UNU World Institute for Development Economics Research
(UNU-WIDER)

WIDER Annual Lecture 8

Rethinking Growth Strategies

Dani Rodrik

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FOREWORD

The WIDER Annual Lecture is one of the major events in the UNU-WIDER calendar. It provides an opportunity for a distinguished speaker to present their analysis and views on a topic related to WIDER's work on global development. The 2004 Annual Lecture—the eighth in the series—was given by Professor Dani Rodrik of Harvard University on the topic of 'Rethinking Growth Strategies', and took place in the Aula Lecture Hall of the Stockholm School of Economics on 5 November. We are grateful to the Stockholm School of Economics for their hospitality and collaboration and to the Swedish International Development Cooperation Agency (Sida) for their support.

The Lecture addresses one of the core issues in development: how can low income countries achieve faster rates of economic growth? Reviewing the lessons to be drawn from recent history, particularly with regard to Latin America and Asia, Rodrik concludes that successful policies are invariably built on sensible general principles such as a desire to interact more closely with the global economy, to maintain fiscal discipline, and to establish a strong and supportive institutional environment. However, attempts to translate these general principles into a collection of orthodox liberal policies have a patchy record of success, at best. This conclusion is reinforced by the fact that the vast majority of significant growth accelerations over the past 50 years fail to reveal any clear link with economic liberalization.

The alternative framework proposed by Rodrik involves a move away from a blanket prescription and towards a more nuanced strategy which focuses on the particular constraints that prevent a given country from growing faster. The consequent policy recommendations may be quite different for countries that appear superficially to share similar problems, or for the same country at different points of time. Rodrik makes a persuasive case for an alternative strategy which has profound implications for the construction of economic policy in developing countries.

Anthony Shorrocks
Director, UNU-WIDER

AUTHOR'S ACKNOWLEDGEMENTS

I thank Professor Tony Shorrocks for his introduction and for the invitation to give this lecture. I also want to thank Professor Mats Lundahl and the Stockholm School of Economics for hosting the lecture; it was nice to visit, among good friends and in an institution that is so rich with intellectual history.

ABOUT THE AUTHOR

Dani Rodrik is Professor of International Political Economy at the John F. Kennedy School of Government, Harvard University. He is also affiliated with the National Bureau of Economic Research, the Centre for Economic Policy Research (London), the Center for Global Development, the Institute for International Economics, and the Council on Foreign Relations. Among other honours, in 2002 he was presented the Leontief Award for Advancing the Frontiers of Economic Thought.

He has given the Gaston Eyskens Lectures (October 2002), the Carlos F. Diaz Alejandro Lecture at the Latin American meeting of the Econometric Society (July 2001), the Alfred Marshall Lecture of the European Economic Association (August 1996), and the Raul Prebisch Lecture of UNCTAD (October 1997). Professor Rodrik holds a Ph.D. in economics and an MPA from Princeton University, and an A.B. (*summa cum laude*) from Harvard College.

His research focuses on what constitutes good economic policy and why some governments are better than others in adopting it.

Professor Rodrik has published widely on issues related to trade policy, political economy, and economic reform in developing economies. *Has Globalization Gone Too Far?* (1997) was called 'one of the most important economics books of the decade' in *Business Week*. His recent book is *In Search of Prosperity: Analytic Narratives on Economic Growth* (Princeton University Press, 2003). He is also the author of *The New Global Economy and Developing Countries: Making Openness Work* (Overseas Development Council, 1999), an editor of the *Review of Economics and Statistics* and an associate editor of the *Journal of Economic Literature*.

I A BRIEF ROADMAP

This lecture, 'Rethinking Growth Strategies', focuses on growth because we can all agree that achieving sustained poverty reduction around the world will be practically impossible unless economic growth is achieved in poor countries. In addressing *rethinking* economic growth strategies I will explain in greater detail that the kind of certainty and consensus that existed 10 to 15 years ago about the appropriate policy framework for economic growth has almost disappeared. And it is not clear what is going to replace it. I therefore make the case for a particular way of thinking about designing growth strategies. These ideas are still in their early stages of development and have been undertaken jointly in work with a number of my colleagues at Harvard, including, most significantly, Ricardo Hausmann, Andres Velasco and Lant Pritchett. I would like to acknowledge their contribution upfront.

Let me offer an overview of the lecture: the groundwork covers a number of propositions, which I believe almost everybody agrees on by now, and I will try to cover this in a non-controversial way because I think starting from such a common ground is important. I will argue that there are basically two ways that one can go from here. The more conventional way, which has now been developing for some time, is what I call the *Augmented Washington Consensus*, which is the old Washington Consensus augmented, enlarged, and expanded with a number of deeper institutional/governance reforms. I will argue that this is not a very helpful way of thinking about growth strategies for a number of reasons. Then I will present an alternative, which I think is more practical, and is likely to be more productive. Before I get into that alternative approach, I will take a quick detour and say something about an empirical effort to identify some of the correlates of what we call *growth accelerations*; periods of increased economic growth sustained over the medium term. This is important empirical background to the alternative framework that I am going to outline at the end of my talk.

This alternative framework is really a diagnostic strategy; so, unlike the Washington Consensus or the Augmented Washington Consensus, it is not a list of do's and don'ts. It is a framework for *figuring out* what to do (and maybe what not to do) in different kinds of cases and different kinds of countries. It is a strategy for identifying areas where the greatest returns to economic reform are. I will illustrate the power of that strategy with a couple of country cases at the end of the lecture.

II THE COMMON GROUND

Let me start with where I think we stand at present. First, I think everybody would accept that a lot of reform has actually taken place since the 1980s. This is particularly true in Latin America. Figure 1 shows an index of structural reform that was computed at the Inter-American Development Bank. Latin America is the region where the accepted wisdom about what to do to achieve economic growth was adopted with the greatest amount of enthusiasm. I think it is also fair to say that if we had a similar index of how much reform has taken place in sub-Saharan Africa (SSA) we would find that there was a lot of 'structural' reform in SSA as well. Markets are freer, economies are more open, and inflation is lower in most SSA countries today than was the case 15 or 20 years ago. I think most people would agree that when we evaluate the nature of policies today in Latin America and in most of SSA, then by—the conventional standards of how much liberalization, how much privatization, how much macroeconomic stabilization, how much openness to trade has actually taken place—the quality of policies in these two important regions is much better than it was about two to three decades ago. A lot of reform *has* taken place.

