



*Public Lecture at
The Chinese University of Hong Kong*

**Development and Transition:
Idea, Strategy and Viability**

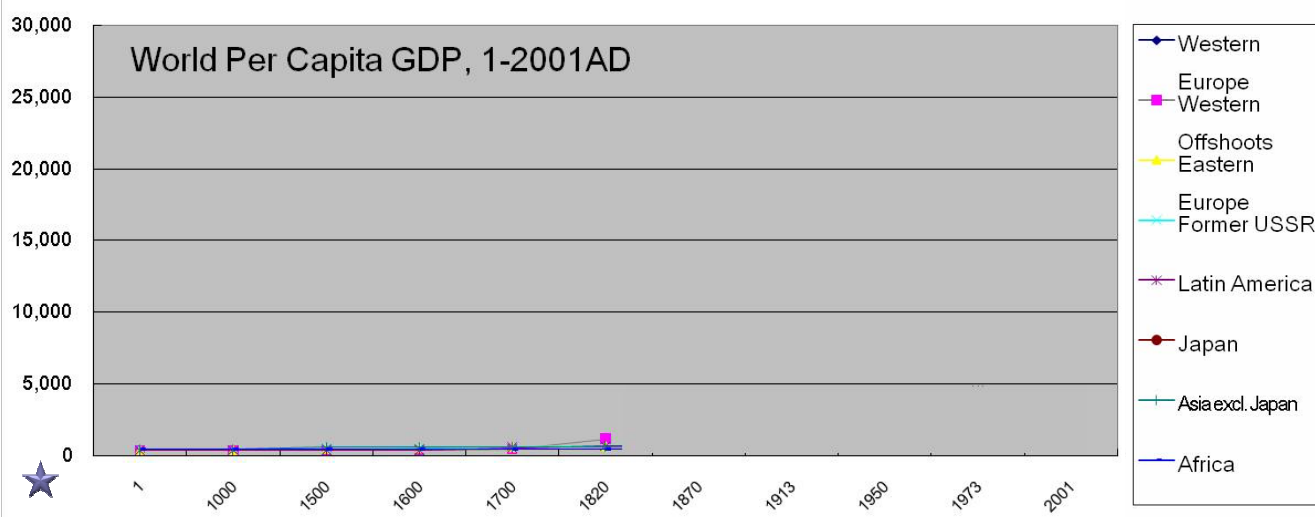
Justin Yifu Lin

**Industrial Revolution and the
Great Divergence**



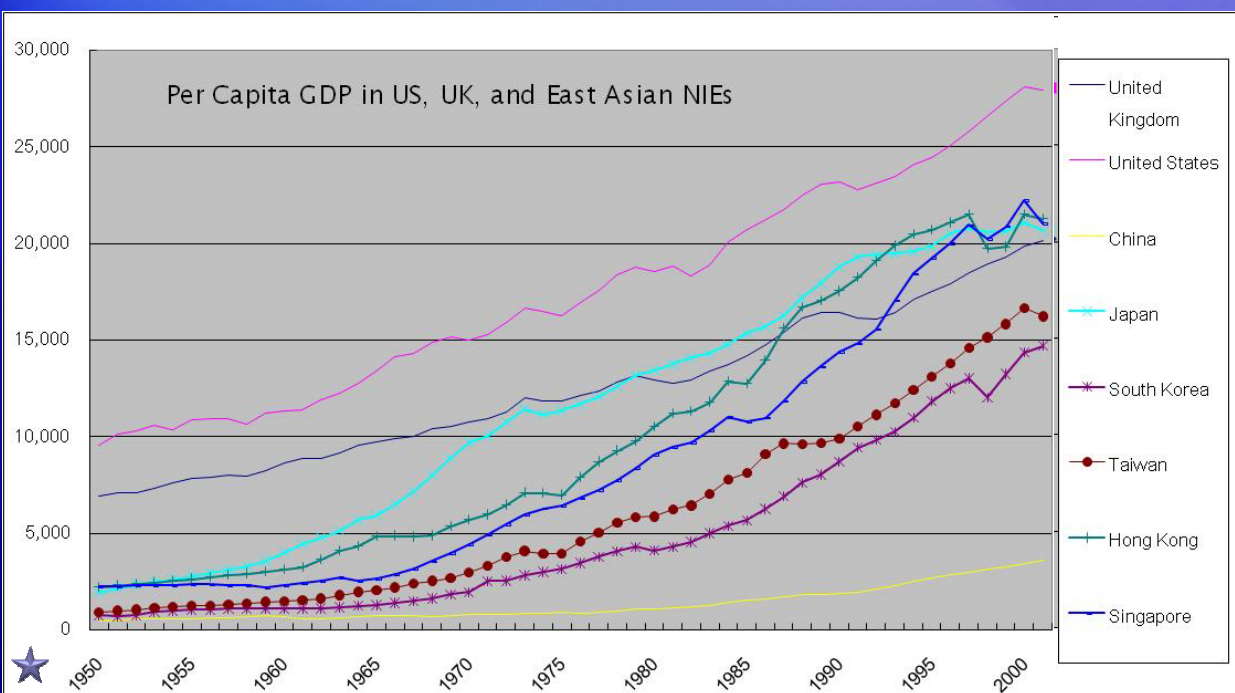
Industrial Revolution and the Great Divergence

