Growth in a time of disruption

By Michael Spence
July 27, 2016 – *Project Syndicate*

Developing countries are facing major obstacles – many of which they have little to no control over – to achieving sustained high growth. Beyond the headwinds generated by slow advanced-economy growth and abnormal post-crisis monetary and financial conditions, there are the disruptive impacts of digital technology, which are set to erode developing economies' comparative advantage in labor-intensive manufacturing activities. With the reversal of these trends out of the question, adaptation is the only option.

Robotics has already made significant inroads in electronics assembly, with sewing trades, traditionally many countries' first entry point to the global trading system, likely to come next. As this trend continues, the imperative to build supply chains based on the location of relatively immobile and cost-effective labor will wane, with production moving closer to the final market. Adidas, for example, is already building a factory in Germany, where robots will produce high-end athletic shoes, and is planning a second one in the United States.

Given all of this, developing countries need to act now to adapt their growth strategies. A sensible framework for doing so must account for several key factors.

First, the problems in advanced countries – from slow economic growth to political uncertainty – are likely to persist, reducing potential growth everywhere for an extended period. In this context, developing countries must not succumb to the temptation to try to boost demand through unsustainable means, such as the accumulation of excess debt.

Instead, developing countries, particularly those in the earlier stages of economic development, must find new external markets for their goods, by maximizing trade opportunities with their counterparts in the developing world, many of which have considerable purchasing power. While such demand will surely not offset the drop in advanced-country demand completely, it can help to soften the blow.

Second, investment, both public and private, remains a powerful growth engine. In economies with excess productive capacity, targeted investment can yield a double benefit, generating short-run demand and boosting growth and productivity thereafter. Given this, shortfalls in investment that promises high social and private returns must be reduced, and even eliminated.

These growth- and productivity-enhancing investments should be financed primarily from domestic savings, though some can also be financed with debt. Long-term, stable infrastructure investments can be financed at least partly by international development institutions.

Third, it is critical to manage the capital account in a way that protects and enhances the real economy's growth potential. Large inflows of capital from countries with low interest rates can easily push up exchange rates, putting the tradable part of the economy under pressure. At the same time, the prospect of a capital-flow reversal adds risk, deters investment, and can produce sudden credit-tightening events.

In this context, selective capital controls and careful reserve management can help to stabilize the balance of payments and ensure that the terms of trade do not change too fast to be offset by productivity growth. In fact, successful developing countries were pursuing

such policies even before the global economic crisis hit.

Fourth, a realistic approach to the digital revolution is needed. On one hand, developing countries should recognize that disruption, while happening fast, will not render their growth models obsolete overnight. China's continued growth and rising household income are creating opportunities for lower-income economies in low-cost manufacturing.

On the other hand, developing countries must accept the inevitability of changes to their growth models caused by digital technologies. Instead of viewing these changes as a threat, and trying to resist them, developing economies should be getting ahead of them, by embracing disruptive innovations. This means investing in the capacity – physical and human – to support their use.

Beyond upgrading manufacturing, developing countries should be preparing for the shift toward services that they will inevitably undergo as incomes rise (though the precise timing is hard to predict). Indeed, they should be seeking ways to exploit opportunities to boost their trade in services, much like India and the Philippines have done.

Fifth, the distribution of gains from economic growth cannot be ignored. The advanced economies tried that, and the result has been rising political polarization, intensifying anti-establishment sentiment, declining policy coherence, and weakening social cohesion. In a low-growth environment, in particular, developing countries cannot afford to make the same mistake.

Sixth, it is important to establish sustainable growth patterns early on. A "green" approach would not only stimulate additional growth; it would also be likely to increase the quality of growth, not to mention the lives of ordinary people. Moreover, it will lead to a far more resilient economy in the long run.

Finally, entrepreneurial activity is vital to translate economic potential into reality. Policies that support such activity, such as by removing obstacles to new business creation and enhancing financing opportunities, cannot be left out of growth strategies. Opening channels for flows of information, ideas, expertise, and talent from abroad can only enhance these efforts.

Developing economies may not have much control over the headwinds that they face today, but that does not mean that they are powerless. Much can be done not just to sustain moderate growth, but also to secure a more prosperous and resilient future.

Michael Spence, a Nobel laureate in economics, is Professor of Economics at NYU's Stern School of Business.