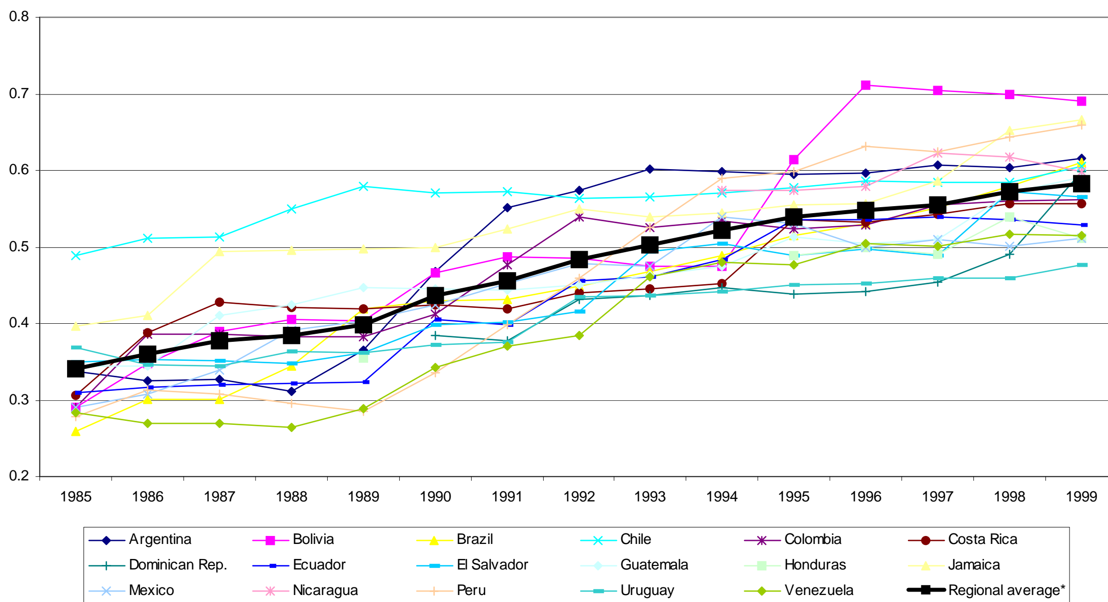


FIGURE 1 STRUCTURAL REFORM INDEX FOR LATIN AMERICAN COUNTRIES

Source: Lora (2001)

But over time, there has been a growing recognition that the response to these reforms has been less than spectacular. There are many efforts in the literature to try to estimate the contribution to economic growth of the conventional economic reforms inspired by the Washington Consensus. Without going into the details of that literature, I think it is now commonly accepted that the countries that adopted this agenda have under-performed. The simplest way to see this is to focus on the experience of Latin America.

Latin America at the beginning of the 1990s faced a bigger convergence gap with the advanced industrial countries than it did in the previous three or four decades. So just on account of the convergence factor alone, we would have expected Latin America to grow faster in the 1990s, without making allowance for the 'improved' nature of Latin America's policies. As we can see from Figure 2, during the 1990s Latin America grew more slowly not only compared to other parts of the world, in particular Asia, but also compared to its own performance in the 1960s and 1970s. That is a *striking* empirical fact, the importance of which is hard to downplay. After all, the Latin America of the 1960s and 1970s is a region of import substitution, macroeconomic populism, and protectionism, while the Latin America of the 1990s is a region of openness, privatization and liberalization. The cold fact is that per capita economic growth performance has been abysmal during the 1990s by any standards. That is also true of productivity performance, so one cannot simply ascribe this to the adverse short-run effects of economic reform. When one looks at economy-wide total factor productivity (TFP) growth in Latin America, one finds that it has been considerably lower than in the 1950s or 1960s or 1970s—periods of import substitution.

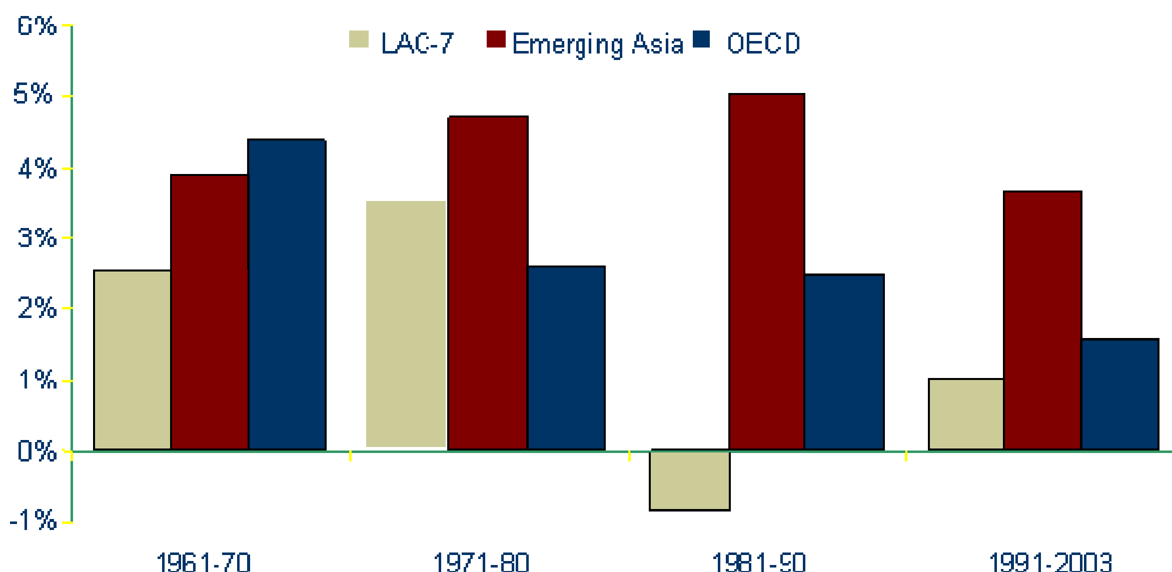


FIGURE 2 RESPONSE TO REFORMS HAS BEEN WEAK AT BEST

Notes: Regional GDP per capita. Asia includes Indonesia, Korea, Malaysia, Philippines and Thailand.

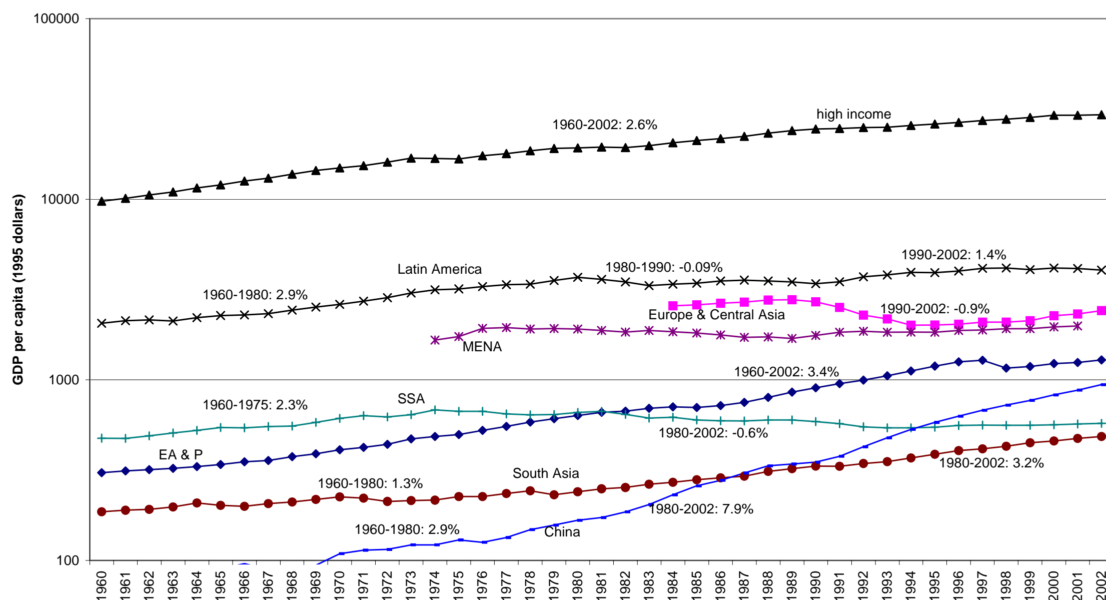


FIGURE 3 ECONOMIC PERFORMANCES SINCE 1960

The good news of course is that, while Latin America and Africa have done very poorly, some of the poorest parts of the world have in fact done extremely well (Figure 3). In particular, China has increased its per capita growth rate since the late 1970s from about 3 per cent to 8 per cent and more—a historically unprecedented rate of economic growth, when sustained over such long periods of time. The rapid rate of growth in China is extremely important because growth there makes a tremendous contribution to poverty reduction in the world. Other parts of Asia have done well too: Vietnam has been another very strong performer since the late 1980s; India, the world's second most populous country after China, has also doubled its economic growth since around 1980 and that is another source of good news.

