

# OECD DEVELOPMENT CENTRE

## POLICY BRIEF No. 12

### Policies for Economic Take-off

*by*

**Jean-Claude Berthélemy and Aristomène Varoudakis**

- Political commitment is the key ingredient needed for economic take-off and long-term growth. Poor countries will be unable to escape the vicious circle of poverty unless they and the international community join forces.
- Inappropriate financial policies can lead to a decline in and poor allocation of savings, subsequently holding back growth.
- Trade liberalisation not only strengthens growth, but also enhances the effectiveness of other economic policies.
- Basic education is a prerequisite for economic take-off, just as the subsequent training of skilled labour is one of the keys to long-term growth.
- Policies aimed at fostering long-term growth must be complementary; mistakes in one area can totally undermine efforts made elsewhere.

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## **Introduction**

Development parameters for what, during the Cold War, was known as the Third World have altered dramatically with the rise of emerging economies over the past two to three decades. This economic take-off, originally confined to a handful of countries, soon spread, first to Asia and then to some Latin American countries in the 1990s. All these nations now contribute significantly to the increasing globalisation and interdependence of the world economy. Although this bodes well for the dynamics of world growth over the coming two or three decades, it nonetheless raises two major questions.

The first concerns the future growth rate of emerging economies. How much longer will they be able to sustain the extremely rapid growth that they have been posting since their take-off? Is this growth, which is evidenced by a narrowing of the gap between them and the developed economies, by its very nature predestined to slow down in the near or not-so-distant future?

Other countries are obviously showing signs of an upturn, so the growth of the world economy could be spurred for several more decades by the successive take-off of an increasing number of economies, but this raises a second major question: how many developing countries will emerge? Is it overly optimistic to assume that even the poorest African nations will eventually achieve take-off, thereby rendering the very term “developing country” meaningless?

This Policy Brief, which is based on the Development Centre’s major survey of long-term growth in 1993 and draws on the great strides made in growth analysis since the late 1980s, aims to provide some answers to these questions<sup>1</sup>. It focuses on the future of poor countries. Although history has clearly demonstrated the dynamic growth of emerging economies — which are expected to continue to catch up in coming years — it is difficult to predict the future of economies that have not yet emerged. In the 1950s and 1960s, very few observers were able to anticipate the future success of Asia. Likewise, few between the two World Wars foresaw the economic emergence of Japan. The long list of forecasting errors in the field includes some prompted by over-optimism. Ghana, the “Gold Coast” of the 1950s, was thought to be headed for a brilliant future, as was Uganda, “the pearl of Africa”. At the turn of the century, Argentina was considered to be an emerging country on a par with Australia, Canada and New Zealand. These errors are understandable. Basically, economic take-off constitutes a break in trends that no forecasting model based on past experience can predict.

Economic take-off is not a random phenomenon for all that. The policies and attitudes of both the national governments and the international environment are decisive influences. It is therefore worthwhile identifying the factors that can create a climate conducive to economic take-off and speculating that advances in the policies implemented by poor countries will lead to economic development. However, a dose of realism is called for: it is only possible to increase or decrease the likelihood of a take-off, which will always be dependent on historical, geopolitical and human factors that cannot be forecast.

After reviewing past examples of developing countries that have caught up with their developed counterparts, we identify the factors that can be used to assess their growth. This will form the background to a discussion of the conditions required for poor countries to achieve economic take-off.

## **Are Developing Countries Catching Up with Developed Countries?**

### ***An Increasing Number of “Emerging” Economies***

Post-World War II economic history has shown that a take-off can occur despite an initially critical situation. This clearly refutes pessimistic projections, fairly widespread in the past, that doubted the developing world's ability to catch up with the developed world. Factors such as a scarcity of natural resources and overpopulation led authors such as Myrdal (1968) to use the term “drama” to describe the growth outlook of Asian countries. But while these economies have demonstrated exceptional growth potential, regions with comparatively abundant natural resources (Latin America, Africa and the Middle East) failed to take off during the same period.

The example of take-off which immediately springs to mind is that of Japan. After the ravages of World War II, its per capita income was comparable to that of Brazil, more than three times lower than that of Argentina, and nine times lower than that of the United States<sup>2</sup>. Since then, Japan has posted steady growth, overtaking Argentina in 1966 and achieving per capita GDP equivalent to 90 per cent that of the United States in 1991. This example may be somewhat atypical historically, as Japan began its industrial growth between the wars. However, the Japanese experience was reproduced, albeit some years later, by other East Asian countries, in particular South Korea<sup>3</sup> and Chinese Taipei<sup>4</sup>. These two countries, whose per capita GDP was comparable to or lower than that of the Côte d'Ivoire and Ghana in 1950, have considerably outstripped them (per capita GDP nearly ten times higher in the early 1990s), overtaking Argentina in the mid-1980s and reaching 50 per cent of the US level in the early 1990s. The more recent take-off of countries such as Tunisia and Thailand, which had per capita GDP comparable

to the Côte d'Ivoire and Ghana in 1950, but nearly three and four times higher respectively in 1990, offers proof that these experiences can be reproduced in other countries.

Still more recently, sweeping economic reforms introduced in China, India and Vietnam in the 1980s and early 1990s are already bearing fruit. These countries have achieved remarkable growth rates, once again demonstrating that market mechanisms and a political commitment to promoting economic prosperity are key ingredients in any economic take-off.

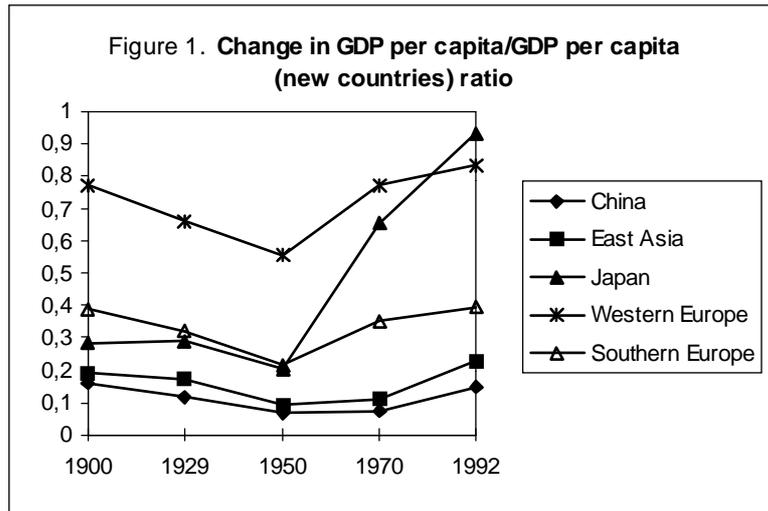
Cases of countries that are on the way to catching up with developed economies should not, however, obscure the low-growth problems facing many developing countries.

