Rethinking the Growth Diagnostic approach

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- Evolution of development policy thinking
- Growth diagnostic approach
- Critical assessment
- Concluding remarks

Evolution of development policy thinking

Phase 1: From 1950s until about the late 1970s: the era of import substitution in industrialization (ISI)

Phase 2: From about the late 1970s: Convergence of policy debate towards outward-oriented development strategy (‘Washington Consensus’)

Phase 3: From about the mid 1990s: Reconsideration of Washington Consensus

* Augmenting Washington Consensus reforms
* Emphasis on well-focused reforms as an alternative to Washington Consensus

Phase 1: From 1950s until about the late 1970s: the era of import substitution in industrialization (ISI)

- ‘Export pessimism’ - developing countries have little room for diversifying their primary-commodity dependent economies by diversifying into export-oriented manufacturing.

- Import-substitution industrialization (ISI) as the regnant policy regime

- Emphasis on state-led growth, with emphasis on development planning

  The state was considered as the ‘omniscient’ leader of the development process

Phase2: From about the late 1970s to Early 1990s: resurgence of neo-classical policy advocacy (outward-oriented growth), culminating in ‘ Washington Consensus’

A notable shift in development thinking in favor of market-oriented, private-sector led development with greater outward orientation

Outward oriented growth is expected to alleviate poverty through <u>both</u>:

faster growth

and

greater employment intensity of growth

(labour is the only resource owned by most poor people)

- Three reform imperatives came out of the analyses of growth/development experiences in the 1950s and 1960s:

  liberalisation,

  stabilization, and

  privatisation

- A powerful and well-organized epistemic community developed around these ideas, gaining key positions in the US government, World Bank and IMF, and also in finance ministries and central banks of many countries.

- Williamson (1989) labelled the new policy advocacy ‘Washington Consensus’

Phase 3: Reconsideration of ‘Washington Consensus’

Propelled by,

- Mixed results of Washington Consensus reforms in many countries

- Political economy constrains in the implementation of Washington Consensus reforms: reforms (in particular trade liberalisation) helped some poor but hurt others, making reforms politically unpalatable

(also, the attack was partly ideologically driven)

Augmenting the Washington Consensus

The year 1990 marked a tipping point in the evolution of ideas about economic development (Williamson 2000).

The World Bank's *Word Development Report 1990*:

An attempt to incorporate new evidence of significant externalities for growth from expenditure on publicly provided services (education and healthcare) in the mainstream policy advocacy

Presented the first ‘dollar-a-day’ headcount measure of global poverty (Estimated 1.1 billion people lived in extreme poverty at the time)

Proposed a three-pronged strategy for poverty alleviation

- Promote market-oriented growth (Washington Consensus)
- Direct basic health and education services to poor
- Develop social safety net to assist individuals unable to take advantage of market opportunities (conditional income transfer and providing social safety net)

Subsequently, enforcement of the rule of law (in particular property rights) and creation of sound business environment were added to the reform package (based on the ‘new growth’ literature)

Emphasis on ‘focused’ reforms as an alternative to Washington Consensus

- Randomized evaluation
- Growth diagnostic

Growth diagnostic approach (GDA)

‘The question now is not whether Washington Consensus is dead or alive; it is what will replace it’, Rodrik (2007).

The key proposition

By figuring out the one or two binding constraints on their economies and then focussing on lifting those, countries will be more likely to achieve success from their reform effort.

‘Go for the reforms that alleviate the most binding constraint(s), and, hence, produce the biggest bang for the reform buck, rather than use a spray-gun approach in the hope that we will somehow hit the target, focus on the bottlenecks directly’

‘ Presented with a laundry list of reforms, policymakers have either tried to fix all of the problems at once or started with reform that were not crucial to their country’s growth potential. A more often than not , reforms have gotten in each other’s way with reforms in one area creating unanticipated distortions in another area’.

(Hausmann, Rodrik, and Velasco (2006), p. 12.

Proposes a ‘tree methodology’ for finding out the binding constraint(s)

