General Discussion: Strategies for Growth

Chair: Erkki Liikanen

Mr. Gurria: Yesterday, we mentioned that agglomeration and proximity in large labor markets worked. In fact, we mentioned some compensatory policies for countries or regions that didn't have it. Of course, geography should not serve as an alibi for poor performance. Everything that we've heard this morning is that policies are the single most important element of success. In fact, our work at the Organisation for Economic Co-operation and Development shows that the bulk of cross-country divergence in gross domestic product (GDP) per capita is explained by differences in policies. Therefore, the strategy for growth has to rest on economic principles that transcend geography—free trade; open product markets; effective education systems; quite critical fiscal and monetary policy; and, in some cases, like the transition economies that have not addressed those issues fully, flexible labor markets. They matter a lot more than geography. Even the examples that we've seen—a very dramatic example in the case of Africa—go to the issues of governance and go to the issues of checks and balances and democracy rather than to the issue of simple geographic luck.

In fact, we have seen it everywhere. The lack of convergence of Europe and Japan with the United States in the last two decades had to do with very rigid labor policies, underutilization of labor, and lack of flexibility even in educational policies and universities, etc. My only concern here is that the political economy of reform—which means how you get the good policies in place—is the single most challenging issue because the question of how do you reform and win the next election at the same time seems to be posing itself more and more and more. And because the answer is that many of the reformers are losing the next election, there seems to be a generalized reticence either to put the reforms in place or that the guys who come after the reformers feel the obligation that they have to undo everything that was done before.

Ms. Swonk: There seem to be some strong themes coming out of everything that was said and one of them is, "Is democracy good or bad?"

Certainly, for India, I would like to know an opinion on that. And, in pushing through reforms, China seems to have an upper hand in doing so, although we did note its lack of diversity in its population. Also, demographics came up on the India situation on its being a positive. I would like some comment on the demographic issue of literacy of women, in which India has a deep disadvantage relative to China, which has been known as one of the major impetuses. I think it was Stan Fischer yesterday who said China was going to be speaking English anyway, so the English advantage is not clear there.

The other couple of quick issues include foreign direct investment (FDI), which has come up among all of you as a very important positive factor, which was not the conclusion of some of the papers yesterday. Internal saving was a driver, but in these countries, particularly in the Central European countries where I have spent time, it is clearly an important role, especially with the foreign ownership. That seems to be in divergence with some of the other conclusions that were said. I know there are some complementary issues.

And the issue that I think is very important and would like your comments on is how we talk about resource-rich countries having an advantage and opportunity, yet one would almost argue that the good times they have received have bred complacency and given some opening—I would argue with the case of Venezuela there has been a back stepping on economic reforms and some of these issues. You mentioned democracy with accountability—I am not sure that exists anywhere in the world today. But that is just my own bias of my own view of our Washington democracy at the moment.

Those are the issues that seem to be common themes, but there is some debate with what we said yesterday. So, I would like your comments on that.

Mr. Corbo: It is very interesting to listen to what is going on, both in China and India, and then the progress in Eastern and Central Europe. There is another region in the world that is still alive, and that is Latin America. Let me just say that part of our tragedy in Latin America was that we had one macro crisis after another for the last 50 years. The second one we were too isolated from foreign trade. We have also made some progress. On the macro side, just like in Eastern and Central Europe and also India, we have learned the importance of fiscal responsibility. All over the region, there has been major progress on the fiscal side.

Also, we have learned the importance of having independent central banks. Putting both together, inflation has been reduced all over the region. Major progress has been made in bringing inflation growth to the Central and Eastern European level that we had sought.

We have further to go on integrating to one economy. Still, we are too isolated from foreign trade, compared with where the world is going.

Third, we have a lot to do from the point of institutional building and human capital development. But Latin America is doing well. Today, the current account in the region as a whole is in order. Behind this, we have rediscovered macro responsibility. As I have learned from many, many here, the first issue you need to have in order to clear the condition for sustainable growth is to get the macro under control, and there we have made tremendous progress that will help us avoid a major crisis that has been disastrous for the region in the last 50 years.

