Gist of Economic Survey 2017-18 [Chapter 5]: Is there a "Late Converger Stall" in Economic Development? Can India Escape it?

INTRODUCTION

- **These are the best of economic times especially for those living in poorer countries:**
  - The **global "bads"** – war, violence, deprivation and poverty – are at unprecedentedly low levels.
  - The **global "goods"** – standards of living, access to essential services, and material well-being – have improved at a historically unprecedented pace to reach levels never witnessed in humanity's history. This is particularly true of India, which has been one of the world's most dynamic performers since 1980.
  - **Economic convergence**, the process of poorer countries "catching-up" with richer countries and closing gaps in standards of living, has been a big driver of some of these developments.
  - Since the mid-1980s, the process of catch-up has broadened, as the number of poor countries growing faster than advanced economies has substantially increased.
  - Furthermore, the rate of catch-up has also accelerated. In other words, there has been "**convergence with a vengeance**".
- **Convergence between India and USA:**
  - In 1960, India was a low income country with a per capita income (in PPP terms) of $1,033 which was about 6% of U.S. per capita income at the time.
  - India attained lower middle-income status in 2008 and today has a per capita income of $6,538, which is 12% of the U.S.
  - If per capita income in India grows at 6.5% per year, India would reach upper-middle income status by the mid -to-late 2020s.
- **Notion of Middle Income Trap:**
  - Recently doubts about the convergence process have been articulated around the notion of a "middle income trap." Definitions can themselves be traps so it is important to be careful about them.
  - There was a genuine **low-income "trap."**
    - For a long time, many poor countries were not catching up at all; they were growing more slowly than richer countries, which Pritchett (1997) termed as "**Divergence Big Time**."
  - Similarly, the middle income trap should have connoted that middle income countries would grow more slowly than what would be expected given their level of income (i.e., slower than richer countries), impeding the transition from middle income to high income status.
  - The reasons for the trap/stall were supposed to be twofold:
    - On the one hand, as countries attained middle income status, they would be squeezed out of manufacturing and other dynamic sectors by poorer, lower-cost competitors.
    - On the other hand, they would lack the institutional, human, and technological capital to carve out niches higher up the value-added chain.

- As it turned out, there was neither a middle income trap nor stall.
- Middle income countries as a group continued to grow as fast or faster than the convergence standard demanded. Indeed, some of them–for example, Korea, Portugal, Poland, and Latvia–graduated to high-income status.
- The convergence process remained strong even in the last decade.
- The years from 1980 to 2017 are divided into three periods:
  - 1980 to 1997, the era of divergence in which low-income countries fell further behind;
  - 1998 to 2007, an early period of convergence running from the East Asian financial crisis until the Global Financial Crisis; and
  - 2008 to 2017, the most recent period of "late convergence."
- In each period, growth rates for low-, lower middle-, upper middle-, and high-income countries are compared.
- In the two periods after 1997 the average poor, lower-middle income, and upper middle-income country all grew faster than their high-income counterpart. In that strict sense, there is no middle income trap in any period.
- Furthermore, the convergence process actually accelerated after 2008. The poorest have been growing faster than lower middle income countries, who have been growing faster than upper middle income countries who in turn have been growing faster than the richest.
- The developing world continues to catch up, so rapidly that one could call the process "**convergence with a vengeance**".

LATE CONVERGER STALL

- We will now focus on the convergence process of lower middle income countries such as India that are attempting to make the transition to middle income status.
  - **Late convergence** refers to those attempting to do so after the watershed event of the global financial crisis (GFC).
- So, could gathering global trends adversely affect countries such as India that joined the convergence club later in the process? In other words, could there be a "**late converger stall**" in the process of economic development?
- Evidence for this comes from comparing the convergence process in the periods before and after the Global Financial Crisis (GFC).
  - The Global Financial Crisis (GFC) represented a watershed event, marked by a sharp decline in rates of growth across the world.
  - World growth declined from 4.3% in the ten-year period prior to the GFC to 2.9% in the decade after the GFC.
  - The corresponding numbers for the four major groups of countries were
    - from 3.6% down to 1.4% for advanced economies,
    - 4.5 to 3.3% for upper-middle income countries,
    - 4.9 to 4.2% for lower middle income countries and
    - 5% per annum for low-income countries.

- o The growth declines in upper middle income countries, by 1.2 percentage points between 1998-2007 and 2008-2017 and by .7 percentage points in lower-middle-income countries over the same period.
  - o Underlying these slowdowns are some major developments that could not only damage growth over the long term, but eventually even slow the process of convergence. To these developments we now turn.

THE FOUR HEADWINDS ("HORSEMEN")

- The risk of a Late Convergence Stall needs to be taken seriously because of four headwinds:
  - o hyper-globalization repudiation,
  - o thwarted/impeded structural transformation,
  - o human capital regression induced by technological progress, and
  - o climate change-induced agricultural stress.

