will be more interested in putting their money in Miami or Geneva than in investing it at home. An increase in foreign aid or remittances will finance consumption, housing, or capital flight. These in turn are the circumstances of El Salvador, for example.

When we identify low private returns as the culprit, we will next want to know whether the source is low social returns or low private appropriability. Low social returns can be due to poor human capital, lousy infrastructure, bad geography, or other similar reasons. Once again, we need to be on the lookout for diagnostic signals. If human capital (either because of low levels of education or the disease environment) is a serious constraint, we would expect the returns to education or the skill premium to be comparatively high. If infrastructure is the problem, we would observe the bottlenecks in transport or energy, private firms stepping in to supply the needed services, and so on. In the case of El Salvador, none of these seem to pose serious problems. Hence we infer that the constraint lies on the side of private appropriability.

Appropriability problems can in turn arise under two sets of circumstances. One possibility has to do with the policy/institutional environment: taxes may be too high, property rights may be protected poorly, high inflation may generate macro risk, labor-capital conflicts may depress production incentives, and so on. Alternatively, the fault may lie with the operation of markets insofar as markets cannot deal adequately with technological spillovers, coordination failures, and problems of economic “self-discovery.”³ As usual, we look for the tell-tale signs of each of these. Sometimes, the diagnostic analysis proceeds down a particular path not because

³ Ricardo Hausmann and Dani Rodrik, “Economic Development as Self-Discovery,” Journal of Development Economics, December 2003.

of direct evidence but because the other paths have been ruled out. So in the case of El Salvador we concluded that lack of self-discovery was an important and binding constraint in part because there was little evidence in favor of the other traditional explanations.

It is possible to carry out this kind of analysis at a much finer level of disaggregation, and indeed any real-world application has to be considerably more detailed than the one I have offered here. What I hope I have been able to provide is a glimpse of a type of analysis that is both doable and potentially much more productive than the conventional approach, which lacks any diagnostic component.

Step 2: Policy design

Once the key problem(s) have been identified, we need to think about the appropriate policy response. Here, conventional welfare economics becomes invaluable. The key in this step is to focus on the market failures and distortions associated with the constraint identified in the previous step. The principle of policy targeting offers a simple message: target the policy response as closely as possible on the source of the distortion. Hence if credit constraints are the main constraint, and the problem is the result of lack of competition and large bank spreads, the appropriate response is to reduce impediments to competition in the banking sector. If economic activity is held back because of high taxes at the margin, the solution is to lower them. If coordination or self-discovery externalities are at the root of stagnation, the solution would be to internalize those through government programs or private-sector coordination.

Simple as it may be, this first-best logic often does not work, and indeed can be even counter-productive. The reason is that we are necessarily operating in a second-best environment, due to other distortions or administrative and political constraints. In designing

policy, we have to be on the lookout for unforeseen complications and unexpected consequences. Let me illustrate this point with a few examples from China and elsewhere.

Any economist visiting China in 1978 would have guessed that the most significant constraint holding the economy back was the lack of incentives in agriculture, due to the state purchase system and the communal ownership of land. The recommendation to abolish obligatory deliveries to the state at controlled prices and to privatize land would have followed naturally. After all, these are the first-best solutions to the problems at hand. However, a more detailed consideration of the situation at hand reveals that these policies would have been fraught with danger. Abolishing the state purchase system would have wiped out a significant source of fiscal revenue for the central government, since the difference between the purchase and sale prices of crops constituted part of the government's tax base. Since the government used its crop supply to subsidize food prices in urban areas, it would also have implied a rise in food prices in urban areas, leading to demands for higher wages. Privatization of land in turn would have brought in its wake severe legal and administrative difficulties. Therefore, agricultural price liberalization and land privatization look considerably less desirable once their attendant costs in the form of macro instability, social strife in urban areas, and legal/administrative chaos are factored in.

Of course, this is not an argument for not undertaking reform. It is instead an argument for being creative and imaginative in designing policy responses that are sensitive to these second-best interactions. That in any case is the lesson of the Chinese reforms. For China neither abolished the state purchase system nor privatized land. The incentive problems were solved instead through the two-track pricing system—which involved grafting a market system on top of the state-order system—and the household responsibility system—which effectively

made households the residual claimants of output without giving them ownership rights. Under these reforms, households were required to deliver their quotas to the state at controlled prices, but were free to sell any of their surplus produce at free market prices. As long as the state quotas remain infra-marginal, efficiency in agriculture is obtained. The beauty of this arrangement, easier to appreciate in hindsight than with foresight at the time, is that it de-links the provision of supply incentives from its fiscal and distributive consequences. Therefore it avoids the second-best minefields that the more direct reforms would have stepped on.

