General Discussion: The Future of Economic Convergence

Chair: Marek Belka

**Mr. Silvia:** A couple of themes seemed to be interesting to me. First, you talked about countries being successful by having import substitution and focusing mostly on domestic manufacturing. That was the Asian model versus the other open market model. It seemed almost like a case could be made, if I were a policymaker in an emerging market country, I would want to close my borders and do the import substitution.

Second, as I was going through the comments and reading the text, I got the impression that sometimes there were leaders—for example, there was a discussion about Mongolia. I was thinking, “OK, is that just a function of China? Is Bangladesh a function of India?” And then this table you have of countries that have grown at 4½ percent per annum, I had the impression, “If I look at the Asian list, is that Japan and China driving the whole process and everybody else is coming along for the ride?”

**Mr. Sinai:** This is a general question for Dani. What is the role of finance in convergence—that is, the relationship between the unsustainability of a robust financial system broadly defined and sustainability of growth differentials?
There isn’t much attention to this dimension in your paper—that is, the role of a central bank, financial intermediation and intermediaries, the finance of financing these days across the globe, the state of the banking system, and open financial markets.

With so many financial crises over the last 20 to 25 years, I am curious about the lack of discussion of that in terms of convergence. Is this a broad category or factor not important in your view or was it just not covered in your paper?

Mr. Bergsten: I want to challenge, Dani, your convergence pessimism on a couple of major supply-side factors you did not mention. First, China alone: China is so important it has to be singled out. You acknowledge that. China is 10 percent of the world economy. It is growing at 10 percent, so it is 1 percent of world growth or a quarter or maybe even more of total global growth.

China, on most estimates, is only halfway through the transition from the rural agricultural sector to the modern urbanized sector. Every time a Chinese worker moves from former to latter, her or his productivity rises by a factor of 15. Likewise, China is only halfway through the transition from state-owned enterprises to marketized enterprises. Every shift from that sector to the other doubles the productivity of the worker. The point being there is still huge unrealized productivity expansion from the supply side in China, which explains much of their growth over the last three decades since they moved half already from rural to urban, but gives enormous scope for more. Doesn’t that swamp the factors you are mentioning and shouldn’t it make us quite bullish about China? And, to some extent, the same phenomenon applies in other countries, but for time reasons limit it to China since it is so important.

The second factor is fiscal policy. We have, in a recent study by Joseph Gagnon at the Institute, projected the fiscal positions of the major groups of countries over the next 25 years. We all know for the advanced industrial countries it is terrifying. On current trajectories, which never can be realized, the advanced countries, on average, would have debt-to-GDP ratios of 200 percent 25 years out. The United States would be 240 percent, Europe would be
170 percent, and Japan would be 300 percent. It won’t happen, but those are the trajectories.

For the emerging markets, the comparable number is 50 percent. In short, they are in much stronger position in terms of fiscal policy—much less crowding out of private investment, much less opportunity to do innovative investments, and much greater opportunities to fight whatever downturns and difficulties they may face. They are in a much stronger fiscal position.

Those are just two factors, it seems to me, that suggest your earlier chart with lots of scope to go for convergence to occur really ought to be the main takeaway from your paper.

**Mr. Lin:** I would like to thank you for a very stimulating paper with a lot of thought. I agree with you that the dynamic economic growth in a convergency may not be spontaneous in a developing country, and government facilitation is important.

But I do have a question on your last chart about using undervaluation as a policy instrument to support economic growth, for two reasons. In your paper—but not in your presentation—you mention that imports are more important than exports to stimulate economic growth in a developing country. An undervaluation would be favorable to support exports but it is not favorable for imports. So, in that regard, the effect is doubtful.

Secondly, maybe there is some causality issue. You observed some correlation between undervaluation and economic growth. But the issue is, is that a consequence of rapid economic growth or is it a cause of rapid economic growth? Your calculation of undervaluation is based on Balassa-Samuelson theory. The mechanism is that if the tradable sectors grow rapidly, productivity increases and the wage rate gets pushed up. Then you are going to have a revaluation and an appreciation.