### ***No Worldwide Convergence of Income***

Recent advances in the availability of comparable international data have made it possible to study whether economies are converging globally. Convergence is crucial to economic policy, since the ultimate goal of any development policy is to ensure that poor countries catch up with developed economies. Global convergence increases confidence in market mechanisms as a pillar of economic development. In contrast, a lack of convergence is indicative of structural obstacles to growth and prompts efforts to develop policies to correct and improve the workings of market mechanisms.

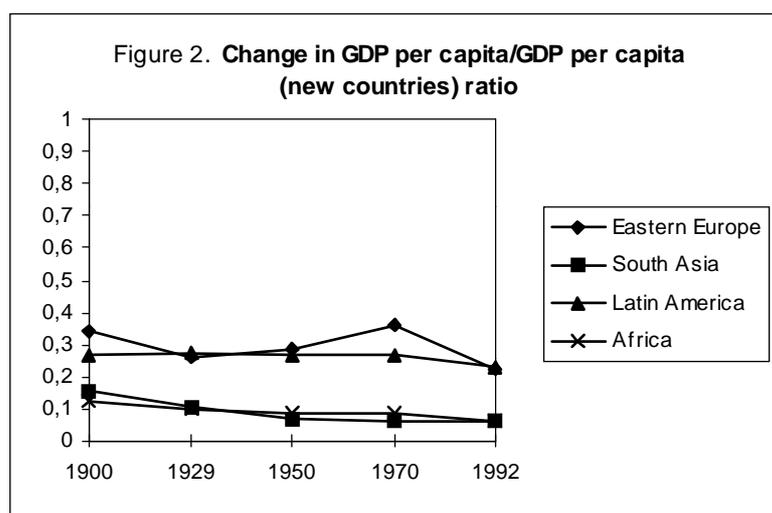
Figures 1 and 2 give an idea of a global convergence trend over a long period beginning early in the century. They were drawn using comparable international data gathered by Maddison (1995) and illustrate the growth in per capita GDP in a number of countries and groups of countries compared with the per capita GDP in the group of "new countries" (United States, Canada, Australia and New Zealand). This group of countries has had the highest per capita GDP level since the beginning of and throughout the century, and is therefore a natural benchmark when studying convergence.

These comparative data can be used to identify two categories of country and two sub-periods when studying convergence. Figure 1 covers countries and groups of countries on the road to catching up with high-income economies. But this process did not begin until the latter half of the century and appeared in successive waves: Japan and Western Europe, Southern Europe, emerging Asia, and China.



The countries in Figure 2 failed to achieve economic take-off. One particularly interesting case is that of the Latin American nations. They were not directly involved in the two World Wars, and so maintained their relative positions throughout the first half of the century. Unlike Western Europe and Japan, however, they adopted inward-looking development strategies immediately after the war and were unable to take off after 1950. In fact, the serious distortions resulting from these policies caused a relative decline that became clear as of the 1970s. The Eastern European bloc is another example of failure due to inappropriate economic policies. The early take-off that began in the 1930s was consolidated between 1950 and 1970 by an extraordinary mobilisation of factors by the centralised economic system. However, the potential of these policies ran out, causing growth to collapse and pulling these nations down to a level comparable to that of Latin America by the early 1990s.

The African and South Asian countries<sup>5</sup> started with initial conditions comparable to those of the East Asian nations and China. They experienced similar economic stagnation until 1970 but, unlike the latter, did not then achieve economic take-off. The most striking example is that of Africa; despite its low level of initial income, it is in decline.



There are thus two categories of countries following very different trajectories: take-off and decline. This situation does not result merely from the economic policies implemented in the different countries, although we show that such policies do have an impact on long-term growth. It also suggests the existence of forks in the growth trajectory, which could be associated with “multiple equilibria”. The term “poverty trap” is used in development theory to describe this assumption. In practice, these situations can help create “convergence clubs” made up of economies catching up with developed economies and economies stalled in the “poor equilibrium” of low growth, or a “poverty trap”.

## Growth Factors in Developing Countries

### *The Role of Savings and Investment*

Seminal work on growth analysis, especially the theoretical work of Solow (1956) and the empirical work of Denison (1967), has produced preliminary conclusions about the reasons why an economy is growing or lagging behind. Generally speaking, calculations show that much of the growth observed can be attributed neither to capital accumulation nor an increase in the working population. This approach also posits that only improvements in factor productivity can underpin sustained growth in per capita income in the long run.

This reasoning is obviously applicable only to the very long term. It therefore does not necessarily conflict with the driving role of investment in the current growth of emerging economies, which are at the midway point in the long process of catching up with developed countries. Standard convergence speed estimates<sup>6</sup> indicate that a poor country in the take-off phase needs at least three decades to make up half the distance between it and the developed countries. The engine for the growth observed in emerging economies over the past two to three decades could therefore simply be investment by these countries, rather than specific policies leading to productivity gains. The conditions for transposing the experience of emerging economies to other developing countries should therefore be fairly easy to identify. However, traditional growth theory holds that this engine will gradually slow down, so caution is to be advised when making growth projections for emerging economies. In other words, these economies are unlikely to experience a growth rate comparable to the present one over the coming decades.

Distinguishing between what is due to a catching-up process attributable to capital accumulation and what results from a technological advance whose causes have yet to be identified is therefore the necessary first step in explaining the growth performances of emerging countries and analysing the future growth of developing countries.

In this regard, recent work on East Asian growth tends to give credence to the theory of catching up by means of capital accumulation<sup>7</sup>. As Table I shows, most of these countries have boasted very high savings and investment rates, as much as 30 per cent to 40 per cent of GDP in China, South Korea, Indonesia, Malaysia, Singapore and Thailand.

