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**APPROPRIATE ECONOMIC POLICIES
AT DIFFERENT STAGES OF CATCH-UP DEVELOPMENT:
TRESHOLD MECHANISMS**

1. State of the Art

Rational economic policy has to depend on the level of economic and social development of a country. This statement seems to be quite trivial. Up to the middle of 1990s, however, most of research devoted to institutional and policy reform implicitly assumed that a developing country has to move along a strict line connecting a current point and an ideal point in institutional space. In most cases, the modern USA economy was set up as a model. Price liberalization, privatization, deregulation, elimination of tariff and non-tariff trade barriers were unconditionally recommended to all developing and transition economies. No distinctions were made between Latin America, Africa or East Europe. The discussion concentrated around the speed of these changes.

The outcome of these recipes has been disappointing. Per-capita GDP for Latin America and Caribbean countries decreased by an average 0.8 percent per year in the 1980s, and grew by mere 1.5 percent per year in the 1990s. In the Middle East and North Africa we observed the average fall of 1.0 percent per year in the 1980s and the average growth of 1.0 percent per year in the 1990s. For 28 countries of East Europe and former USSR, the total loss of GDP amounted to 30% in the 1990s. In Sub-Sahara Africa there was a reduction of the GDP per capita.

It is now widely accepted that the most important causes of the recession were the weakness of the new market institutions and the low quality of governance and that the role of government was underestimated (World Bank, 1997; Stiglitz, 1997; Popov, 2000). A number of recent empirical studies have shown that the recommendations mentioned above could not be considered as universal recipes. Privatization does not necessarily entail restructuring and increase in efficiency. Deregulation may cause financial crises. A thorough analysis of statistical data does not reveal any positive connection between trade liberalization openness and growth (Rodrik, 2003a). A possible conclusion is an agnostic view: only general principles like a necessity of market oriented incentives, economic stability, and property right enforcement merit to be beliefs; each country is unique, therefore concrete policy recommendations can not be extracted from theoretical considerations or data analysis (Rodrik, 2003b).

A different approach is based on the presumption that there exists a link between the set of technological, institutional and cultural indicators and rational economic policy. The absence of general universal recipes means that what may be good for developed countries is not necessarily good for developing ones. Elimination of tariff or subsidies to producers, liberalization of capital flows and deregulation of domestic financial markets, strengthening

government control and promotion of competition may be good or bad for an economy depending on its stage of development.

The necessity of different economic policies and institutions for developed and developing countries is demonstrated by a solid record of historical experiences (Gershenkron (1965), Chang (2002)). Recently there appeared theoretical models offering explanations, why rational catching up strategies should depend on the stage of development.

Two recent papers by Acemoglu, Aghion, Zilibotti (2002a,b) offer a model to explain the dependence of economic policies on the distance to the technological frontier. The authors assume that a change of a country's technological level is equal to the weighted sum of technological change due to imitations and innovations. The speed of imitation is fixed whereas the speed of innovation is larger for more advanced economies. The experience of new managers is most important for imitations, whereas their talents are crucial for innovation. If the distance to the technological frontier is large, the economy would be better off giving managers long-term contracts that would lead to imitation and investment based growth. But once the economy approaches the technological frontier and innovation yields greater returns than imitation, the life-time employment system should be replaced by the competitive selection. It is argued also that the optimal size of firms is an increasing function of the distance to frontier.

In our previous projects (see: Polterovich, Popov 2005, 2006, 2007 Полтерович, Попов (2006a, b)) we used cross-country regressions with a threshold to explain growth rates of average GDP per capita in 1960-99. We studied the impact of import tariffs, increase of government revenue, speed of foreign exchange reserves accumulation, technology transfers and migration, on average growth rates of GDP per capita. It was demonstrated that the impact of each type of policy may be positive or negative, depending on technological and institutional levels. In many cases a threshold combination of GDP per capita and institutional quality indicators was found to separate two different outcomes. For example, impact of FDI on growth may be positive or negative dependently on investment climate index. Democratization accelerates growth only if the rule of law index is higher than a threshold value. A number of models were also worked out to demonstrate the validity of these conclusions (Polterovich, Popov (2005), Polterovich, Tonis (2005) Polterovich, Popov, Tonis (2006)). Moreover, the analysis allowed to trace the major directions of successful evolution – from import substitution to export orientation, from regulation of import tariffs to non-selective policy of the real exchange rate undervaluation, from import of technology to domestically based research and development, from creation of large companies to support of small and medium-size firms. A precondition of economic success is the timely switching of economic policies to avoid both types of mistakes: excessive inertia or premature use of instruments that are effective for more advanced stages of development only. We hypothesize that these mistakes were main causes of catching-up strategy failures for many developing countries.