A. Hyperglobalization repudiation

- Developing countries that came late to convergence now face a very different global trading environment from their predecessors.
  - o Early convergers benefited from the process of rapid globalization or hyper-globalization, reflected in dramatic increases in the world trade-GDP ratio. As a result, Japan, South Korea and China were all able to post average export growth rates of over 15 percent for the thirty years of their convergence periods.
  - o But this globalization has led to a backlash in advanced countries reflected in the decline in world trade-GDP ratios since 2011.
  - o This means that the trading opportunities available to the early convergers may no longer be available.
- **Gravity model of trade:**
  - o One way of understanding the potential impact of the hyperglobalization repudiation is to seek recourse to the gravity model of trade.
  - o Basic gravity theory implies that smaller countries tend to trade more than larger ones.
  - o A world made up of two equal-size countries will experience more trade than a world in which the larger country accounts for 95 percent of world output.
  - o Over time, the world is becoming more equal in the distribution of the underlying output. That is the consequence of convergence.
  - o Therefore, if there is convergence, the gravity model suggests there will also be increased trade.
- During the period of hyperglobalization world trade-GDP rose from about 17% of world GDP to about 31%. About one-third could have been due to the process of economic convergence.

- If the current process of convergence continues, the distribution of world output will become even more dispersed, resulting in an additional increase in the world's trade-GDP ratio.
- The question is whether politics, especially in advanced economies and China, might be able to sustain such an increase in trade.
- Recall that politics in advanced countries is moving defacto in the direction of seeking and forcing lower trade-GDP ratios.

B. Thwarted structural transformation: good growth and sustainable growth

- **Thwarted structural transformation:**
    - Successful development requires two kinds of structural transformations:
        - a shift of resources from low productivity to high productivity sectors; and
        - a larger share of resources devoted to sectors that have the potential for rapid productivity growth.
    - In many cases, however, resources do not shift in this way. They shift instead from informal, low productivity sectors to ones that are marginally less informal/more productive. These are cases of "**thwarted structural transformation**".
- Manufacturing is a critically important sector for ensuring successful transformations.
    - This sector exhibits unconditional convergence toward the world frontier, so that it can become an escalator for rapid growth.
    - This is why "**premature de-industrialization**," the tendency for manufacturing in late convergers to peak at lower levels of activity and earlier in the development process, is a cause for concern.
    - Richer countries attained higher levels of peak manufacturing and earlier in the development process.
- Are late convergers particularly vulnerable to thwarted transformation?
- **Dynamic sectors:**
    - Dynamic sectors are those with high levels of productivity and potential for unconditional convergence.
    - Such a list comprises manufacturing, finance, telecommunications, and professional services.
- We can decompose overall productivity growth into
    - **"good" growth** (i.e., involving desirable structural transformation)
        - Good growth comprises growth accounted for by labor share shifts into good sectors (dynamic sectors) and their productivity growth.
    - **"less good" growth** (e.g., in hotels, restaurants, transport, etc.).
- **Good growth:**
    - Comparing good and less good growth in China and India since 1980:
        - For China, the average share of good growth over the entire period is 53 percent while India's is 37 percent, falling to about 32 percent since the Global Financial Crisis.
    - Whether there is a difference in the correlation between overall growth and "good growth" between the early and late convergers. Two features are noteworthy:

- ▪ Share of good growth is falling over time. This in a sense captures the more general version of the premature deindustrialization point.
        - ▪ Second, in the early period of divergence, there was a positive correlation between growth and good growth but this correlation has weakened over time.
    - o So, there is something to the thwarted structural transformation hypothesis.
    - o China's good growth persists in both periods; India's share of good growth declines in the second period. Both are of course positive outliers to the relationship itself, raising the possibility that while the general pattern is that good growth is necessary for sustained growth, China and India might defy this pattern.

C. Human capital regression

- There is one key difference between early convergence based on manufacturing and late convergence against the strong headwinds of automation and the globalization backlash. And that relates to human capital.
- In early convergence, it was the alignment of human capital endowment (educated but relatively unskilled labour) with the sector associated with structural transformation, namely manufacturing, that allowed for the percolation and spread of dynamism to the rest of the economy.
- Shifts in labor, the so-called Lewisian transformation from farm to factory, were possible because of this co-incidence: growth and structural transformation based on comparative advantage.
- Challenges before late convergers:
    - o They failed to provide even the basic education necessary for some structural transformation.
    - o That failure will prove increasingly costly because the human capital frontier for the new structural transformation has probably shifted further away. Technology will increasingly favor skilled human capital, where the requisite skills will include adaptability and the ability to learn continually.
    - o Growth itself will be based less on comparative advantage and more on some absolute human capital attainment.
- During the 1980s and 1990s, educational attainment of the middle income countries was below that of advanced economies. But the gap was smaller for them then than it is for the lower middle income countries in the more recent period. If this gap persists or widens the kind of transformation enjoyed by the late convergers might prove more difficult for the late convergers, including India.
- There is another India-specific perspective on the human capital challenge highlighted below:

The Learning Poverty Count (LPC) and Learning Poverty Gap (LPG) in Rural Primary Education

- India's primary school enrollment is now nearly universal for both boys and girls at elementary level.