Now this is good news in terms of outcomes but it contributes to the puzzle with respect to *policies*. There is at best an awkward fit between the policy regimes that exist in the most successful countries of the world and the policy regimes that North American economists and multilateral institutions have been advocating around the world. This is probably most visible in the area of trade liberalization. A few years back the World Bank did a study called *Globalization, Growth and Poverty* (Collier and Dollar 2001) to try to demonstrate that the countries that had done the best were those that had globalized the most rapidly. Of course if one defines globalization as the rate at which countries expand their trade volumes, the rate at which they are attracting foreign investment—that is if one defines globalization by outcomes rather than prevailing policy frameworks—then this conclusion is absolutely right. So one finds that the World Bank's star globalizers, China, India, Vietnam and Uganda, have all increased very rapidly their volumes of foreign trade and in most cases their volumes of inward foreign investment as well. But of course if one thought that this was achieved through policies of rapid and across-the-board import liberalization, one would end up very much off the mark (Table 1).

TABLE 1 WORLD BANK'S 'STAR GLOBALIZERS'

Country	Growth rate in the 1990s	Trade policies
China	7.1	Average tariff rate 31.2%, NTBs; not a WTO member
Vietnam	5.6	Tariffs range between 30–50%, NTBs and state trading, not a WTO member
India	3.3	Tariffs average 50.5% (the highest but one in the world)
Uganda	3.0	Moderate reform

Source: Collier and Dollar (2001: 6).

In fact countries like China and Vietnam and India have maintained high rates of import barriers including quantitative restrictions until relatively late. Vietnam to this day is not a member of the World Trade Organization (WTO). And there is something ironic, to say the least, in the empirical reality that the countries that seem to be turning out the best performance in trade are the ones that are playing by different rules: let us call them the GATT rules rather than the WTO rules of world trade. That is just another instance of the paradox that policy regimes in the most successful countries have been highly unorthodox.

Another illustration comes from India (Figure 4). India is commonly presented as a case where the standard story fits rather well. The conventional account is that India

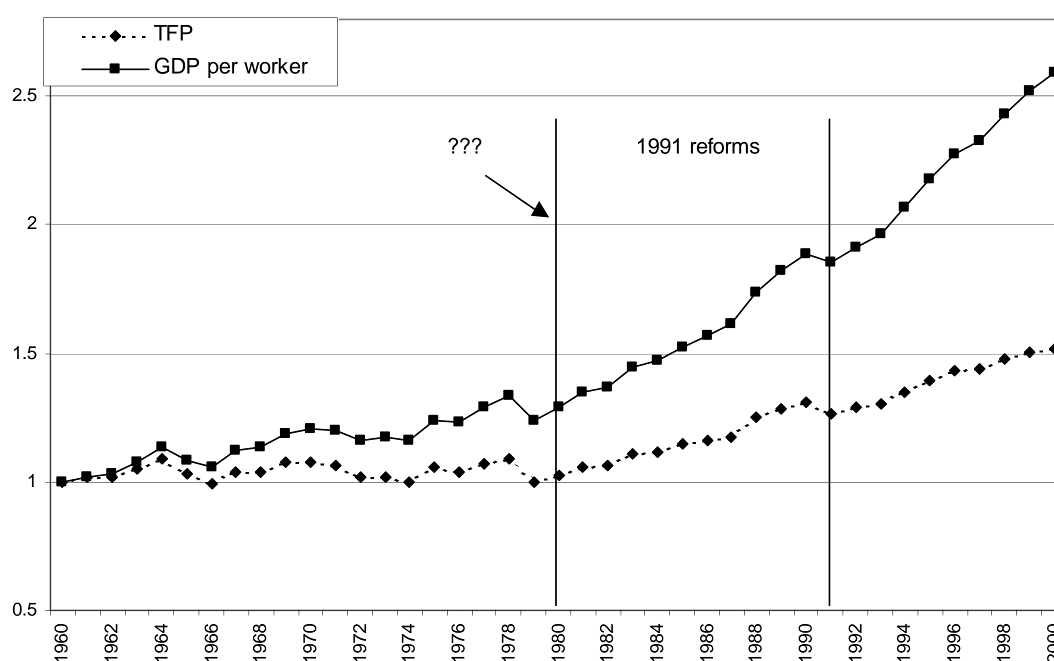


FIGURE 4 THE INDIAN ECONOMIC TAKE-OFF

Source: Bosworth and Collins (2003)

was a sleeping giant that woke up and started to grow rapidly once there was internal and external liberalization, with the decisive break in policy stance taking place in 1991. The trouble with this story is that it gets the dates and sequence quite wrong. We do not have to carry out any fancy econometrics to realize that rapid economic growth in India started a *full decade* before the liberalization of 1991. Whatever it is that doubled India's economic growth rate, starting some time around 1980, it certainly could not have been the 1991 liberalization. There is a puzzle here for sure.

One could also expand the discussion to the earlier period of growth miracles and talk about the East Asian tigers of Taiwan and Singapore, where the policy frameworks were also quite anomalous, essentially combining many of the orthodox ideas about outward orientation and the importance of the private sector with considerable microeconomic interventions, industrial policies, trade protection and so forth (Table 2). But those stories are quite well known and I do not have to repeat them here.

TABLE 2 EAST ASIAN ANOMALIES

Institutional domain	Standard ideal	'East Asian' pattern
Property rights	Private, enforced by the rule of law	Private, but government authority occasionally overrides the law (especially in Korea)
Corporate governance	Shareholder ('outsider') control, protection of shareholder rights	Insider control
Business–government relations	Arms' length, rule based	Close interactions
Industrial organization	Decentralized, competitive markets, with tough anti-trust enforcement	Horizontal and vertical integration in production (*chaebol*); government-mandated 'cartels'
Financial system	Deregulated, securities based, with free entry. Prudential supervision through regulatory oversight	Bank based, restricted entry, heavily controlled by government, directed lending, weak formal regulation.
Labour markets	Decentralized, de-institutionalized, 'flexible' labour markets	Lifetime employment in core enterprises (Japan)
International capital flows	'Prudently' free	Restricted (until the 1990s)
Public ownership	None in productive sectors	Plenty in upstream industries

I said that the successful countries followed unorthodox policy agendas. But as these capsule summaries indicate, one can characterize what they did, at a sufficiently high level of generality, as deploying unorthodox policies in the service of orthodox ends—such as openness, macroeconomic stability, private entrepreneurship, and so on. Hence I think it is possible to come up with certain general principles that have applied in all of these cases: all successful countries have, in one form or another, provided for effective property rights protection and contract enforcement; all successful countries have maintained macroeconomic stability; they have all sought to integrate into the world economy; they all have had a supportive environment for private enterprise and private investment; they have provided for effective prudential regulation of their financial sectors; etc. One can indeed generate a list of commonalities in these countries; however, we cannot take these relatively abstract ends—such as property rights protection, effective prudential regulation, sound money and sustainable public finance, support of private investment—and come up with well-defined policy prescriptions that are valid for all countries at all times. Another way of stating this is that we have a relatively easy time specifying the desirable functions that good institutions and appropriate reform agendas must produce, but we have a very difficult time specifying the form or the design that such arrangements have to take. The blueprints that we are looking for seem to be highly context specific.