- Before the modern era, all nations were in a backward, stagnant, agrarian stage of development.
- China and some parts of Japan and India were richer than Europe.
- After the Industrial Revolution, the great divergence started to occur and the gap is still widening.
- Catching up the developed countries is a dream for all developing countries.



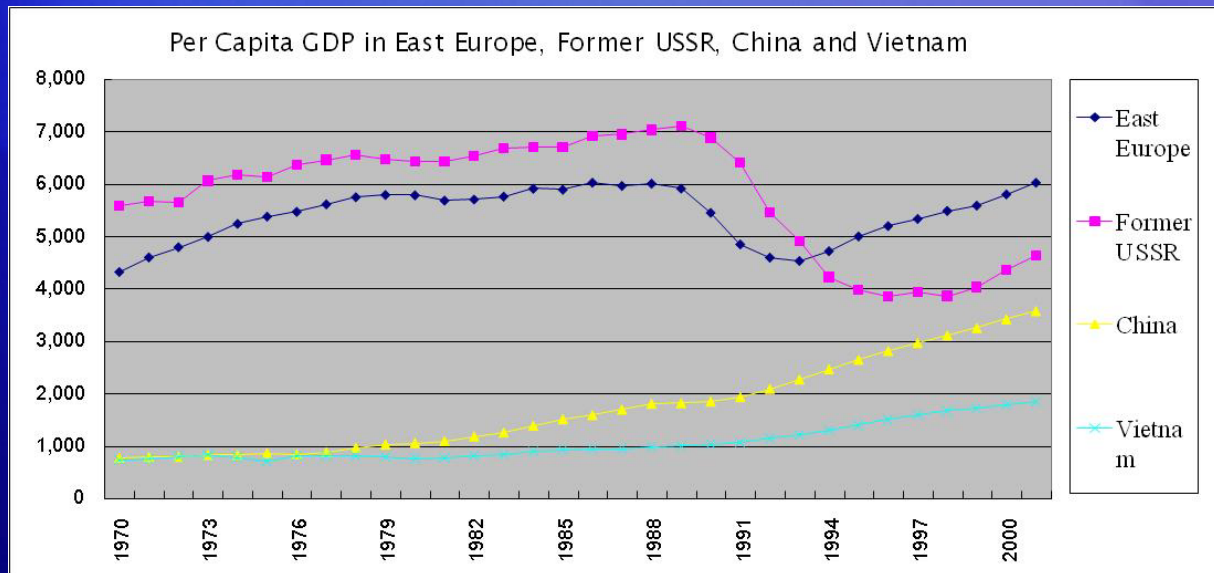
Post WWII Industrialization Drives

- After WWII, most governments in developing countries adopted various policies to promote industrialization in their countries.
- A few East Asian economies succeeded, but all others failed.



