

Industrial Policy and MCC Programs

Background

In recent years, the diverging growth paths of sub-Saharan Africa (SSA) and East Asia have provoked a fresh debate on the role of industrial policy, namely how governments design policies and allocate resources across productive sectors. Many of the global conditions that originally favored the export-led growth and transformation of China and its neighbors no longer exist, raising the possibility that SSA's economic growth path, and the policies adopted to support it, will have very different features. The new global production landscape, featuring highly fragmented supply chains and an emerging "deindustrialization" combined with SSA's missing agglomeration economies and rising labor costs present new challenges to traditional manufacturing-oriented, state-led, export growth strategies. These conditions, coupled with the recent COVID-driven global recession and ensuing debt crisis, require fresh, critical thinking on Industrial Policy in developing economy settings.

Given these challenges, how should MCC support SSA's efforts to spur private sector-led exports (or import substitution) that can accelerate growth and ultimately reduce poverty? How can SSA reproduce poverty reduction results similar to the Asian Miracle given the realities of the current global landscape and the unique local challenges throughout the SSA region? How can MCC help identify pragmatic policy options along the spectrum of state-led versus free market approaches?

Motivations for Industrial Policy

To capture the social benefits otherwise lost to market failures, states pursue industrial policies that coordinate and direct resources, information, and know-how toward productive industries. Certain policies operate horizontally across an economy to support industry growth without favor or bias. For example, establishing transparency and regulating information rules in credit markets can help overcome the barriers that low or asymmetric information risks pose to banks and investors. Investments in utilities and infrastructure can encourage the growth of businesses that depend on electricity and roads. Vertically-oriented policies, in contrast, favor specific sectors or activities for investments, e.g. steel manufacturing in South Korea or garments in Ethiopia, either for their perceived competitive advantage, their benefits to an economy, or reasons of political economy.

Historically, state-owned enterprises (SOE) were a common intervention of industrial policies. With the state's financial, infrastructural, and political support, including protection from foreign competition, SOEs can surmount the entry and growth barriers that normally face private firms. In other cases, states allocate massive support to private industrial or service conglomerates to establish domestic capacity, subsidize their entry into foreign markets, and strengthen their competitive advantage (e.g. Korean chaebols). In some cases, success stories emerged, particularly in East Asia, where governments fostered sectoral development and gradually supported their entry into internationally competitive markets—often aided by complementary import policies and undervalued exchange rates -- sparking rapid economic growth.

A Thumbnail Sketch of Industrial Policy Perspectives

A long stream of economics literature has debated the role of industrial policy in steering structural transformation. These policies, ranging from heavy, state-led control of industries to more market-oriented approaches, offer lessons to governments today seeking the right ingredients for stimulating transformation and growth.

Big Push models from the 1940s and 1950s envisioned large, state-led investments in capital-intensive industries. Features included:

- Large scale investments which aimed to immediately confer efficiencies necessary to compete in modern industries
- Picking sectors for support, which proved to be tricky whether due to the political economy, costly subsidies, or the simple difficulty in assessing prices and transaction costs.

Import Substitution models, adopted by many Latin American countries in the 1950s and 1960s, aimed at once to reduce reliance on primary good exports and technologically advanced imports:

- Picking and subsidizing new “infant” industries and protecting them from foreign competition
- Early take-offs, but long run failures to grow, mature, and compete successfully
- Balance sheet losses, worsened government deficits, distorted prices, and entrenched workforces that resisted later reform efforts.

Export-led growth, a strategy pursued in the 1970s and 1980s across a number of East Asian economies, resulted in historic rural-urban transitions and rapid rates of economic growth, most notably in China:

- Private firms capitalizing on low wage, labor-intensive manufacturing processes
- Targeted government subsidies and protection to specific firms and sectors coupled with performance metrics and monitoring
- Gradual removal of supports and protections upon achieving a competitive viability
- High levels of investment in human and physical capital
- Macroeconomic stability coupled with undervalued exchange rates
- Sound banking policies and high savings rates

The emerging *Washington Consensus* in the 1990s, followed by the influential report by the Commission on Growth and Development in 2008, provided a counterpoint to heavy-handed industrial policies of the past, advocated market-oriented solutions to economic development, but also endorsed a competent, market-facilitating role of government.

- Ending firm-level supports, privatizing SOEs, and eliminating trade protections
- Reducing fiscal deficits by cutting spending, including on social safety nets
- Greater exposure to international price and exchange rate volatility
- Investments in infrastructure that crowd-in private investment
- Expanding access to demand through greater regional market integration

A New Industrial Policy for SSA?

