# Prasarn Trairatvorakul: From here to there – transition in emerging markets

Speech by Dr Prasarn Trairatvorakul, Governor of the Bank of Thailand, delivered in the Thailand@Harvard Series, Harvard Kennedy School, Boston, Massachusetts, 7 October 2013.

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Distinguished guests, ladies and gentlemen,

It is a pleasure for me to be back here at Harvard and to have a chance to contribute to the Thailand@Harvard series. Boston has certainly changed a lot since I graduated over 30 years ago. But the warmth and sense of intellectual purpose that I still feel here makes it all seem like yesterday. And by that I don't necessarily mean the stress of studying for my general exam!

Later this week I will be attending the Annual Meetings of the IMF and the World Bank. Undoubtedly one of the key issues that will be discussed is the recent growth slowdown in many emerging market economies. Certainly, among market commentators and in policy circles, ***the medium-term growth prospects for China, India, Brazil and other emerging economies have become the talk of the town.*** And it will be the focus of my remarks today.

***What happens in emerging markets matter.*** Together, they account for more than half of world GDP.[1] Since the early 2000s, when Jim O'Neill at Goldman Sachs coined the acronym BRIC for Brazil, Russia, India and China, emerging markets have powered global economic growth. By mid-2009, these economies were growing 7 percentage points faster than the G7 economies and contributed around two-thirds of world output growth.

With growth slowing sharply, the crux of the debate right now is ***whether the slowdown is temporary,*** reflecting one-off negative shocks, ***or long-lasting,*** as the initial growth spurt from undertaking "low-hanging fruit" reforms dissipate and the transition towards a more sophisticated growth model not yet accomplished.

I will not argue for or against either of these views. Rather, let me put on my economist's hat and say that "it depends". But don't worry, I will not spend the next 10 minutes boring you by spelling out all the arguments on each side or listing all the strengths and weaknesses of emerging market countries. Instead, ***I will highlight what I see as the critical steps needed*** to successfully see these countries through the current transition. This leads me to a focus on domestic factors.

***Ultimately, growth depends primarily on what happens at home.*** External conditions alternately provide headwinds or tailwinds, but the ability to counter or take advantage of these shifts is determined by domestic capabilities. Now some of you may think of endowment of resources, such as land and labour, as the most fundamental domestic factor. And you are right. Factor endowments do give some countries a head-start over others. Oil exporting countries are a prime example.

***But the long-run prosperity of nations is not bound by their endowments.*** Times magazine recently ran an article on the fact that Holland is Europe's largest tomato exporter. One of the most critical ingredients in growing tomatoes is sunshine. Holland is cold and gets little sunshine. Greece is hot and has plenty of sunshine. Yet the Dutch can produce 70kg of tomatoes per year in a square metre of his temperature controlled greenhouse whilst Greek and other Mediterranean grower get approximately 7kg through traditional open-air

[1] In purchasing power parity terms.

plantations. Ironically, in the summer Greece imports tomatoes from Holland because local farmers are unable to grow enough during the hottest time of the year.

***Natural and geographical constraints can be overcome.*** Japan and Singapore also spring to mind as countries that have made much of their limited resources. ***Critical to long-run growth is how you make use of and develop your resources.*** Doing so requires constant reshuffling of factors of production. Workers, capital, and land has to be devoted to activities that generate the most value added for the economy. ***In other words, growth requires structural change. Advanced economies are simply not blown-up versions of developing economies. They are structurally different.*** Development entails more than just aggregate growth. It requires significant transformation in the productive structure of the economy.

In Thailand the average worker in the manufacturing sector is roughly 10 times more productive than those in agriculture. Yet, the latter employ about 40 percent of our workforce compared to 15 percent in manufacturing. It is easy to see that ***simply moving workers from agriculture to industry can lift our income tremendously.*** In fact, this was precisely one of the key drivers of Thailand's growth in the 20 years prior to the 1997 crisis. During this time, the share of employment in agriculture fell by a third, releasing workers to the more productive manufacturing and service sectors. Thailand's experience is quite typical of many others in Asia.

***Emerging market countries have not only grown rapidly over the last few decades, they have also changed dramatically.*** Sustaining growth going forward hinges on the continuation of this process of change and upgrading. For Asia, industrializing the agriculture sector through the adoption of modern methods and the development of agribusinesses will be a key source of productivity growth. Similarly, the composition of the service sector, which is also quite large, has to shift from low-productivity activities to modern, high value-added services.

***Countries that have achieved sustained growth are those that are better at removing the bottlenecks that impede such transformation.*** This typically requires a number of key fundamental capabilities, such as macroeconomic stability, rule of law, good education, strict enforcement of contracts, a competent bureaucracy, good governance, and low tolerance of corruption. ***These are often encapsulated under the rubric of strong institutions. One can think of institutions as the set of rules and norms that both governs the incentives of economic agents as well as constrains their behavior.*** Good institutions encourage growth, bad institutions stifle it. Entrepreneurship, a critical driver of structural change, relies heavily on the institutional environment. The contrast between North and South Korea serves as a striking example of how institutional differences can lead to wildly divergent paths between two regions that were initially very similar culturally and geographically.

This does not mean that a country needs to achieve comprehensive institutional development before growth can occur. "Big bang" institutional reform is typically infeasible. ***Instead, tackling the most binding constraints one-by-one can yield substantial growth benefits.*** A country does not need to attain Swiss level of institutional quality in order to be able to compete with Swiss producers in many products. For example, China's growth miracle has occurred through selective market-oriented reforms against a backdrop of pervasive economic and political institutional weaknesses.