**Table I. Gross Investment as a Percentage of GDP**

	1970	1993		1970	1993
China	28	41	South Asia	16	23
South Korea	24	34	Sub-Saharan Africa	21	16
Indonesia	16	28	North Africa-Middle East	19	28
Malaysia	22	33	Latin America	22	20
Singapore	39	44			
Thailand	26	40			

source: World Bank (1995)

These investment performances surpass those observed in other developing countries, where investment rates have rarely exceeded 20 per cent over the past three decades. From this point of view, East Asia's growth is not "miraculous", but rather the logical outcome of investment efforts. Ten extra points of investment can trigger additional growth of around two points in per capita income, which is considerable.

There is certainly some truth in this theory. If East Asian investment had been the same as that of Sub-Saharan Africa since the 1960s, the East Asian miracle would have been stillborn, but this does not fully explain the seeds of the emergence of Asian countries nor is it an economic policy recommendation for other developing-country candidates for the take-off process. It is important to understand why emerging countries have posted relatively high investment levels compared with other developing countries. Part of the explanation lies in a better return on capital, associated with high factor productivity. From this point of view, it is somewhat artificial to dissociate growth due to capital accumulation from that due to productivity gains completely. The availability of savings also plays a role. These countries have generally managed to invest heavily without posting recurring trade deficits, i.e. without relying structurally on foreign savings to finance investment. In a world where capital mobility is imperfect and potential investors steer clear of economies with major macroeconomic risks, the availability of abundant national savings is clearly the best guarantee of buoyant investment. For the rest, the concomitant relationship that may exist between external financing and growth should not be interpreted as a causal relation running from one to the other.

These two explanations make reference to a number of auspicious factors, some of which are entirely unrelated to the policies in place — for example, cultural traits encouraging saving. Yet performances can nonetheless be influenced profoundly by policies.

The economic environment resulting from the macroeconomic policy applied impacts on investment behaviour. Firstly, low savings in an economy are nearly always related to low public sector savings. Hence, a sound budget policy is a prerequisite for sustainable long-term growth. Excessive public spending, however financed, can discourage investment. When this results in penalising taxation, return on investment is affected. If it leads to a public deficit, private investment on the financial market is crowded out. Monetary policy can also affect growth: high inflation will create a climate of macroeconomic instability that discourages savings and investment. Generally speaking, as a recent study on Latin America<sup>9</sup> shows, macroeconomic instability associated with public deficits and inflation acts as a disincentive to growth. A World Bank study on the East Asian "miracle"<sup>10</sup> also posits that sound macroeconomic policies have been key ingredi-

ents in the success of this region's economies. In contrast, the World Bank often attributes non-growth to the inappropriate management of macroeconomic policies<sup>11</sup>.

### ***The Role of the Financial System***

Financial system intervention policies can also have a significant direct impact, either positive or negative, on capital accumulation. Savings are built up and allocated to various investment projects — with varying degrees of efficiency — via the financial system. Accordingly, the efficiency of this system is a key to explaining the growth performances of emerging countries. These countries may not have totally efficient financial systems, as the Development Centre's study on Chinese Taipei<sup>12</sup> shows, but they have nonetheless functioned relatively satisfactorily, channelling a considerable volume of savings to investment in the productive system. The recent history of Latin America and Africa shows that inappropriate government policies can seriously damage the financial system, and consequently savings and investment. The scarcer the capital, the higher the opportunity cost borne by the community when it is wasted. A dysfunctional financial system has often blighted the economic performances of these countries.

An example of so-called "financial repression" policies implemented by governments that hamper the workings of the financial system is described in the Development Centre's study on Argentina<sup>13</sup>. Like many Latin American countries, Argentina long opted for an interventionist financial policy, which seriously distorted interest earned by and allocation of savings. In the period from 1945 to 1957, this intervention culminated in the direct management of all bank deposits by the Central Bank and interest rate manipulation. Although this policy was eased somewhat as of 1957, real interest rates on deposits remained negative until financial liberalisation was attempted in 1976. The distortions in the financial system were worsened by the impact of high inflation, followed by hyperinflation, on the price system. Senegal<sup>14</sup> is another example, characteristic of behaviour in Africa. The government forced the vast majority of banks to misuse funds by financing insolvent borrowers, both individuals with ties to the government and poorly managed public enterprises. This wasted financial resources and eventually led to the insolvency of the banking system, with consequent serious damage to savings and investment.

In some cases, it is possible to reverse policy fairly quickly, with financial liberalisation undoing the negative effects of earlier repression. This proved true in the case in Tunisia<sup>15</sup>, which embarked on an ambitious liberalisation policy in the late 1980s. But it only works if the financial system still comprises more or less viable structures. In Senegal, for example, the entire financial system needs to be

rebuilt, and liberalisation measures alone will be inadequate. The failure of financial liberalisation in Argentina, Uruguay and Chile in 1976-77 also shows that such measures can only be effective in a stable macroeconomic environment.

### ***The Role of Foreign Trade Exposure***

Even though capital accumulation accounts for a significant share of the growth differential between countries that have taken off, especially in East Asia and other developing countries, there is more to it than that. These countries also narrowed the technology gap at the same time. This is clearly shown, for example, in the Development Centre's study on Chinese Taipei<sup>16</sup>. This country has steadily caught up with total US factor productivity. This trend has picked up speed since the mid-1980s, when productivity gains sharpened more than can be attributed to a mere catching-up phenomenon. They are to a large extent due to spending on research and development and higher education.

This catching-up phenomenon is also confirmed by calculations carried out by the World Bank<sup>17</sup>, which clearly show that the East Asian nations attained total factor productivity growth of 1 per cent to 2 per cent per annum from 1960 to 1990, comparable with and in many cases higher than that recorded in the United States (around 1 per cent per annum). In contrast, the African countries and the majority of the Latin American countries<sup>18</sup> saw their total factor productivity decline on average, which means that they probably did not catch up technologically over this period.

These observations and recent developments in growth analysis suggest that the policies implemented can have a lasting influence on growth through technological catching up. The essential role of trade policy must be taken into account when trying to understand East Asian performances relative to those of Latin America and Africa.

