

IMF MACRO CONFERENCE
RODRIK PRESENTATION

Before this panel, we were talking with Mike Spence, and he said he was glad we were having this session on growth. Of course, it's not as if the crisis completely eradicated the field. So, while the crisis has certainly taught us new things, it's not as if it calls for a complete rethink of what we knew about growth.

I'm going to offer my take on what it is that we've learned and how this applies in the new environment. Obviously, the main new thing is that the context in which we are going to be thinking about growth policies might be different. The context arises partly from the difficulties that the advanced countries are going to be facing: the debt overhang and, possibly, lower growth. What does that do to the growth prospects of the developing countries?

There are various doubts about the system for cross-border financial flows as we go forward, and there is a huge systemic worry about whether we're moving toward a world without a leader or without leadership where it's going to be hard to sustain any kind of global cooperation.

The first thing I want to emphasize, because I think this is an issue that keeps getting missed in our discussions on growth, is that the fundamental force that's driving growth in developing countries is that of convergence. There's a large gap between potential output provided by the technology levels that already exist in the advanced countries, and actual output, based on the technology that developing countries currently have – and it's this gap that really drives development.

However, the second key thing is that this is a potential to be achieved rather than one that automatically takes place. In other words, convergence is conditional. It isn't automatic, it's going to depend on the things that you do and that you get right.

The point about growth depending on convergence is important, because it puts your focus on the supply side of things, on what countries are doing in order to be able to absorb those technologies, and it pushes your mind away from the demand side. When we think about developed countries and whether they'll be growing, so much of the discussion today is about whether the dynamic of the world is no longer coming from those advanced countries, and whether the poor countries can grow nearly as rapidly. But I don't think this is

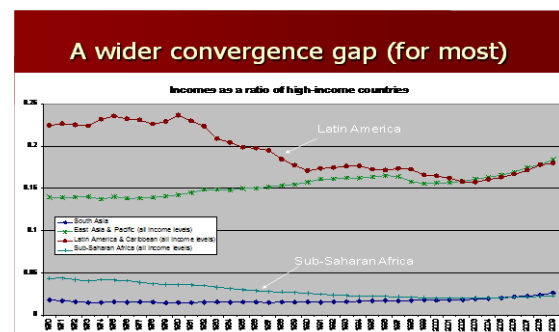
a big issue, because regardless of how rapidly the rich countries grow, the convergence gap is still there. In fact it is bigger than it's been in a long time.

So to a first order of approximation, over the medium term the growth rate of the rich countries is largely irrelevant to the question of how much growth you can actually have in the developing and emerging markets. In other words, how rapidly the frontier is moving is of second order importance relative to the gap between where the frontier is and where the poor countries are.

The bad news, however, is that since convergence is conditional, it really depends on having a good handle on what the right policies in the developing world are. Here we have had a succession of various consensuses, and now the consensus is best represented by the Growth Commission Report that Mike Spence put together. It is a consensus about pragmatism and about search. It's a consensus about context specificity, about appropriate policies, and it moves us away from a list of do's and don'ts that we had focused on a decade or so ago.

Prior to the crisis, developing countries were growing very rapidly, so one question is, "What does that tell us about what's likely to happen in the future, and is that growth sustainable?" I think part of the growth of Latin America and Sub-Saharan Africa prior to the crisis was misleading, because much of it was really making up for lost ground, and those regions had experienced a long period of lagging behind. On the other hand, that also means that the convergence gap between those parts of the world and the advanced countries is actually wider than at any time since the 1970s.

Look at Latin America. Consider the ratio of per capita income in these different parts of the world as a share of per capita income in the rich part of the world. What you see in Latin America, if you look at just the last decade, is the process of convergence, but if you take it all the way back to the 1970s what you see is the two points that I made earlier. That is, first, that it is starting to make up for lost ground, and second, that this convergence gap, between the average income level in Latin America and that in rich countries, is actually wider now than what it's been since the 1970s. The ultimate dynamic, the potential for



growth and catch-up and convergence, is actually larger right now than at any time before.