A second illustration comes from another Chinese institutional innovation: township and village enterprises (TVEs). The TVEs were the growth engine of China until the mid-1990s, with their share in industrial value added rising to more than 50 percent by the early 1990s. Formal ownership rights in TVEs were vested not in private hands or in the central government, but in local communities (townships or villages). From the lens of first-best reform, these enterprises are problematic, since if our objective is to spur private investment and entrepreneurship, it would have been far preferable to institute private property rights (as Russia and other East European transition economies did). Here again, the first-best logic runs into trouble. A private property system relies on an effective judiciary for the enforcement of property rights and contracts. In the absence of such a legal system, formal property rights are not worth much, as minority shareholders in Russia soon discovered to their chagrin. And it takes time to establish honest, competent courts. In the meantime, perhaps it makes more sense to make virtue out of necessity and force entrepreneurs into partnership with their most likely expropriators, the local state authorities. That is exactly what the TVEs did. Local governments were keen to ensure the prosperity of these enterprises as their equity stake generated revenues directly for them. In the environment characteristic of China, property rights were effectively

more secure under direct local government ownership than under a private property-rights legal regime. The efficiency loss incurred due to the absence of private control rights was probably outweighed by the implicit security guaranteed by local government control. It is difficult to explain otherwise the remarkable boom in investment and entrepreneurship generated by such enterprises.

Or consider the case of achieving integration into the world economy. Policy leaders in countries such as South Korea and Taiwan in the early 1960s and China in the late 1970s had decided that enhancing their countries' participation in world markets was a key objective. For a western economist, the most direct route would have been to reduce or eliminate barriers to imports and foreign investment. Instead, these countries achieved the same ends (i.e. reduce the anti-trade bias of their economic policies) through unconventional means. South Korea and Taiwan employed export targets and export subsidies for their firms. China carved out special economic zones where foreign investors had access to a free-trade regime. These and other countries that opened up successfully but in an unconventional manner—Malaysia, Mauritius, and many others—presumably did so because their approach created fewer adjustment costs and put less stress on established social bargains.

Let me offer as a final illustration the case of a saving-constrained economy. Saving constraints can arise because households are in some sense short-sighted or do not fully internalize the high rate of returns that prevail in the real sector, in which case the first-best response would be to subsidize saving (say by offering favorable tax treatment of saving). Or they could arise because financial intermediation is not working properly, in which case the first-best response is to enhance the legal and supervisory apparatus that governs the financial markets. These solutions are impractical and/or take a long time to implement in low-income economies.

A second-best solution is a moderate amount of financial repression—what Hellman, Morduck, and Stiglitz call “financial restraint.”⁴ This entails controls on bank entry and ceilings on deposit rates, which generate rents for incumbent banks. Paradoxically, these rents induce banks to expand effort to mobilize deposits (since there are rents to be earned on them). The quality and level of financial intermediation can both be higher than under financial liberalization.

The bottomline is that while the first-best is an obvious place to start, the lesson of successful countries is that desired objectives—supply incentives, effective property rights, integration into the world economy, saving mobilization—can be achieved in a variety of ways, often taking unconventional forms. Functions that institutions perform do not map into unique institutional forms. We need to be imaginative, look for home-grown solutions, and be prepared to experiment.

Step 3: Institutionalizing reform

It is in the very nature of the growth diagnostics approach that I outlined above that the identity of the binding constraint will change over time. Schooling may not be a binding constraint at present in a country, but if the strategy works and investment and entrepreneurship is stimulated, it is likely to become one unless the quality and quantity of schools increase over time. The poor quality of the judiciary may not have high cost at present, but legal shortcomings are likely to loom larger when the economy develops and becomes more sophisticated. Poor financial regulation may not be an issue when financial intermediation is rudimentary, but can prove to be explosive when the economy begins to boom.

⁴ Thomas Hellmann, Kevin Murdock, and Joseph Stiglitz, “Financial Restraint: Toward a New Paradigm,” in M. Aoki et al, eds., The Role of Government in East Asian Economic Development: Comparative Institutional Analysis, Clarendon Press, Oxford, 1997.