Let me illustrate that point more concretely by quoting at length an interesting passage from a lecture that Larry Summers gave in 2003. His theme was economic growth and he was trying to make the argument that we actually do know a fair bit about what produces it. The operative part of his lecture went as follows:

> I will suggest that the rate at which countries grow is substantially determined by three things: their *ability* to integrate with the global economy through trade and investment; their *capacity* to maintain sustainable government finances and sound money; and their *ability* to put in place an institutional environment in which contracts can be enforced and property rights can be established. I would challenge anyone to identify a country that has done all three of these things and has not grown at a substantial rate. (Summers 2003)

I have italicized some key words here because what Summers is really telling us is that we can only specify some abstract general abilities and capacities to achieve certain outcomes and not specific policies. Does the ability to integrate with the world economy come necessarily with openness to imports and capital flows? Does sustainable government finance and sound money imply independent central banks, floating exchange rates and inflation targeting? Does a good institutional environment mean an Anglo-American type corporate governance regime, or even a legal regime based on private property? Not if the experience of the growth champions of the last half century is a guide. So we can agree with Larry Summers that property rights and contract enforcement, openness, sound money and

sustainable fiscal balances are important. But that still leaves a whole lot unanswered as to how we can achieve these. If the example of China, India and Vietnam, and before them other successful Asian countries, is any guide, these outcomes can be achieved—and indeed are typically achieved—through highly divergent or heterodox institutional arrangements.

I would like to illustrate this further with the experience of China, because China makes such a good example (Table 3). Think of the following thought experiment; suppose you were asked to go and advise the Chinese government in 1978 about the reforms they should undertake. The first thing that you would know is that China is mostly a rural country and the vast majority of the poor live in the countryside. You would immediately note that the reason for poverty is low agricultural productivity. What might the solution be? It would not take long to realize that the problem is largely one of central planning: farmers are told how much to produce and at what price. So the first recommendation is to *liberalize the price system* and to allow farmers to produce and sell at market-determined prices. But that would not be enough because, after all, these are farmers who do not own their own means of production, land. Market pricing alone does not give farmers the right incentives to improve productivity and make the right production and saving decisions. So price liberalization would have to be supplemented with the *privatization of land*. You cannot stop there either, because the moment you eliminate central planning, institute market pricing and privatize land, you immediately run into a public finance problem. The problem is that the government relies on the implicit tax that it derives from purchasing crops from the communes at low prices and selling them at somewhat higher prices in urban areas. If you simply get the government out of this, then you have the problem that the underlying fiscal revenue of the

TABLE 3 THE INDETERMINACY OF INSTITUTIONAL FORMS:
A CHINESE COUNTERFACTUAL

Problem	Solution
Low agricultural productivity	Price liberalization
Private incentives	Land privatization
Fiscal revenues	Tax reform
Urban wages	Corporatization
Monopoly	Trade liberalization
Enterprise restructuring	Financial sector reform
Unemployment	Safety nets
And so on …	

government will collapse and you will face a macroeconomic problem. So the next recommendation on your list has got to be *tax reform*: to find alternative tax instruments in order to make up for the lost revenue that privatization and price liberalization entail.

But the problems are not over yet. The moment that you liberalize prices and abolish the state order system what happens is that workers in the urban areas no longer have access to food rations at below market prices in government-run stores. Now they would want higher wages in order to deal with higher food prices, and that means that you have to provide urban enterprises with the ability to pay higher wages. Because these are state enterprises, you have to give them some autonomy with which they can decide on their wage and price decisions and respond to demands for higher wages. This calls for *corporatization of state enterprises* at the very least. This creates another problem in its wake. The state enterprises are huge behemoths that can exercise monopoly power if given the freedom to raise prices. How are you going to deal with that? The easiest way is to import price discipline from abroad through *trade liberalization*. But once you liberalize trade you have to worry about the problem of inefficient enterprises. How are they going to be restructured? That obviously requires in turn *financial sector reforms* so you can lubricate the process of restructuring. And if you are restructuring you are also going to get unemployment and you better have some *safety nets* in place to deal with that. And so on and so forth.

By the time you have run through these things and you look at everything that you have to do you have basically arrived at the standard Washington Consensus agenda. My first conclusion from this thought experiment is to underscore the point that the Washington Consensus agenda is not silly. When you think systematically about how different areas of reform are related to each other, you end up with a list of reforms that are quite similar, as we have just seen in the context of China's reforms. The policy advisor who went through this process would be entirely justified in feeling really good about a job well done; having actually foreseen ex ante how each one of these things are complementary and how some of them would not work without the others. On the other hand, you can also imagine how the Chinese government might have reacted to this long list of reforms; they would likely have thought: this reform business is really tricky; maybe we should not do it for another ten years.

The Chinese experience is interesting because we know what actually happened. We know that the Chinese government did reform, but they did not do any of what we have just covered. What the Chinese government did was entirely different (Box 1). Rather than liberalizing the markets wholesale and eliminating central planning, what they did was institute a two-track pricing system and they grafted a market pricing system on top of the state order system. They did not eliminate central planning. The nice thing about that was that two-track pricing insulates

BOX 1 CHINESE SHORTCUTS

- Household responsibility system and township and village enterprises obviate the need for ownership reforms
- Two-track pricing insulates public finance from the provision of supply incentives
- Federalism, 'Chinese-style' generates incentives for policy competition and institutional innovation

public finance from the provision of private incentives. This was a practical solution that they arrived at experimentally, by having confidence in their ability to generate home-grown reforms. The reason that two-track pricing insulates public finance from the provision of supply incentives is that incentives matter only at the margin, so as long as farmers can trade at the margin at market-determined prices it does not matter if inframarginal units have to be sold to the state at below-market prices. So you get efficiency but you also maintain the existing form of public finance for the state.

Similarly in the area of property rights, rather than institute private ownership in land and in industry, the Chinese government instead implemented various institutional innovations, such as the 'household responsibility system' and township and village enterprises (TVEs). TVEs are particularly interesting. They were able to elicit inordinate amounts of private investment and acted as the engine of growth for the economy through the mid-1990s. Thus they were clearly effective in providing some form of property rights and in stimulating private entrepreneurship, and one wonders how exactly that was achieved in the absence of *private* property rights. One possible explanation is that in the absence of a well-functioning judiciary, private entrepreneurs are better protected through alliances with local government—their most likely expropriator—than through the legal system. A private property-rights system, which is the default mode of legal reform, relies on efficient third-party enforcement of contracts. In advanced industrial countries, this is achieved through the courts. In a transitional economy, courts can hardly be expected to work well. Consider Russia, for example, which tried to do property rights reform the conventional way and generated very little real, effective property rights because of the inefficiency and corruption of its judiciary. The comparison between the two transitional economies shows that it might be a lot easier to achieve effective property rights when entrepreneurs ally themselves with local governments than when they throw themselves at the mercy of the courts.