Let us consider several problems related to the theory of stages of development in greater detail.

Stages of development and industrial policy. The debates on whether free trade or protectionism are more conducive to growth are as old as economic research itself. For the XIX century, although detailed statistics does not exist, there are some powerful examples, suggesting that the growth-promoting nature of free trade is not obvious: China after the Opium Wars had to open her economy to international trade completely, but GDP per capita in 1949, when the communists took power, was at the same level as in 1850; 100 years were lost for growth despite pervasive globalization. Recent empirical studies (Rodriguez and Rodrik, 1999;

O'Rourke and Williamson, 2002; O'Rourke and Sinnoit, 2002; see for a survey: Williamson, 2002) found that there is no conclusive evidence that free trade is always good: whereas protectionist countries grew more rapidly before the WWI, they exhibited lower than average growth after the WWII.

The same argument applies to the industrial policy in general. Whereas for developed countries industrial policy may be of little use, for countries that are catching up it may promise high returns. With respect to rapidly growing countries of East Asia this argument was made in the World Bank Development Report "East Asian Miracle" (WDR, 1993).

The debate, in fact, is even more general – it is about the impact of industrial policy in a developing economy. Whereas for developed countries industrial policy may be of little use, for countries that are catching up appropriate (export-oriented) industrial policy promises high returns. With respect to rapidly growing countries of East Asia this argument was made in the World Bank Development Report "East Asian Miracle" (WDR, 1993), but the issue is by no means settled and the controversies continue.

Foreign exchange reserve accumulation. Empirical evidence seems to suggest that the accumulation of foreign exchange reserves (FER) and undervaluation of the exchange rate contributes to economic growth of a developing economy by increasing both the investment/GDP ratio and capital productivity. The discussion and interpretation of these stylized facts is offered in (Polterovich, Popov, 2005; Rodrik, 2007)). There are reasons to believe that FER accumulation may result in real exchange rate undervaluation that allows taking full advantages of export externality and triggers export-led growth. Besides, FER build up attracts foreign direct investment because it increases the credibility of the government of a recipient country. FDI inflow may increase real exchange rate and nevertheless accelerate economic growth. It is assumed that one or the other mechanism prevails at different stages of development.

Strategies of catching up and policies for imitation and innovation. This issue was examined to some extent in our previous research project (<http://www.nes.ru/english/research/projects/proposal/2002-2003/polter-popov.htm>), but is far from being exhausted, so we intend to pursue this direction of research.

Is it possible and efficient for a middle income country to follow knowledge-based strategy of economic growth, or a critical level of industrial development has to be reached as a prerequisite for switching to modern technologies?

To what extent should a developing country rely upon the technology transfer from the West? A related question, what should be imitated? Should we imitate the most progressive technologies or much cheaper technologies of the previous generations? If so, could we speak about the optimal strategy to shorten the distance in technological levels between less and more developed countries?

It was found that the influence of foreign research is stronger than domestic one even for such developed countries as Italy or Canada ((Aghion and Howitt (1998), p. 392). At the same time, Evenson and Westphal, 1995 argue "...that technology is in fact created in LDCs" (p. 2212) due to difficulties to transfer it from abroad. Why is this the case? A possible answer is that LDC have no appropriate infrastructure to absorb the transfer of technologies. Then a natural question arises: which role should the government play to stimulate knowledge based-economic growth?

There is a consensus that strong property rights are a crucial prerequisite of economic growth. It was taken for granted that intellectual property rights have to be strengthened as well. Quite recently, however, several authors have cast serious doubt upon the last statement (Chang (2001), Boldrin, Levine (2002)). Sakakibara and Bransletter (2001) studied the 1998 Japanese patent law reforms and did not find any evidence of its positive impact. These and a number of other results "...raise the possibility that strengthened intellectual property rights have led to the socially wasteful accumulation of defensive patent portfolios." (Sakakibara and Bransletter (2001). P.99).

