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BY JOHN JULLENS

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Throughout much of human history, economic output was firmly yoked to the size of a country's labor force. Because productivity growth was negligible, the countries with the largest populations, such as China and India, could put the most people to work. They reigned as the world's largest economies. Things changed suddenly during the late 1700s. A number of economic, institutional, and other factors coalesced in England to unleash the Industrial Revolution, which was transformational — at least in the handful of Western countries that rose to dominance through their economic prowess and resulting military and political power. Everyone else fell behind.

Incredibly, this great divergence has persisted for more than 250 years. Today, the global economy still consists of only 30 or so high-income countries, roughly the same number of middle-income countries, and a very long tail of 140 or so low-income countries. This last group is still finding it difficult to industrialize, and at least 34 of these countries remain fragile and vulnerable to outright collapse.

This circumstance doesn't really jibe with orthodox economic theory. As access to new technologies and other know-how opens up, and as domestic savings and investment are complemented with external financing, theory predicts that growth in low-income countries should accelerate and the gap with wealthier counterparts should narrow. In fact, many pundits, including the Nobel Prize–winning economist Michael Spence, believe we are currently living in the middle of a century-long journey, during which the rest of the world will catch up with the developed economies of the West. By the time what Spence dubs "the great convergence" is over, around 2050, he says, as much as 75 percent of the world's population will live in developed economies — in contrast to a mere 15 percent today.

But it's not clear that Spence's optimistic prophecy will come to pass. In reality, developing countries almost invariably get caught in various types of growth traps that make it difficult to reach high-income status. Since the 1950s, at least 80 countries, in every major region of the world, have achieved an increase in annual per capita income of at least 2 percentage points for at least eight consecutive years. Yet during that same period, only a handful managed to escape the dreaded middle-income trap (classified by the World Bank as having a median gross national income [GNI] of US$6,750 in 2011 dollars). The few favored exceptions are largely in East Asia: Hong Kong, Japan, Singapore, South Korea, and Taiwan. What's more, the rate of progress recently slowed down again after an unparalleled growth spurt in the early 21st century. (Between 2000 and 2014, annual growth rates in emerging markets had outpaced those in developed ones by almost 5 percentage points, as reported in the *Economist*). It's no wonder Morgan Stanley strategist Ruchir Sharma, writing in *Foreign Affairs*, coined the term *ever-emerging markets* to describe the all-too-common cycle of promise and excitement when a country appears to take off — and the bitter disappointment when its growth stalls long before anything close to economic parity is achieved.

Several interrelated issues ex-

Illustration by Lars Leetaru

plain why emerging economies have found it so difficult to achieve convergence. But ultimately, the root cause is the lack of integration among the three primary disciplines that must inform any coherent catch-up strategy: development economics to guide a country from low- to high-income status, political science to design the enabling institutional environment, and strategic management to create competitive world-class firms over time. Perhaps most alarming, the third discipline, strategic management of domestic firms, is often not even part of the conversation. The result is a series of growth fallacies that have led many policymakers astray.

Emerging markets need a fundamental reversal in approach. The conventional wisdom advocates implementing large-scale economic and institutional reforms that shape the overall business and political environment. But it would be more effective to selectively use reform initiatives tailored to each country's unique mix of business dynamics and industries, to improve domestic firms' resources and capabilities at each stage of a country's economic development.

Think about it like a professional sports team. For years, we've been focusing on the playing field — making sure the grass is cut, and the lines are clear. But if the individual players don't have the capabilities they need to compete, none of that really matters. Those players are an emerging country's domestic firms. They need the right training (and nurturing) to compete to win against world-class "teams" from more mature countries. Without such capable firms, emerging markets will inevitably get stuck somewhere along the way.

Getting Growth Wrong

Many economists and policymakers still believe that developing countries should simply open up domestic markets to foreign direct investment, liberalize their financial systems and exchange rate regimes, remove all barriers to competition, and specialize in those activities in which they have inherited a comparative advantage. These analysts are influenced by a near-religious belief in free markets, trade, and competition that goes all the way back to Adam Smith's invisible hand and David Ricardo's subsequent musings on British cloth and Portuguese wine.

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But the positive relationship between trade liberalization, competition, and economic development is ambiguous at best. For instance, trade restrictions can actually benefit a country depending on whether it is already developed or still developing, whether it is big or small, and whether it has a comparative advantage in those sectors that are receiving protection. Conversely, premature trade liberalization can hurt a developing country, as the entry of much more experienced and better-resourced foreign multinationals can drive fledgling indigenous firms out of business. This can force the developing country to de-industrialize and revert to activities with lower added value. In other words, slavish adherence to the free market orthodoxy may inadvertently doom a developing country to the production of simple, low-margin manufactured goods, agriculture, and the extraction of finite natural resources.