The point is not that China did everything right and that all countries have to imitate them. What I am trying to illustrate is a much more general issue about the multiplicity, or the non-uniqueness, of institutional arrangements that achieve desirable ends. So if our objective is to achieve productive efficiency (whether of the static or dynamic kind), there are some universal principles such as property

rights, market-oriented incentives and rule of law. These are universal in the sense that you can just get off the plane in any country that you have never been to, know nothing about that country, and still come out and say property rights, incentives, and rule of law. There is no chance you could possibly be wrong, since it is difficult to think of circumstances under which the pursuit of these ends (in the appropriate manner of course) could be bad for the economy. The real issue is not these general principles, but how we are going to accomplish them. The operational question is: how do we map these principles into practical guidelines? By non-uniqueness, what I have in mind is that these principles do not map uniquely into specific designs. We need reform strategies that are sensitive to domestic opportunities and constraints. That is the essential lesson of the Chinese strategy.

I turn now to the last point on which I think by now there is fair amount of agreement. Since we know less than we thought we did, and since a lot of the actual success on the ground depends on how we craft these highly specific policies, then it is going to be desirable to allow national governments to have some degree of *space* and room for manoeuvre for policy experimentation. We see this newfound emphasis on experimentation in a number of different ways. We see it in academic work, which is increasingly emphasizing the amorphous nature of institutions and the need for policy experimentation. We also see it at the level of international lending agencies, where there is much more talk about 'country ownership'. Poverty reduction and growth strategies (PRSPs) are now supposed to be the result of some domestic deliberative process.

There is a groping toward an alternative, but what that alternative is remains unclear. There is in fact the danger that one can take the kind of arguments I have been outlining here and end up with a nihilistic attitude which suggests there is very little that economists, as development professionals, can actually do to help governments. I am going to argue that this is not the right way to go either. 'Anything goes' is not the right policy message.

III THE FALSE ALTERNATIVE

One alternative that has been shaping up for some time is what I call the *Augmented Washington Consensus* (Table 4). The idea here is that we basically keep adding things on to the policy agenda, as prevailing policies continue to disappoint. Sometimes the same agenda is called 'second generation reforms'. I remember a Latin American finance minister explaining, in all seriousness, how his country had done all the second generation reforms, and even the third generation ones, and now was on to the fourth generation. The economy of this country was stagnant.

TABLE 4 THE WASHINGTON CONSENSUS AND 'AUGMENTED' WASHINGTON CONSENSUS: WHAT TO AVOID

Original Washington Consensus		'Augmented' Washington Consensus … the previous ten items, plus	
1	Fiscal discipline	11	Corporate governance
2	Reorientation of public expenditures	12	Anti-corruption
3	Tax reform	13	Flexible labour markets
4	Interest rate liberalization	14	Adherence to WTO disciplines
5	Unified and competitive exchange rates	15	Adherence to international financial codes and standards
6	Trade liberalization	16	'Prudent' capital-account opening
7	Openness to direct foreign investment	17	Non-intermediate exchange rate regimes
8	Privatization	18	Independent central banks/inflation targeting
9	Deregulation	19	Social safety nets
10	Secure property rights	20	Targeted poverty reduction

This is actually quite a wide-spread phenomenon: as the growth response to the standard reforms ends up being very weak, we have the tendency to say that obviously this was not enough and we need to do more. So if trade liberalization did not work well, this must be because labour markets were not flexible enough, with the implication that the next set of reforms have to be in the area of labour markets. If opening up the financial markets did not work, it was because prudential regulation was weak, so now we are in need of international financial codes and standards and improved financial governance. If privatization did not work well, well maybe that is because we lacked good enough social safety nets. People who lost their jobs became upset, which undercut the legitimacy of privatization. So social safety nets need more attention; and so on.

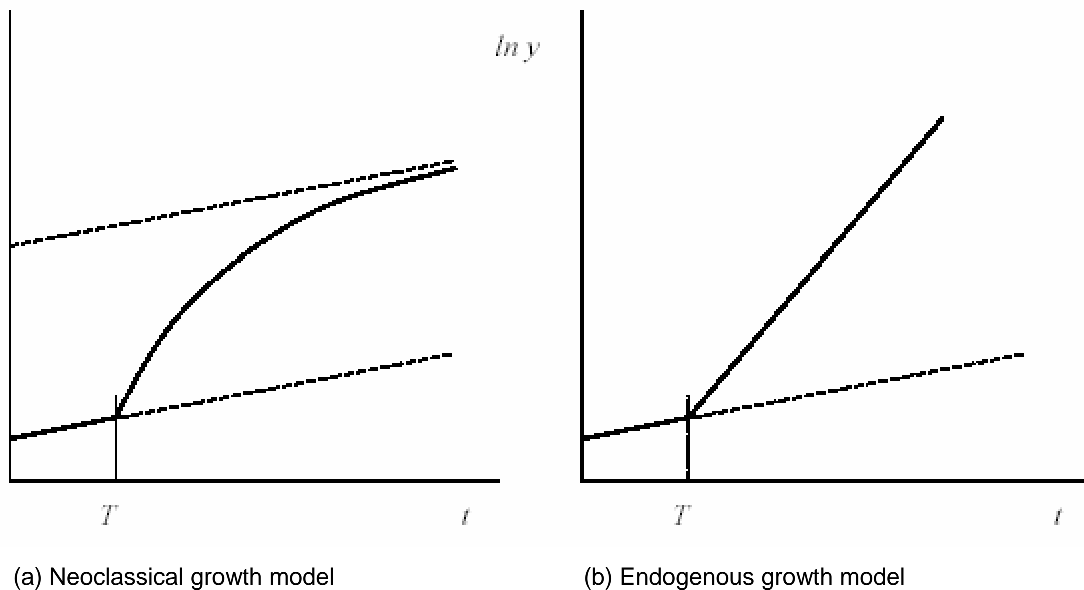
With the list of reforms augmented in this fashion, the immediate issue is how one prioritizes them. The current approach can be summarized, with little exaggeration, as one of: *do whatever you can, as much as you can, as quickly as you can*. As a matter of basic economics this represents a faulty strategy. When we are in second-best situations, it is simply not true that any reform is good; or that the more areas reformed, the better off you are; or that the deeper the reform in a single area, the better off you are. This is just a simple matter of second-best economics.

What I am going to suggest here is an alternative, focused on trying to identify the most binding constraints on economic growth. What we should be after are the distortions that hurt the most at any point in time.

IV THE EMPIRICS OF GROWTH ACCELERATIONS

Before I get into a discussion of growth diagnostics, let me take a quick detour through some empirical work. I want to ask what happens when countries all of a sudden start to grow. While there is a huge literature on cross-country growth empirics, surprisingly none of this literature has actually looked at what happens just around the time when countries start to grow. The basic theory of economic growth is that if you have a really meaningful economic reform at time *t*, then that is going to be rewarded by a significant increase in the economic growth rate at that time *t* (Figure 5). If you are in the world of neoclassical growth models with diminishing returns to reproducible factors of production, then the growth bonus will be temporary. If you are in the world of endogenous growth models where there are no diminishing returns, then this growth effect could be permanent. But in either case, if you want to see what kind of things actually cause increases in growth, you should look at what happens just when these growth accelerations take place. The standard growth regressions do not do this. They simply stack different time periods on top of each other, by five or ten-year averages. They do not look for the turning points in growth.