Evolution of capital market institutions, globalization and economic growth. There is no evidence that the free movement of short term capital promotes economic growth (Stiglitz, 2000; Griffith-Jones, Montes, Nasution, 2001; Singh, 2002). The IMF has admitted that forcing developing countries to open their markets to foreign investors could increase the risk of financial crises. "The process of capital account liberalization appears to have been accompanied in some cases by increased vulnerability to crises," the fund said in a report (Prasad et al., 2003) prepared by its chief economist, Kenneth Rogoff. The report said there was little evidence that IMF policies encouraged economic growth in poor countries. It warned countries to be cautious about integrating with the global economy and suggested they try to achieve a balance by creating strong domestic financial institutions. Foreign direct investment (FDI) appear to be more correlated with economic growth, but there are reservations to this statement. In Nyatepe-Coo (1998), it is demonstrated that the productivity of foreign direct investment depends on institutional setting of a country.

Migration. The most important restrictions and barriers that remain in the world economy today are not those in international trade and capital flows, but in the movement of people across national borders. In words of Dani Rodrik, "if international policy makers were really interested in maximizing worldwide efficiency, they would spend little of their energies on a new trade round or on the international financial architecture. They would all be busy at work liberalizing immigration restrictions" (Rodrik, 2001). Compared to 100 years ago, the world is much less globalized today in terms of the free flow of labor.

In a neoclassical Heckscher-Ohlin framework the free movement of labor, capital and goods are substitutes in a sense that the each of the three can lead to the reduction of wage differentials between the North and the South. There is really no purely theoretical argument, which can justify free trade without at the same time justifying free migration (Hammond, Sempere, 1999). To explain why it is to the benefit of Western countries to support free trade and to oppose free movement of labor at the same time, one has to look at the gains from immigration of skilled workers ("brain gain") and take into account the welfare state policies in the rich countries (Wellisch and Walz (1998), Schiff (1998)).

In short, the North and the South may have conflicting migration objectives. The North is interested in attracting migrants, who are highly endowed with human and other forms of capital, and restrict entry of migrants with limited endowments. The South would like to stem the flight of human and other forms of capital, and would prefer free emigration of unskilled labor as a partial solution to poverty (Schiff, 1997). Bhagwati and Hamada (1974) proposed a tax on emigrants, with that tax levied by the receiving (developed country) party and transmitted in one form or other to the sending (developing) country. This tax cannot be levied by developing countries unilaterally without violating freedom of movement, so there is not much they can do without the cooperation of the West.

The theory of relative stages of development gives a birth to a number of open questions that are needed to be answered. Probably, the most important problem consists of studying mechanisms that are responsible for formation and evolution of policy threshold levels. The problem is very broad. To understand it more precisely, let us consider some concrete questions.

A. “Bad institutions” often mean that an economy fall into “institutional trap” – an inefficient but stable equilibrium. If, for example, institutional quality does not exceed a threshold level then industrial and social policies do not stimulate economic growth (see Полтерович (1999, 2004), Tonis (2003)), and low living standards and high inequality make prerequisites for low level of institutions. What kind of forces could modify the threshold level so that the system came out of the institutional trap? (see Полтерович (1999, 2004), Polterovich (2008)).

B. Are good institutions a necessary prerequisite for high sustainable economic growth? Since almost all high income countries have institutions of high quality, there is a temptation to say “yes”, assuming that they have reached prosperity due to good institutions. However, the correct answer is not so simple. We know that economic miracles started in a number of countries under bad institutions. Another objection: during last decade, corruption in Greece was evaluated much higher in comparison to Chili, whereas Greece successfully approached more advanced European countries whereas Chili fell behind. If the answer is “no”, then a next question arises: “Under what kind of policies might bad institutions not prevent fast economic growth?”

C. It is widely accepted that civic culture influence institutions, and institutions define rate of economic growth. To what extend does reverse causation take place?

D. It is asserted in many papers that trust of people to each other is an important factor of good institutions and economic growth. One can assume that level of trust strongly influences threshold level for a number of economic policies (in particular, credit policies). In sociological surveys, trust is measured usually by the share of respondents that answer “yes” on the following question: “Can most of people be trusted?” There is currently a database -World Value Survey- that contains information on preferences, values, political and religious attitudes in different countries and in different periods of time (since the 1980s for at least some countries). Recent research, however, does not reveal any significant influence of trust on economic performance (Kornai, J.&Susan Rose-Ackerman (eds.), 2004). How to explain this fact?