Focusses exclusively on economic growth

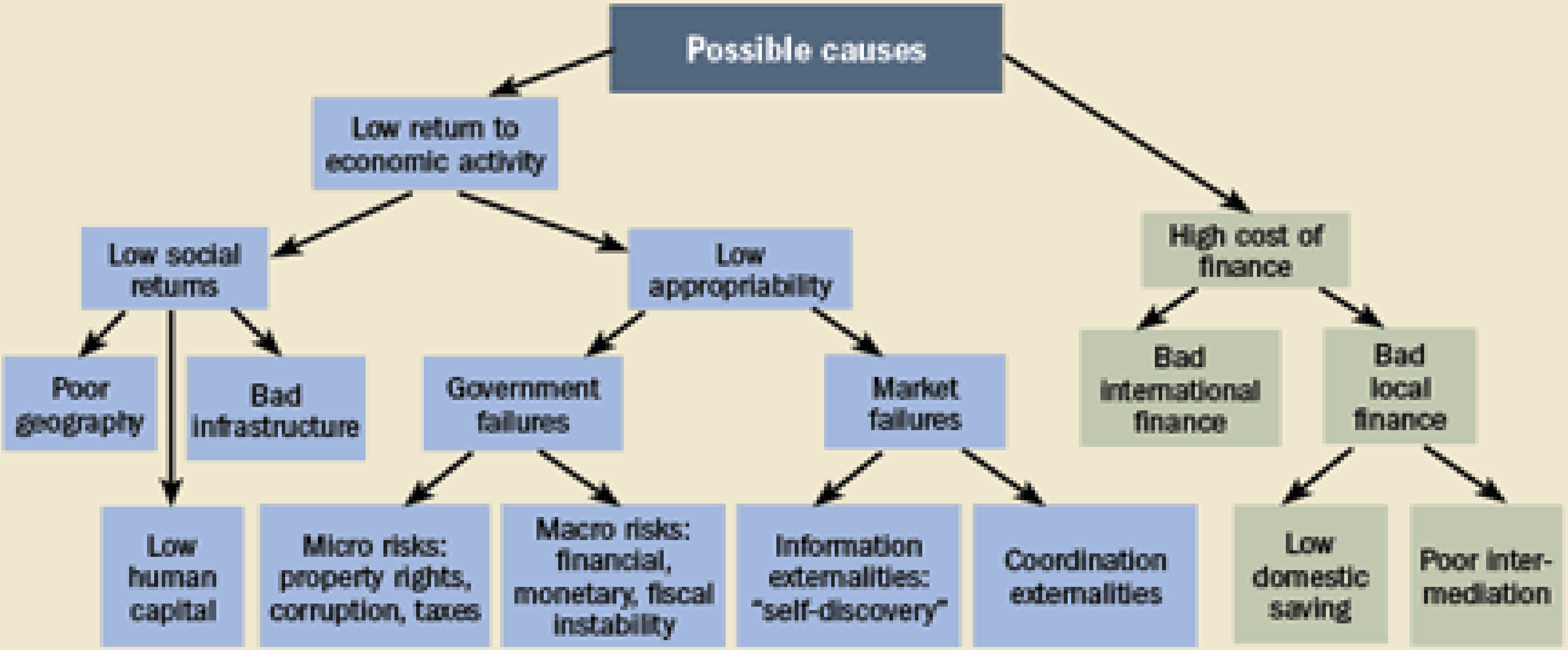
‘While development is a broad concept entailing the raising of human capabilities in general, we believe increasing economic growth is the rate central challenge that developing countries face’

(Hausmann, Rodrik, and Velasco (2006), p. 12.

Time for a checkup

A decision tree, such as the one below, can help identify the biggest obstacles to growth.

Problem: Low levels of private investment and entrepreneurship



Source: Hausmann, Rodrik, and Velasco (2005).

Examples (from Hausmann et al 2006)

Economic stagnation in Brazil in the 1990s

Binding constraints

inadequate domestic saving and too little emphasis on education. ‘Too may ideas, not enough money’

Prognosis:

- High domestic interest rate (the highest interest rate in Latin America)
- Excessive use of foreign saving (foreign capital inflow)
- High salaries of educated personnel (the highest in Latin America)

Economic stagnation in El Salvador in the 1990

The binding constraint

The lack of self discovery: ‘lack of ability to develop higher-productive activities and non-traditional products that can be produced at local level’

Prognosis

The lowest lending rate (the lowest in Latin America)

Massive remittance inflows

The lowest return to education in Latin America

International development agencies have ‘bought’ the new approach and undertaken growth diagnostic in a number of countries.

CID team

Brazil, El Salvador, Brazil, Albenia

World Bank

Armenia, Bangladesh, a number of Baltic countries, Brazil, Cambodia, Egypt, India, Madagascar, Morocco Pakistan, Tanzania, Thailand

Asian Development Bank

Philippines, Nepal, Indonesia

Has policy advocacy based on these studies yielded a better growth outcome?

Assessment

(1) Justification/rationale of GDA is based on a misleading interpretation of Washington Consensus

Washington Conesus is simply a <u>policy blueprint</u>

It advocate a ‘policy rules’ approach to decision making’, not a spray-gun approach

‘Washington Consensus aims to remove all distortions at the same time’ is simply an attempt to setting up a ‘straw man’.

Sequencing of reforms is central to the Washington Consensus policy advocacy

(2) Private investment/capital accumulation many not necessarily be the key to economic growth

There are many countries that have achieved high growth without a high investment rate to begin with: domestic saving/investment is partly endogenous to growth process

Ignores possible complementarity between public investment and private investment

(3) Implementation of the methodology is not straightforward.

The identification of the binding constraint/s are to be based on both price- and non-price signals.

- In the presence of various market distortions, it is important to use shadow prices, which are hard to come by
- The use of non-price signals requires an in-depth knowledge of the country

Given these problems, it is possible for researchers applying GDA to a given country to come up with different binding constraint(s) or, worse still, come up with a diagnosis based on their own ideological predilections in the guise of identifying ‘binding constraints’

(4) Overlapping nature of the cause of poor growth indicated by the branches of the decision tree.

A critical assumption of GDA is the independence of the branches in the decision tree. But this assumption may not necessarily hold

Eg: Consider the two upper branches of the decision tree: high cost of finance and low private economic returns.

Lack of investment opportunities under a deregister policy regime can explain both

(5) **Specifically designed to detect binding constraint to 'igniting growth' in stagnant economies**

Growing economies are outside the scope of GDA

Focuses on constraints that are biding today, but not necessarily in the future (static nature of the approach)

For many economies, the problem is not how to start growth but how to sustain and/or accelerating growth

This requires different policies

(6) Pays little attention to international dimensions of growth

GDA is based on the assumption that the constraints on growth are on the supply side.

Ignores opportunities for ‘demand responsive’ growth in an open economy context

Ignores the role of foreign trade as a disciplinary force and a source of marketing and technological knowhow

Feenstra and Hamilton 2006

Concluding remarks

GDA has made an important contribution to the debate on policy reforms by drawing attention to the need for paying attention to country-specific factor in policy advice

But

Its application is not straight forward

and

The claim that Rodrik and others make that GDA is the ‘only thing that should be on the menu’ is not ‘rigorous’ or ‘credible’.

There are no reasons why the two approaches can be combined to ensure sensible policy advice.

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