Reform and Transition in 80s-90s

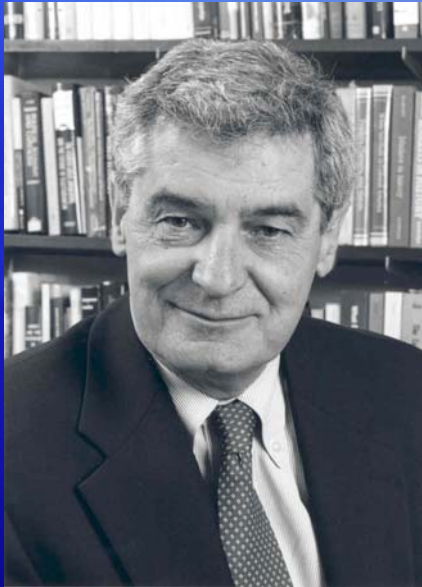
- The socialist countries started their transitions to a market economy and most other developing countries started their reform in the 1980s
- China and Vietnam has had dynamic growth ever since the reform started.
- Countries in Eastern Europe and Former Soviet Union encountered transition collapse and long stagnations.
- Most other developing countries performed worse than before and had the lost decades in the 1980s and 1990s.



Questions for the Lectures

- Why did Japan and the NIEs in East Asia succeed but most other developing countries fail in their development attempts?
- Why did China and Vietnam have a dynamic growth but most other developing and transition countries encounter economic collapse, stagnation and various crises in the reform and transition.
- Adam Smith's Question: Why are some countries rich and other countries poor?

Intriguing Questions for Economists



- The consequences for human welfare involved in questions like these are simply staggering: Once one starts to think about them, it is hard to think about anything else.

Robert Lucas, Jr. Marshall Lectures, 1985

Determinants of Development



Proximate causes

- Natural Resources
- Physical capital
- Human capital
- Technology

Deep, Fundamental Causes

- Competing Hypothesis:
 1. *Luck*
 2. *Geography*
 3. *Institution*
 4. *Culture*
 5. *Openness*
- Most economists now agree that the institution is the key

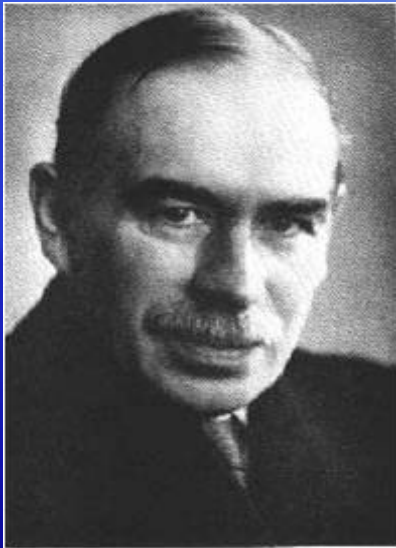
What Determines Institutions

- Conflicts of vested-interest groups :
 1. *Olson: duration of stability and distributional coalition*
 2. *Grossman and Helpman: protection for sale*
 3. *Acemoglu, Johnson, and Robinson: extractive institutions vs. Neo-European Institutions*
 4. *Engerman and Sokoloff: endowment, production pattern, and equal or unequal distribution of income, human capital and power*

Puzzle

- Why did NIEs in the 1960s, Chile in the 1970s, China and Vietnam in the 1980s start to take off without observable changes in the composition of their vested interest groups?

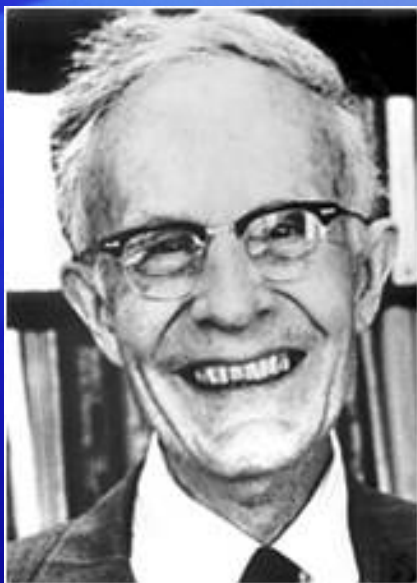
The Key is Ideas not the vested interests



- *But, soon or late, it is ideas, not vested interests, which are dangerous for good or evil.*

*John Maynard Keynes, 1935,
The General Theory of
Employment, Interest and Money,
Chapter 24.*

Social Thought Shapes Institutions



- *The dominant social thought shapes the institutionalized order of society.*
- *Social thought consists of various political, social and economic ideas*

*Theodore W. Schultz, 1977,
Economics, Agriculture and
the Political Economy*



Government, Political Leaders and Social Thought

The Government and Institutions

- The government is the most important institution in a country.
 1. Membership is universal
 2. powers of compulsion over its citizens
- The other institutions in the country are shaped by the government's policies.
- Therefore, the quality of government determines the success or failure of development in a country..