Today, recognition that market-led economic growth requires careful government stewardship and support has led to a revived interest in industrial policies. Much of this owes to the widening understanding of the role market failures continue to play, whether in the creation and dissemination of

knowledge or the externalization of important social goods, such as equity and environmental quality. In the “New Structural Economics” proposed by Lin (2010), industrial policy can succeed if it nimbly responds to a country’s evolution of comparative advantage, a function not only of its endowments and infrastructure but the wider landscape of technologies and knowledge. Along similar lines, product space analysis, proposed by Hausmann and Klinger (2006), proposes concentrating resources on specific goods or sub-sectors that lie just within an economy’s technological reach to achieve faster growth.

How can state support to industry best be deployed in the context of evolving market landscapes? This is particularly pressing in SSA, where conditions bear some similarity to Asia’s historic starting points, yet present-day opportunities and constraints are very different. Thanks to emerging labor-saving and skill-biased technologies, low labor costs confer fewer advantages to countries competing for manufacturers, resulting in a global “deindustrialization” and shrinking manufacturing’s share of employment. Worsening matters, relatively high labor costs throughout much of SSA push remaining manufacturing opportunities further out of reach. As a consequence, while SSA’s population has steadily urbanized, the historically accompanying productive benefits of city growth—these include specialization, scale efficiencies, and agglomeration economies—remain conspicuously absent. Meanwhile, against this backdrop that, policy makers must weigh investments geared to sparking short-term industrial growth against more long-term fundamental growth determinants, such as human capital and institutional quality, each of which carry distinct implications for the pace and duration of any ensuing growth.

Questions for the EAC

Many of MCC’s programs in SSA face precisely these challenges, particularly in Ethiopia. In its constraints analysis, MCC identified Ethiopia’s foreign exchange shortage and the underlying policies that hamstringing export earnings as the country’s most critical bottleneck to economic growth. (See attached Annex.) To address these issues, MCC will support trade policy and institutional reforms and government capacity building to foster private investments in exporting industries. Throughout this process, MCC and its counterparts in Ethiopia will confront a variety of questions:

- 1. *How should governments incentivize private investments, domestic and foreign, in their economies?*** Subsidies, tax breaks, infrastructure, dedicated industrial parks, tariff protections, and other means of state support can attract private sector investment, both domestic and foreign. But knowing the right balance and timing remains difficult, as is implementing decisions efficiently and professionally.
 - While export growth remains a priority, can smart import substitution strategies help foster domestic industries, generate employment, and reduce pressure on foreign reserves?
 - Is manufacturing the only channel through which structural transformation and growth can occur? What role could services play in raising productivity and generating exports?
 - How can policy makers weave long-run investments in human capital into budget priorities geared toward short-run payoffs, such as infrastructure and tax breaks?

- 2. *What role should SOEs continue to play in countries where they remain dominant (e.g. Ethiopia)?*** Lessons from the 20th century suggest SOEs and other state-supported private enterprises can help economies grow, but transitioning them into fully privatized, market-disciplined firms has been key to long run sustainability. Knowing when and how to achieve this, however, remains difficult.
 - What criteria can guide the dismantling and/or privatization of SOEs?

- What role can or should foreign investors play?

3. *How can SSA economies integrate into global value chains?* Declines in transportation costs and improvements in information technology have scattered elements of global value chains (GVCs) to locations where costs are cheapest. But most GVC activities hosted in SSA capture little of the final good's value, fail to absorb industry-specific know-how and technologies, and rely decreasingly on unskilled labor.

- How can SSA economies enter GVCs that are highly fragmented? Or, in light of the current Covid-19 pandemic, could the sudden reflex to concentrate supply chains geographically further threaten SSA's opportunity to enter GVCs?
- Given the decreasing demand for unskilled labor in high technology GVCs, how can states identify other comparative advantages to pursue feasible and profitable activities for export? Can private investors be empowered to learn and exploit these advantages?

4. *How can SSA broaden its export markets?* SSA's domestic markets are often too small to sustain the demand for large scale productive activities, implying the need for regional market integration. Yet intra-African trade accounts for only a 5% of SSA economies, and almost none of it is in manufactures. Improving transport infrastructure, increasing trade finance, and removing tariff and border-crossing barriers may unlock larger regional markets for SSA manufacturers and motivate investments in production capacities that achieve scale efficiencies.

- What immediate steps can policy makers take to achieve greater regional integration (e.g. Africa FTA facilitation, other regional agreements, common markets) to grow market size and scale economies?

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Annex: Industrial Policy in Ethiopia

Background and History

Since the early 2000s, the Government of Ethiopia (GoE) has actively pursued a structural transformation strategy that combines heavy investments in agriculture and infrastructure alongside a parallel reform of laws governing private sector activity. Despite these efforts, however, and the accompanying economic growth, Ethiopia economy remains largely untransformed, and its policies still bear the heavy footprint of Marxist, state-led development.