The fact that an economy trades on the international market is the best guarantee of its ability to take advantage of technological advances made by developed countries, either through imports of capital goods and inputs or through familiarisation with new goods available on the international market. Thus, the above-mentioned study on Chinese Taipei revealed that economy's remarkable ability to absorb foreign technological progress, which is not unrelated to its early opening up to foreign trade. In comparison, Argentina, whose extent of foreign trade exposure plummeted between 1930 and 1950 following the introduction of protectionist policies and did not rise again until the late 1980s, is an example of the negative effects of such policies on the ability of an economy to take advantage

of foreign technological advances. Until the early 1930s, this country absorbed all such advances almost immediately; from the 1930s to the 1960s, only some of them, or at best several years later; and from the 1970s to the 1990s none at all.

For small economies, international trade is also the only way that firms can gain access to a large market, which is necessary to improve the technological efficiency of production by taking advantage of economies of scale, and an international outlook is also crucial if firms are to develop competitive behaviour. The Senegal study is a good example, and typical of the situation of many African nations, of an economy that is too small to ensure an efficient scale of manufacturing production and where the protectionist policies in force until the early 1990s impeded industrial development.

There are many comparisons available on the effect of foreign trade exposure on growth<sup>19</sup>. They corroborate, to a certain extent, the previous observations, despite problems with building reliable and internationally comparable indicators of foreign trade exposure. A study by Sachs and Warner (1995) offering a composite foreign trade exposure indicator is interesting, and confirms the theory whereby an inward-looking economy cannot develop rapidly. Maddison (1995) reached the same conclusion when examining the evolution of world growth since 1820.

Foreign trade exposure should, however, be accompanied by other economic policy measures that ensure a growth-friendly environment based on integration into the global economy. In particular, it should go hand-in-hand with policies that ensure the competitiveness of a nascent manufacturing industry. Otherwise, the economy will not develop, thereby jeopardising its chances of catching up with developed countries. Here again, country studies conducted by the Development Centre provide several interesting examples.

The growth of Chinese Taipei, like that of other emerging East Asian economies, was based on the development of manufacturing industries that are competitive on international markets. Foreign exchange policy played a decisive role, not only by preventing an overvalued real exchange rate, but also by ensuring stability. The opening up to foreign trade by Tunisia in the mid-1980s was accompanied by a realistic foreign exchange policy that enabled increased industrial exports of labour-intensive goods, such as textiles and garments. This resulted in both growth and higher employment. In comparison, Senegal's attempted transition to trading with foreign markets between 1986 and 1989 foundered, in part because the CFA franc was so blatantly overvalued that very few Senegalese industrial firms could take advantage of the opportunities created by the foreign trade policy, which was soon abandoned. Conversely, following the January 1994 devaluation, Senegal was able to make another stab at open trading conditions, giving it a healthier growth outlook.

Foreign exchange policy obviously does not explain everything, even though an appropriate policy in that area is undoubtedly a prerequisite for manufacturing competitiveness. Many other factors determine competitiveness and they are all engines for growth.

### ***The Role of Education***

Growth experts have long recommended investing in education. Seminal work by Denison (1967) on growth-factor accounting stressed the training of labour as one such factor. Recent case studies by the Development Centre in the Long-term Growth Series confirm that improving the level of education has contributed significantly to the growth observed over the last three to four decades<sup>20</sup>.

Among the cases studied, Chinese Taipei is particularly instructive, since it highlights the advantages of implementing a sequential policy under which priority is first given to primary education, then to secondary education and then to higher education. In this country, education's contribution to growth came in three successive waves with the development of primary education (1950-70), secondary education (1970-80) and then higher education (since the 1980s). Overall, this active and well-targeted education policy accounted for 9 per cent of the growth and 23 per cent of the productivity improvements posted from 1951 to 1991.

The only case where the work of the Development Centre has not led to conclusive results in the field is that of Senegal. This may be due to shortcomings in available data, but the country also made a certain number of mistakes that must not be repeated if education spending is to bear fruit. Firstly, unlike Chinese Taipei, Senegal's education policy set out with considerable emphasis on secondary and higher education (which were allocated as much as half the total education budget), even though the literacy rate of the adult population was no more than 40 per cent even in the early 1990s. The vast majority of the population has not benefited from investment in education over the last three to four decades, even though large amounts were spent on secondary and higher education, to which just a small minority of the population has access. Graduates cannot find jobs, which is another indication that education has not been tailored to the needs of the economy. Secondly, the mismatch between skills supply and demand can also be due to an economic environment that is not conducive to the efficient use of available skilled labour, such that the latter is wasted.

What this latter argument means is that the available human capital cannot be used for just any activity. Skills are vital when producing goods using more or less advanced technologies, but not necessarily useful for traditional activities.

Policies able to influence the structure of the economy therefore condition the efficient use of the skills available. In Senegal's case, the economic strategy was long incompatible with the efficient use of human capital.

A look at the reasons why human capital can influence growth can help make this point clearer. Chiefly, human capital is necessary to assimilate and master modern production techniques or to design technical innovations. Most developing countries have not reached the stage of promoting research and development activities. There have been a few recent exceptions, such as Chinese Taipei where research and development spending rose very quickly, thereby stimulating growth as of the mid-1980s. Apart from these exceptions, however, developing countries are at the stage where they use technological advances made elsewhere. Such assimilation requires in itself skilled labour to incorporate and tailor new techniques to the capacities of the national economy. Subsequently, the main channel through which human capital can bolster growth in developing countries consists of activities that contribute to catching up with foreign technological progress<sup>21</sup>.

A country cannot make up a technological lag under just any conditions. The economy has to have an international outlook, otherwise new technologies cannot be observed and assimilated. Consequently, it is highly probable that human capital cannot stimulate growth in the context of a closed economy. In such a context, activities based on the assimilation of technological discoveries will not be very developed, and the human capital accumulated at the cost of often considerable effort will be wasted in the form of graduate unemployment, the misemployment of graduates in rent-seeking activities or through a brain drain. This assumption is confirmed by a Development Centre study<sup>22</sup> using a large data base combining time series and international comparisons.