But the mechanism may not exist in a developing country during the rapid economic growth phase, because we know that in a developing country they have a dual economy. They have surplus labor in the traditional, agricultural sectors. In this process, even the tradable sectors expand very rapidly and absorb a lot of labor force.
But the wage rate may not increase that much. If you use the Balassa-
Samuelson theory as a reference they seem to have real undervaluation.
But, if you take the dual economy into consideration, that exchange
rate may be the equilibrium exchange rate. So, if my conjecture is
right, I would say what we observe as undervaluation actually is the
equilibrium exchange rate.

Secondly, you cannot use undervaluation as a way to stimulate
growth. This seems to be consistent with your observation that for
a certain income level, the correlation between undervaluation and
growth tends to disappear.

Mr. Eichengreen: I am sympathetic to the story, Dani, more sym-
pathetic I conjecture than most. I agree convergence is conditional,
that economic structure matters, that policy can in principle influ-
ence structure for the better. Unlike Fred, I am also convinced many
of the high-growth economies are poised to slow down, but partly for
one big reason you didn’t mention—demographics. Half of the East
Asian miracle, a lot of scholarship suggests, was due to a compressed
demographic transition, that Asian countries enjoyed dramatically
increased rates of labor force participation and youth dependency
ratios. That’s a big contrast between East Asia and Brazil, or between
East Asia and Latin America more broadly, in terms of their demo-
graphic prospects for the last quarter century.

Mr. Kim: I don’t have any difficulties following the arguments of
the paper, and the comment made by Pier Carlo that represents the
views of the OECD, which is a club of rich nations. I think the audi-
ence may be interested in hearing the views of an economist from an
emerging economy.

I basically think you try to compare the development experiences of
advanced countries and developing economies, based on the frame-
work of the development experience of the current Western World.
You cited a few works by Angus Maddison, and Angus Maddison
studied China’s economic development and others over a period of
2,000 years. He showed that for 1,800 out of 2,000 years, the East
outproduced the West. But only for the past 200 years has the West
outproduced the East. There he showed how one region can surpass the other. What his study shows is that one region doesn’t surpass the other by following the so-called catch-up theory model. You based it upon the catch-up theory model and then tried to compare the income gaps between advanced countries and developing countries and concluded the income gaps have not narrowed.

And my question is, How can you categorize those advanced countries in one group—United States, European countries, New Zealand, Australia, and Japan in one category—and the rest of the world in another category? The countries in the rest of the world are not homogenous at all. I am wondering whether you view that those rich countries—according to your category—have followed the same development path as in the past? The Japanese development experience and the German development experience are as distinct between them and are much different from those of the United States and others. They may also be as distinct from the experience of development of Asian countries and others. That is my first comment.

My second one is, it seems to me that you emphasize too much the importance of macroeconomic policies. You showed that some countries, including Asian Tigers and others have grown by using—the so-called unconventional methods. Just a few minutes earlier, Justin Lin talked about the effects of undervaluation of currencies. Of course, there are some positive effects of such policies on economic growth in the short term, but many emerging economies are now fully aware there also are some side effects of such policies. No country can ever maintain sustainable development by primarily basing it upon the so-called unconventional policies.

For the case of undervaluation of its currency, how is such a country able to incorporate the inflationary pressures that emanate from undervalued currencies, if such a policy is maintained for long? How is such a country able to maintain a balance between export and domestic demand sectors if such undeveloped currencies are maintained for long? We all know that, without correcting for such imbalances, a country is not able to maintain long-term growth. I am wondering how you view the so-called side effects of relative price distortions.
Mr. Ortiz: I really liked the paper, Dani. I think ultimately it is obviously productivity across sectors and nations that do explain convergency. I have one very specific point—that is, divergence between Latin American nations’ growth. One factor that explains importantly the difference in convergence and that you do not really treat in your paper is the whole question of the management of macroeconomic policy. Latin America, as you know, suffered a series of financial crises. There was a lost decade in the 1980s and there were further financial crises in the 1990s. It seems that since the financial crisis of the 1990s, a relatively recent time, Latin America has put in place sensible macro policies, both on the fiscal and monetary side. It is a recent experiment. Good performance in Latin America in the last decade before the crisis is explained to a good degree by the achievements of a macroeconomic environment that has allowed for productivity gains in relevant sectors of the economy. This also has a lot to do with explaining the differences between savings and investment in Latin American nations. The growth in savings and investment in Asia was very, very fast and was facilitated largely by the absence of bad macro policies and economic crises. The question is whether Dani agrees with this or not.