In our paper on Growth Diagnostics, Hausmann, Velasco and I illustrate this with the example of the Dominican Republic. This country was able to spur growth with a number of sector-specific reforms that stimulated investment in tourism and maquilas. But it neglected making the institutional investments required to lend resilience and robustness to economic growth—especially in the area of financial market regulation and supervision. When September 11 led to the drying of tourist inflows, the country paid a big price. A Ponzi scheme that had developed in the banking sector collapsed, and cleaning up the mess cost the government 20 percentage points of GDP and led the economy into a downward spiral. It turned out that the economy had outgrown its weak institutional underpinnings. The same can be said of Indonesia, where the financial crisis of 1997-98 led to total economic and political collapse. It may yet turn out to be case also of China, unless this country manages to strengthen the rule of law and enhance democratic participation.

Sustaining economic growth may be even harder than stimulating it. This was the clear message of the research that Ricardo Hausmann, Lant Pritchett, and I undertook on “Growth Accelerations.” We found in this research that growth accelerations—our criterion was an increase in growth of 2 percentage points that was maintained for at least 8 years—are a fairly frequent occurrence. On average a country has a one in four chance of experiencing a growth acceleration in any given decade. Sustained growth, by contrast, is rare. Very few of the 83 accelerations we uncovered had turned into sustained convergence with the living standards of the rich countries.

What is needed to sustain growth? I would emphasize two forms of institutional reforms in particular. First, there is the need to maintain productive dynamism over time. Natural resource discoveries, garment exports from maquilas, or a free-trade agreement may spur growth

for a limited of time. Policy needs to ensure that this momentum is maintained with ongoing diversification into new areas of tradables. Otherwise, growth will simply peter out. What stands out in the performance of East Asian countries is their continued focus on the needs of the real economy and the ongoing encouragement of technology adoption and diversification. Market forces are not necessarily enough to generate this dynamism, and need to be complemented with pro-active public strategies.⁵

The second area that needs attention is the strengthening of domestic institutions of conflict management. The most frequent cause for the collapse in growth is the inability to deal with the consequences of external shocks—i.e., terms of trade declines or reversals in capital flows. Endowing the economy with resilience against such shocks requires strengthening the rule of law, solidifying (or putting in place) democratic institutions, establishing participatory mechanisms, and erecting social safety nets. When such institutions are in place, the macroeconomic and other adjustments needed to deal with adverse shocks can be undertaken relatively smoothly. When they are not, the result is distributive conflict and economic collapse. The contrasting experiences of South Korea and Indonesia in the immediate aftermath of the Asian financial crisis are quite instructive in this regard.

Concluding remarks

I have offered here not a policy reform agenda, but a way of thinking about such an agenda that I think has considerably more potential than the Washington Consensus in any of its variants. I have tried to show that the diagnostic approach I advocate can be implemented, that it has the advantage that it provides country-specific solutions, and that it is by its very nature

⁵ See Dani Rodrik, “Industrial Policy for the Twenty-First Century,” unpublished paper for UNIDO, Harvard University, 2004, for an elaboration of this thesis.

sensitive to political and administrative constraints. This approach is inherently bottom-up: it empowers countries to do their own diagnostic analyses. It warns multilateral organizations against uniformity and excessive restrictions on “policy space.” Even when it does not yield clearcut results on what the binding constraint is, it provides a useful framework for discussing what should be done and why.

Furthermore the diagnostic approach embeds all major existing strategic approaches to growth, and serves to clarify the conditions under which they are relevant. Hence, a substantial rise in foreign aid will work in settings where a country is saving-constrained. Industrial policy will work when private returns are low due to informational and coordination failures. Reducing trade barriers will work when such barriers are the main determinant of the gap between private and social returns to entrepreneurial activity. And so on.

Finally, the diagnostic approach has the advantage that it employs economists in their proper capacity: as evaluators of trade-offs instead of as advocates. Carlos Diaz-Alejandro once quipped, paraphrasing Oscar Wilde, that an economist is someone who knows the shadow price of everything but the value of nothing. The diagnostic approach makes virtue of this occupational hazard: it asks economists for estimates of shadow prices (of various constraints associated with economic growth) and not for their value judgements.