That's also true for Sub-Saharan Africa, which experienced rapid growth in the last decade or so. But as you can see from the chart, relative to the frontier it's actually way below where the continent was earlier. It's only Asia that has had sustained convergence in this period, so it's really Asia where the convergence gap has diminished.

What is convergence conditional on? What are the prerequisites? I'm just going to give you a very quick rundown of my take on these things, and then develop about half of the argument, because I think it's the half that's more relevant for this discussion.

The economic part of convergence is a process of ongoing structural transformation. A lot of the growth in the developing world takes place through the creation of new industries at higher productivity levels and through a transfer of resources within those economies from the lower-productivity activities to the higher-productivity activities.

Tradeables, in particular modern tradeable industries, play a very important role and, therefore, safeguarding the health of modern tradeable economic activities becomes very important in this process. That's why the exchange rate becomes very important. Policies that promote tradeables become very important. And that's why, from this perspective, a certain amount of financial de-globalization may not be bad news for developing and emerging markets, because it allows them to maintain exchange rates that might be more competitive than would be the case otherwise.

I will develop this issue about structural transformation a little further on. But first I want to mention the second point, because I think it's an important complement. That is, the other thing that we've learned about the process of convergence is that sometimes you get the short-term economics right, but you also need to get the medium-term politics right. And the medium-term politics is really the building up of what I call institutions of conflict management. Economies are consistently buffeted by a variety of shocks -- they might be internal shocks, they might be external shocks -- and the ability to handle those shocks and bring about the macroeconomic and policy adjustments that those shocks require is a key determinant of whether growth spurts fizzle out. The key is whether you have an inability to handle the shocks or are actually able to handle them. That's a key difference between countries that are able to engineer a succession of growth accelerations or growth spurts

versus those that simply experience one-time growth for a while -- and then the growth fizzles out.

I'm not going to say anything further about the political aspects. I just wanted to highlight this as a very critical feature that we need to bear in mind.

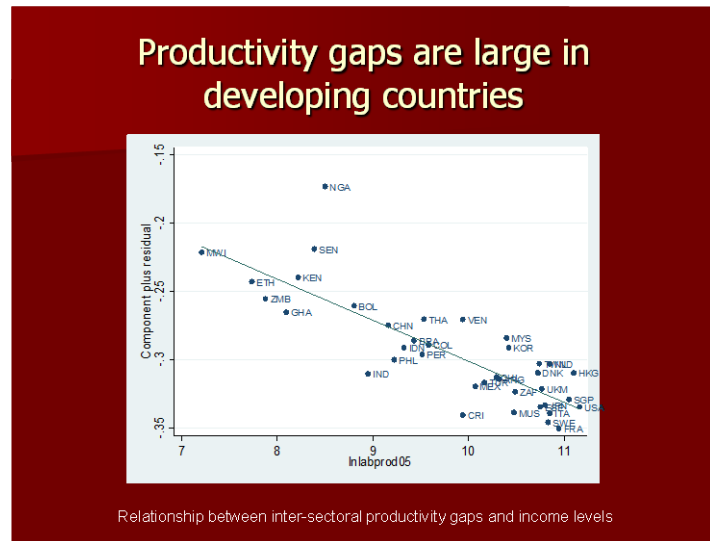
Turning back to the need for structural transformation, I want to highlight this because I think it is a key issue. An old concept in development economics is dualism, and this still remains the key feature of the developing world. Developing countries are a mix of high productivity and low productivity activities and there are typically very large gaps in the productivity levels across these activities.

