

Wealth of Nations: What Drives High Growth Rates?

By Michael Spence*

With China and India growing at high rates, there has been a dramatic increase in the fraction of the world's population that is experiencing the benefits and challenges of rapid growth. There are a number of common ingredients in the cases of sustained high growth that have been observed: a functioning market system, high levels of saving, public and private sector investment, resource mobility and the capacity to accommodate rapid change at the microeconomic level without leaving people excessively exposed to the risks inherent in creative destruction.

But it is the resources of the global economy that stand out as driving forces in sustaining high growth. These come in three parts.

-- Demand: In a relatively poor economy, demand is limited and its composition does not necessarily correspond to sectors of comparative advantage. The global economy is huge, in comparison; and at the right prices and costs, demand is, for practical purposes, unlimited.

So, once the challenge of identifying industries in which the country can invest in acquiring a comparative advantage is met, growth in exports will not be constrained by demand, and growth in the economy can occur at a rate determined by the savings and investment rates. Much of that investment in the early stages will go to the export sector which can grow at rates high enough to pull the economy along. As we saw in Japan, Korea, Singapore and now China, the growth of exports can set in motion a process of sustained growth which is transmitted to the whole economy and could not be achieved by relying on domestic demand alone.

These are the dynamic equivalents of the gains from trade for developing countries. Developing economies are small in relation to global demand and hence they can grow and increase share without having the terms of trade turn against them (China being a possible exception because of its size). They are constrained primarily by their capacity to invest, once the growth process is started. They use underutilized or surplus resources, particularly labor, so that the growth in exports does not come at the expense of declines in other sectors. Advanced economies cannot grow at anything like these rates and the rapidly growing developing economies will eventually slow down.

-- Technology: A second resource the global economy provides is know-how. This ranges from engineering and production technology, to managerial expertise and knowledge of global markets -- and it does not have to be redeveloped domestically from scratch. And unlike most commodities, when knowledge is transferred from A to B, both have it.

One avenue for imported technology to travel is by foreign direct investment. But there are cases -- Japan and Korea -- in which there was significant technology absorption from the rest of the world and relatively little FDI. Here, foreign education and explicit programs aimed at learning played important roles.

-- Investment: A third area in which the global economy supports higher than otherwise attainable growth is investment, or more precisely through investment beyond the capacity of the domestic economy to save. One component is FDI, typically not a large fraction of total investment (20% of overall investment would be typical). But its magnitude understates its importance, because of its role in bringing technology, know-how and access to external markets.

Beyond FDI, it is possible to invest at rates that are higher than domestic savings can provide. But this area is complex and controversial. Financial investments, unlike FDI, can be reversed easily; and

if reversals are sudden, they can create exchange rate volatility, collapses in asset values, and failures in the banking system. This was observed in the currency crises of the late 1990s, and the understanding now is that imperfectly developed or informationally immature capital markets are vulnerable to volatility, and that complete openness and sudden shifts to complete convertibility of the currency may not be wise. Gradualism, experimentation, and pragmatism are better guiding principles.

Substantial inbound capital in excess of savings may raise the value of the local currency and reduce the competitiveness of the nascent export sectors. An elevated level of the domestic currency or volatility will serve as a deterrent to domestic and foreign investment in export sectors.

Some public sector borrowing to finance public sector investment makes sense if the developing country's fiscal system is sufficiently well structured to ensure the future capacity to repay the debt, and if its political system is such that commitments can be kept. The record, here, is not reassuring. The high-growth cases have not involved much investment financed by foreign savings. The current trend is the opposite: toward building up reserves (modest in some cases, and very large in China). This means running surpluses on current account (goods and services) and deficits on the capital account. That is, domestic savings exceeds investment.

As the high-growth economies become richer, the relative importance of the domestic economy as a driver of growth increases. The critical role of exports remains, but is at its highest early in the process when the domestic economy is small. Take Japan: It lost its growth momentum in the '90s in part because at its advanced stage domestic consumption is a required engine of growth. Beyond the catch-up phase, growth cannot be sustained on a healthy export sector alone.

It is hard to argue with the diagnosis of sustained high growth in the past half-century. But people do question the future applicability to developing economies that are "starting late."

The argument is that for those countries that are not resource-rich, the principal resource that they have is abundant labor, inexpensive relative to its productive value, and that the natural territory for comparative advantage is in labor-intensive manufacturing or services. For these countries, the argument goes, it is impossible to compete with China and prospectively India. One reason is that the size of China and India, and a variety of advantages that go with scale, are insurmountable. Another is that the infrastructure investments make China hypercompetitive and difficult to match. The conclusion is that one needs to wait for China and India to grow, and that at some point their incomes will rise to the point that they are no longer in labor-intensive sectors.

This argument is unlikely to be right. While China and India are formidable competitors, exchange rates can adjust to increase the competitiveness of export sectors of new entrants. In addition, while we sometimes talk about labor intensive-industry as if it were one big lump, in reality there are hundreds of niches. In addition, multinationals are risk-averse and unlikely to source in their supply chains in just one or two countries. Finally, China and India together now account for close to one-fifth of the U.S. economy, and they are becoming an important source of demand for exports of developing countries -- so that newcomers have expanding markets in these two rapidly growing economies.

In short, the global economy remains a resource for generating and sustaining high growth in developing countries. China and India, accounting for 40% of the world's population, are in high-growth mode and pulling much of Asia with them. There have also been recent increases in export and overall growth in Africa, though some of that is attributable to an upsurge in commodity prices.

Latin America, with the notable exception of Chile, has been stalled at lower middle-income levels, but has the human resources and other assets to shift back onto high-growth trajectories.

The prospects for developing countries are, in fact, probably more favorable now than they have been, perhaps, since World War II. International trade is growing faster than global GDP. The benefits of decades of learning with respect to operating global supply chains are accessible. Information and technology continues to lower transactions costs and to be a powerful integrating force. But perhaps even more important, the key players in all this -- the leaders in emerging economies who have the responsibility for building policies that support private sector entrepreneurship and that lead to sustained inclusive growth -- have a wealth of experience to rely on. No one is in the dark.

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