



Growth Diagnostics: A New Approach to Growth Strategy

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I. Why a new approach to growth strategy

- Disappointments at the Washington Consensus. 
- Problems with the second-generation reforms revolving around governance and institutions 
 - An impossibly broad and ambitious agenda that is insufficiently differentiated according to the needs of different countries.

II. Analytics of reform/growth strategy

- Suppose an economy starts with k distortions, $t = (t_1, t_2, \dots, t_k)$, with marginal social valuation of activities diverging from marginal private valuation:

$$\mu_i^S(\tau, \dots) - \mu_i^P(\tau, \dots) - \tau_i = 0$$

- What is the effect on growth (or welfare) of removing one distortion leaving the other $k-1$ unchanged?

$$\frac{du}{d\tau_j} = -\lambda_j + \sum_i \lambda_i \frac{\partial [\mu_i^S(\tau, \dots) - \mu_i^P(\tau, \dots)]}{\partial \tau_j}$$

Total effect = direct effect + sum of all other indirect effects (positive or negative)

II. Analytics of reform/growth strategy

- Where do indirect effects come from?
 - Lowering one distortion can have good or bad effects. Example: liberalizing trade of intermediate inputs; relaxing borrowing restrictions under moral hazard.
- Undertaking partial reform while leaving other distortions in place can have large, small, or even negative effects on growth and welfare.