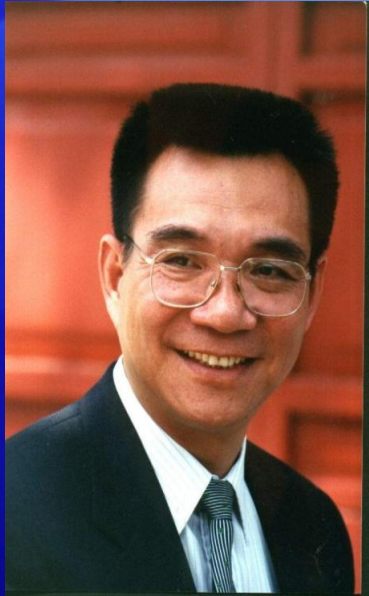
The Political Leader and the Government

- The government is run by political leaders
- Therefore, the quality of the government is determined by the political leaders' behaviour

Political Leaders and Social Thought

- The behaviour of political leaders depends on their motivation.
- The political leaders' motivation:
 1. tenure security
 2. status in history.
- The best way to secure the tenure and historical position is to bring prosperity to the nation.
- Following the dominant social thought about economic development is the optimal choice for the leaders.
 1. *The leaders' bounded rationality*
 2. *Easy to mobilize public supports*

My Hypothesis: Idea and Development Failure



- Continuous technology innovation is the foundation for sustained, dynamic growth
- If the institutions are right, a developing country can exploit the advantage of backwardness and catch up the developed countries.
- The bad institutions are shaped by inadequate ideas about priority development of heavy industry when their capital endowments were scarce.

My Hypothesis: Idea and Transition Failure



- The failure of transition is due to the governments' transition strategy, which ignores
 1. *The existence of large amount of nonviable firms in their economies*
 2. *The distorted institutions were the second-best arrangements for protecting the nonviable firms.*



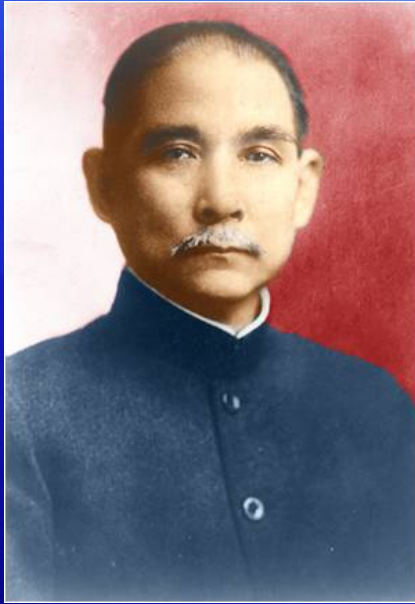
Modernization Aspiration



Aspiration for Industrialization

- The great divergence occurred only after the advent of Industrial Revolution in the West.
- Industrialization, especially the development of big, heavy industries, was viewed as a key to economic prosperity and political independence.
- Germany in the late 19th century and Soviet Union in the 1930s provided the evidence.

