

Economic Growth After the Crisis

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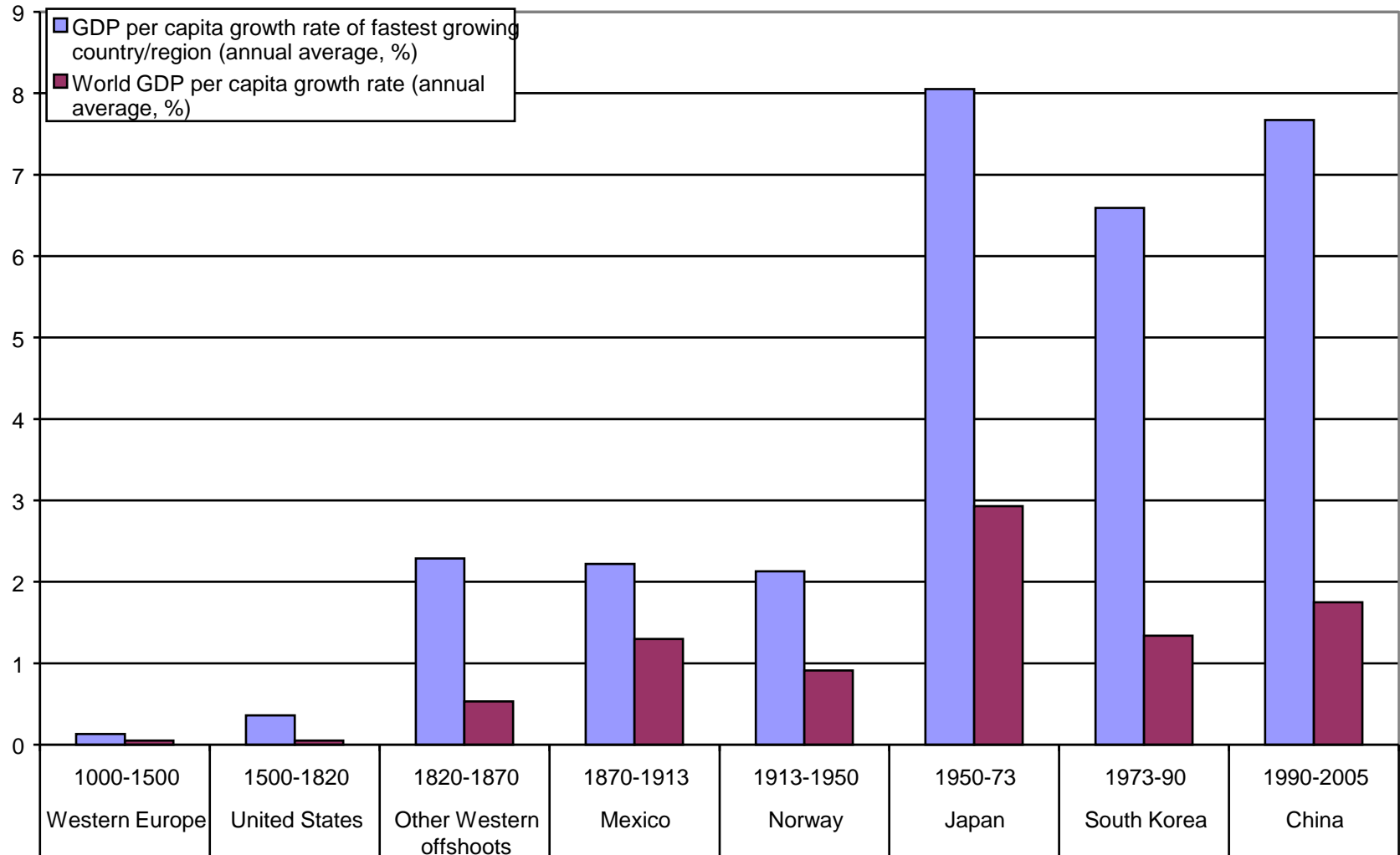
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Argument