Mr. Hale: I have two questions. Mr. Collier, one of the bigger developments in China in the last five years is the emergence of China as a major power in Africa. China-Africa trade is now at $40 billion. In the first half of this year, Hu Jintao, the prime minister and foreign minister of China, announced multibillion dollar investments in Nigeria. How will China change the African outlook and the African power equation?

Professor Srinivasan, India today has 6 million manufacturing jobs. China has 60 million manufacturing jobs. One of the explanations for this is India's labor laws. India has restrictive labor laws brought in by Anglican missionaries 150 years ago to protect Manchester. How come the Indian government cannot repeal these labor laws to make India a manufacturing power like China has become?

Mr. Sinai: This is an informational question for T.N. Srinivasan. You mentioned 8 percent to 10 percent expected growth going forward for India and 10 percent for China. I have a series of questions related to the optimistic view that you have. Can we believe the data on India and China?

Second, what is the potential GDP growth in India? What is your assessment of that?

Third, would these growth rates be sustainable, or would there be strains on capacity resources and finance to have those kinds of growth rates?

And then, what about political and geopolitical impediments to those kinds of growth projections?

For Jan Svejnar, how tight and large are the trade flows among countries within Central and Eastern Europe, and how responsible has trade been, as opposed to privatization and the role of central banks, for the growth pickup in the last five years?

Mr. Kroszner: Angel Gurria mentioned some issues that I had with respect to endogenaity of institutions, but I just wanted to think about what lessons can we draw from the experiences on how we can get institutional improvement because that is really the only way to get sustained growth. Paul Collier's explanation was particularly interesting.

Second, in particular with respect to Africa, what are the best and worst aspects besides the short-time horizon of the Africa Growth Opportunity Act (AGOA)?

Mr. Fischer: I have three points. Jan, on the performance of the countries you are looking at, there was a lot of controversy at the time about measures of GDP and their validity, particularly in the pre-reform period. I wonder if you would comment on that.

Second, Paul, on Africa, when you started talking about human geography, I thought you might say something about human capital. I don't know if that is geography or something else, but it would be interesting to hear your views.

Third, to Diane Swonk: I didn't say the Chinese were all going to speak English. I said the capital markets in Shanghai might speak English. Mervyn King has a campaign to make cricket the national game of China, but I'm much less ambitious than that.

Mr. Frenkel: Well, there recently have been so many comparisons between the China-India syndrome. Yet the per capita income, as you indicated, between those two countries—which were approximately the same, say, 15 years ago—has tripled in China and about doubled in India, and a significant gap ensued.

As we look at export strategies, the two countries have adopted fundamentally different approaches. Whereas China relied very significantly on exports, India did not.

My questions are the following. First, is it possible that the reliance of China on exports has, in a way, planted the seeds for objections and tensions in the international economy and have actually encouraged potential protectionism against China, which may provide the answer to Stan's question about trees growing to the sky? This, in and of itself, may be an issue. Is there something more general?

Second, it is said that in India, growth is bottom-up, from the individual entrepreneur expending himself, etc. Whereas in China, it is top-down, starting from the government that is directing and instructing. This, in and of itself, provides some of the more robust base to the Indian growth. I wonder if you have a comment on this.

And finally, one cannot escape the impression that the infrastructure in India is extraordinarily problematic. But the same remark was also made five years ago and 10 years ago. One wonders, what's in it that makes it so difficult, and what's in it that makes the bureaucracy so difficult? Is it related to the democracy-nondemocracy distinction between the two countries? Is it related to the colonial heritage? I just wanted your reflections.

Mr. Fraga: This is for Professor Srinivasan. My read of International Monetary Fund reports and other sources is that the consolidated budget deficit in India is approaching 8 percent of GDP. I wonder if, underneath all this excitement, something more dangerous is building up. If you could, please address that.

Mr. Collier: The political economy of reform: Geography is not an alibi for the lack of reform. It is an explanation for why Africa's political economy of reform is particularly difficult. The present commodity booms also delay reforms. Statistically, it is much harder.

I asked my friend Ngozi Okonjo Iweala, until very recently finance minister of Nigeria, whether high oil prices were making her job harder or easier in Nigeria. She just laughed her head off, and said, "Harder, harder, harder."