Mr. Fischer: Dani, I am trying to understand what “growth is determined on the supply side” means. Your theory seems to be that countries can produce a lot of manufactures and then if they subsidize by undervaluing, they can sell them and grow rapidly. So what is the meaning of “it’s determined on the supply side?” They need the exchange rate to get the incentives to be able to sell their goods.

Mr. Rodrik: Terrific comments and questions. I’ll have to go through them very quickly, obviously. Let me pick up from the very last question that Stan Fischer asked, while the question is fresh. Then I’ll try to go through the rest in order.

If you think what successful countries are doing is to compensate for various market or government failures that keep their modern tradable sectors too small from the standpoint of growth, then what economic theory says is you ideally ought to be either removing the constraints that prevent those modern tradable sectors from expanding or, if for whatever political reason or other deep-seated economic
reason that is difficult, you should be compensating for those short-comings by subsidizing these sectors directly.

You can view the traditional industrial policy approach, which is to subsidize them, as essentially a response of that kind. And some countries have been more successful at doing this than others. Now, with industrial policy, you don’t get the kind of imbalance that you are talking about: you can imagine a policy of subsidizing your modern tradables and letting the real exchange rate adjust to take care of the external balance. So you have more rapid structural change in the direction of your modern tradables, but any increase in the supply of domestic tradables is matched by increasing domestic demand. The real exchange rate appreciates as a result of your subsidization of tradables, but not enough to completely offset the effect of the subsidy.

Now, both because these kinds of direct industrial policies, for reasons discussed in my paper, are very difficult and messy to practice and also because increasingly World Trade Organization rules have come down hard on these kinds of policies, a policy of undervaluation has been a mechanism that countries—most critically, of course, China—have used as a way of essentially doing the same thing. But as you point out, undervaluation has the effect of not only subsidizing your tradables, but taxing consumption. Therefore, you are going to get current account surpluses, which are a byproduct of this. This is obviously something that systemically large countries cannot keep on doing. Small countries might be able to. It is something I would recommend a lot of small African countries to try to do, if they can get over the Dutch disease and the aid and remittance-induced currency overvaluation kinds of problems. It is clear that it has worked in the past. Now it is running to its limits, because systemically large countries are not going to be allowed to keep on doing that. The basic idea is that the general strategy of countries that have been very successful has been to use these kinds of shortcuts of compensating through various policies, whether it is industrial policies or currency undervaluation, to compensate for market or government failures that prevent structural change in the requisite direction. It is a way of stimulating supply-side growth, with the external imbalance an occasional side effect.
Let me go back to some of the questions and key points that were made. John Silvia mentioned the potential role of import substitution in closing off the borders. I would put it slightly differently. I would say a lot of countries—especially low- and middle-income countries—have a tremendous amount of potential to do import substitution. But this doesn’t mean you need to close off your borders. It just means finding ways of unlocking energies of your domestic entrepreneurs and investors to invest not just in the frontier kinds of industries that will be highly competitive in world markets, but can simply compete against Chinese imports in your domestic markets.

Many African countries are importing stuff they ought to be producing. In Ethiopia, you don’t produce cardboard boxes or chairs or tables. These are things they ought to be producing. If you produce these items, it doesn’t mean you are going to be exporting them—you are going to be replacing imports. Still, these industries aren’t taking off. So there is tremendous room for import substitution in that sense, not necessarily, however, through high-trade barriers.

Allen Sinai mentioned the role of finance in growth. You are quite right. As you mentioned it, I noticed I didn’t talk about that. It is a very long discussion, but I will put my short take on it. The role of finance depends very much on whether you view these countries’ growth prospects constrained mostly on the saving side. You don’t get high investment and structural change, because there isn’t enough access to finance, access to saving, or savings isn’t being intermediated correctly. So that gives you one angle on what constrains growth.