- Growth in developing world => increased supply of tradables, especially of the “non-traditional” kind
- Global macro stability => smaller current account imbalances
- Hence can no longer replicate recent pattern of growth
 - Based on willingness of U.S. to run large CA deficits
- How much of a conundrum is this?
- Less than we might think, once we realize what drives growth in developing countries is share of tradables output in GDP
 - Not trade surplus/GDP or export/GDP
- Solution is to
 - Allow developing nations, especially large, middle-income ones, to subsidize their (non-traditional) tradables, while
 - Also requiring that they follow real-exchange rate policies consistent with near-balance on the CA
- This enables developing nations to increase supply of tradables without running large CA surpluses

Globalization's upside: the expanding growth frontier

Historical experience with growth

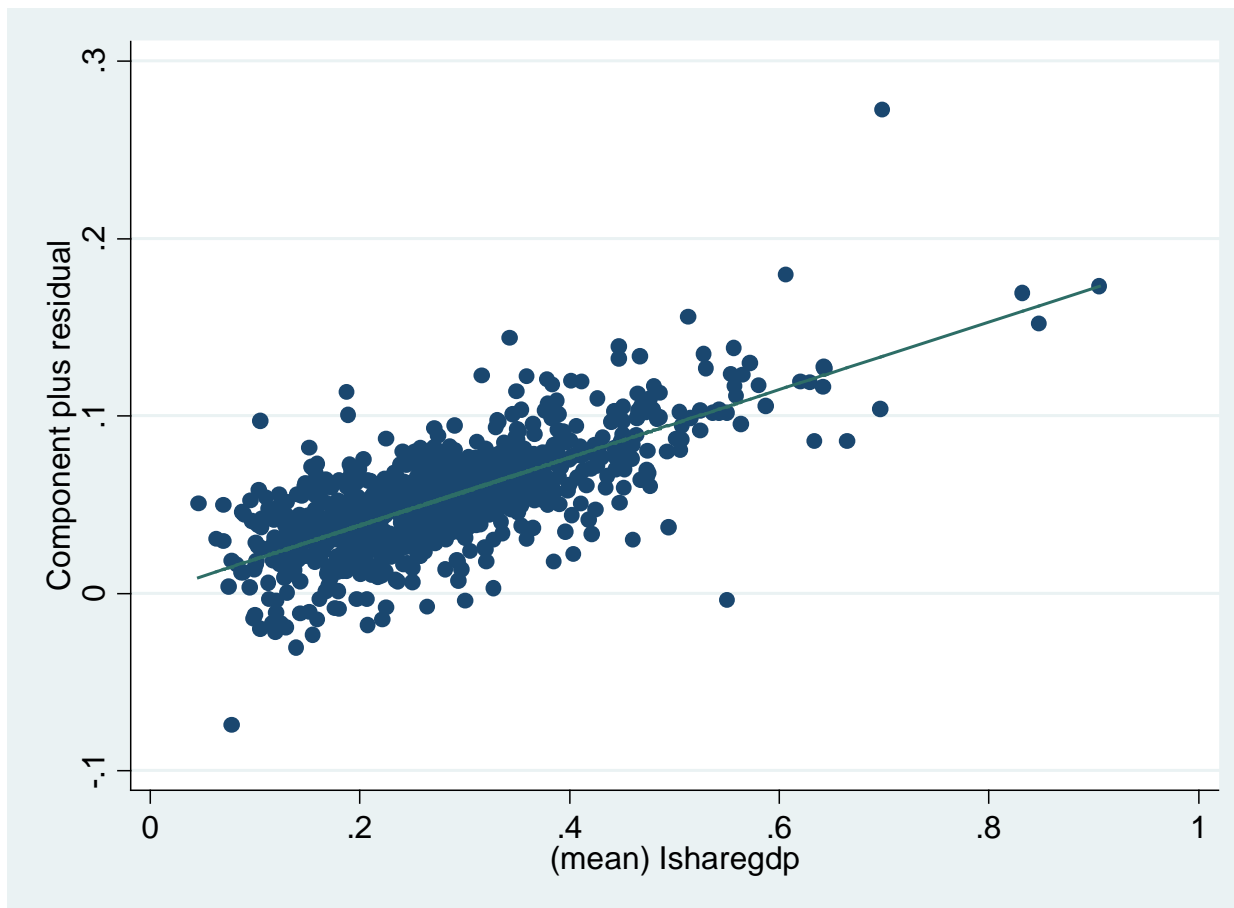


Where did growth come from?

