Development: New world, new economics

©REUTERS/Kacper Pempel

Interview with **Justin Yifu Lin**, World Bank Chief Economist

In 2008, the Chinese economist Justin Yifu Lin became the first person from a developing country to be appointed World Bank Chief Economist. At the Bank, Dr Lin has pioneered "New Structural Economics," which aims to find the right balance between the roles of the market and the state in developing countries' economies. In the run-up to the Annual Bank Conference on Development Economics (ABCDE), which this year will be hosted at the OECD, he spoke to Brian Keeley.*

Brian Keeley: Your work on New Structural Economics represents a change of direction for development economics. How would you characterise the discipline so far?

Justin Yifu Lin: Development economics is a relatively new discipline. It didn't appear until the post-war period. At the beginning, the understanding was that to reach high-income levels, a developing country needed to have the same industrial structure as a developed country. But developing countries didn't have that. The understanding was that this was because of market failures caused by some kind of structural rigidity. So governments were advised to intervene to support the development of those new industries and to adopt import substitution strategies. By the late 1970s and early 1980s, the development thinking switched to the Washington Consensus–government failures were perceived as more serious than market failures, so it was thought better to have a policy framework to achieve a balanced budget and for government not to intervene directly in industrial development. Its goal was just to level the playing field, and the market would essentially do the rest.

> Developing countries sought to develop the industries prevailing in high-income countries, but these were not aligned with their comparative advantages

You suggest these approaches were both flawed. Why?

Firstly, structural economics. Developing countries sought to develop the industries prevailing in high-income countries, but these were not aligned with their comparative advantages. So firms were not viable, and their products were not competitive in domestic and international markets; there had to be a lot of subsidies and protection, which opened the door for political and industrial elites (and the like) to have so-called rent seeking. That led to corruption and political capture in developing countries that pursued those kinds of policies.

Then, with the Washington Consensus there were two issues: it did not appreciate that the various distortions of the past were a way to support non-viable firms. If the distortions were removed immediately, those firms would go bankrupt, causing unemployment and social instability. Also, it did not consider the necessary role of the state in overcoming the issues of compensation for externalities and co-ordination of infrastructure improvement or institutional change, which are crucial for the development of new sectors.

A key aim of New Structural Economics is to better understand the roles of the market and of the state in economic development. I think it should be a more balanced view than the development thinking we've had so far.

How is it more balanced?

Economic development is a process of continuous technological innovation and structural transformation. In this process, a well-functioning market system is the foundation for effective resource allocation. However, moving into new sectors and new industries requires co-ordination to ensure investment in hard infrastructure, like transportation and telecommunications, or improvement in soft infrastructure, like the financial system and education system. Individual firms will not be able to internalise all those changes by their own decisions. There's a market failure there: it is not something the market will do on its own, so it requires the government to co-ordinate various private firms' investments or for the government to make those investments itself. That's one role for the state.

> Since 2000, developing countries' growth rate has been much faster than developed countries'. Global governance needs to reflect these realities

The second concerns "first movers", who may experience failure or success as they enter new sectors. With failure, they pay all the costs. With success, it's a signal to the economy that this new sector represents the economy's comparative advantage, so it's going to attract a lot of new entrants, limiting the first mover's potential profits and its initial incentive to enter the new sector. In a high-income country, the patent system compensates the first mover. But in developing countries, they are entering into industries that are new to them but that are mature in the global system. So the government needs to find some way of providing incentives to the first mover.

Overall, instead of the government trying to move the economy from A to Z–from being based on agriculture to being heavily industrialised–in one giant leap, you're talking about nudging it from A to B, then B to C and so on?

Right! I use the term "facilitating state". The government's intervention should be limited to sectors where the economy has latent comparative advantage–in effect, there is a comparative advantage, but because of the lack of facilitation and co-ordination, it has not been harnessed yet. The government's role is to remove the constraints for domestic private firms, if there has been spontaneous entry, or to encourage the investment of foreign firms to the sector. In this interaction between the state and the private sector, the government facilitates, but it does not impose.

How do you prevent, say, corruption in your model?

I think the propensity for corruption and rent seeking depends on the scale of the subsidies. As the new sector in the above approach is consistent with the economy's comparative advantage, a government's small incentive to the first movers will be enough to compensate them for the information externalities they generate. The government's facilitating role is mostly in co-ordinating required improvements in hard and soft infrastructure. So the opportunity and incentive for any rent seeking will be small.

Does this model only work in an authoritarian state?

Government commitment is necessary, but it doesn't depend on whether it's authoritarian or democratic. Ireland is a recent example. Before 1987, its economy was a basket case. But after '87, the Irish Industrial Development Authority's industrial policy focused on selected industries, including information, electronic, pharmaceutical and chemical industries, and later on financial services. For 20 years, Ireland enjoyed a similar growth rate to East Asia and became one of the highest-income countries in Europe. Certainly, Ireland now has problems, but not because of its industrial policy. Mauritius also has had very successful industrial policies. Both of them have democratic systems.

How significant is it that a Chinese citizen is now World Bank chief economist, and does your appointment reflect a rethinking of global governance in response to the rapid evolution of the world economy?

Good question. Before 2000, more than 60% of global GDP was produced by the G7 countries, and the international institutions reflected that reality. But since 2000, developing countries' growth rate has been much faster than developed countries'. Global governance needs to reflect these realities. I think the reason why I have the honour to be the first Chief Economist from a developing country reflects these changes in the global landscape. In the past, the funding for development, as well as the ideas, mainly came from high-income countries. But now the world is entering into a new era: developing countries themselves can generate a lot of funds for development both in terms of investment and even in official development assistance. At the same time, developing countries provide useful lessons for each other. Robert Zoellick, president of the World Bank, gave a speech last fall at Georgetown University on democratising development economics, in which he asserted that every country should have an equal opportunity to make a contribution to development thinking and practice, and each country at every level of development can learn from each other.

You're clearly rethinking development economics. In the wake of the crisis, is economics in the market for new ideas?

In the past few years, one of the most popular terms in economics has been "rethinking". The function of economic theories is, first, to explain observed economic phenomena and to predict how they are going to evolve, and, second, to provide policy frameworks for coping with challenges or exploiting opportunities arising from the observed phenomena. This global crisis certainly was unexpected. The existing theory failed to predict its arrival and once it came, failed to predict its seriousness. For example, the existing theories believe that a financial system through competition will self-regulate. Well, now we understand that that kind of theory is imperfect. So there is a lot of rethinking in mainstream economics, and certainly in development economics as well. I think that's a very healthy trend.

*Dr Lin will speak at the ABCDE event, hosted at the OECD in Paris from 30 May to 1 June 2011. Brian Keeley is senior editor in the OECD Directorate of Public Affairs and Communications.