Similarly, the conventional wisdom holds that economic development is a function of democratic political institutions that ensure arm's-length government–business relationships, deregulated labor markets, and private ownership and shareholder control. At first blush, that makes sense — the vast majority of today's high-income countries are democracies. However, here too, the evidence shows that major institutional reform, and indeed democracy, is not a prerequisite for economic growth, at least initially. Some of the most successful development cases in history, including China today and South Korea in the postwar years, took place under unambiguously autocratic governments.

A related growth fallacy is the assumption that the best theoretical solution is also implementable in practice. In reality, emerging markets are characterized by numerous institutional voids, as Harvard Business School professors Tarun Khanna and Krishna Palepu have written extensively about, such as shoddy infrastructure, nascent capital markets, and endemic corruption, which make pursuing "first-best" solutions virtually impossible. In addition, these institutional voids vary from country to country, making effective economic development policies highly situation-specific. In other words, each country's development journey will have to be unique, due to initial differences in factor endowments (land, labor, capital, technology), institutional environments (political system, property rights, financial system, labor markets), domestic firm capabilities (technology, processes and systems, brand, management), and culture.

The conventional wisdom also falters because it implicitly assumes that economic development is a linear process, through which higher and higher income levels are reached in a progressive and gradual fashion. In reality, a poor country's long and difficult journey from low- to high-income status runs through distinct development stages. Each stage is characterized by different challenges, policy objectives, and tasks at the political, economic, and firm levels. Policymakers will encounter new growth traps at every step along the way. What is needed to lift a country out of poverty may be quite different from what is needed to navigate across the middle-income trap, which, in turn, may be entirely different from what is required to sustain a successful high-income country (a GNI of $12,476 or higher).

Policymakers thus face a formidable challenge, as they have to change course several times along the way — each time having to overcome stiff resistance from those with a vested interest in maintaining the status quo. To add further complexity, economic development discussions normally take place at the relatively abstract policy level, as opposed to the firm-level trenches where the battle is ultimately won or lost. As a result, government policy is typically focused on advancing the overall business environment, and is seldom designed to address and improve individual firm performance.

Rethinking Development

Given the complexity and ever-changing nature of the intervention required, it is not surprising that so few countries have been able to transition successfully from one economic development stage to another. Although a comprehensive theoretical framework has yet to be developed, examples of successful initiatives from various emerging markets — most recently those in East Asia — suggest a preliminary set of guiding principles for each of the four major phases of an emerging market's economic development journey. A country can evolve this way from relying primarily on country-based comparative advantages (for example, ultra-low labor costs) to developing a sufficient number of domestic companies that possess world-class differentiated capabilities of their own.

Phase 1: Breaking free. Many emerging countries remain poor (a GNI of $1,025 or lower) indefinitely not because local policymakers don't understand the basics, but rather because their economies are stuck in subsistence growth traps. In these traps, market forces alone are insufficient catalysts for the industrialization and development process. Such growth traps result from structural impediments that differ from country to country, but typically include some combination of economic constraints (such as inadequate access to affordable financing), political constraints (such as excessive bureaucracy), and firm strategy constraints (such as the absence of a skilled workforce).

For example, in emerging economies where the vast majority of the workforce is employed in farming-related activities, the agricultural sector is typically controlled by a wealthy, landed elite with little incentive to upset the status quo — and enough power to block or stall reforms. As a result, land reform programs specifically designed to break the stranglehold of the landed elite are often a prerequisite to long-term economic development. As described by journalist Joe Studwell in *How Asia Works: Success and Failure in the World's Most Dynamic Region* (Grove Press, 2013), Japan, Taiwan, South Korea, and China all implemented meaningful land reform programs early in their economic development journeys — in contrast to their less successful counterparts in Southeast Asia, India, and South America.

Phase 2: Catching up. Once the initial set of growth barriers has been broken, policymakers must focus more broadly on the industrialization process. It is difficult to become a high-income country solely by producing and exporting agricultural products and other natural resources while importing most manufactured goods. Industrialization directly raises productivity and income levels. It also prevents the inevitable deterioration of a country's terms of trade, which otherwise occurs when the country must pay for importing increasingly sophisticated and expensive manufactured goods with its own exports of much cheaper primary products (which often have far less stable demand).