Sun Yat-sen on China's Industrialization



- *The development of key and basic industries is the priority in China's industrialization.*

Sun Yat-sen, 1919

Mao Zedong on China's Industrialization



- *Without industry there can be no solid national defense, no well-being for the people, no prosperity and strength for the nation.*

Mao Zedong, 1955

Mao Zedong on China's Industrialization and Independence



- *Chairman Mao once said: our nation has obtained political independence, but if our nation wants to achieve complete independence, the completion of industrialization is necessary. **If the industry is not developed, a country may become the other country's vassal even after the country has obtained independence.***

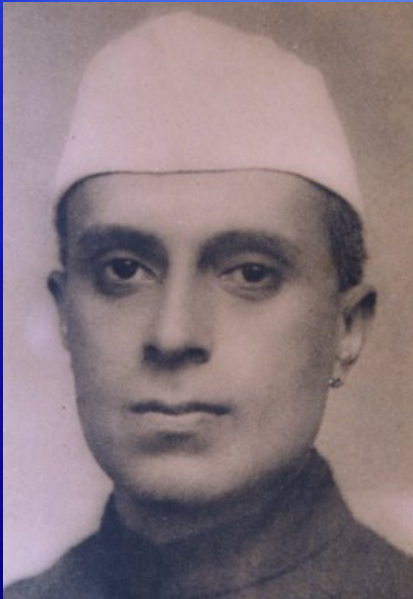
Zhou En-lai, 1953

Nehru on India's Industrialization and Independence



- *No modern nation can exist without certain essential articles which can be produced only by big industry. **Big industry must be encouraged and developed as rapidly as possible, but the type of industry thus encouraged should be chosen with care. It should be heavy and basic industry, which is the foundation of a nation's economic strength and on which other industries can gradually be built up.***

Nehru on India's Industrialization and Independence



- *No country can be politically and economically independent, even within the framework of international interdependence, unless it is highly industrialized and has developed its power resources to the utmost.*

Jawaharlal Nehru, 1946

Ideas and Social Thought



Social Thought on Heavy Industry Development

- Marx's Two-sector Economy:
 1. *The production of means of production should grow faster than the production of consumer goods.*
- Prebisch-Singer thesis
 1. *Developing countries that focus on production and export of commodities will be exploited by developed countries that focus on production and export of manufactured goods.*

Social thought on Government Intervention

- List's Infant Industries thesis
- Development Economics
 - *Market Failures*
- World Bank, IMF and other international agencies promote the government's interventions for industrialization.

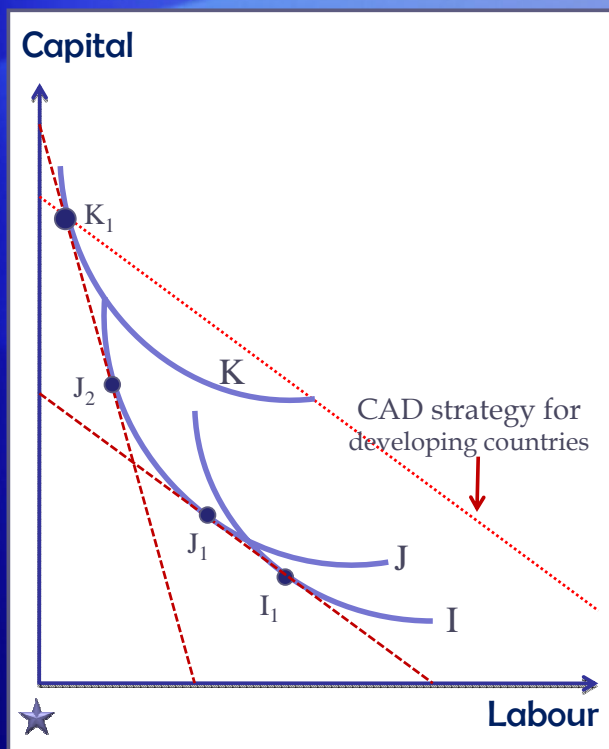
The Social Thought is incorrect

- The political leaders' aspiration for developing advanced heavy industry is noble.
- The failure to have advanced, heavy industries in the developing countries was not because of market failure, rather it was because of the viability problem of firms in the heavy industries.