2. Goals of the Project and Methodology

The main goal of the project is an exploration of mechanisms that are responsible for formation and evolution of policy threshold levels. We plan to expand the stage of development theory outlined above to understand what are appropriate technological and institutional preconditions and the best strategies of switching from protectionist policy to free trade and liberalization of capital flows, what is a rational balance of imitation and innovation policies, to what extent intellectual property rights have to be protected, and how a middle income country with high quality of human capital may cope with the problem of brain drain.

A special accent will be made on the interconnections of the civic culture, institutions and economic growth. In particular, we intend to check the following hypotheses.

- I. A concept and indicators of “good institution” have to depend on a stage of development.

To explain this statement, let us consider the following example. East Asian and European economic miracles took place under very different initial conditions and institutional structures. Nevertheless, they have an important common feature. As a rule they started from rather centralized systems (except Ireland) and liberalized their economies very gradually. In all of them, including modern Ireland, a miracle was designed in the framework of development plans, and special institutions were created to develop planning procedures and to stimulate fulfillment of plans. A central feature of all planning procedures was intensive interaction and close cooperation between the business and the state (Kuznetz (1988), Qian (2003), Stiglitz (2001), World Bank (1993, 1997), Rodrik (1995a,b), Cazes (1990), Jantti et al (2005)). For developed countries, typical forms of this cooperation (named for Japan and Korea as “Japan (Korea)-corporation”) would be considered as a sign of bad institutions.

- II. Fast economic growth creates incentives for institutional improvements since investments into production turn out to be more productive than investment into rent seeking activities (see Полтерович (2004?)). This changes behavior of private agents as well as higher state rulers, and may give a birth to civil society formation.
- III. A connection between trust (and honesty) and stage of development levels is actually non-linear because the perceptions of the notion of trust change over time: whereas in the traditional society people respond to questions about trust having in mind their experiences in a relatively small community, in more industrially developed countries with high urbanization and high mobility of population the notion of trust is usually applied to a larger group of people, not to a narrow community. These differences in perceptions could explain why it is difficult to reveal the linear relationship between trust and growth. The same consideration is applicable to honesty as well.
- IV. More complicated technology creates incentives for enhancing honesty levels and developing civil society.

Having in mind a synthetic nature of the project, we intend to make use of theoretical and empirical approaches combining macroeconomics of endogenous growth (see: Aghion, Howitt, 1998), institutional theory, and econometrics models. An interesting direction of the econometric work is cross-country comparison of globalization policy effects under different technological levels and in various institutional environments.

Several techniques may be used to check this hypothesis. First, one could search for similarities in evolution of economic policies of developed countries. In most of them economic policy of the central governments played much more broader and important role in the past than now. The government interference was particularly strong in the periods of turmoil. One could explain why USA “new deal” policy and French indicative planning were implemented, and why privatization and deregulation processes took such a long time in France, Italy or New Zealand.

Second, analysis of differences in economic policies of a small group of quickly developing countries on the one hand and less successful economies on the other hand is particularly promising.

Third, general analysis of transplantation of economic and political institutions from one country to another one may be very helpful (La Porta et al (1998), Berkovitz (2003), Полтерович

(2001)). Transplantation turns out to be an important mechanism that accelerates institutional development. However, there are numerous examples of unsuccessful attempts to imitate the most advanced institutions and policies. The experience of transition economies gave particularly rich and impressive set of transplantation failures (Stiglitz (2003), Полтерович (2001)). In a number of cases, more successful was transplantation of institutions that had prevailed in advanced countries at the earlier stages of their development.

3. Tentative Topics for Master Theses

1. Stages of development and foreign trade policy
 - 1a. Impact of openness on the distorted markets
 - 1b. Explaining cross-country differences in external trade to GDP ratios
 - 1c. WTO rules: are they growth promoting?
2. Evolution of capital market institutions, globalization and economic growth
 - 2a. Successful liberalization of capital flows: what are the prerequisites?
3. Strategies of catching up and institutions for imitation and innovation
 - 3a. Technology transfer as an engine of growth
 - 3b. Intellectual property rights protection: searching for the best solution.
4. “Good governance”: what does it mean for a middle income country.
5. Globalization, underdevelopment traps, and group convergence.
6. Accumulation of foreign exchange reserve, industrial policy, and economic growth
7. Brain drain, and economic growth: a problem of international cooperation
8. Institutions and growth: two sides causality
9. Evolution of civil culture and economic growth.
10. Trust and Growth
11. Transplantation of democracy institutions

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