Conversely, an open trading policy cannot stimulate growth as much when it is implemented in an economy where a shortage of skills makes it unprepared to take advantage of technological advances made elsewhere in the world. It is therefore essential to consider these different growth policies in parallel.

## **Policies to Foster Economic Take-off in Poor Countries**

### ***Non-growth and the Need for an Active Policy***

Until now, it has always been assumed that the relation between growth factors and economic performance was uni-directional, but these factors are often themselves dependent on economic performance, which can profoundly modify

the conclusions able to be drawn from our analyses in terms of economic policy recommendations. Let us re-examine the case of financial development to illustrate this point.

Although it is clear that financial development affects economic growth, the development of the financial system itself is related to the wealth of the nation and its growth. The more developed and dynamic an economy, the greater the demand for financial intermediation services. These activities are usually subject to fixed costs, such as the creation of banking networks and the gathering of data on companies and investment projects. The more developed an economy, the better the return attained on these fixed costs by the financial intermediaries. Consequently, economic growth can both propel and result from the growth of the financial system. This reciprocal interaction, first covered in the ground-breaking work of Goldsmith (1969), obviously complicates any analysis of the role that the policy covering the financial system can play in stimulating growth.

Analysis of this twofold impact suggests the existence of a cumulative process that will result in several possible long-term equilibria<sup>23</sup>. If the financial sector is underdeveloped, growth will be low, increasing the obstacles to financial development and ensuring a lasting paralysis of the financial system. Conversely, the rapid development of financial structures and economic growth can reinforce one another in an advanced economy, creating a stable balance. In other words, the initial financial development of an economy can pull it either downwards into a “poverty trap” or upwards into an advanced economy. This analysis is confirmed by econometric work using international comparison data at the Development Centre<sup>24</sup>.

What economic policy recommendations can be made in these circumstances? Governments have considerable leeway to influence, for better or worse, the workings of the financial system. Interventionist policies known as “financial repression” are equally harmful regardless of whether the economy is poor or wealthy at the outset. What is more, if these policies totally or partially destroy the financial system, reversing them can be ineffective, as the case of Senegal demonstrates. Once an economy has fallen into a “poverty trap”, it is extremely difficult to get back out. Only a broad, goal-oriented policy aimed at rebuilding a viable financial sector from scratch is able to break the cumulative process of the simultaneous decline in the real and financial spheres of economic activity. In other words, the easier it is to destroy a financial system using traditional “financial repression” policies, the harder it is to reverse these policies by introducing financial liberalisation.

This analysis in terms of multiple equilibria can be applied to areas other than the financial sector. A few illustrations are given below.

Educational development can itself be associated with a reciprocal interaction with growth, giving rise to multiple equilibria. The accumulation of human capital depends, for at least two reasons, on the level of development reached by the economy. Firstly, the efficiency of the educational system may depend on the amount of human capital already available in the economy, such that demand for education will rise with the level attained. Secondly, the poorer the economy, the greater the constraints on the financing of education spending, which is the responsibility of the public authorities in most countries. It is very difficult to find the tax revenue needed to finance public spending policies in a poor economy. As a result, the poorer the economy, the smaller the education supply. A low level of human capital and economic poverty are thus mutually reinforcing such that an economy finds itself either stuck in a poverty trap or driven towards sustained growth.

Here again, public intervention can be decisive. A policy of subsidising education, based on making education a public spending priority, may prove indispensable to bring the economy out of its initial underdevelopment. In the same way, policies such as trade policy that can affect the efficiency of human capital potentially have a major impact on economic take-off.

The same reasoning could be applied to other types of public spending, such as on the infrastructure, which can be a source of growth because of the externalities it generates, especially through a reduction of transaction costs. In return, making such investments depends on growth and the development level of the economy. A Development Centre sample of some 30 developing countries confirms the existence of bi-directional causality between growth and the development of the infrastructure and other public spending. According to this study, public spending has a significant impact on growth and the productivity of public capital spending is markedly similar to that of private capital spending<sup>25</sup>.

There is also a parallel between the role of the financial infrastructure, whose importance in the growth process was discussed earlier, and that of the physical infrastructure, in particular communications. In both cases, these provide instruments for reducing the transaction costs, whose importance in the process of development of a society<sup>26</sup> is known, and whose implementation itself depends on the level of development already achieved. Clearly, growth and public spending creating growth are always locked in a circle to some degree, but this does not mean that it is impossible or inadvisable to implement public spending policies. On the contrary, public spending will often significantly influence the initial conditions that determine the existence of a poverty trap, and the quality of the policies implemented in this regard will determine to a large extent the ability of an economy to begin its take-off to escape from such a poverty trap.

Institutions can also interfere with the growth process and create multiple equilibria. One such example is situations of political instability, one of the main problems that has had to be dealt with by African economies in the decades subsequent to their independence. African experience shows that political instability has a negative impact on growth<sup>27</sup>. Its effect is primarily felt by factor productivity, which is affected by destruction and unrest of any type caused by political instability, and by capital accumulation, which cannot take place unless there are some guarantees as to the lasting nature of investments made. At the same time, the poverty of an economy may be a source of instability. This is the case when political and social unrest arises from an increasingly hard-to-control conflict over sharing scarce national wealth. Subsequently, poverty and political instability are mutually reinforcing, leading to explosive situations such as those experienced by a great many African nations since independence.

Once again, appropriate policies can increase the chances of an economy's escaping this cumulative process. The quality of public spending policies can play a significant role in this regard. It has been shown<sup>28</sup> that political instability rises when defence spending (army, police) is high and social spending on such areas as health and education is low. In the same way, the risks of political instability created by structural adjustment policies can be managed in such a way as to minimise potential political and social unrest, possibly using outside financial assistance<sup>29</sup>. A good illustration of this is the way in which countries in the franc area were able to use international aid to ward off social crisis after the 50 per cent devaluation of the CFA franc in January 1994.

The quality of the policies implemented cannot be ordained. Reducing defence expenditure presupposes a relatively democratic political regime. Introducing truly redistributive policies for the poor involves the national government's being genuinely interested in the common good<sup>30</sup>. The effectiveness of public spending cannot be ensured if the use of public funds is poorly controlled; from this point of view, the government must be accountable in accordance with procedures that ensure the greatest possible transparency. These conditions may be particularly difficult to obtain in a poor economy.