Development Strategy and
Institutions



Optimal Industrial Structure, Development Strategy and Viability



- *The optimal structure of an economy is endogenously determined by the economy's endowment structure.*
- *Developing Country's attempt to develop heavy industry is a comparative advantage defying (CAD) strategy*
- *The firms in the CAD industries will be nonviable in an open, competitive market*

CAD Strategy, Institutions and Government Failures

- **Viability, policy burden and policy supports**
- **Types of Policy Supports:**
 1. *Direct subsidy*
 2. *Preferential tax treatment, Trade barriers and monopoly*
 3. *Interest rate, foreign exchange rate distortions*
- **Price Distortions, planning and administrative allocations**
- **Rent-seeking, directly unproductive profit seeking, and soft budget constraints**

CAF strategy and Market Institution

- Alternative to the CAD strategy is the comparative advantage-following (CAF) strategy, which attempts to facilitate the firms to follow the economy's comparative advantage determined by the economy's endowments.
- The firms in the CAF strategy will be viable.
- Firms will follow the economy's comparative advantage in choosing technology and industries only if the factor price reflects the relative abundance of each factor in the endowments.
- Competitive markets are required for relative prices to reflect the relative abundances of factors in the economy's endowments.

CAF Strategy and Developmental State

- The government may play a more active role than that of a minimum state in the developing country
- When the government pursues a CAF strategy, a certain industrial policy is desirable in the country's industrial upgrading.
 1. *Information*
 2. *Coordination*
 3. *Externalities*

CAD and CAF Industrial Policies, What Different?

Case of Automobile Policy (Per Capita Income in 1990 International Dollar)

	US	Japan	Korea	India	China
1955	10,970	2,695	1,197	665	818
1965	14,017	5,771	1,578	785	945
1975	16,060	10,973	3,475	900	1,250

Comparison of Performance

The consequence of CAD strategy	The Consequence of CAF strategy
Difficult to exploit advantage of backwardness	Facilitate exploitation of Advantage of backwardness
Initial investment-driven growth but soon lead to stagnation, and divergence	Dynamic growth and convergence
Closed economy	Openness
Inequality	Equity

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Ideas of Transition



Changing Social Thought and Washington Consensus

- The Failure of CAD strategy led to the Capitalist triumphalism.
- The new social thought is encapsulated in Washington Consensus, which intends to build up the necessary institutions for a well-functioning market economy
- Shock therapy is a version of Washington Consensus.
 1. *Market liberalization*
 2. *Privatization*
 3. *Fiscal discipline*

The Failure of Washington Consensus

- Socialist countries adopting the shock therapy encountered “L” curve instead of “J” curve in their transition path.
- Other developing countries following the Washington Consensus encountered lost decades in 1980s and 1990s.
- China and Vietnam did not follow shock therapy.

What's Wrong with Washington Consensus

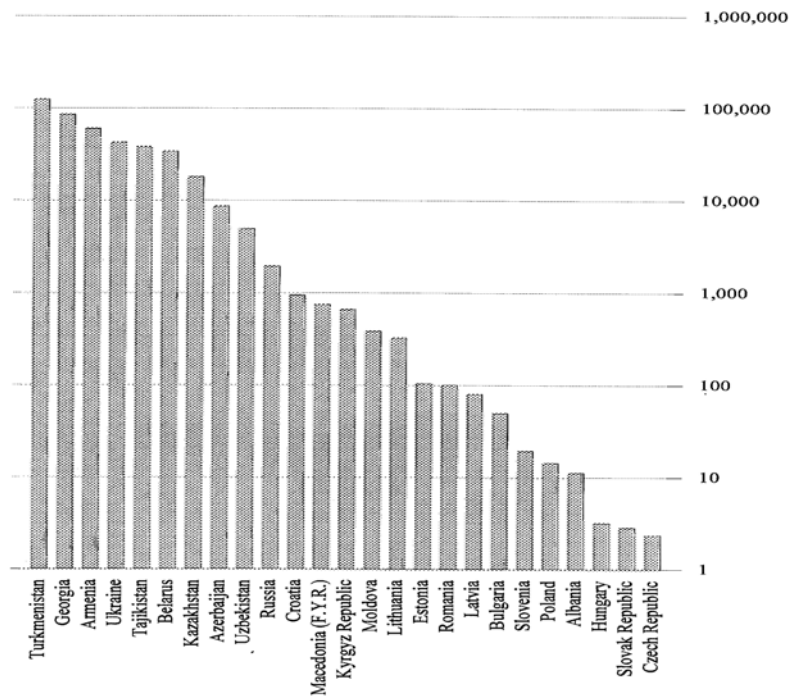
- The Washington Consensus and shock therapy treat the existing distortions in the socialist and developing countries as exogenous
- In fact, those distortions are second-best arrangements for protecting large number of nonviable firms in the countries.