- High-growth countries are those that are able to undertake rapid structural transformation
 - from low-productivity (“traditional”) to high-productivity (“modern”) activities
 - to tradables in particular
 - and to industrial activities within tradables
- “You become rich by producing what rich countries produce”*
 - cf. 19th century pattern of global commerce

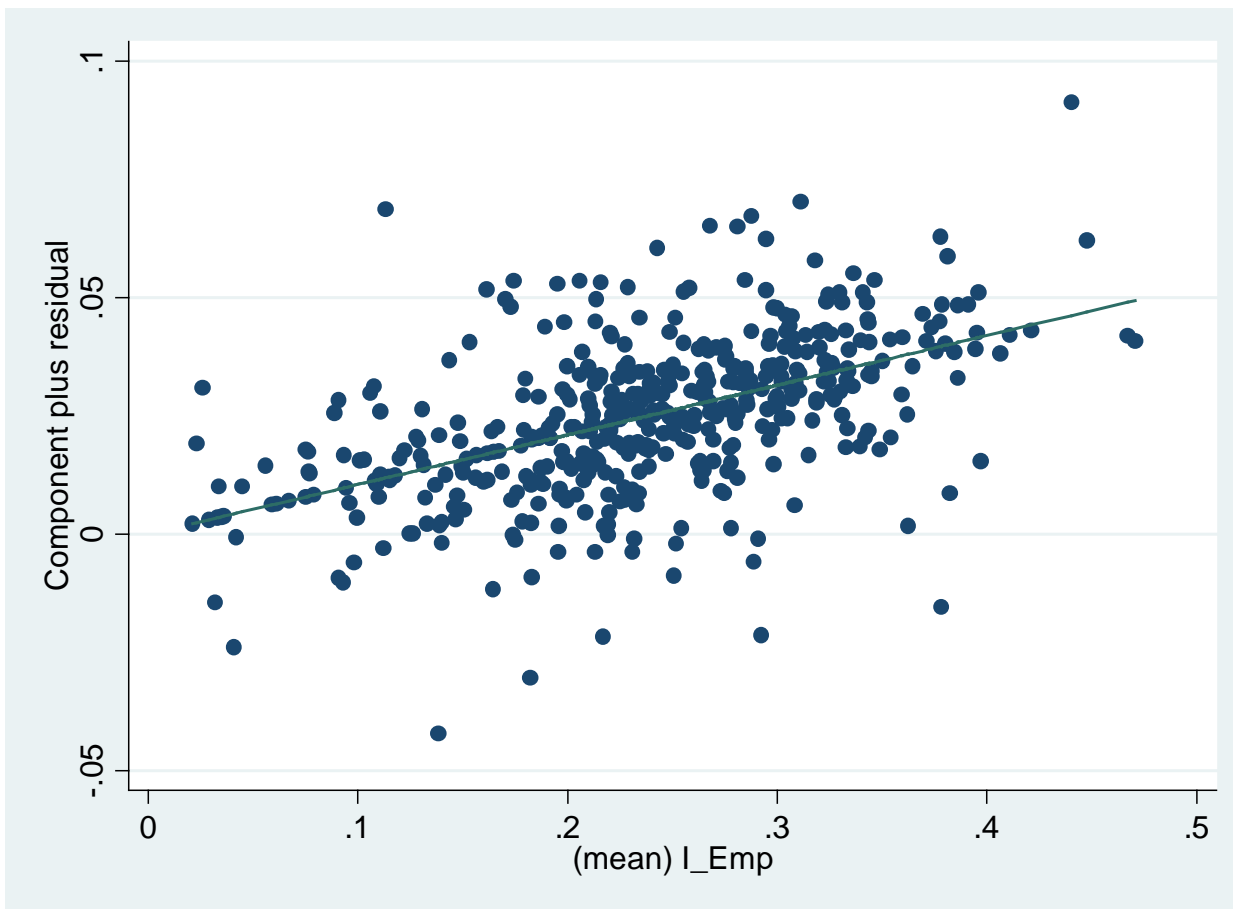
* See Hausmann and Rodrik (2003), Hausmann, Hwang, and Rodrik (2007), Rodrik (2009).