Similarly, elections statistically delay reform. We are seeing that doubly in Nigeria now. An election and a commodity boom, and goodbye, Ngozi.

China in Africa: The president of China just went around Africa a few months ago saying, "We don't ask questions."

A transparent statement that we are not going to be transparent, right? The stumble for Africa mach 2 has both bad features and good. The bad feature is that just as the governance of resource rents was getting onto the global agenda through the Extractive Industries Transparency Initiative, along comes China outside that pact and is liable to undermine it. So, that is a very severe negative.

There is one little positive outlook at the macro level. Dutch disease is a thing of the past. China is able to supply construction services totally as tradable as imported services.

I've just been to Angola, where I was trying to persuade the government that you actually need to spend some money locally on construction to try and get some transfer from the oil onto the local population.

Let me say a few things about the good and bad about AGOA. The good features of it compared with Everything But Arms (EBA), include the fact the rules of origin are much better, but that is dependent upon a special waiver, which is renewed annually. The coverage of countries is much better. EBA applies *only* to the least developed.

That is the sort of gesture politics that, as soon as you think about it, you realize how stupid it is. Which countries in Africa are actually going to break into global markets for manufacturing? Is it Liberia and Somalia and Sierra Leone, or is it Senegal and Ghana and Kenya? So, EBA just applies to the completely irrelevant class of countries, as did the Hong Kong offer in the Doha Round in December.

To Stan's question about human capital, I'll note two things. One is that just as small population is an impediment to reform, so are low levels of education and especially low levels of secondary education.

In effect, you need a critical mass of people with secondary education or above, and Africa has been doubly hit by very low levels of secondary education and small populations.

I would finally say that up to now, Africa has hemorrhaged financial capital. It has had the biggest financial capital flight of any region. But, on my analysis, it is now going to build up with human capital flight. That has to be a terrible problem.

Mr. Svejnar: On Angel's points on the political economy of reform: It is very important. I fully agree with you. Paradoxically, earlier on in the transition economies, it didn't matter so much. What came as a great surprise to us was that whether a right-of-center government was replaced by the left-of-center, they continued the reforms. It's actually getting a little bit more sensitive. It's a bigger issue now.

In response to Diane's point on FDI: It came up yesterday; it was in the paper by Eswar Prasad, Arvind Subramanian, and Raghu Rajan, but it was hidden in it. It is really important. It seems that at least in the countries that I've looked at, FDI is key. And, in this resource abundance issue, there the particular question is the reserve funds that have been established. There is a lot of pressure to use them for current expenditures. There the question will be, Will they sustain or resist that or not? That is very important.

Mr. Corbo, I agree with you on the importance of fiscal responsibility and independence of central banks. In fact, I will go a step further. The creation of independent central banks and improving their capabilities is one of the most important institutional developments that we've seen in those countries. We look at institutions and their role. This will be one that is really important.

There was an issue of labor laws. Certainly, the transition economies, especially those further west, need to make labor laws less stringent. More flexibility needs to be introduced.

Mr. Sinai, the point on trade flows is very important. These are various, of course. These are generally very open economies. Many of them have exports/imports exceeding 50 percent of GDP. But the important flows are actually between these countries and the rest of the world, not so much among themselves. In other words, once they eliminated the Council for Mutual Economic Assistance, the European Union, Japan, or China, depending on where you are, became very important. So, I would say that trade is extremely important as an engine of growth for these countries.

To Randy Kroszner's point about institutional improvement: It is very important. The lesson that I would say we've had in the transition economies is not that institutions have been ignored, as some people have been charging, but good institutions are extremely hard to create. It is not lack of effort (of course, we could always try more), but it is something difficult, and one needs to persevere in going there.

Stan, on the measures of GDP, I agree with you. I didn't have time to mention it, but basically there has been debate as to what extent one could really measure things well. There have been recalculations, and, subsequently, what I would stress here is that one can argue whether GDP in Ukraine went down 60 percent as the data suggest, or 40 percent. Either way, the picture or pattern is there. Some of the micro studies are indicating that, yes, one is not too far off the mark. For instance, even in the measures of inequality, if you do it by income or by consumption, you come up with similar measures. The main story carries through, although a caveat is in order.