Another perspective on what constrains growth is the absence of perception of high profits in these modern tradable activities. That is a very different model, because it suggests if you change entrepreneurs’ perceptions about the presence of profits in these new industries that finance wouldn’t necessarily constrain them. So we ask many entrepreneurs in developing countries, “If I give you $25 million where would you invest it?” There are many countries, I can assure you, where they would look at you and in some cases they will say, “Can I put the money in Geneva?”
There is this absence of perception of profitable opportunities. Now not all countries are like that. Two big countries that presumably are finance- or saving-constrained would be Brazil and Turkey, two key examples where there is a big role to be played on improving access to finance and intermediation. Their domestic savings are so low relative to profitable investment opportunities. In many other countries, it is not finance that binds or constrains, it is perception of profitability. If you are in an economy like that, financial liberalization—opening up to external finance—can have very adverse effects. Precisely, more finance coming in overvalues your exchange rates and further undercuts the profitability and high expectations in tradables. That is the kind of context where putting the emphasis on finance can backfire.

I don’t disagree with Fred Bergsten in terms of the huge potential—and he put it very well—especially in China. China is very much halfway in the process. The potential is huge. The question is, What are the mechanisms through which that potential is realized? China’s model of growth in the last 20 to 30 years has been to take those very-low-productivity peasants and put them into manufacturing for producing on world markets, where, as you say, the productivity gains have been very high.

Now the question is, If those options of putting them into manufacturing are drying off because the rest of the world will not allow external imbalances of this magnitude, can you get the same kind of growth if you are putting these farmers into construction instead or into other kinds of services? And where is the demand going to come from to generate those jobs in construction and other services in the first place? What is there to guarantee those services will have a high enough productivity that export or export-oriented manufacturing had? And what is going to happen to the workers in the manufacturing sector, which will have to shrink somewhat and therefore displace workers? These are the questions. It is not a question about the potential; the potential, as I emphasize, is huge. The issue is whether these structural challenges easily can be managed or not. I view them somewhat more pessimistically than perhaps many others do.
Fred also mentioned there is much more room for fiscal policy. And Guillermo Ortiz also mentioned that macroeconomic policy—including fiscal policy—is much better managed now in developing countries in Latin America. That is absolutely right! I view this as an enabler. These are the background conditions, which allow productive structural change to take place. I view these as a reason why average growth in the developing world will be higher in the future. That’s because we are going to be cutting off the lower tail of the bad collapses into crises, our inability to respond to external shocks. So we are cutting off the lower tail of growth outcomes.

But whether you use this macro and fiscal room to generate productive growth is a very big and different question. It is a big puzzle why Mexican productivity growth is so much lower economy-wide in the last few decades, compared with those decades of stabilizing development in Mexico (1950-1980), where inflation was much higher, where fiscal policy was much worse, and where trade policy was much worse. This is a real puzzle in terms of why, when the background conditions seem to be so appropriate, we are not getting the overall economic growth that we were getting before.

Mr. Padoan: Two short points on pessimism versus optimism in emerging economies. Our analysis shows this often is conditional upon the right mix of structural policies you implement. These are not the same for all countries. This, of course, sounds obvious. It doesn’t come naturally that, once you open up your economy, you have structural changes. Dani was showing it in the right direction. There is a lot of policy discussion that needs to be made in these emerging economies to actually exploit and become optimistic in terms of exploiting the productivity gap.

The other point is about the exchange rate. Justin made the point that undervaluation is actually an equilibrium outcome of fundamentals. This is the chicken-and-egg story. Of course, fundamentals drive the real exchange rate. But, then, you have to take the appropriate policy actions to make that reflect in the currency markets, so you do not get stuck into what was an equilibrium exchange rate and doesn’t happen to be anymore. This can be controlled up to a point.
One of the results we get is, for instance, as structural change goes on. What happens to an emerging economy is that the structure, dimension, and nature of the capital account changes. For instance, you may have more foreign direct investments (FDIs) other than bank lending according to the kind of structural reforms you are carrying out in a number of sectors. So, you may want to have some sequencing there to avoid being stuck in an equilibrium exchange rate, which was the equilibrium exchange rate a long time ago. And it is not there anymore.