(Partial) correlation between growth and relative size of industry: industrial value added shares in GDP



Five-year panels, controlling for initial income

(Partial) correlation between growth and relative size of industry: industrial employment shares



Five-year panels, controlling for initial income

What has worked: “productivist” policies

- Sound “fundamentals”
 - Growth-oriented governments, following
 - Market-friendly policies
 - Macro stability
- But also:
 - Industrial policies in support of new economic activities
 - Undervalued currencies to promote tradables
 - A certain degree of repression of finance, to enable:
 - Development banking
 - Subsidized credit
 - Undervaluation

How undervaluation drives growth through its effect on industry:


	Dependent Variable			
	(1) Industry share in GDP	(2) Industry share in employment	(5) Growth - TSLS	(6) Growth - TSLS
<i>In current income</i>	0.079** (9.99)	0.025 (1.51)		
<i>In initial income</i>			-0.134** (-8.33)	-0.071** (-4.39)
<i>In UNDERVAL</i>	0.024** (3.62)	0.042** (4.87)		
<i>Share of Industry in GDP</i>			1.716** (7.59)	
<i>Share of Industry in employment</i>				1.076** (6.15)
Time dummies	yes	yes	yes	yes
Country dummies	yes	yes	yes	yes
Observations	985	469	938	459

In columns (5) and (6), industry shares are regressed on *In UNDERVAL*, *In income*, and lagged *In income* in the first stage. Source: Rodrik (2009)

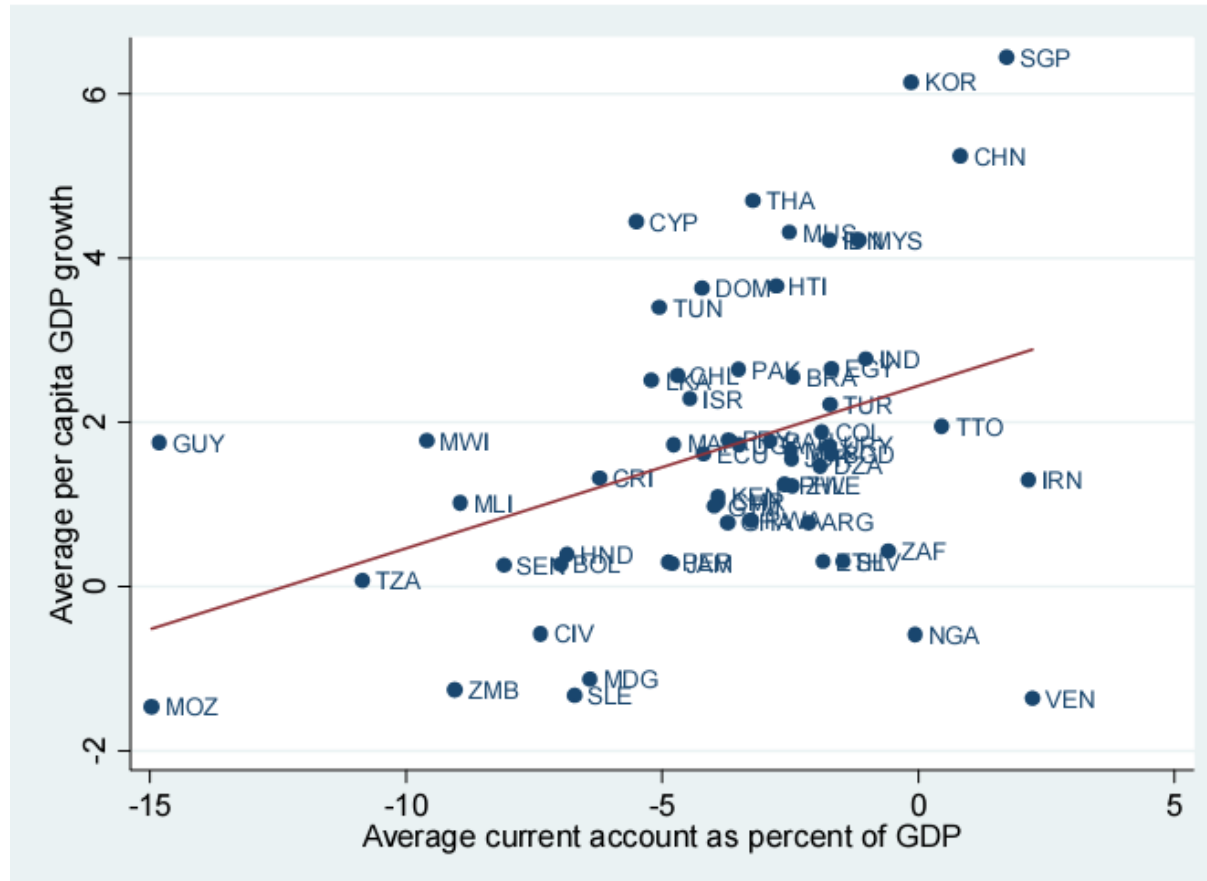
... combined with an enabling external environment