Multiple equilibrium phenomena may also be found at this stage, as considered for example in the literature on corruption. When few players are corrupt, there is little incentive for corruption, unlike the case in a system where corruption is widespread<sup>31</sup>. As a result, progress in this area often calls for radical reforms rather than gradual action. In the end, it is the political will of a country's leaders to encourage economic and social progress that determines the quality of the policies implemented and the chances of successfully catching up with advanced economies.

On the whole, the poverty trap analyses suggest that the problem of take-off is mainly one of making a qualitative leap, rather than increasing the quantity of accumulated production factors. By contagion, conditions conducive to take-off have been achieved in an increasing number of countries in Asia and then Latin America. The question now is how to take advantage of these experiences to help poor countries.

### ***Drastic Reforms Are Needed for Economic Take-off***

The spread of growth in East Asia, the recent increase in the number of emerging economies, and the accumulation of increasingly informative experiences in the area of the impact of economic policy on growth are all factors that could hold out the hope in future of take-off for some or all poor countries, notably African nations. Several African countries experienced rapid growth in the early 1990s; one was Uganda, which posted a growth rate of 10 per cent in 1995. The average for sub-Saharan African countries the same year was between 3.5 per cent and 4 per cent<sup>32</sup>, thereby ensuring a moderate but real improvement in per capita income. However, caution is called for. To what extent are the policies implemented sufficient to promote sustainable growth in these countries? Moreover, recent successes are too closely tied to the business cycle — being linked to price movements on commodities markets — to be extrapolated reliably for forward-looking projections. Furthermore, these same African countries only experienced average growth of 0.7 per cent per annum from 1991 to 1994, and 1995 was the first year of positive per capita GDP growth since 1989. Most of these countries are still burdened by a number of serious handicaps associated with the cumulative processes characteristic of poverty traps.

The experiences of emerging economies show that drastic reforms are usually necessary to open both an economy and a society to modernity in the space of some ten years. The reform process affects all aspects of economic activity. Agrarian reform is often necessary, not only for its redistributive effects, but also and above all to create incentives to improve agricultural productivity<sup>33</sup>. Historically, agrarian progress has always proved a prerequisite for take-off. Industry must be made more dynamic, not to the detriment of agriculture, but by introducing a competitive framework under which private initiative can develop. The banking sector should be able to back large companies in their development projects, which involves setting up a suitable institutional framework. General government should be modernised and given efficient tools for taxation and management of public spending. Distortions created by legislation are sources of profit for individuals in authority and must be eliminated as far as possible in order to prevent the spread of rent-seeking behaviour .

If this modernisation is slow to take hold and reach a large proportion of the population, those who lose by the reforms — for example landowners, public sector employees and owners of companies enjoying special benefits — have even greater latitude to challenge them. Past failures in certain countries also reveal that government intervention to modernise must not come about only in and to the benefit of the public sector or protected minorities. All too often, especially in Africa, leaders have seen modernisation as being synonymous with state control. This inhibits the spread of progress: widespread profit-seeking behaviour in the modernised sectors of society as well as state crises become inevitable, as the Development Centre's study on Senegal has shown. Exposure to foreign trade has proved to be an effective way of discouraging this type of behaviour in the examples of the successful take-offs of developing countries.

### ***Inward Investment: Cause or Consequence of Growth?***

In the context of an increasingly globalised world economy, commercial and financial integration into the world market is and will certainly continue to be a common feature of all take-offs. Having set out the arguments in favour of foreign trade exposure. It would now be useful to examine international financial integration, given that all emerging economies share an ability to attract international capital.

Emerging economies are also those that receive, or received during their take-off phase, significant flows of foreign capital. At present, the extent of capital flows is measured by looking at both direct investments and portfolio investment on the new stock exchanges created in most of these countries. Since 1991, the East Asia and Pacific region has received more than half the direct investment flows into developing countries, or a total of \$43 billion in 1994. The main emerging financial markets in 1996 include South Africa, Malaysia, Chinese Taipei, South Korea, Brazil and India, with capitalisation in excess of \$150 billion<sup>34</sup>. The development of all these markets has been stimulated by their growing integration into the world market.

There is therefore a close correspondence between the phenomenon of emerging countries and that of emerging markets, a factor which characterises the development of financial markets in these same countries. This observation is a natural offshoot, in the context of the financial globalisation of the world economy, of what was said previously about the role of the financial sector in growth. Different studies emphasise the fact that the development of new stock exchanges significantly stimulates the growth of developing countries<sup>35</sup>.

As for the role of financial development in growth, the main question is one of causality. It is highly unlikely that direct inward investment is the main cause of economic take-off. Experience has shown that international capital is invested in economies that have set up institutions and structures conducive to growth. Socio-political stability is the first prerequisite for direct inward investment, because investors are highly sensitive to risks inherent in such investment. Macroeconomic stability is also essential, as can be seen by the flight of capital during macroeconomic crises.

As a result, implementing specific incentive policies to attract foreign capital should not be an immediate priority for a government seeking to promote economic take-off. If the domestic conditions necessary for growth have not been created, international investors will have insufficient prospects of return and will not be motivated by tax or customs breaks offered by the host country. This has been shown by the World Bank, one of whose studies suggests that the business climate, which depends notably on the preferential treatment granted to foreign investors, only influences direct investment in economies where such investment is already high.

On the other hand, if economic reforms are undertaken to put the economy on the road to modernisation, breaks granted to foreign investors will stimulate capital intake. Introducing such a policy has proved useful in China, for example. It has been the main recipient of foreign direct investment for several years, and such investment has stimulated growth, as shown by a study carried out by the Development Centre.

It therefore seems reasonable to assume that although causality initially runs from growth factors to capital contributions, subsequent encouragement of foreign direct investment can stimulate growth.

