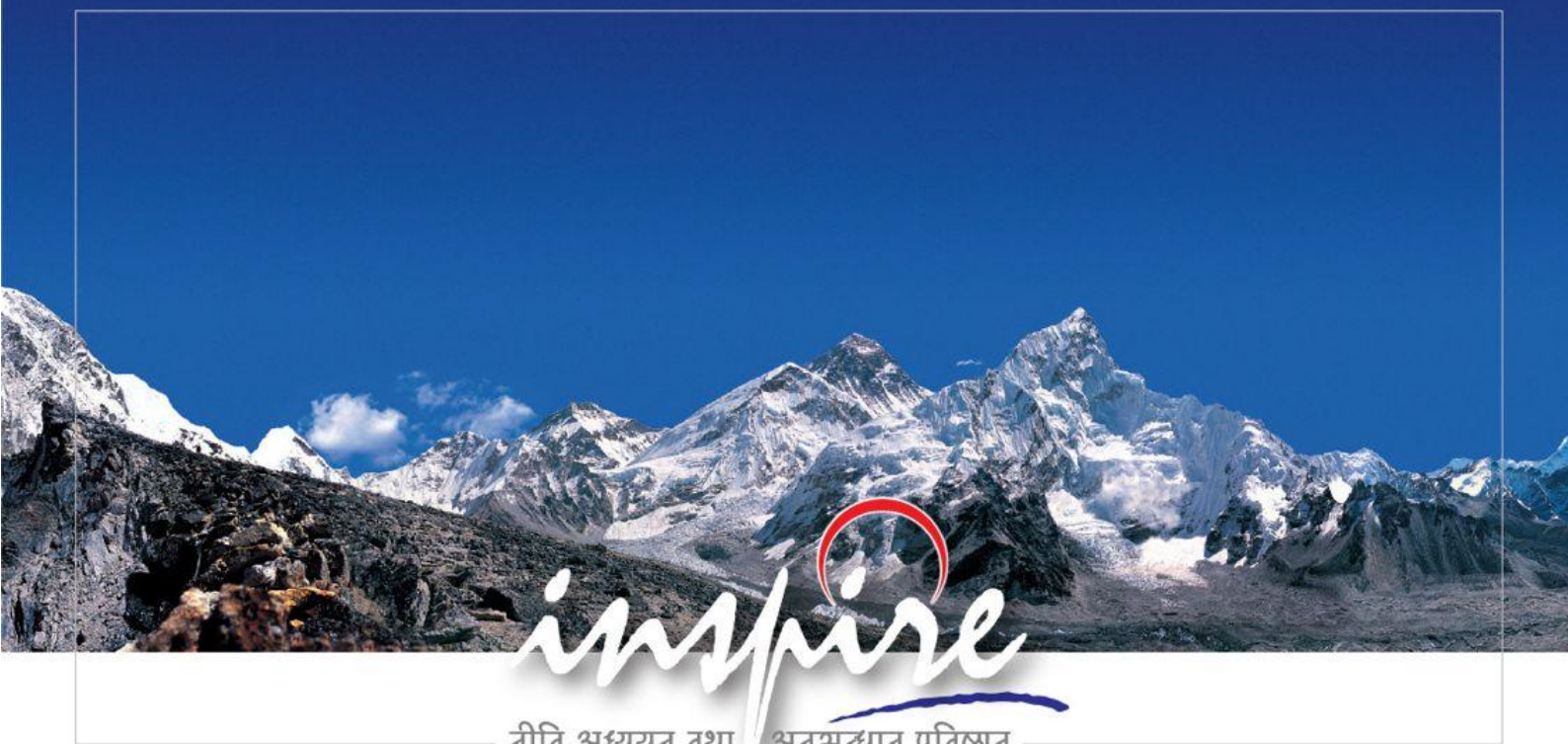




New Structural Economics:

A Framework for Rethinking Development and Policy

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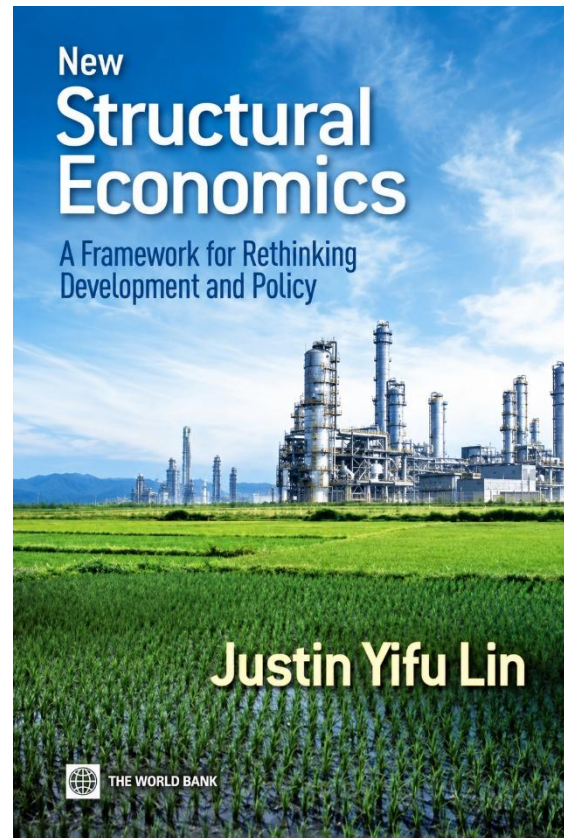
Book Review

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Why do some countries become rich while others remain poor? Professor Justin Yifu Lin opens his book *New Structural Economics: A Framework for Rethinking Development and Policy* with a historical comparison of economic growth income and others. Until the eighteenth century, society was mostly agrarian and the global GDP per capita growth rate was roughly around 0.05% for a millennium. It would have taken around 1400 years for the world economy to double at this pace. In the nineteenth century the GDP per capita growth rate reached about 1% and in the twentieth century it reached about 2%. Hence, doubling world income then took about 70 and 35 years in the nineteenth and twentieth centuries, respectively. However, this economic progress was highly uneven. The experience of the Asian Tigers showed that poorer countries could catch up with advanced economies. Still, many others continued to struggle to achieve sustained growth.

Since Adam Smith wrote his seminal book 'An Inquiry into the Nature and Causes of the Wealth of Nations', economists and policymakers have been curious about the idea of sustained economic growth. Even though the Industrial Revolution brought rapid growth, it was limited to a small group of countries. By the end of the twentieth century, some developing countries had begun to narrow



the gap with advanced economies. The economic success of Asian Tigers gave the developing world a ray of hope. But such success remained relatively limited. Even after following different development strategies, many countries struggled to catch up. These differences prompted economists to ask a major question: what does it take to achieve sustained economic progress?

Development economics, which became a major subdiscipline of modern economics after World War II, provided answers in two broad phases. During the first wave of development economics, the economists considered the state to play a leading role in building industries. Hence,

many governments tried to establish advanced industries. However, these attempts did not produce the expected outcomes, partly because many of these countries lacked the resources and capabilities to support advanced industries. Then came the second wave of development economics. Development economists of this wave gave more importance to the market. The concept of liberalisation, privatisation and economic stability was promoted during this time. But these reforms also failed to deliver sustained growth in many developing countries. As the author argues, both approaches paid little attention to what countries could produce at different stages of development.

The limitations of both the earlier waves of development economics created a need to rethink how economies develop. Economic growth is not just limited to producing more of the same goods but requires better technology, more productive industries and the movement of workers into better jobs. Positioning itself within the third wave of development economics, the framework of New Structural Economics places these changes at the centre of development. It argues that countries should build industries that suit their available labour, capital and natural resources. In short, countries should pursue their comparative advantage through

appropriate economic policies. As the countries' comparative advantages improve, they can upscale their economic activities or upgrade their industries. Markets help guide investment, but governments have an important role in providing infrastructure, coordinating investments and removing barriers to entry into new industries.

Professor Justin Yifu Lin, the author of *New Structural Economics: A Framework for Rethinking Development and Policy*, is a leading Chinese development economist and Honorary Dean of the National School of Development, Peking University. He is a member of the Standing Committee of the Chinese People's Political Consultative Conference (CPPCC) National Committee and Vice Chairman of its Committee on Economic Affairs. Lin served as Chief Economist and Senior Vice President of the World Bank from 2008 to 2012, becoming the first economist from a developing country to hold that position. His experience in both China and international development institutions informs the central argument of the book: development is neither a process that markets can accomplish alone nor one that governments can successfully engineer from above. Rather, markets and governments need to complement each other in the process of structural transformation.