Pre-1974, Ethiopia's imperial government promoted industrialization through a succession of five-year plans that focused on promoting import-substituting light manufacturing. The government deployed tariffs and import restrictions to protect domestic as well as financial incentives to direct investment into selected industries, including oil refining, cement, sugar and textiles. These actions achieved some success in attracting foreign investment that supported the expansion of medium to large-scale manufacturing, but translated into relatively modest job growth.

Under the Derg (1975-1991), GoE nationalized much of the manufacturing that developed within the imperial era, imposed price controls, and pegged the Birr at a fixed rate to the dollar.¹ State-owned enterprises (SOEs) came to dominate the manufacturing sector, which presided over a decline in sector performance and increasing dependence upon government resources for operational support. Here, as in today, severe shortages of foreign exchange developed, which intensified the struggle that many firms faced to source necessary inputs. Manufacturing value added collapsed.

Meanwhile, agriculture stagnated following land reforms that upended the structure of rural society. The government nationalized land and compelled the rural population into the formation of cooperatives and collectivized production, which also entailed forced resettlement. The government administered agricultural marketing, dissolving incentives for productivity and growth. Civil conflict then aggravated an emerging and deepening economic crisis.

Increasing agricultural productivity from a very low level occupied much of the economic development agenda of the Ethiopian People's Revolutionary Democratic Front (EPRDF) following its rise to power in 1991. The diffusion of modern agronomic technologies among smallholder farmers along with introduction of chemical inputs and improved seed underpinned a growth acceleration, while the government also invested heavily in rebuilding and expanding rural infrastructure, education and services. Although the government in principle intended a transition back to a market economy, privatization was gradual and only in designated sectors. Utilities remained in public hands as well as several strategic industries, including banking, air travel, chemical manufacturing, sugar and tobacco processing, and freight logistics. Over time domestic investors could set up banking operations and to participate in logistics and other types of businesses. Ethiopia opened again to foreign investment, but opportunities were narrow, so as not to threaten domestic firms.

Structural Transformation Efforts

¹ Under its successor, the Ethiopian People's Revolutionary Democratic Front (EPRDF), a crawling peg was introduced that provided very little additional flexibility to the exchange rate regime.

Focused on structural transformation, the GoE continued to promote high value agricultural exports in horticulture and meat products in light of perceived competitive advantages, but development plans focused increasing attention on industrialization, particularly in labor-intensive products in textiles, leather and leather products. Over a twenty-year period, Ethiopia achieved impressively high levels of growth, with many years of back-to-back 10 percent growth. Structural transformation, however, failed to materialize. The share of Industry value added within the economy grew little and has not exceeded 14-15 percent of GDP. Meanwhile, GoE relied substantially on foreign borrowing to finance these programs and has recently lost much of the concessional terms it once enjoyed. At the same time, Ethiopia's export sector has struggled to produce enough to finance the country's demand for imports.

Ethiopia's export composition remains highly undiversified. Over 80 percent of export earnings derive from primary products: coffee, pulses, oilseeds, and cut flowers, with scarcely any value addition. Ethiopia does not even realize the full benefit of this limited range of comparative advantage. Agricultural productivity, although significantly higher than twenty years ago, remains very low.

Trade and Manufacturing Possibilities

Ethiopia's biggest constraint to growth is its shortage of foreign currency, necessary for accessing critical inputs for production. Weak export performance, the fiscal imbalances, and here the continuing strains that the SOEs impose upon government resources—including the preferential treatment of their demands for foreign exchange, and the overvalued fixed exchange rate regime, have all contributed to this shortage for decades. The problem, however, recently has intensified, and the impacts are spreading through the economy. Over the last four years exports fallen, and economic growth has now begun to contract and is likely to contract further due to the COVID-19 crisis.

Meanwhile, over the last five years, GoE has invested billions of dollars throughout the country to develop infrastructure for industrial parks to attract FDI, primarily into textiles and garments manufacturing for export. While likely intended to generate employment at large scale, firms located in these parks are the largest source of Ethiopia's export earnings growth. But the industrial parks have yet to integrate with local economies, and weaknesses in infrastructure and government coordination have hamstrung many of the firms' operations. Net foreign exchange earnings by the parks, moreover, are low, and while the parks have created tens of thousands of jobs, numbers are well below expectations.

GoE, grappling with burgeoning youth unemployment and the political instability that portends, seeks to elevate the parks contribution to improving the country's employment, exports, and growth. Questions facing GoE include:

- Should Ethiopia focus strategically on consolidating its role as a low-wage, low-cost exporter?
- What strategies can harness know-how from these firms to share in the domestic economy, contributing to diversification of economic capability and to a reinforcing interaction with urbanization?
- What forms of private sector and government collaboration do such strategies require, and how can this best be incentivized?
- Are there lessons from the experience of other federated countries (with sub-nationally empowered authorities) for industrial policy and trade promotion?