- Permissive of industrial policies
 - At least until GATT and
 - Until recently
- Willing to absorb excess supply of tradables
 - U.S. attitude of benign neglect towards current account deficits
 - BW I and II
 - Unconcerned with undervaluation in developing countries
 - Again, until recently

How does the new global environment change all this? (I)

- Less external finance
 - No big deal if countries are not saving-constrained
 - And most are not 
 - Good news to the extent that it reduces pressures for currency overvaluation

Countries that rely less on net external resources grow faster



How does the new global environment change all this? (2)

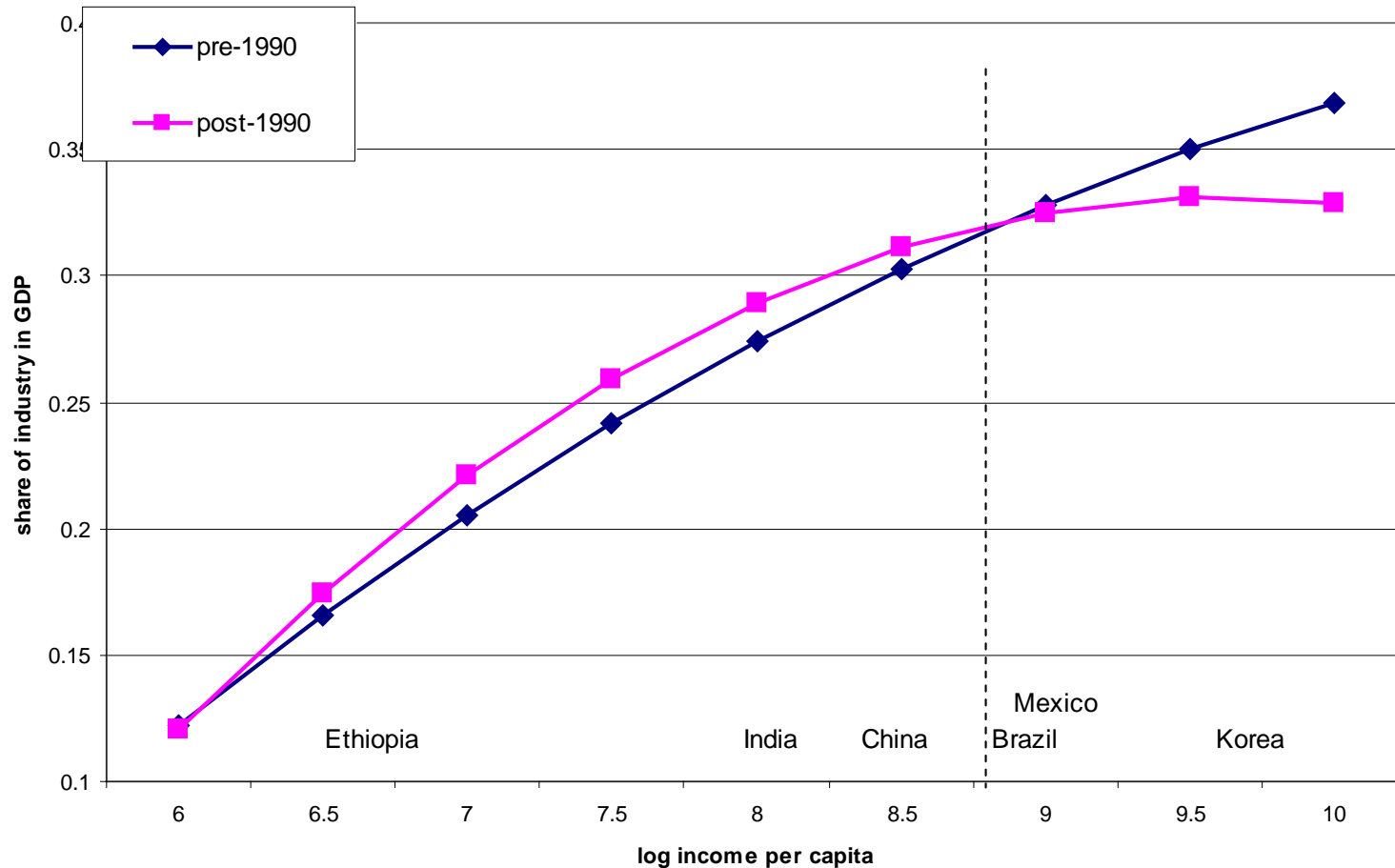
- Lower growth in industrial countries
 - Convergence gap depends on differences in income *levels* with advanced nations, not on how rapidly the latter are growing
 - Slower growth in demand for developing nations' exports
 - Terms-of-trade effect
 - Unambiguously negative if manufactures prices decline more than primary products, but hard to believe it will have major impact on underlying growth rates
 - Possibly positive otherwise
 - Volume-of-trade effect
 - Reduction in export growth of no consequence in itself, unless we assume Keynesian under-employment of resources
 - **But can be serious obstacle if it slows down the rate at which modern tradables can expand in developing nations'**
 - » What matters is not export/GDP but "modern" tradables/GDP
 - » (There is very little association between X/GDP and growth in post-1990 data (5-year panels) once industry shares are controlled)