- Yet, both cross-country evidence and evidence from India suggests that educational outcomes are incommensurate with years of schooling: learning lags attending.
- Here we present estimates of learning outcomes drawing parallels from the poverty measurement literature. Specifically, we estimate a learning poverty headcount (LPC) as well as a learning poverty gap (LPG).
- **Learning poverty headcount (LPC)** and **Learning poverty gap (LPG):**
  - LPC <u>measures the number of children who do not meet the basic learning benchmark</u>.
  - LPG additionally takes into account <u>how far each student is from the benchmark</u> i.e the LPG measures the gap between the the basic learning benchmark and the average scores of those students who did not meet the benchmark.
- **Tests in reading and arithmetic:**
  - Estimates of LPC and LPG are rendered possible by the Annual Survey of Education Reports (ASER) that have over time tested a sample of children between the ages of 5 and 16, residing in rural India.
  - Students are tested in terms of a set of tasks in reading and arithmetic. These tests amount to an absolutely minimal or basic level of educational attainment–akin to the poverty or subsistence line.
  - Specifically, we chose this line as being able to read a simple story (in the local language), and being able to do subtraction – roughly meeting the passing standard for grade 3. For the present analysis, we focus on children between in grades 3 through 8.
  - **Findings:**
    - The findings are stark. On math and reading, India's absolute LPC is between 40 and 50 percent: in other words, roughly 40-50 percent of children in rural India in grades 3 to 8 cannot meet the fairly basic learning standard.
    - Discouragingly, this poverty count score rises over time, substantially in the case of math.
    - There is some consolation that <u>since 2014 has the trend started to show some improvement</u>; and also consolation that at least there are <u>no significant differences in the LPC for boys and girls</u>.
    - The most recent level of the LPG is about 25% for reading and a little lower for math.
    - In higher grades a larger proportion of students meet basic benchmark.
    - Learning levels of children in rural India are far below where they should be. It is sobering enough that learning poverty counts are around 40 percent, roughly where India's consumption poverty numbers were in the 1970s.
  - But if technology going forward is going to be even more human capital intensive as current trends suggest, the wedge between the opportunities offered to the future labour force and the capabilities to take advantage of them will widen even further. That is the true magnitude of India's human capital challenge.

D. Climate change-induced agricultural stress

- A final factor impeding late convergence relates to agriculture.
- <u>Lewisian structural transformation</u> required the release of resources into the modern sector under conditions of rising agricultural productivity. Part of the reason was the need to produce enough food to a growing population. That was only possible if agricultural labor productivity grew rapidly enough.
- **Divergence on agricultural productivity:**
    - Growth rates for richer countries have been consistently greater than for developing countries.
    - For the poorest, these growth rates have even declined post-GFC.
    - For example, Indian agricultural productivity growth has been stagnant, averaging roughly 3% over the last 30 years.
- Indian agriculture is vulnerable to temperature increase and still heavily dependent on precipitation. If climate change raises temperatures and the variability of rainfall, farmer revenues could decline by up to 20 percent to 25 percent in nonirrigated areas.
- For the late convergers, agricultural productivity is critical not just for feeding people but for ensuring human capital accumulation in those who move from agriculture to the modern sectors.
- Agriculture could yet come back to haunt the structural transformation fortunes of the late convergers.

LESSONS FOR INDIA

- Since 1980, India has been rapidly catching up, posting an average per capita GDP growth rate of 4.5%, a rate substantially greater than registered previously, which is in the top quartile of countries over that period, and amongst the highest for continuous democracies.
- But this fast growth has occurred with <u>limited transfer of labour resources from low productivity to high productivity and dynamic sectors</u>, and despite <u>relatively modest agricultural growth</u>.
- The risk for India–as for the other late convergers–is that resources (especially labour) will move from low productivity, informal sectors to other sectors that are marginally less formal and only marginally more productive. That is the "late converger stall" that India must avoid.
- **Key to sustainable growth:**
    - <u>Rapidly improving human capital</u>–healthy individuals, including all women, with the basic education to continually learn and adapt–will be key to sustaining India's dynamic growth trajectory.
    - <u>Rapidly improving agricultural productivity</u>–against the headwinds of climate change and water scarcity–will be another key to achieving good growth and hence sustainable growth.
    - And, the <u>hyperglobalization backlash in advanced countries</u>, over which India has little control, <u>must recede</u> to create a favorable external climate to sustain rapid growth.
- There is no Late Converger Stall, as yet, but it would be wise to act to head it off.