Several East Asian countries have demonstrated that leveraging land reform and other rural productivity initiatives (for example, investments in fertilization, irrigation, and infrastructure) and migrating the resulting surplus farm labor into more productive activities, such as manufacturing goods that are currently imported, can be an effective strategy for jump-starting the industrialization process. Doing so will typically require some form of direct government intervention, as few local firms will have the capabilities or scale to compete with their more experienced foreign competitors. Of course, such interventions may have some initial downsides, such as higher prices for consumers, but they should be seen as an investment in the country's future economic development. They are therefore every bit as important as similar investments in infrastructure and education. From an emerging market policymaker's perspective, the real question is not whether to intervene, but what form the intervention should take and which industries should be targeted.

Some of these initiatives will be horizontal, such as providing financing and reducing bureaucratic red tape to unlock entrepreneurial activities. But policymakers should also introduce complementary vertical initiatives to facilitate the flow of surplus farm labor into high-potential target industries. Given the lack of capable domestic companies at this early stage, the focus should be on whatever comparative advantages happen to be available locally, be they ultra-cheap labor, access to natural resources, a favorable location, or a large domestic market. Country leaders should also consider the target industry's specific technological and other spillover potential that can be deployed in other industries. For most emerging markets, the initial focus will likely be on simple, nondurable consumer goods, such as clothing, that are labor intensive, are relatively simple to produce, and do not require advanced technical and managerial skills.

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The type of intervention can take various forms, and will need to be adapted to the requirements of the target industry and the specific economic, institutional, and cultural environment in each country. Tariffs are an obvious choice, at least initially, as they directly protect local firms from premature foreign competition. Importantly, they don't require funding through public resources — which are likely still quite limited. Other options include low-cost financing, favorable tax rates, below-market land and utilities prices, and direct subsidies to selected industries.

Phase 3: Moving out and up. Using the strategies described in the previous phase, a low-income country can experience a period of economic development that can last several years. But growth rates will eventually come down again, as the number of imported goods suitable for domestic production dwindles, the supply of surplus farm labor runs dry, and costs begin to rise — all of which make local firms steadily less competitive.

At this point, domestic firms must enter into more value-added activities and engage in head-to-head competition with rivals from developed markets. The government will need to help homegrown firms move from relying primarily on country-based comparative advantages and copying basic production capabilities to developing firm-specific competitive advantages and acquiring advanced innovation, operations, and go-to-market capabilities. Instead of passively relying on whatever static set of resource endowments (natural resources, a large labor force, and so on) their country may have inherited, emerging market governments must play an active role in dynamically creating new sources of competitive advantage.

This is a difficult and time-consuming process, because the difference between merely good and world-class firms is often embedded in capabilities that may have been honed for decades. In addition, world-class firms naturally have little interest in sharing their trade secrets with anyone, let alone with emerging market firms that could, over time, become formidable global competitors themselves. And cutting-edge innovation in high-potential industries, such as green energy and nanotechnology, increasingly requires massive investments that are far beyond the means of all but the largest firms.

Therefore, it is important to adopt a deliberate approach to upgrading the domestic industrial base over time, perhaps starting, as James Cypher and James Dietz recommend in *The Process of Economic Development* (Routledge, 1997; rev.

2007), with simply exporting the goods that were previously imported but are now produced locally, and then expanding internationally into more advanced countries and challenging categories, such as capital goods (for example, factory equipment), intermediate products (such as batteries), and, eventually, durable consumer goods (such as cars). This step-by-step process would expose domestic producers to foreign competitors early and encourage them to reach global performance standards themselves — initially, just for a few relatively simple goods, but over time, also in more complex and knowledge-intensive product categories. This is precisely the economic development path followed by Japan, South Korea, and Taiwan.

But simply exposing domestic players to ever-tougher foreign competition is not enough by itself. If domestic firms are ever to catch up with their far more experienced foreign competitors or, in some cases, to take advantage of latecomer advantages in sunrise industries where firms from developed markets can be burdened by their installed customer base and older technology standards, emerging market governments will need to take an active role. They must engage in a process of incremental capability building and innovation by encouraging the transfer of technology and know-how from developed markets and the insertion of local companies into global value chains and innovation networks (for example, through local investment and partnering requirements). They must also make substantial investments in areas such as education, training, and applied research. In addition, they will need to create an enabling financial environment, including credit provision to selected industries. More controversially, they may want to maintain some combination of capital controls, active currency management, close supervision over the banking system, and mild financial repression to ensure that scarce capital is disproportionately directed toward investment, and that domestic firms can meet economic and social developmental goals in a more stable business environment.