The book was first published in 2012, in the aftermath of the global financial crisis of 2008-2009 and amid renewed debates about the strengths and limitations of prevailing economic theories. Written in seven chapters, the book develops the framework of New Structural Economics by examining why economic structures differ across countries, how comparative advantage changes as economies develop, and how governments can facilitate rather than distort this process. Lin's central distinction is between development strategies that follow comparative advantage and those that attempt to defy it.

The **first chapter** provides the intellectual foundation of New Structural Economics and explains why economic structures differ across countries. A country with abundant labour but limited capital faces very different opportunities from a country with advanced skills and lots of financial resources. Economists describe these resources as 'factor endowments' and they strongly influence a country's comparative advantages.

Lin states that even well- intentioned government interventions failed in many countries because important substitution and protection were the major strategies of development, rather than policies based on the comparative advantages those countries possess. One of the main reasons for the failure of many former socialist and

developing countries to achieve dynamic growth during their transition processes was that they attempted to defy the comparative advantage and gave priority to development of capital-intensive industries when capital in their economies was scarce. New Structural Economics is based on the following ideas:

First, an economy's structure of factor endowments evolves from one level of development to another. Therefore, the industrial structure of a given economy will be different at different levels of development. Each industrial structure requires corresponding infrastructure (both tangible and intangible) to facilitate its operations and transactions.

Second, each level of economic development is a point along the continuum from a low-income agrarian economy to a high-income post-industrialised economy, not a dichotomy of two economic development levels (poor vs rich or developing vs industrialized). Industrial upgrading and infrastructure improvement targets in developing countries should not necessarily be based on those that exist in high-income countries.

Third, at each given level of development, the market is the basic mechanism for effective resource allocation. However, economic development as a dynamic process entails structural changes, involving industrial

upgrading and corresponding improvements in “hard” (tangible) and “soft” (intangible) infrastructure at each level. Such upgrading and improvements require coordination and generate significant externalities that affect firms’ transaction costs and returns on capital investment. Thus, in addition to an effective market mechanism, the government should play an active role in facilitating structural changes.

For the author, a poorer country will be more competitive in activities that depend on abundant labour or natural resources. Capital-intensive industries may require long-term subsidies to survive. Supporting such capital-intensive industries can consume resources that could have been used in creating more competitive businesses and jobs in sectors where the country has comparative advantages. Competitive firms generate high returns on investment, which helps in capital accumulation. This accumulated capital can then support new investment. Hence, with growing skills and better technology, industries can be upgraded.

Latecomers also have an opportunity. They can easily adopt and adapt technologies already developed elsewhere. Hence, they can save the full cost of inventing everything from scratch. This explains why a developing economy can grow faster than those already operating

with advanced technologies. However, potential does not automatically become production. No single firm can provide all the services required to develop a new industry. A pioneering firm bears the cost of testing a new market while competitors can learn from its experience. Private investment may therefore fall below what would benefit society. These coordination problems and spillover benefits provide a rationale for a facilitating state.

The government should focus on providing physical infrastructure and improving institutions, regulations and financial arrangements. It may also offer limited support for pioneering investment. Lin calls an industry’s unrealized competitive potential its ‘latent comparative advantage.’ The aim is to remove the obstacles that prevent firms from realising that advantage so that firms can compete without permanent protection.

Second chapter uses New Structural Economics to explain the findings of the Growth Commission’s *Growth Report*. The report identifies five common features of successful economies such as openness to the world economy, macroeconomic stability, high savings and investment, market-based resource allocation and committed, credible and capable governments. Competitive markets guide firms towards industries suited to their country’s resources. Governments help

them upgrade by improving infrastructure and coordination. The main message of this chapter is that countries need policies best suited to their evolving comparative advantage rather than a one-size-fits-all growth formula.