How does growth in world trade affect possibilities of structural change?

- Positive effect on demand side
 - Can sell more abroad, without experiencing declining terms of trade
 - High returns to “cost discovery”
- Negative effect on supply side
 - Compete with China and other low-cost exporters in home markets
 - Lower returns to import substitution
- Post-1990, the positive effect has dominated in low-income countries, while negative effect has dominated in middle-income countries

The changing income gradient of industrial activity

Relationship between income per capita and industry share in GDP



Based on a quadratic regression of industry share on per-capita GDP.

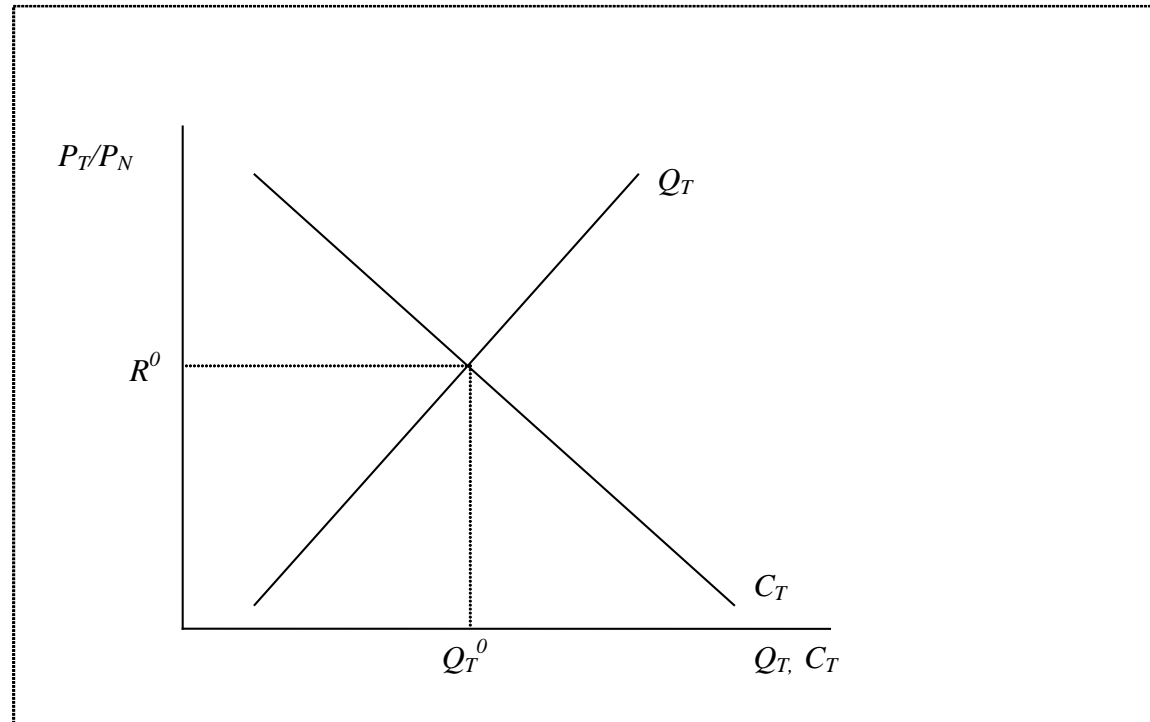
Likely effects of slowdown on world trade (1)