Consider the relationship between a measure of dispersion of labor productivity across different sectors of an economy and the level of

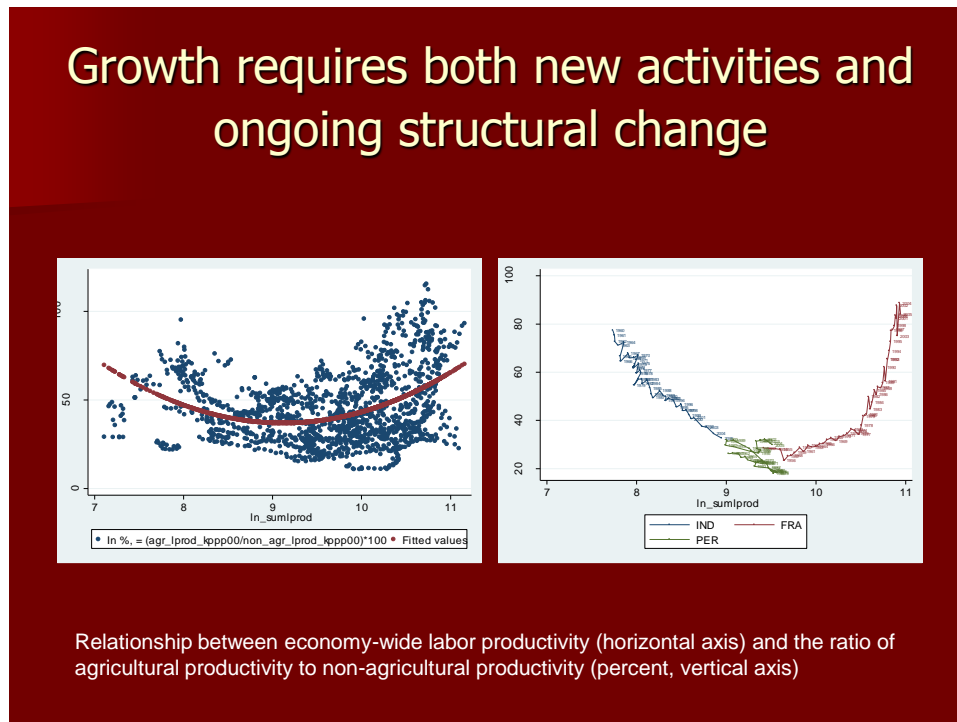
development of that economy. What you can see as you look (along the horizontal axis) at the average level of labor productivity in an economy is that as you go towards the rich economies, inter-sectoral productivity gaps shrink. In the poor and middle-income economies there are very large gaps in labor productivity.

The key implication from a policy perspective is that the composition of output is of first-order of importance for economic performance and economic growth in a developing country, although it is of only secondary in importance in a rich country. Getting the composition of output mix right is going to be very important for developing countries to achieve.

Next, take agriculture, and compare its labor productivity to productivity in the rest of the economy, and then ask what happens to this ratio over the course of development. There's a very well behaved universal U-shaped relationship here. That is, the relative productivity of agriculture first falls and then rises. What is this capturing? It's capturing a phenomenon over the course of development that is a mix of two things. First, at very low



levels of development you need new industries to arise. If you're starting from a very low level of development, everybody's working in agriculture and there's no industry, so basically agricultural productivity is pretty much the same as productivity in the rest of the economy. What sets growth going is that you start developing new industries, and therefore the relative productivity of agriculture starts to fall.



That's the first dynamic, but then over time people shift from agriculture into the rest of the economy, and that drives the process of convergence within the economy and the relative productivity of agriculture starts to catch up with that in the rest of the economy. You need those two things: new industries and a process of ongoing transformation, ongoing movement of labor and other resources from the old to the new.