Poor countries can also have recourse to concessional funding in the form of development aid. Such financial assistance, usually provided by OECD Member countries, can play a role in the take-off phase. The investment required to create the minimum infrastructure and train the necessary skilled labour is expensive; the costs can exceed the local financing capacity. In the same way, and perhaps more importantly during the take-off phase, the political acceptability of the necessary structural reforms can be conditioned by temporary explicit or implicit transfer policies aimed at those socio-economic groups feeling the burden of the adjustment measures. The use of development aid to finance such transfers can be a judicious move. This is clearly shown by the Development Centre's study on the political feasibility of adjustment. More generally, when the economy is stuck in a poverty trap due to bankrupt institutions or the absence of human capital or

infrastructure, its own resources are insufficient to finance the initial expenditure required to get out of this situation and start on a virtuous circle. Under these circumstances, inward investment is vital.

Evidently, such expenditure is a risky investment and the return is not immediate. Foreign aid therefore has a major role to play in this type of situation, but to be effective, it must go beyond a token contribution, because otherwise the economy would most probably be drawn back to the initial poverty trap equilibrium at the first hitch. Moreover, this aid policy must be incorporated into an active strategy on the part of the local authorities to initiate a process of sustainable growth: the governments of donor countries can help countries that are candidates for take-off, but cannot replace them in the design and implementation of their foreign policy.

In other words, although growth can technically be partially financed by foreign savings, there is another condition for take-off that is even more decisive and hard to satisfy: the design and implementation of a true growth strategy tailored to local conditions. This presupposes that political leaders form a long-term strategic vision. Donor countries also understand that a long-term vision is necessary, as shown by the published conclusions of a think tank organised by the Development Assistance Committee<sup>39</sup>.

### ***Elements for a Long-term Strategy***

A comparison of the recent history of emerging countries with the current situation of poor countries clearly shows that the latter still need to overcome considerable obstacles. It is not easy to make the transition from the analyses of growth determinants to concrete policy recommendations for overcoming these obstacles.

Firstly, population growth in these countries is not controlled, reaching or exceeding 3 per cent per annum in some 15 African nations. As a result, these countries have very high dependency ratios — often over 50 per cent — and the working population is therefore a minority. In addition, the number of school-age children usually exceeds the existing education funding capacity. Emerging countries have to a large extent built their growth on a rapid development of human capital, something that is not really possible for poor countries, although it is obviously in their best interests to take whatever measures are possible to minimise this handicap. Accordingly, the entire East Asian model should be re-examined to ensure that it matches local capacity in poor countries. This is particularly true of the foreign trade exposure strategy, whose effectiveness is diminished in the absence of skilled labour.

Secondly, these countries lack not only skilled labour for the production of goods and services, but also sufficient numbers of competent managers to design and administer economic policy. It is therefore not possible to implement an elaborate growth policy, which would require detailed monitoring by the public authorities, unlike in East Asia where many of the managers and leaders have been educated at the best American universities since the 1950s.

Thirdly, a growth strategy cannot be properly considered in a climate of great uncertainty over national policy and institutions. The credibility of the policies considered must be secure if they are to be effective, which cannot happen if the government is weak or does not have a clear vision of its future. Here again, the contrast is striking with the post-World War II experience of such countries as Japan, South Korea and Chinese Taipei.

Fourthly, most African nations have now experienced over 30 years of political instability and poor management of public affairs. This heritage continues to haunt existing governments, even though the current generation of leaders cannot be blamed for past errors. Developed countries are to some degree responsible for these errors, because of the competition between the Eastern and Western blocs to attract the various developing countries into their respective camps during the Cold War<sup>40</sup>.

A stable government is a key ingredient in the implementation of a long-term growth strategy, because the relevant measures have to be stretched over a number of years; examples include the development of the school system, the construction of a basic infrastructure, and even the modernisation of economic institutions. Furthermore, political instability usually paralyses the economic policy decision-making process. Political stabilisation must therefore be a priority wherever the political situation is uncertain. There is no substitute for national leaders, as the dismantling of apartheid in South Africa shows. The international community can play a decisive role by guaranteeing each stage in a peace process, facilitating the demobilisation of various armed factions and helping to organise democratic elections, as in Uganda. Such assistance is, when it leads to political stabilisation, an invaluable contribution on the part of international organisations and aid agencies.

Once the political situation is firmly on the road to stabilisation and the country is run by a government that genuinely wants to encourage long-term economic and social progress, the first step is then to establish a clear long-term view. Under the pressure of events and in the absence of sufficient numbers of competent managers, these countries long implemented economic policies that had no continuity or real strategy<sup>41</sup>. The adjustment phase of the 1980s produced a certain degree of consistency in policies, but the original policy was designed by international financial institutions rather than the countries concerned. The result

was a policy that was not properly internalised by those who applied it. In addition, the timescale was determined by adjustment programmes covering a few years, rather than the long term.

A long-term view must necessarily be based on experience acquired worldwide concerning the impact of economic policy on growth. In this regard, recommendations made by the World Bank and the International Monetary Fund should not be overlooked. But this view must also be built on social choices stemming from as broad as possible a consensus and taking into account national strengths and weaknesses. Otherwise, its implementation would eventually prove to be politically unsustainable and economically unrealistic.

Experience shows that the only winning growth strategies are those based as far as possible on market forces. In the same spirit, the long-term vision to be developed must make allowance for the inevitable globalisation of the world economy, as long as this policy of liberalisation is implemented realistically, taking into account the initial shortcomings of the productive system. The strategy implemented cannot succeed if it ignores the need for the competitiveness of tradable goods activities, notably the manufacturing industry. The modernisation of the economy necessarily involves the development of these activities, which are sources of technological progress, can help reduce susceptibility to commodity market shocks, and are in the end necessary for the successful integration of the national economy into the world economy.

An economic structure conducive to take-off and sustainable long-term growth has to be built in several stages. Relatively simple macroeconomic measures should be taken immediately to correct any currency overvaluation that would nullify the benefits of trade liberalisation, as shown by the Development Centre's case study on Senegal. The currency needs to be stabilised to avoid any subsequent unpredictable fluctuations in the real exchange rate, which would cloud the visibility of the future needed by potential investors. Public deficits that crowd out private investment must be brought under control: even when such deficits are offset by development expenditure, the net effect of this expenditure on growth may still be negative.