Of course, there are strong arguments against such active government intervention. These include not only the social costs, such as higher retail prices, lower interest rates on deposits, and fewer individual investment opportunities. There is also the potential for widespread corruption, and for domestic firms to become dependent on government protection. But the risk of failure doesn't negate the necessity of trying, as no country has ever caught up without significant, albeit temporary, direct government support. To mitigate the risks of active intervention, governments should focus on enabling, even forcing, domestic firms to continually upgrade their capabilities and competitiveness, helping to cull the losers rather than pick the winners, and setting clear and credible timetables for phasing out support initiatives. For example, in the 1960s and '70s, South Korea's government enforced a strong export regime, specific performance standards, and sunset clauses to expose domestic firms to world-class performance standards early and weed out those that ultimately couldn't compete.

To be sure, a more interventionist stance demands a highly capable government sector that is fully independent, yet sufficiently connected with the private sector to jointly achieve ever-higher levels of economic and societal development while avoiding excessive degrees of corruption and bribery. However, these attributes are more a function of the domestic political system — and especially whether certain groups enjoy privileged access to key government decision makers — than they are a particular economic development approach, as South Korea, Taiwan, and others have demonstrated.

Phase 4: Staying sharp. As the economy matures and domestic companies become more capable, the government's role must change again from active intervention during the initial three catch-up phases to a more passive enabling stance. However, that doesn't mean the government's job is over once the country has achieved high-income status. The ever-accelerating pace of innovation continually pushes out the global productivity frontier to higher performance standards, requiring ongoing investments. Countries whose companies fall behind in this process of industrial upgrading and knowledge acquisition will become steadily less competitive and ultimately face lower growth rates. Governments need to help local companies stay sharp through such means as sponsoring research in advanced new technologies, investing in complementary upstream and downstream industries, creating a supportive regulatory environment, and providing financial incentives to reduce up-front investment requirements and mitigate startup risk for local entrepreneurs.

In addition, structural change inevitably produces winners and losers (even when society on the whole benefits). That hands governments an important related role in smoothing the transition process that goes well beyond simply ensuring free market competition, low tax rates, and vigorously enforced intellectual property laws. For example, many governments of developed countries face serious policy challenges as manufacturing activity migrates to lower-cost countries. Their economies become increasingly reliant on the tertiary sector: service industries. As a result, many workers are forced into subsistence service jobs unless they have the education, experience, and aptitude required for high-end professional services sectors such as healthcare, finance, or management consulting. When few workers are able to make this difficult transition, individual poverty can become surprisingly common in otherwise highly developed countries.

Finally, even developed countries may simply lack enough firms with world-class capabilities to sustain their economy as a whole. For example, Italy remains overreliant on its many small, family-owned businesses. They are capable of high levels of craftsmanship but often don't have the resources and scale to compete with low-cost competitors from countries such as China. Unless these companies can become more capable (and larger), Italy will be effectively forced to turn to old-fashioned protectionism, which in the long term only undermines its economic competitiveness. The orthodox economist's solution of simply letting noncompetitive local firms be replaced by more efficient foreign competitors not only is challenging politically, but also fails to recognize that local firm ownership still matters to a region's prosperity. Most multinationals remain overwhelmingly local in, for example, the makeup of their executive teams and location of their business activities with the highest added value.

Timing Is Everything

The number of countries that remain mired in poverty today makes all too clear the need to think differently about development — both to improve human welfare and to reduce the global impact of related challenges, including pandemics, terrorism, and military conflict. In addition, emerging markets will remain the best potential source of the economic growth many developed countries will need to meet their rising social and public debt obligations.

For emerging markets to avoid the growth traps that have long held them back, government leaders need to apply the right remedies at the right time, with interventions directed at the specific bottlenecks that prevent domestic firms from steadily improving their capabilities relative to world-class competitors. Such policies should focus on integrating tailored economic, institutional, and firm policies at each development stage, and engaging in a continual process of industrial upgrading and rebalancing. The key is to craft a national development strategy from the bottom up, rather than starting with a general set of policies and principles and trying to deduce specific recommendations and initiatives from the top down.

The result of such efforts is a winning team: a crop of highly productive homegrown companies that have the capabilities to compete on the global stage, and that can create an economic base at home that is broad and resilient enough to provide plentiful high-paying jobs, encourage a thriving services sector, spawn advanced technologies and innovation, and invest in local communities.

Of course, all this is not to imply that capitalist free market economics and liberal democracies are suddenly passé. Indeed, they will probably still be the endgame in most, perhaps even all, cases. But the likelihood of getting there may actually be much higher if governments and multilateral institutions do not insist on them early on — and instead give countries the tools and time they need to catch up. +

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