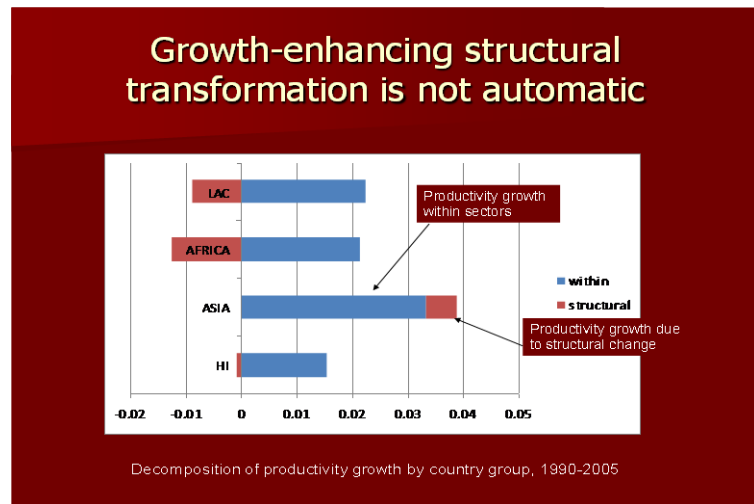
It would be nice if this were an automatic process that every country experiences, and after all, if you go back to Sir Arthur Lewis's model of dualism, I'm not describing anything that's very different from that. In Lewis's model there is a quasi-automatic movement of workers from traditional industries to modern industries.

The striking thing--and this is one of the most surprising things I've seen in the last few decades -- is that in large parts of the world today, structural transformation is taking

place in reverse. That is, within economies people are moving from high-productivity activities to low-productivity activities, and not the way that they should. This shows the decomposition of overall labor productivity growth in different parts of the world across different sectors, and then it decomposes overall labor productivity growth into components to show what's

happening on average within individual sectors. That's the blue bar. The red bar shows the impact on economy-wide labor productivity growth of reallocating labor across different sectors, so the red component is the structural transformation component. It's the part that you want to add to growth as labor moves from low-productivity to high-productivity activities.

Asia behaves in the way that you think all developing countries would behave. Whether you look at China, India, or Thailand, labor is moving from agriculture and other lower-productivity activities to high-productivity activities. For the same period, when you look at Latin America and Africa, you get a big surprise. Here, there's growth-reducing structural change that is taking place. Think about manufacturing shrinking and informality expanding. That is one explanation. It's not the entire picture but that's one window into what is happening. It's a part of the picture we've missed by looking, for example, at how successful export-oriented manufacturing has become in Latin America. We've forgotten to ask the question, What happens to the workers who are displaced from these firms that become more productive, in part, by rationalizing production, by upgrading technology, by substituting capital for labor. These workers end up not in more productive activities, but in less productive activities.



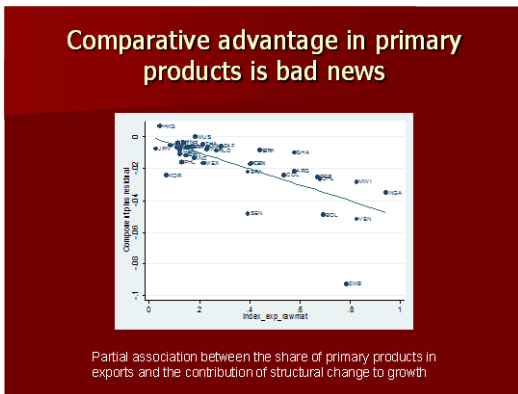
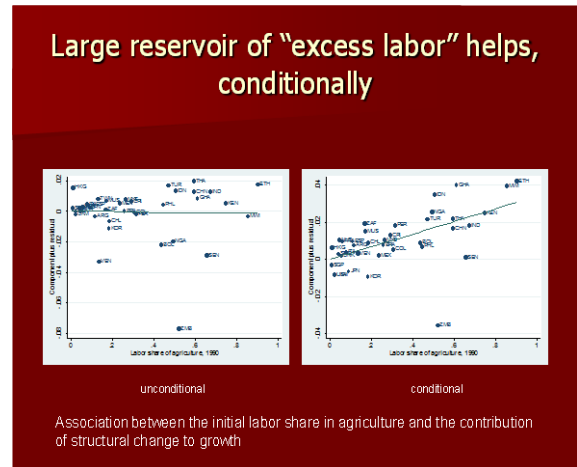
The high-income countries are those where there aren't large gaps in productivity,

and that's why the inter-sectoral component is not very large in that group of countries.