Shock Therapy's Triangle of Impossibilities

- Privatization worsened Soft Budget Constraint.
 1. Firms in the priority sectors still encountered policy burdens.
 2. The government is responsible for those policy burdens and is obliged to provide policy supports.
 3. The privatized firms have higher incentives to ask for higher protection and subsidies.
- Privatization weakened taxation capacity.
- It is impossible to achieve market liberalization, privatization and fiscal discipline simultaneously.
- The shock therapy led to rampant inflation in Russia and other transition economies in FSU and EEC

Inflation in the Five Years of Transition

Figure 1. Cumulative Increase in Aggregate Consumer Price Index During the First Five Years of Transition¹
(Logarithmic scale; in number of times)



China's Approach to Transition



Deng Xiaoping on Approach to Transition



- No matter it is a white cat or a black cat, as long as it can catch mouse it is a good cat.
- Cross the river by groping the stones.

Deng Xiaoping

Dual-track Approach and Transition Dynamics

- China adopted a dual-track approach in the transition.
 1. Giving partial autonomy to farmers and SOEs to improve incentives.
 2. Introducing dual-track in prices and resource allocation and allowing private firms to enter the formerly suppressed sectors but requiring SOEs and farmers to deliver the obliged quotas to the state as in the past.
 3. Liberalizing the price and market of goods when the majority of the goods are allocated by the market.
- The approach resulted in stability and dynamic growth simultaneously.
- Other successful reforming countries, such as Vietnam and Mauritius, also followed this approach.



Why are East Asian So Special?

Resource Constraints

- The governments in East Asia were influenced by the same social thoughts
- The East Asian leaders were constrained by the paucity of natural endowments in their choice of CAD strategy
 1. *High inflation in Taiwan when it pursued the CAD strategy in 1950s*
 2. *High inflation in Korea when it pursued the heavy machinery and chemical drive in the 1970s*

Cultural Heritage and Political Philosophy

- The paucity of natural endowment and the pragmatism in Chinese culture
 1. 中庸 *Zhongyong* (*Keep the golden mean*)
- Pragmatism and political philosophy
 1. 实事求是 *Shishi qishi* (*Finding truth from facts*)
 2. 解放思想 *jiefang sixiang* (*Liberalizing one's mind from dogmatism*)
 3. 与时俱进 *yushi jujin* (*Adapting policies to the changing environment*)

Luck, geography, culture are
arguably factors in East Asia's
success stories



Lessons for Transition and Reform

- Take measures to improve incentives
- Introduce a dual-track system, allowing entry to the repressed sectors and continuing to provide necessary supports to the nonviable firms
- Liberalizing a sector when most products in the sector are allocated by market
- Constantly introduce necessary regulations and laws to strengthen market institutions

Concluding Remarks



Summary of Main Ideas

- Technology upgrading is the most important driving force for long-term dynamic growth.
- The government is the most important institution in a developing country as its policies determine the quality of other institutions in the country.
- Idea is the most important determinant of the qualities of a country's policies and institutions.



Summary of Main Ideas

- The endowment is the most important binding constraint in a country's choice of technologies and industries.
- The comparative advantage is the most important guiding principle for formulating development policies.
- The viability is the important concept for understanding the cause of distortions in an economy.
- The pragmatism is the most important policy guidance for economic transition.

Poverty Is Not Destiny



- *All nations have opportunities which they may grasp if only they can summon up the courage and the will.*
- *It is possible for a nation to take a new turn if it is fortunate to have the right leadership at the right time.*

Arthur Lewis, 1955

Knowledge is the Foundation of Freedom



- *Freedom of the will ... means nothing but the capacity to make decisions with knowledge of the subject.*

Friedrich Engels, 1877

Conclusion

- *Hope that the Lectures will contribute to the knowledge that helps the developing and transition countries in the world to jump from the kingdom of necessity to the kingdom of freedom in their pursue of economic development and transition.*