- Largest adverse effect on low-cost exporters of manufactures
 - Those with large trade surpluses (e.g. China) have room to substitute domestic demand (for tradables) for foreign demand
 - Real exchange rate appreciation is the least bad of the alternatives
 - At least has the virtue that it increases home demand for tradables
 - Those with deficits (e.g. Vietnam) have far fewer options
 - Cannot increase domestic demand for tradables without worsening the external balance
 - Will have to contend with sharply diminishing returns on the export margin (through protectionism or adverse terms-of-trade movements)
 - Will have to suffer larger growth collapses
 - Moderately offset by beneficial effects of real depreciation

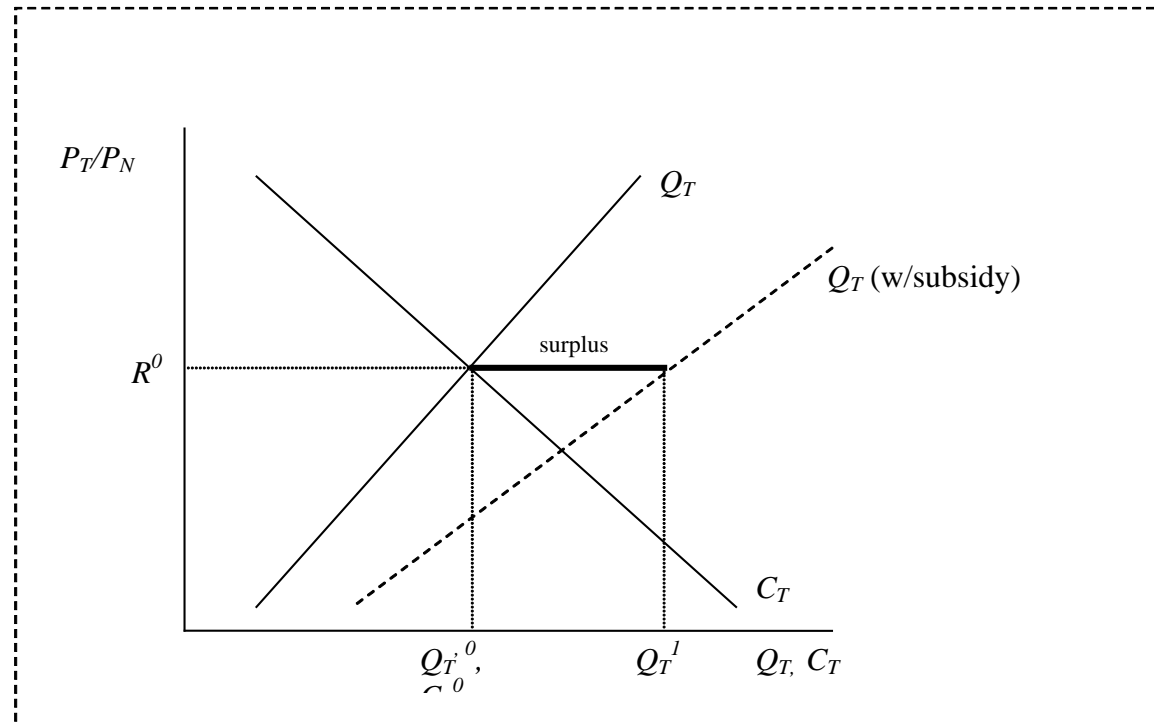
Likely effects of slowdown on world trade (2)

- Middle-income countries, however, will not get much breathing room for import-substitution
 - Since excess supply of exports from low-income countries will spill over into their markets
 - Unlike the standard gains-from-trade story, this is one where countries' growth prospects depend on their producing goods similar to those in the richer countries
 - Better to allow them to subsidize their tradables than to force them into overt protectionism
 - Subsidies are first-best in any case in the growth model posited here
 - Subsidies are neutral with respect to trade balance and target source of the problem more directly 
 - Industrial policies (of the “modern” type) more crucial than ever
 - WTO rules on subsidies even less appropriate going forward
- The slower the recovery in advanced countries, the steeper the trade-off between growth in low-income countries and growth in middle-income countries 