In the longer term, those tradable goods growth sectors in which the economy could have a comparative advantage if investment were made in them must be identified. It is clear, however, that the market itself, rather than the government, will identify the best-performing sectors. Public intervention at in-depth sectorial level is unnecessary, as the experience of East Asia<sup>42</sup> shows; it can also be damaging, as the failure of sectorial loan allocation policies in many countries has demonstrated.

The government does have a role to play in setting up institutions needed to ensure that market mechanisms work properly: helping to control transaction costs by creating an efficient infrastructure, introducing institutional regulations, and promoting appropriate resource allocation by these markets, especially the financial market. Overhauling the financial system obviously plays a strategic role here, and one whose urgency cannot be overstressed because of the long lead times required to create a modern and efficient production system. Modernisation is also urgent, because in many regards it complements other actions to be undertaken. A Development Centre study<sup>43</sup> has also shown that trade liberalisation is ineffective when the financial system is not sufficiently developed. This stems from the fact that free trade presupposes that the economy is able to shift production factors, especially capital, to sectors that offer the most promising trade outlook. In addition, the World Bank<sup>44</sup> has shown that privatisation programmes, which are necessary in economies that were formerly strongly state-controlled, are ineffective in the absence of a sufficiently developed financial system. The backing of efficient financial intermediaries and money markets is a prerequisite for the successful selling off of public assets. Here again, OECD Member countries can help candidates for take-off a great deal, even if only by sharing their experience with them.

Finally, the trade policies of the OECD Member countries also have a role to play. Free-market, transparent and predictable trade policies on the part of developed countries are needed to enable firms in a country in the take-off phase to identify their markets accurately. Obviously, it is better for developing countries that markets in developed countries be as open to them as possible, but it is even more important to avoid investing their limited resources in activities where barriers to entry are insurmountable because trade policies have been toughened. Accordingly, in cases where full and immediate liberalisation might be considered undesirable by developed countries, a firm commitment to the future development of the trade policy (which must not disadvantage producers from developing countries) would be welcome. It is clear that, as regards the globalisation of the world economy, it is in the best interests of developing countries that poor countries gradually catch up with them, thereby creating a more buoyant, efficient and balanced world economic system. Trade policies implemented with regard to developing countries must take this into account.

## **Conclusion**

The success of emerging economies offers a number of valuable lessons which poor countries would do well to heed if their own economic take-off is to succeed. Even though the experiences of East Asian nations cannot be reproduced exactly in Latin America, Africa and the Middle East, the economic authorities in these latter regions can draw on them to strengthen their chances of take-off.

National authorities must be fully committed to progress. Sweeping reforms are necessary to encourage transactors to seek productivity gains rather than pure economic rent, to improve economic efficiency and to perfect tools and knowledge. Not all societies are ready at the same time for such transformations, but experience has shown that political commitment can result in initially unpredictable progress in these fields.

When political commitment exists, no effort should be spared to help the national governments to make a success of the economic take-off, something that is never guaranteed. Political authorities must be helped to forge a consistent and realistic long-term vision, to identify complementarities between the various growth factors, and to ensure the political feasibility of proposed reforms.

This Policy Brief has examined the factors that should exist in this context: market economy-oriented economic institutions to provide incentives for progress; economic and social infrastructures to ensure the smooth running of market mechanisms; an education policy that allows labour to take advantage of the opportunities offered by technological progress; and a stable macroeconomic environment that improves the visibility of the future. These factors complement one another and must be introduced simultaneously, but the very poverty of the countries aiming for take-off makes achieving this goal hard, because of the scale of the resources required to escape the vicious circle of poverty. As a result, this goal very often cannot be attained without the combined efforts of national governments and the international community.

## Notes and References

1. The Development Centre seminar on the future of African economies also proved useful [Berthélemy (1995)].
2. Source: Maddison (1995).
3. See Lee (1995).
4. See Dessus, Shea and Shi (1995).
5. India, Bangladesh, Myanmar, Pakistan and the Philippines. The latter is included in this group because its behaviour does not resemble that of other East Asian countries.
6. See Mankiw, Romer and Weil (1992).
7. See Young (1995).
8. The North Africa-Middle East region proved to be an exception in 1993, doubtless owing to the inclusion of military expenditure in investment.
9. See Hausmann and Gavin (1996).
10. World Bank (1993).
11. World Bank (1994).
12. Dessus, Shea and Shi (1995).
13. Véganzonès (forthcoming).
14. See Berthélemy, Seck and Vourc'h (1996).
15. See Morrisson and Talbi (1996).
16. Dessus, Shea and Shi (1995).
17. See Nehru and Dhareshwar (1994).
18. With the exception of Brazil, Chile and Colombia.
19. A forerunner in this field was the Development Centre study carried out by Little, Scitovsky and Scott (1970).
20. Argentina, Kenya, Senegal, Chinese Taipei and Tunisia. Kenya was studied by Azam and Daubrée (forthcoming).
21. See Benhabib and Spiegel (1994).
22. Berthélemy, Dessus and Varoudakis (1996).
23. See Berthélemy and Varoudakis (1996).
24. See Berthélemy and Varoudakis (1996).

25. See Dessus and Herrera (1996).
26. See North (1994).
27. Azam, Berthélemy and Calipel (1996) attempted to assess the impact of this on African economies.
28. See Azam, Berthélemy and Calipel (1996).
29. See Haggard, Lafay and Morrisson (1995).
30. The influence that the nature of the political regime can have on growth was studied by Varoudakis (1996).
31. See Bardhan (forthcoming) for a review of literature in this field.
32. Source: World Bank (1996).
33. Japan's experiences during the Meiji era and those of Chinese Taipei in the 1950s are good examples.
34. Source: "Financial Flows and the Developing Countries", World Bank, May 1996.
35. Levine (1996).
36. See "Financial Flows and the Developing Countries", World Bank, May 1996.
37. Démurger (1995).
38. See Haggard, Lafay and Morrisson (1995).
39. See OECD-DAC (1996).
40. See Berthélemy, McNamara and Sen (1994).
41. The case study on Senegal by Berthélemy, Seck and Vourc'h (1996) describes a characteristic example.
42. See World Bank (1993).
43. See Berthélemy and Varoudakis (1996).
44. See Demirgüç-Kunt and Levine (1994). This study is based on the experience of nine developing countries that have implemented privatisation programmes.

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