ECONOMIC TRANSFORMATION AND DIVERSIFICATION[1]

Limited diversification in exports and the broader structure of the economy has been an underlying characteristic of many low-income frontier economies. Concentration in sectors with limited scope for productivity growth and quality upgrading, such as primary commodities, may result in less broad-based and sustainable growth. Moreover, lack of diversification may increase exposure to adverse external shocks and macroeconomic instability. This presentation is based on ongoing IMF work that examines the role of diversification in the macroeconomic performance of frontier economies using both cross-country data and case studies, and analyzes diversification in both trade and the broader domestic economy. Some key messages are:

Economic development critically involves diversification and structural transformation—that is, the continued, dynamic reallocation of resources from less productive to more productive sectors and activities. This process involves not just external trade, but the broader economy. Increases in diversification are strongly associated with lower volatility and higher growth.

There are major differences across regions and countries in the degree to which they have succeeded in diversifying and transforming their economies. Over an extended period, East Asia has on average been particularly successful in diversifying its exports, particularly in comparison with sub-Saharan Africa. Much of the progress has occurred through diversification along the 'extensive margin', that is, through entry into completely new products.

Structural transformation crucially involves changes not only in the type, but also in the quality of goods produced. Producing higher quality varieties of existing products can constitute a way of building on existing comparative advantages. It can boost countries' export revenue potential through the use of more physical- and human-capital intensive production techniques. Overall, East Asia has on average benefited significantly from quality upgrading. Yet, it is important to note that the potential for quality upgrading varies by product. Agricultural and natural resources tend to have lower potential for quality upgrading than manufactures. Therefore, for frontier economies at early stages of development, diversification into products with longer quality ladders may be a necessary first step before large gains from quality improvement can be reaped.

Case studies of individual countries suggest that:

- **Diversification and structural transformation are often underpinned by reforms and policy measures that are general in scope**, such as improving the quantity and

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quality of infrastructure or essential business services, or setting up a welcoming environment for foreign investors. It remains an open issue to what extent industry-focused and narrowly targeted measures have historically helped underpin diversification efforts.

- **Effective policy measures come in "waves" and aim at exploiting the evolving comparative advantages of the economy in changing external conditions**. The types of reforms underpinning diversification and structural transformation in the early stages of development are different from those required later on and need to be adapted to the external environment faced by the economy.
- **The frequency with which new products are introduced and the rate at which they grow can indicate potential policy-driven bottlenecks**. Little entry may indicate that barriers deter firms from exporting or experimenting. If survival rates are low, firms may face more obstacles than expected. If surviving firms cannot expand, they may have inadequate access to finance.

Some key issues for discussion:

Where growth is not underpinned by structural transformation, can it prove sustainable? And can it be inclusive? In other words, is an expansion of productive private manufacturing and service sectors essential to job creation and unemployment reduction?

What factors can spur or, alternatively, impede diversification in frontier economies? What are the relevant market and government failures, and how can their effect be mitigated? To what extent can weak institutions, labor and product market rigidities, or public-sector inefficiencies impede structural transformation and diversification?

What factors can spur or, alternatively, impede quality upgrading? Are insufficient human capital and lack of financial development of particular concern to those middle-income countries that have already started diversifying and are now focusing on quality upgrading?

How does the rapid expansion of modern, tradable services affect development strategies and the nature of structural transformation? Can modern services, including business, scientific, technical, financial, and IT services, prove a driver of sustained growth and job creation in developing countries? What kind of policies and institutions are needed for developing countries to take advantage of the globalization of services?