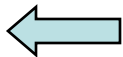
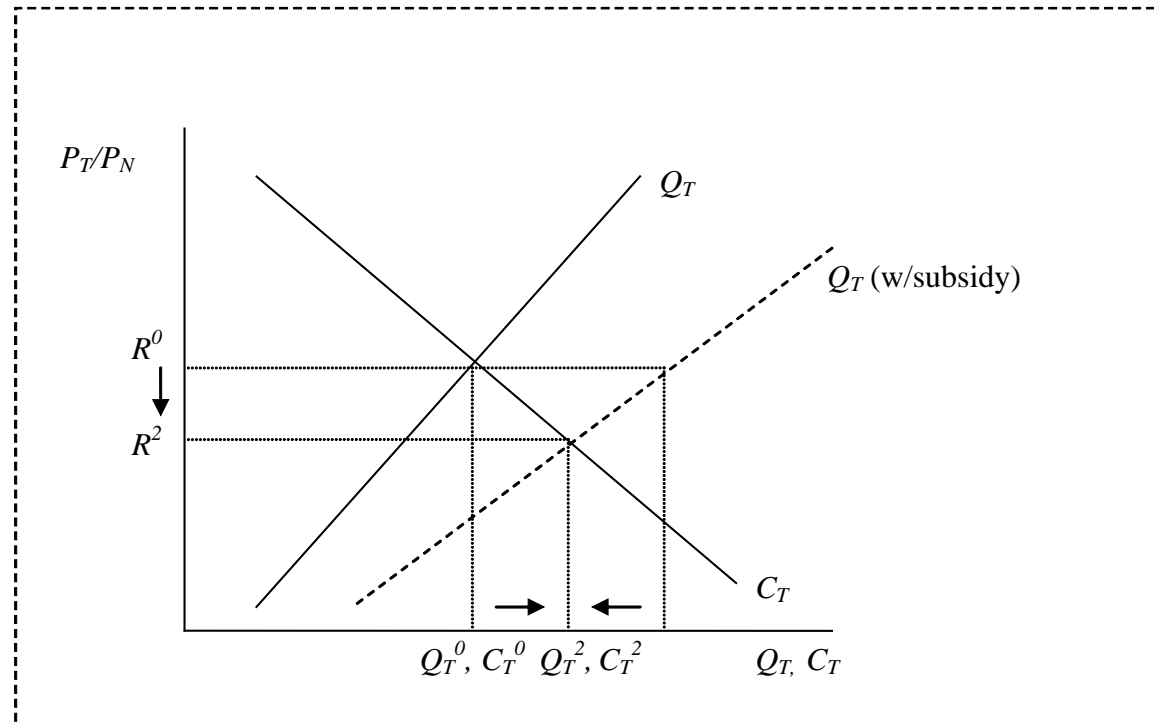
Subsidies, the real exchange rate, and the supply of tradables (1)



Subsidies, the real exchange rate, and the supply of tradables (2)



Subsidies, the real exchange rate, and the supply of tradables (3)



How it all adds up

1. Global macro stability requires small external imbalances
 - Can no longer have imbalances of the order experienced by China and the U.S. recently
2. Growth in developing world requires increase in supply of tradables produced there
 - But achieving this via currency undervaluation in the larger developing countries violates requirement 1
- Only way to square the circle:
 - Allow subsidies on non-traditional tradables in large or middle-income developing countries
 - Which, combined with real exchange rate appreciation, would be neutral with respect to the trade balance
 - Allow undervaluation of currencies in low-income or small developing nations
 - Where subsidization policies are impractical for fiscal and institutional reasons
 - Aggregate effect on global external imbalances should be small

Governance challenges

- Managing economic conflict between low- and middle-income countries could be key challenge in the future
- Getting the balance in global governance right
 - Neither so little of it that countries feel free to embark on beggar-thy-neighbor policies
 - E.g., large current account surpluses
 - Nor so ambitious that it constrains development-friendly policies tailored to domestic circumstances
 - E.g., subsidies
- Right model is GATT rather than WTO