The Catch-Up Game

An academic and a policymaker share insights on what makes countries grow, in good times and bad

THE current financial crisis has brought the issue of growth and stimulus back into sharp focus. To gain insights into this issue, Archana Kumar from *Finance and Development* magazine turned to two experts: Michael Spence, a Nobel Prize–winning economist, and Mahmoud Mohieldin, Minister of Investment of the Arab Republic of Egypt. Both have served on the Commission on Growth and Development—a group of policymakers and academics that came together for two years to explore the causes, consequences, and internal dynamics of sustained high growth. The commission, which completed its work well before the financial crisis took such a severe turn, recently published its findings in *The Growth Report: Strategies for Sustained Growth and Inclusive Development.*

***F&D:* What are the critical actions needed in advanced economies to lessen the impact of the financial crisis on the real economy?**

Spence: We face two scenarios in the developed economies. One, if we don't effectively solve the credit crunch problem, it will cause extraordinary and widespread damage to the economy outside the financial sector. And that scenario will be worse than anything we've seen in the post-war period. There is a reasonable chance that with a focused global effort—I mean an internationally coordinated one—we can avoid that scenario. It will not immediately settle the stock markets because they are operating on a completely different dynamic that has to do with fear, but it is still important and policymakers should focus on that. So I would put that at the top of the list.

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The second scenario is a little harder to get people to focus on, but because we have already seen tremendous growth slowdown, we need both a well-thought-out fiscal stimulus that has a time dimension to it and a plan to restore fiscal balance in the long run that can prevent further chaos in the financial markets. Larry Summers, among others, has talked about this at some length.

So those would be my two candidates: deal with the real effects of the financial crisis and, to the extent possible, recapitalize the financial system; and then focus on the fiscal side. Of course, the financial system cannot be recapitalized fast enough to solve the credit lockup problem, so it has to be solved with direct interventions of various kinds: guarantees for transactions that are being cleared in the interbank transaction system, the U.S. Federal Reserve buying commercial and municipal paper, and so on.

Mohieldin: The first thing is restoring confidence, and the second thing is restoring confidence. The issue of trust and confidence in, and the credibility of, the financial system is very crucial today. Whatever we can do to restore confidence is going to be beneficial, not just for the developed countries but also for the developing countries.

As Professor Spence just mentioned, we need to think of some shortcuts—some supportive measures—until we can get the financial institutions back in order. To fund crucial development projects, and for trade and investment, countries need adequate finance. And the issue of finance, along with the issue of confidence, means that the mechanics of support should be put in place very quickly to restore the normal functioning of the financial system.

***F&D:* How about emerging markets? What are the critical actions they can take to protect their growth rates at this time?**

Mohieldin: You cannot put all developing countries and emerging markets in one category, especially now, because they are exposed in different ways to current crises. So particular policies are likely to be more relevant to some countries than others. Take the rising commodity prices, for example. Some countries have benefited, and others were harmed.

But nobody is benefiting from the financial crisis. It's not a zero-sum game. For small open economies, including say a country like Egypt, it feels like being on a boat in a very turbulent sea. What we need to do is keep that boat safe by making some sort of precautionary arrangements and enhancing the safeguards. And we need to continue to use commonsense approaches in doing business.

Also, achieving and maintaining growth through more investment is crucial. Take the case of Egypt and many other countries in the rest of Africa. They could rely on private sector investment, especially on productive sectors such as infrastructure. It takes time to see the outcome of such beneficial projects, but they pave the road for future prosperity.

Another important area to think about now is the way economic performance, including growth performance, is measured. We are, at the moment, dependent on "lagging indicators." It is like driving a car without even a clean rearview mirror. Things on the road ahead don't appear to be very clear. To accurately assess the impact of the financial crisis on the performance of developing countries, we need clear and leading indicators that show the symptoms of trouble. And that is not always possible because many of the developing countries do not have sophisticated financial systems, including active stock markets.

Mohieldin: Achieving growth through more investment is crucial.

So whatever is happening or is going to happen in developing economies as a result of the financial crisis is not being clearly revealed, and I fear these countries will be hit directly in the bone. Without any buffer or financial shelter, growth, unemployment, the welfare of people, and—unfortunately—poverty would be directly affected.

Spence: I agree with Minister Mohieldin—stabilizing and keeping the boat afloat are key priorities. For the countries that can afford it, domestic investment—including domestic public sector investment and employment—makes a lot of sense at time when the global economy has created a bit of a vacuum. And for poor countries that are commodity importers at the 10 percent of GDP level with high portions of household budgets going to food, the right response is for the global community to get together and help them.

***F&D: The Growth Report* says that "sustainable high growth is catch-up growth and the global economy is the essential resource." What do you mean by that?**

Spence: We called it catch-up growth because of the global economy's contribution to growth—which we found was an essential element after looking at the dynamics of the successful high-growth cases. It is pretty well understood from trade theory and modern growth theory that global markets are big and a country can grow pretty fast without expanding its market share much—and if it has the terms of trade. But the other part, which is emphasized by Paul Romer and other distinguished leaders in the area of growth theory, is that catch-up growth is really about learning. It's about knowledge transfer. It's expanding your potential output based on what the economy—both the private and public sector sides—comes to have expertise in doing, and that is the catch phrase, no pun intended, for catch-up growth. This is what, we believe, more than anything else enables countries to grow at rates in the 7–10 percent range, and nobody else can do that. You can't do it in isolation and you can't do it as an advanced country with no counterexamples because you have to invent all the technology that moves the production possibility out, whereas developing economies can, at least for a period of time, import it. You have to import it and adapt it so it takes a considerable amount of ingenuity, innovation, and adaptation.