So the exercise that I want to report on is one that looks at what happens during these periods of growth acceleration. First, I need to define what a growth acceleration is. In joint work with Ricardo Hausmann and Lant Pritchett, we defined a growth acceleration as an increase in a country's growth rate by at least two percentage points per annum. We also required that growth be at least 3.5 per cent per annum subsequent to the acceleration. Finally, since we do not want to pick up



(a) Neoclassical growth model (b) Endogenous growth model

FIGURE 5 GROWTH ACCELERATIONS: WHAT DOES THE THEORY SAY?
EFFECT OF IMPROVEMENT IN GROWTH FUNDAMENTALS AT TIME *T*

cases of rebound after prolonged crises, we also required that the level of income exceed the pre-acceleration peak level. Our time horizon is eight years, so we look for increases in growth rates of two percentage points per annum that are maintained for at least eight years.

The first question is how many countries have actually experienced these significant growth accelerations. The surprise, to me at least, was that these things happen very frequently (Table 5). When we exclude the eight years at the beginning and eight years at the very end of our time sample, we are left with the period between 1957 and 1992 over which we can search for growth accelerations. The pleasant surprise was that we identified no fewer than 83 cases of growth acceleration over this period. These were drawn from all parts of the world, including SSA. Even though they are concentrated in the 1960s and 1970s in SSA rather than in more recent decades, it is striking that even here there is a large number of countries that managed to experience these growth accelerations. The minimum increase in growth we required is 2 percentage points, but in practice many of these growth accelerations involved jumps in the growth rate of a much larger magnitude—up to 8 or 9 percentage points. These are huge increases in economic growth. Of course, most of these accelerations were not sustained. If we add the more demanding requirement that these growth accelerations be sustained not for most of the decade, but for two decades, then basically around half of them disappear. Nevertheless, getting such an increase in growth for the better part of a decade is not a bad thing. The question is what causes these growth accelerations?

TABLE 5 EPISODES OF RAPID GROWTH, BY REGION, DECADE AND MAGNITUDE OF ACCELERATION, 1957–92

Region	Decade	Country	Year	Growth before	Growth after	Difference in growth
Sub-Saharan Africa	1950s & 1960s	Nigeria	1967	–1.7	7.3	9.0
		Botswana	1969	2.9	11.7	8.8
		Ghana	1965	–0.1	8.3	8.4
		Guinea Bissau	1969	–0.3	8.1	8.4
		Zimbabwe	1964	0.6	7.2	6.5
		Congo	1969	0.9	5.4	4.5
		Nigeria	1957	1.2	4.3	3.0
	1970s	Mauritius	1971	–1.8	6.7	8.5
		Chad	1973	–0.7	7.3	8.0
		Cameroon	1972	–0.6	5.3	5.9
		Congo PR	1978	3.1	8.2	5.1
		Uganda	1977	–0.6	4.0	4.6
		Lesotho	1971	0.7	5.3	4.6
		Rwanda	1975	0.7	4.0	3.3
		Mali	1972	0.8	3.8	3.0
		Malawi	1970	1.5	3.9	2.5
	1980s & 1990s	Guinea Bissau	1988	–0.7	5.2	5.9
		Mauritius	1983	1.0	5.5	4.4

		Uganda	1989	–0.8	3.6	4.4
		Malawi	1992	–0.8	4.8	5.6
South Asia	1950s 1960s	Pakistan	1962	–2.4	4.8	7.1
	1970s	Pakistan	1979	1.4	4.6	3.2
		Sri Lanka	1979	1.9	4.1	2.2
	1980s	India	1982	1.5	3.9	2.4
East Asia	1950s &	Thailand	1957	–2.5	5.3	7.8
	1960s	Korea	1962	0.6	6.9	6.3
		India	1967	–0.8	5.5	6.2
		Singapore	1969	4.2	8.2	4.0
		Taiwan	1961	3.3	7.1	3.8
	1970s	China	1978	1.7	6.7	5.1
		Malaysia	1970	3.0	5.1	2.1
	1980s &	Malaysia	1988	1.1	5.7	4.6
	1990s	Thailand	1986	3.5	8.1	4.6
		Papua New Guinea	1987	0.3	4.0	3.7
		Korea Rep.	1984	4.4	8.0	3.7
		India	1987	3.4	5.5	2.1
		China	1990	4.2	8.0	3.8
Latin	1950s &	Dominican Rep.	1969	–1.1	5.5	6.6
America	1960s	Brazil	1967	2.7	7.8	5.1
and		Peru	1959	0.8	5.2	4.4
Caribbean		Panama	1959	1.5	5.4	3.9
		Nicaragua	1960	0.9	4.8	3.8
		Argentina	1963	0.9	3.6	2.7
		Colombia	1967	1.6	4.0	2.4
	1970s	Ecuador	1970	1.5	8.4	6.8
		Paraguay	1974	2.6	6.2	3.7
		Trinidad & Tobago	1975	1.9	5.4	3.5
		Panama	1975	2.6	5.3	2.7
		Uruguay	1974	1.5	4.0	2.6
	1980s &	Chile	1986	–1.2	5.5	6.7
	1990s	Uruguay	1989	1.6	3.8	2.1
		Haiti	1990	–2.3	12.7	15.0
		Argentina	1990	–3.1	6.1	9.2
		Dominican Rep.	1992	0.4	6.3	5.8
Middle East	1950s &	Morocco	1958	–1.1	7.7	8.8
and North	1960s	Syria	1969	0.3	5.8	5.5
Africa		Tunisia	1968	2.1	6.6	4.5
		Israel	1967	2.8	7.2	4.4
		Israel	1957	2.2	5.3	3.1
	1970s	Jordon	1973	–3.6	9.1	12.7
		Egypt	1976	–1.6	4.7	6.3
		Syria	1974	2.6	4.8	2.2
		Algeria	1975	2.1	4.2	2.1
	1980s & 1990s	Syria	1989	–2.9	4.4	7.3

Table 5 continued

Region	Decade	Country	Year	Growth before	Growth after	Difference in growth
OECD	1950s & 1960s	Spain	1959	4.4	8.0	3.5
		Denmark	1957	1.8	5.3	3.5
		Japan	1958	5.8	9.0	3.2
		USA	1961	0.9	3.9	3.0
		Canada	1962	0.6	3.6	2.9
		Ireland	1958	1.0	3.7	2.7
		Belgium	1959	2.1	4.5	2.4
		New Zealand	1957	1.5	3.8	2.4
		Australia	1961	1.5	3.8	2.3
		Finland	1958	2.7	5.0	2.2
		Finland	1967	3.4	5.6	2.2
	1980s & 1990s	Portugal	1985	1.1	5.4	4.3
		Spain	1984	0.1	3.8	3.7
		Ireland	1985	1.6	5.0	3.4
		UK	1982	1.1	3.5	2.5
		Finland	1992	1.0	3.7	2.8
		Norway	1991	1.4	3.7	2.2

Source: Hausmann, Pritchett and Rodrik (2004)

The disappointing part of the empirical exercise was to find that these growth accelerations tend to be highly unpredictable (Table 6). We grouped the potential determinants of growth accelerations under three headings. One is economic reform; that is economic liberalization in the conventional sense of opening up and stabilizing the economy. The second is changes in the nature of *political* regime. And the third is changes in external circumstances, which we captured by changes to the terms of trade. Focusing on economic liberalization, what we find is that the match between significant economic liberalization and the timing of growth accelerations is *extremely* imperfect. *So less than 15 per cent* of growth accelerations were preceded or accompanied by economic liberalization. That is to say that the vast majority of growth accelerations *do not* take place in the context of standard economic liberalization programmes. Looking at it the other way around, we can also ask what is the proportion of significant economic liberalizations that subsequently produced growth accelerations? There the ratio is less than one in five. So only about 18 per cent of significant economic liberalizations are subsequently accompanied by growth accelerations. It turns out that our principal tool for producing growth accelerations has very weak leverage over the desired outcome.