***But eventually, the growth process has to evolve to be sustained.*** At this point weak institutions will hamper growth. Transitioning towards a diverse and sophisticated growth model is only possible once ***institutional strength is achieved along sufficiently many dimensions.*** This reflects the existence of large complementarities. A strong legal system and enforcement of property rights, for example, won't boost innovation much if the education system fails to produce a skilled workforce. A highly educated workforce cannot contribute meaningfully if macroeconomic stability is lacking. Good macro policy will make little difference if corruption is rampant. ***The individual institutional elements complement each other in such a way that the whole is greater than the sum.***

***Without sufficiently broad institutional development, growth will stall.*** Many analysts actually believe that several emerging market countries are already at this point. As such, moving forward will be possible only with further institutional reforms. Such a sentiment is echoed in former premier Wen Jiabao's description of China's impressive growth performance as "unstable, unbalanced, uncoordinated, and unsustainable".

So we know, by and large, what is needed. Indeed, economists have done a very good job at *explaining* the importance of institutions for growth. ***But how do we achieve institutional change?*** Why do some countries manage to improve their fundamental capabilities while others languish? This is the heart of the matter. It is not hard to spot bad institutions when we see it and propose changes that would seemingly yield large benefits. It is another issue entirely how to make the change happen. In this regard, policy prescriptions that call for "growth enhancing structural reforms" or "strong institutions" alone is partial at best. That's like saying that if you want to get fit, you should exercise. Good advice, but not very useful.

A practical reform strategy must be based on a ground-level perspective of how institutional change happens. Policy can then be tailored to maximize the chance of success. So how does institutional change happen? ***The answer seems to be a mixture of history, will power, and luck.*** It relates to the complex power dynamics in a country. Structural reforms create winners and losers. The winners are often diffused and dispersed. Conversely, the losers are often easily identifiable, powerful and well-organised. Institutional change must go up against vested interests. This process falls squarely in the political domain. And as we are reminded by the events in Egypt and elsewhere, the political process and power struggles are rarely clean. Exercise is sweaty and messy.

***The fact is, institutional reform is highly contingent.*** They depend upon events transpiring in a particular way at critical junctures. This is shaped by the prevailing political economy context and social attitudes at the time, as well as luck. There was nothing inevitable in Deng Xiaoping's rise to power in China in the late 1970s, which was the key pivotal moment that set China towards economic reforms that bolstered the role of market forces. The set of events that transpired were highly contingent on the outcome of a power struggle between remnants of the Cultural Revolution leadership, namely the Gang of Four, and more reform-minded members of the Communist Party. In other countries, such power struggles have come out on the other side and oppressive economic institutions remained.

***A confluence of factors, especially at critical junctures, largely determines the path of institutional change and development.*** The window of opportunity comes and goes. We must be ready to seize it as a society. ***Successful growth-promoting reforms are pragmatic and opportunistic.*** Building institutions is *not* like building a house – brick by brick in a linear fashion. It is more like scoring a goal in soccer. There are many moving parts at the same time, the play is unpredictable, and it involves an enormous amount of tacit unseen coordination among players. Ability, hard work, and team spirit have to come together in a harmonious manner. Moreover, the outcome is highly contingent on certain events at pivotal moments. A foul here, a red card there can make all the difference. Sports commentators call these "momentum swings".

Countries must seek to make the most of these windows of opportunities to build reform momentum. Successful policies will be those that are mindful of a country's history and leverage on prevailing political economy contexts. The long-run performance of countries hinges critically on this because ***the outcomes of institutional change tend to be highly persistent.*** How rules and norms evolve depends heavily on what they are today. Thus institutional development often follows a virtuous circle, such as in South Korea, or a vicious spiral, as in the case of Zimbabwe.

From this perspective, ***there is an enormous amount of heterogeneity among emerging market economies.*** Where a country stands in terms of its history and readiness for institutional change will distinguish those which are just experiencing a temporary deceleration from those that might be facing more of a structural slowdown. The destinies of emerging markets are not strictly bound to each other. Some will succeed, and a few may not. It is not useful to lump countries together into one group or under one catchy acronym or another. Going forward, ***each country needs to be analyzed more as individual stories.***

**Ladies and gentlemen,**

Emerging market countries are at a critical juncture. Much has been accomplished, and much potential remains. This is the key transition point. ***How successfully a nation manages this transition will depend primarily on domestic factors.*** Specifically, its ability to instigate structural change and implement institutional reforms. I believe that big strides can be achieved if we can push through our individual glass ceilings. But I am also realistic that realizing this potential and coordinating societies on the good outcome will be enormously challenging.

To move forward, ***there needs to be a collective change of attitudes and mindsets*** – particularly towards things like corruption, good governance, and consideration for the public good. Here there is good news and bad news. On the positive side, mindsets and attitudes are things within our control. The bad news is that changing attitudes and mindsets is perhaps one of the most difficult things to do. ***As Leo Tolstoy once wrote "Everyone thinks of changing the world, but no one thinks of changing himself."***

For many of you here who will go on to serve in public policy, I urge you to embrace this challenge and give you my wholehearted support. ***Today is a legacy of the past, but history is not destiny.*** You can make a difference and we need more people who devote themselves to do so.

Thank you very much for your attention.