Mr. Srinivasan: First question: How do you reform and win the next election? It is important also not to misread the results of an election. For example, in India in the last general election, the incumbent government was defeated. Those who came to power—the government in power now—interpreted that result as the verdict against whatever they were claiming they were doing in the area of reform. But if you do an in-depth analysis, it is not very clear whether the electorate was informed that this is what is going to happen if you do reform and this is what we have done. It was not a referendum in reforms in any sense of the term. While it is important that reformers keep in mind if they want to reform, they have to win elections, not to misread elections is equally important.

Democracy: Is it good or bad? The first thing is that we shouldn't confuse the instrumental role of democracy for reforms or whatever with the intrinsic virtue or value of democracy. Let's be clear that democracy is good from an intrinsic perspective. There can be no two opinions about it. Taking the instrumental role, there could be a difference of views, as Paul was talking about.

But I would say this: In the Indian context, you raised the question of female literacy and female participation in the labor force. Here again, there is a substantial difference across the country. Southern and coastal states have gone much further with respect to female literacy and that is reflected in that many states in the south have reached replacement levels of fertility, and they are facing a more aging problem not seen in the northern states, which have higher fertility rates and so on.

Democracy has led to learning in the rest of the states, which have been lagging behind the faster-growing southern and coastal states. These states are now recognizing that investment in education and particularly female education and female literacy is important. Here again, democracy is doing the right thing.

But one thing is that it will take a longer period of time. If there is one disadvantage in the democracy it is that you have to do some convincing to bring about agreement to push forward, that will take a little longer time. Other than that, there can be no doubt, in my view at least, that democracy, even in the instrumental sense, eventually is going to be successful.

FDI is very important. Here again, the contrast between India and China is very clear. In the Chinese case, quite a significant part of

FDI went to making China an export platform. FDI went also to infrastructure; whereas in the Indian case, for a number of reasons—particularly the caps on FDI and exports—they didn't. Because of other reasons—small-scale industry and other cobwebs in Indian policymaking—FDI didn't go to the exports sector. So, there is a difference. It is not just FDI, but also where the FDI goes and how the FDI performs.

Now, to Vittorio Corbo: It is true it is good to learn the virtue of macroeconomic stability. That, per se, is not enough. As I was saying, if you have huge microeconomic distortions, macroeconomic stabilization isn't going to deliver much. You have to move away from a unicausal macro fixation to think in terms of all economic policy framework, and micro distortions couldn't be kept out of this.

India's labor laws: This is outrageous, as you rightly pointed out. This is well-known. Even as early as the 1960s, Professor Mahalanobis—the architect of India's planning, etc.—had said India's labor laws had been enacted in imitation of labor laws in rich countries. This is going to come at the expense of growth and more egalitarian growth. That is indeed what happened. Reform of labor laws is the number-one priority. It will happen. It is now again that a slow recognition is taking place. And the politics have changed. It is a more regional coalition. So, there is a hope with this new change in the political scene that the political competition will transform the competition for growth, rather than competition for redistributing subsidies.

China's emphasis on exports with India: That again is a related question to India's bottom-up approach and China's top-down. My feeling is that China's approach is bottom-up in some ways. China has used different provinces as an experiment with different policies, for example, the household responsibility system that started in areas of China and was later adopted by the regime to push forward.

India, on the other hand, is much more top-down than it is bottom-up. So, my reading of the stories is different. I would argue that India has not experimented enough with the diversity that it has across its states to try out alternative approaches to reform. That will happen also.

That is my response to Allen Sinai's question. I looked at it from a growth accounting perspective, looking in detail at capital accumulation, labor, human capital accumulation, total factor productivity, etc. Taken together, the potential for sustaining India's growth at 8 percent or so for the next couple of decades is very good. This is again the policy change such as those for labor laws, bankruptcy laws, and other things that are needed, particularly in the infrastructure area that is connected with the policy reforms. Still, the electricity is in the state hands in a large part of the country. Again, moving away from that, that is important. Potentially, this is not a question of resource constraints or anything that is going to come in the way.