Finding a way of reversing this perverse outcome is critical if emerging markets in Latin America and Africa are going to be able to generate ongoing sustained growth based on desirable structural transformation as opposed to simply high commodity prices or short-term capital-inflow-driven growth spurts.

A couple of things seem to be playing a role in driving this distinction between countries that are experiencing the right kind of structural change versus countries that are not. One key thing is that a country's initial comparative advantage matters a lot. If you're starting out with a comparative advantage in natural

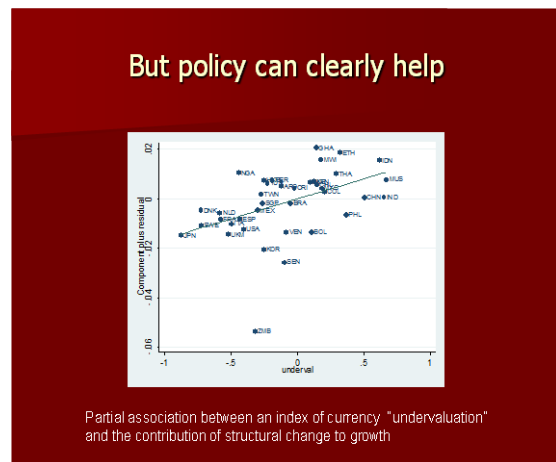
resources, in primary products, and you globalize based on that comparative advantage, consider that those are sectors that cannot absorb a lot of labor. Therefore, those kinds of growth models aren't generating a lot of employment in the more productive parts of the



economy. Part of the bad news is that integrating into a world economy with a comparative advantage in natural resources isn't conducive to the kind of structural change that will drive long-term sustained growth.

But there are also indications that you can offset

that with various policies, two in particular. One policy is, once again, the exchange rate. We find that countries that have competitive exchange rates have more desirable structural change. Overvaluation is the enemy of growth-increasing structural change, and undervaluation is a help to achieving it. The second policy worth thinking about is labor



market policy. Countries with more flexible labor markets tend to be better at promoting structural growth, at increasing structural change, than other countries.

By way of conclusion, let me connect this perspective on growth with some of the systemic issues that I started off with. First, to review what it is that I've tried to emphasize here: it's to move us away from a discussion about who is the growth engine of the world and whether developing-country growth will be adversely affected by low growth in the rich countries or not. That is a demand-driven, short-term perspective on growth that isn't the right way to think about medium- to long-term growth in the developing countries. You need to think about it from the supply side, to look at it from the perspective of the mechanisms of engines of growth within the developing countries. That engine is structural change within the developing world, a process that's fraught with difficulties. It requires policy support.

From the standpoint of the policy environment and the role of multilateral institutions, the key thing is to provide for an environment where developing countries have the room within which they can pursue the appropriate structural transformation policies and, as well, the room to pursue those policies with the kinds of instruments that have the least adverse spillovers on the rest of the world. Putting it somewhat differently, as I said earlier, what you need to do in developing countries is to change the composition of output and to do that with the least amount of spillovers. For example, consider global macro imbalances. What has happened in the last 20 years is not what I have just urged, because precisely what China has done is change its composition of output through undervaluation policies that have spilled over into its external surplus. But in principle, you can achieve the transformation of output that you need not through exchange rate, macro policies, but through sectoral, microeconomic policies. That is, you can achieve it through trade and industrial policies that have direct effects on the structure of output and production but don't have effects on the relationship between income and expenditure on the external balance.

The international environment has pushed China to pursue the wrong kinds of policies on the currency front, because it has prevented China from using its trade and industrial policies because there is much greater discipline in the World Trade Organization than we have had on exchange rates. What we need to do is move to a world where we have much greater discipline on currency policies, because those create first-order spillovers

across countries. The quid pro quo is that we should have less discipline over trade and industrial policies, so we can actually reconcile the need for structural transformation in the developing world with the need to minimize macroeconomic imbalances.