TABLE 6 PREDICTABILITY OF GROWTH ACCELERATIONS

(a) All growth episodes	
Proportion of growth accelerations that are preceded or accompanied by:	
Economic liberalization	14.5
Political regime change	50.6
External shock	27.5
Proportion of occurrences of column variable that is accompanied or followed by growth accelerations:	
Economic liberalization	18.2
Political regime change	13.6
External shock	5.1
(b) Sustained growth episodes only	
Proportion of growth accelerations that are preceded or accompanied by:	
Economic liberalization	16.2
Political regime change	56.8
External shock	23.5
Proportion of occurrences of column variable that is accompanied or followed by growth accelerations:	
Economic liberalization	9.1
Political regime change	7.1
External shock	1.4

Notes: Figures are percentages. As in the probits, we allow for a five-year lag between a change in the underlying determinant and a growth acceleration. The timing of the growth acceleration is the three year window cantered on the initiation dates shown in Table 5.

Source: Hausmann, Rodrik and Velasco (2004)

One plausible reading of this evidence is that we need to think about growth-stimulating policies in a different way. What the numbers suggest is that growth accelerations are actually not that difficult to produce: if we take our numbers at face value what they imply is that a country has a one-in-five chance of achieving a growth acceleration in any decade. So these things are not that difficult to achieve, but what sets them off is apparently not ambitious economic reform programmes but highly idiosyncratic changes. In all of these cases something happened that unleashed growth, at least for a certain period of time, and what that was seems highly dependent on the conditions of the different countries.

V A DIAGNOSTIC STRATEGY FOR REFORMS

So this is where the diagnostic approach to growth strategies comes from. The idea is to identify, for each country, the area where the biggest bang for the reform buck lies. A priori there is no reason to think that these areas are going to be identical in different countries. If we actually were able to undertake such a diagnostic exercise, we would then have a pointer to the distortions that we need to tackle first to get the largest response in terms of economic growth.

Let me briefly outline how such a growth diagnostic could be done.

$$\underbrace{g}_{\text{growth}} = \sigma \left\{ \underbrace{\left(\left(\underbrace{1-\tau}_{\text{appropriability}} \right) \times \underbrace{\rho}_{\text{social return}} \right)}_{\text{private return to accumulation}} - \underbrace{r}_{\text{cost of financing accumulation}} \right\}$$

The equation comes from any standard model of economic growth, and says that along a balanced-growth path, the rate at which an economy is growing depends on three things:

- the social return to accumulation in its broad sense, that is the return from accumulating physical capital, human capital, entrepreneurship, technology and so forth;
- the extent to which the social return is appropriable by private entrepreneurs, which we call appropriability; and
- the cost of financing accumulation.

Obviously the higher the social return, the higher the accumulation and the growth rate of the economy. But you could be in an economy where the underlying productivity is very high, but investors cannot appropriate the private returns because taxes are high, property rights are not well protected, macroeconomic risk is too high, and so on, such that private appropriability is low. Then the economy would grow slowly despite the high social returns. On the other side of the ledger, growth could also be depressed because the cost of capital is too high. Obviously the higher the cost of capital, the more scarce are investible resources in the economy, and the lower will be the amount of investment that can be financed. The equation provides us with a taxonomy that differentiates, at the most aggregate level, among three different reasons why the rate of growth of an economy is low. It could be that the cost of capital is too high, or the social return to investment is too low, or appropriability is low.

The first step in the analysis is to try to figure out which among these three seem to be the most binding constraint. Is growth low because of inadequate social returns

to investment, inadequate private appropriability of the returns, or inadequate access to finance? You can think of this exercise as going through a decision tree (Figure 6). Depending on which branches of this decision tree we choose, different areas of reforms are implicated and different policies called for. So if the problem is one of low private returns and we decide that the issue is one of poor appropriability, we want to ask next whether the problem originates with micro risks or macro risks. If it is micro risks, is it a question of property rights, corruption, or taxes? If it is a question of macro risk, is it something to do with financial markets and probability of fiscal crises? If this is a case of low social returns, is it due to poor infrastructure, low level or poor quality of complementary factors of production (such as skills), or poor geography? If it is low appropriability, maybe it has to do with externalities of some kind rather than poor institutions or macro risk per se, so we may want to examine things like information spillovers or coordination failures. On the other hand, if it is a question of high cost of capital, or a scarcity of investible resources, then we need to ask whether the problem originates from low savings domestically, poor domestic intermediation, or poor integration with the international financial markets (e.g., collateral constraints and other items that reduce a countries access to foreign borrowing).

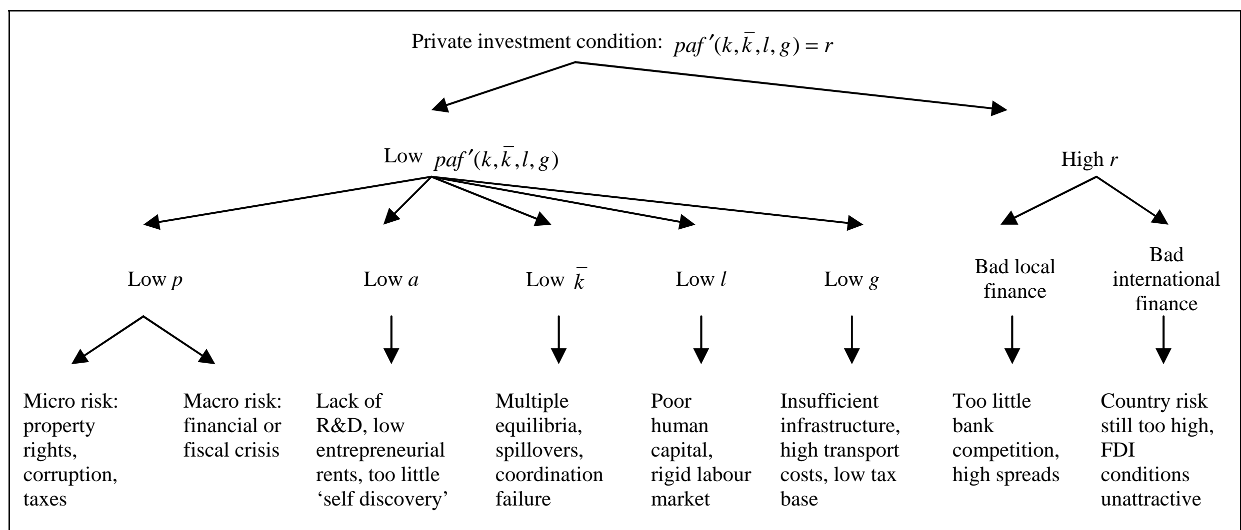


FIGURE 6 PROBLEM: LOW LEVELS OF PRIVATE INVESTMENT AND ENTREPRENEURSHIP

Notes: p private approbability; a total factor productivity; k individual capital stock; l labour input; $\bar{k}$ aggregate capital stock; g government provided infrastructure; r domestic lending rate.