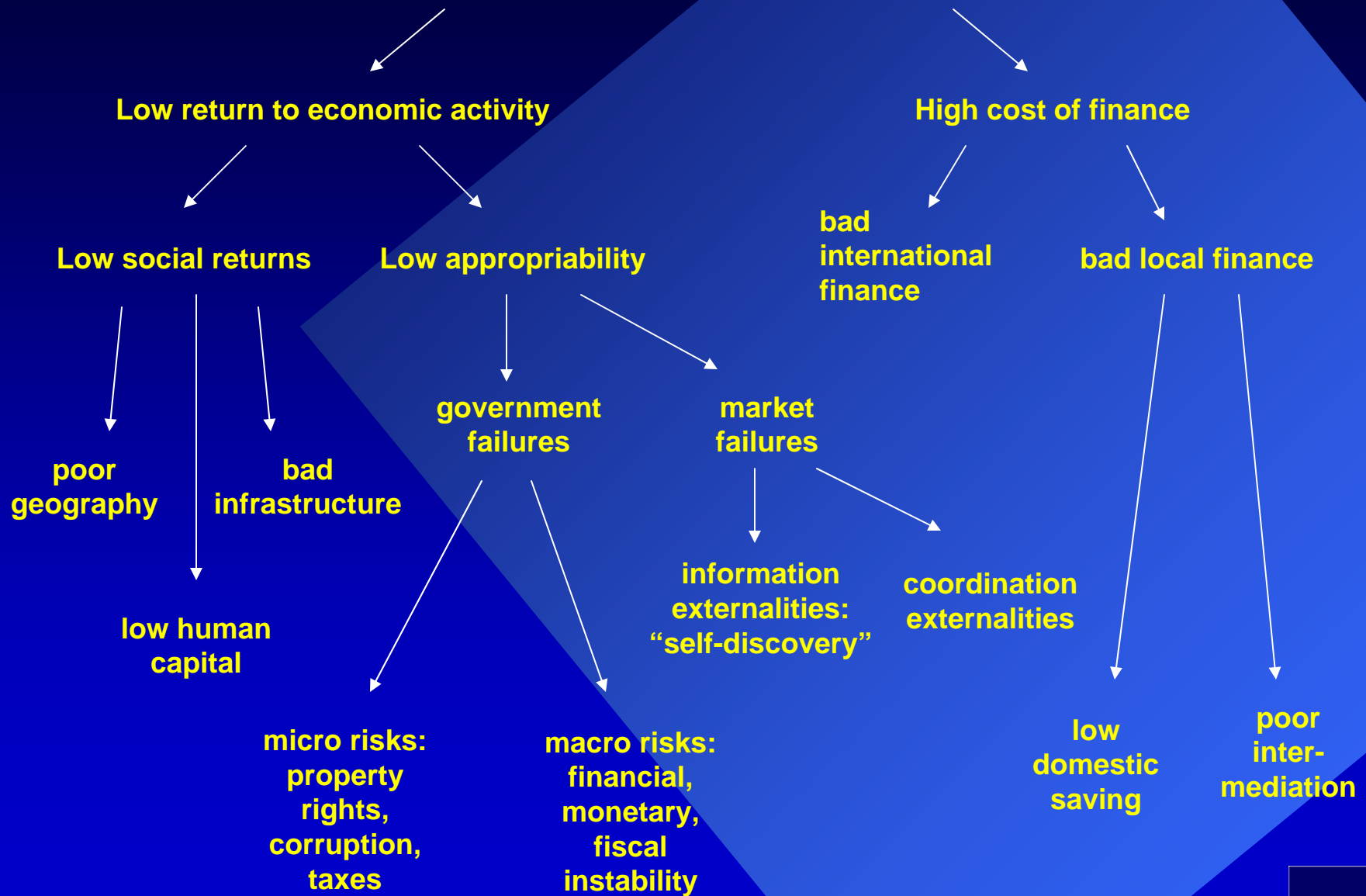
II. Analytics of reform/growth strategy

- Five reform/growth strategies:
 - Wholesale reform
 - Do as much and as best as you can
 - Sophisticated second-best reform
 - Target the largest distortions
 - Focus on the most binding constraints

III. Growth diagnostics

- What does growth diagnostics do?
 - Identify the most binding constraints and figure out policy priorities with biggest impact on the basis of second-best thinking.
- How to identify the most binding constraints?
 - Identify proximate determinants of growth.
 - Figure out which of those post the greatest impediments to higher growth.
 - Identify the specific distortions behind the impediments.
- Using the following problem tree as a roadmap

Low levels of private investment and entrepreneurship



IV. From theory to practice

- Explicit search for “diagnostic signals”:
 - “If story A is correct, signals x, y, and z should present”.
- Searching for price signals, such as return to education, interest rates, cost of transport:
 - If low education is a serious problem, returns to skill/education should be high and unemployed skilled people should be low.
 - If investment is constrained by savings, interest rates should be high and growth respond to changes in available savings (e.g., inflow of foreign capital).
 - If poor transport links is a constraint, there should be bottlenecks and high private cost of transport.

IV. From theory to practice

- Searching for non-price signals:
 - The camels and the hippopotamus.
 - When a constraint binds, it results in activities designed to get around it:
 - High tax → high informality.
 - Poor legal institutions → high demand for informal mechanisms of conflict resolution and contract enforcement.
 - Poor financial intermediation → internalization of finance through business groups, etc.

IV. From theory to practice

- Searching for historical growth episodes.
- Finding out what the business community says.
- Bench-marking with other countries and other periods.
- For fast-growing economies, focusing on constraints to sustaining growth and lagging regions.

V. Operational relevance for ADB

- Growth diagnostics provides a useful framework for thinking about development challenges and constraints in DMCs in preparing country partnership strategies, drafting ADO country reviews, and designing sector interventions and projects.
- Undertaking growth and poverty diagnosis should be key part of ADB's country-specific analytical work.
- ERD is planning pilot studies in collaboration with regional departments, with a view to developing it into a standard analytic tool for possible mainstreaming in ADB's ETSW.

Source: Hausmann, R., D. Rodrik, and A. Velasco. 2005. Growth Diagnostics. Harvard University.

Washington consensus



Original Washington Consensus

1. Fiscal discipline
2. Reorientation of public expenditures
3. Tax reform
4. Financial liberalization
5. Unified and competitive exchange rates
6. Trade liberalization
7. Openness to FDI
8. Privatization
9. Deregulation
10. Secure property rights

"Augmented" Washington Consensus, 1-10 plus:

11. Corporate governance
12. Anti-corruption
13. Flexible labor markets
14. WTO agreements
15. Financial codes and standards
16. "Prudent" capital-account opening
17. corner exchange rate regimes
18. Independent central banks
19. Social safety nets
20. Targeted poverty reduction