Third chapter, written with Célestin Monga, an economist and former Vice-President and Chief Economist of the African Development Bank, proposes the **Growth Identification and Facilitation Framework (GIFF)**. GIFF is a six-step framework that helps a country identify which industries are feasible for its growth. GIFF makes the book more practical than a theory-based call for cooperation between government and business.

First step is to identify new industries in which the country can have latent comparative advantage. For this a country must assess growing economies with similar resource conditions but an income level roughly twice its own. Then, it should identify tradable goods and services that those economies have produced competitively for about twenty years. This helps to identify the potential opportunities for entry.

Second step is to identify the domestic firms that already operate on their own in the identified sectors in first step. Then, the government should look for the hurdles that prevent expansion or better production for those firms. Government can then

implement policies to remove those binding constraints. **Third**, if domestic firms are absent in those identified sectors, government should encourage and attract foreign investors to invest in those industries. Additionally, government should help new local firms emerge through incubation programmes.

In the **fourth step** developing countries should consider the self-discoveries of their domestic firms. Government should support these domestic firms in upgrading the industries. **Fifth**, the developing countries with poor infrastructure should focus on developing industrial parks or special economic zones to attract interested domestic and foreign firms. This is because developing countries lack the capital to invest across the whole country at once. They can start from targeted regions and then expand the infrastructure development to other parts of the countries. Sixth, compensate pioneering firms for their risks. But this support must be limited in duration and cost. The objective is to encourage discovery, not create protected monopolies.

Chapter four is the application of GIFF in the Nigerian context. The **fifth chapter**, co-authored with Lixin Colin Xu, examines financial structure and economic development. The core message of the chapter is that the financial system should fit the businesses it serves. Small firms

based on existing technologies have different needs from large companies who need to invest on research and development as well. Local banks may understand the needs of these small entrepreneurs better than distant lenders or stock markets. Advanced production requires a variety of advanced financial instruments. Expanding finance alone is not sufficient. Copying the financial structure of a rich country may not serve the needs of ordinary businesses.

Chapter six focuses on the relationship between development strategy, institutions and economic performance. Here, the author argues that developing countries can catch up with richer nations by building industries that suit their available labour, capital and natural resources. Trying to establish advanced and capital-intensive industries in the early stages of development create firms that cannot survive without government protection and subsidies. Supporting these firms means wasting resources, encouraging lobbying for favours and weakening economic stability. In contrast, industries that match a country's comparative advantage can be competitive and create jobs. These competitive industries accumulate capital and enhance skills needed to move into more advanced industries.

The chapter also argues that weak institutions and market distortions can arise

from a misguided development strategy. Therefore, reform must address why firms depend on government support. The chapter also warns against abruptly removing protection when doing so would cause many existing firms to collapse. China's dual track approach shows how a country can support new competitive industries and manage the transition of older industries at the same time without a sudden shock. Sustainable development is thus the result of strengthening an economy's productive capabilities and upgrading industries as those capabilities grow.

In the **seventh chapter**, Lin states that there are opportunities for poorer countries to industrialise by learning from advanced economies and attracting industries that are relocating from richer countries as they lose the comparative advantages they once possessed. As wages rise in the advanced countries, they tend to relocate labour-intensive industries to new locations where wages are lower. But cheap labour alone is not enough. Government must identify the industries that are in line with its comparative advantages. Additionally, it should address the barriers related to poor infrastructure, an uncertain business environment and other constraint.

The strength of the book lies in its space for debate. Prominent development economists like Dani Rodrik, Anne O

Krueger, Ha-Joon Chang and others have provided their perspectives and critiques of the New Structural Economics perspective. Such views enrich the debate on NSE's approach to development.

From the **Global South perspective**, the book offers a clear idea that developing countries can catch up with rich countries if they focus on the industries that align with their comparative advantages. Development should begin with a country's own resources and capabilities instead of copying the economic structure of rich countries. NSE's framework gives developing countries room to shape their own development paths. However, the success depends on the government's ability to identify opportunities, address barriers such as poor infrastructure, and implement supportive policies and others. Comparative advantage should therefore be a starting point for transformation. Low wages alone are not enough to create sustained economic progress. From **Nepal's perspective**, NSE can help answer the question of **what to produce**.



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