Source: Hausmann, Rodrik and Velasco (2004)

Fundamentally if we are able to carry out this exercise, then we would have a much better ability to focus our effort. We could focus political capital and administrative resources on areas where the returns are the largest. So a country where private returns are very high but investment is constrained by lack of investible resources and very high cost of capital, for example, will respond very differently to the provision of foreign aid than an economy where the problem is not access to investible resources or low savings or high cost of capital, but either low social returns to capital or low appropriability by private investors of the existing returns. In that second type of economy, foreign aid is not going to achieve much. Or foreign aid would be much better targeted at increasing appropriability for private investors instead of supplementing domestic saving. If private returns are low due to disadvantageous geography, poor infrastructure, or low levels of complementary factors of production such as human capital, we would want to focus instead on education, or on improving public infrastructure and transport links with the rest of the world. Poor property rights or high taxes will call for yet another focus. These are very obvious things, but it is remarkable how little these kinds of ideas have actually been put into practice when designing country programmes.

Let me give a couple of concrete illustrations of how this kind of approach can be useful. In a recent paper Ricardo Hausmann, Andres Velasco and I, lay out the theoretical foundations for the diagnostic approach, and discuss a number of empirical illustrations. In the paper we report mini-case studies of three Latin American countries: El Salvador, Brazil and the Dominican Republic. Here I focus on the first two which will be adequate to make the point.

El Salvador and Brazil look, in some respects, very similar because they both have low investment to GDP ratios (relative to their own historical averages) and they have both been growing recently at low rates, again relative to their historical trends. But when looking closely, following the diagnostic approach and running through the decision tree, it turns out that they are suffering from very different problems. The nature of the ‘binding constraints’ is very different.

El Salvador is an economy where the problem cannot be a high cost of capital or low access to investible resources. This is an economy with low real-interest rates, where the banking system is flush with liquidity, where banks cannot find enough borrowers domestically and are actively looking for customers outside the country. It is an economy which receives more than 10 per cent of GDP as transfer of resources from abroad in the form of remittances; yet whenever remittances increase it is not investment that goes up, but domestic savings that goes down. So El Salvador has all the symptoms of an economy where the problems lie not with the high cost of capital, or lack of investible funds, but with poor returns. So, are the poor returns due to poor social returns, or to low appropriability? And if it is low appropriability, does that arise from poor institutional structures and poor property rights or does it arise from some inherent market externalities that reduce the private return of investment even though social returns are high.

It is relatively easy to rule out the hypothesis of poor institutions, since El Salvador is ranked relatively highly in terms of institutional capability both by the World Bank and by private surveys. It cannot be high taxes either; the country has one of the lowest tax ratios in the continent. It cannot be macroeconomic instability, because the economy is dollarized and has low inflation. So our diagnostic strategy leads us to eliminate most of the likely suspects for low private returns.

Our conclusion in this case, arrived largely through a process of ruling out other explanations, was that El Salvador suffers from lack of incentives for private entrepreneurs to invest in non-traditional areas—too little incentives for 'self discovery'. This is the result of limitations inherent to a system that is fairly *laissez faire* in its orientation. One problem is information externalities: investors that undertake forays into new areas generate useful cost information to imitators, and their rents, when successful, are dissipated through imitative entry. Another is coordination failures: the initial investor in, say, pineapples cannot make money unless there are enough other simultaneous investments. One can easily convince oneself that in an economy like El Salvador the most binding constraint is the low return to private investment, which in turn arises from market imperfections that block economic diversification. And this conclusion leads us to think of a proactive role for the government focused on fostering entrepreneurship in non-traditional areas. It leads us, in short, to a rather heterodox agenda of policy reform.

The situation in Brazil is very different. Brazil has all the symptoms of an economy where private returns are very high. In El Salvador, when entrepreneurs were asked what they would do if we gave them US$50 million dollars to invest, we elicited in response mostly silence (and occasionally a suggestion that they would put the money in Miami). In Brazil there is no problem with figuring out areas where there are profitable investment opportunities; the private sector is teeming with such ideas. If investment is not higher, the reason is that real interest rates are extremely high. It is in fact amazing that there is so much investment in Brazil in view of how high real interest rates are. Investment demand is high, but it is constrained by low domestic saving and a binding external borrowing constraint. So in Brazil it seems to be the financing constraint that binds. That conclusion in turn leads to a policy agenda that is very different from the one in El Salvador. The problem is not how to increase returns to investment, but how to reduce the cost of capital. We need to enhance domestic savings, improve domestic intermediation in the banking system, and ultimately also increase the value of the collateral that Brazil presents to international financial market so that the external financing constraint can become less binding.

I hope these two vignettes illustrate how the diagnostic approach leads to a policy agenda that is much more much focused on the apparent constraints and which therefore economizes on scarce political and administrative resources of the government.

Finally, just one word on the Dominican Republic: this is an example of an economy which grew fairly rapidly until a couple of years ago, at which time it collapsed as a result of a financial crisis. Growth in the Dominican Republic was stimulated by removing obstacles that a few key sectors faced, essentially tourism and maquilas. When a crunch developed in the financial markets, there wasn't enough regulatory capacity to prevent a Ponzi scheme from spreading in the financial system. The result was a financial crisis and the end of growth. Hence this is a case that shows how the binding constraint to growth changes over time. In the Dominican Republic, the quality of institutions and of the regulatory system (particularly with respect to financial markets) eventually became the binding constraint. So implementing a growth strategy cannot be a one-time thing. If, say, poor labour skills are not a constraint at the moment, they will surely become one eventually with sufficient growth (if investment in human capital does not keep up).

The diagnostic approach is a useful way of thinking about designing growth strategies both because it is practical and because it essentially encompasses most existing policy orientations. So if you think that the key to development is greater economic aid, this framework tells you exactly under what circumstances that is true. Maybe there are indeed some countries where economic aid is key, but El Salvador is one case where we can be fairly certain aid is not going to do much. For those who think the key lies with the quality of institutions and of governance, the approach helps us figure out the circumstances under which that is indeed true. In neither Brazil, nor El Salvador does this policy agenda seem to be particularly growth-promoting at the moment. The Dominican Republic, by contrast, shows the costs of delaying regulatory reforms once growth has picked up.

VI CONCLUDING REMARKS

I hope to have convinced you that the diagnostic approach is a useful way of looking at growth issues. This approach helps us become more selective and focus our energies on where the returns seem to be the greatest. In this regard, it presents a great advantage relative to the Washington Consensus (in its many variants) with its laundry-list approach to reforms. It also makes better use of what economists have to offer: it asks economists for their guesses of shadow prices of various constraints, and not their subjective evaluation of the political feasibility of different kinds of reforms (which is how the Washington Consensus often gets implemented in practice).

Having said all this, let me end by reminding everyone that I and my colleagues have so far only scratched the surface of this alternative approach. Much more work needs to be done; we are continuing our work on this, and my hope is that we will be joined by others on this productive agenda.

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