Mohieldin: The 13 successful cases [in *The Growth Report*] of sustained high growth since the Second World War used their integration with the world in a very successful way through the vehicles of knowledge—obtaining it either directly by sending people to get educated abroad, or getting them through training programs—or even through foreign direct investment.

I am from a generation that was taught that the three pillars of any economic activity were land, labor, and capital, and when you added them together with an entrepreneur, you would see the marvels of economic activity. Today those three pillars have been replaced. In an interesting piece of work, Professor Romer discusses endogenous growth, and—according to him—the three new aspects of development are, first, learning, innovation, and the transfer of ideas. Second, labor has been replaced by "people," not just those who are in the workplace but those who *could be* in the workplace as well as those who are communicating with them. Third, to be safe, they added "other things," which could be anything such as capital, additional resources, etc. So today the three pillars are ideas, people, and other things.

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Mohieldin

The success stories of Singapore, Malaysia, Korea, China, and, more recently, India and Vietnam are based on these new pillars, rather than the traditional ones. And further integration with the rest of the world can benefit countries even more. This means globalization is going to remain relevant, even though I'm saying so at a time when people might be questioning the very merits of globalization.

***F&D:* But the global economy itself is in severe distress. Do you still think that engaging with the global economy is a prerequisite for achieving high growth?**

MOHIELDIN: As I just mentioned—even at a time when the global markets have seen some very negative developments and when the Doha Round is continually failing—I still believe in the merits of the global economy for small, open economies, such as Egypt and others in the region. The global economy has also benefited larger countries, such as China and India. I still believe in the value of expanding demand through exports, enhancing capacity to finance growth by foreign investments, developing our knowledge by learning from others. We can not do any of these without globalizing.


Spence: Catch-up growth is about learning.

SPENCE: I will only add one thing. There are approximately 4 billion-plus people in parts of the world that are pretty well off, or growing rapidly, and that number has been expanding, and now there is a great deal of hope. Hope being the right word. And if we allow the global economy to shut down and truncate the opportunities that all of these people—the ones in the successful economies and the ones that are probably in the process of entering that group: that is, a good chunk of the rest of the world's population—we will (*a*) do something that is deeply unfair by taking away one of the principal underpinnings of that growth and prosperity, and (*b*) it will have consequences in the way people think about their relationship with each other in the world. It is worth a big effort therefore to protect some version of the open global economy.

***F&D:* Have you identified a "model" for growth in the post–World War II era? Or, if you had written *The Growth Report* in 2008, it may have offered different policy prescriptions for high growth?**

SPENCE: It may not be the only model, but it was the only one we were able to find. In a sense, it's an empirical statement—others may invent different ones for particular circumstances. For instance, Dubai may go from a natural resources economy to a global service economy, and India has certainly done things in an odd order, by developing the [highly educated] service industries. Having said that, in some sense, it is the only model that we know of. If we wrote the report in late 2008, we would have emphasized the volatility and insurance aspects more, because when they get out of control they produce crises. Also, we already know that such crises are debilitating for progress and growth, and do not adequately support growth policies.

MOHIELDIN: For policymakers, the report is particularly useful because it highlights the *list of don'ts*. It is especially relevant for countries that are not geographically close to the 13 high-growth countries we identified in the report—most of which are in Asia. The closest country to us is Oman, which is a very particular case, at least in terms of the relatively small population size. This is not to undermine what Oman has achieved, which is a great deal, especially in areas related to investment in human capital and to equity. But the East Asian countries, such as Singapore, China, Malaysia, Korea, and Japan, are learning from each other's experiences. The proximity helps, not just geographic proximity, but also cultural proximity.

***F&D:* What is the one key policy ingredient critical for achieving sustained high growth—notwithstanding your caveat of "individual country conditions"?**

MOHIELDIN: Investment in human capital. Investing in education and health, and the provision of public goods, is a crucial but neglected issue—neglected because the investment will not be reflected in outcomes today or tomorrow. It will take a generation, or more, to see a return on good investments in human capital, or even the investment in infrastructure in a wider sense so you can support the human capital development.

SPENCE: I am very tempted by that view—high levels of investment in long-term horizons are very important for future generations and would seem to deserve to be at least near the top of the list, but I would pick openness to the global economy. I think it is the other potential candidate.

***F&D:* What is the least understood thing about growth?**

SPENCE: This is very hard to answer, because it depends a little bit on who one's talking to or about what; but I would pick the crucial contribution that is made by political leadership, consensus building, building communication, giving people a vision of what's going to happen that allows them to participate over time enthusiastically in a process that involves short-run sacrifices. If you take it away, the chances of achieving high growth are very low, and I think many, many people don't understand that very well. I certainly didn't at first.

MOHIELDIN: It depends on the audience, but generally the idea that growth is a proxy for many other things, a reflection of all of the good things that society has been managing to do to achieve something, is not very well understood. Growth stands for the aspiration of people from an economic and social perspective—and it has the beauty of being measurable. It is a summary of the progress of a nation. ■

Archana Kumar is a Senior Editor on the staff of Finance & Development. *This is an edited version of the interview. In-depth coverage of the Growth Commission's work and ideas can be found at* www.growthcommission.org.