

Lessons from India and China

Comment for the FT.Forum on Martin Wolf column “In the brave new world, Chindia’s uneven rise continues,” *Financial Times*, March 20, 2007.

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It is indeed extraordinary that a pair of countries that not long ago were the world’s biggest economic laggards are now the world’s biggest engines of growth.

The recent developments, including the evidence cited in the Bosworth-Collins paper and Martin Wolf’s column, shed light on some of the most important questions in growth theory. The first question is the hypothesis of Alwyn Young, popularized in Paul Krugman’s famous article “The Myth of the Asian Economic Miracle,” that the success of Asian countries was mostly based on force-fed capital accumulation, and that it would therefore run into diminishing returns, as opposed to growth in total factor productivity (TFP). (The latter might, in turn, be attributed for example to catchup with the West, or else to something called Asian values.) Apparently capital accumulation explains only roughly half the economic miracles on China and India. The rest is TFP after all, though liberalization seems a more likely explanation for it than Asian culture.

Second is the question whether fiscal expansion is good or bad for growth. On the one hand, old-fashioned mainstream macroeconomics says that fiscal expansion boosts growth in the short run. On the other hand, most growth theory says the opposite, at least in the long run: large public sectors are usually wasteful, inefficient, and distortionary, while fiscal deficits soak up saving and crowd out private investment. The case of India seems to illustrate neatly that both are true. India’s growth first took off in the 1980s, *before* economic reforms. Why? Fiscal stimulus to aggregate demand. But by 1991 the deficits were unsustainable, and the country suffered a crisis. Then came the political will for serious market reforms, which produced a supply-led longer-term acceleration in growth in the 1990s. But some serious adjustment problems probably still lie ahead in the paths of both countries: large budget deficits in India and large bad bank loans in China.

The third big question is whether political liberalization needs to come before or after economic liberalization (the old “Pinochet vs. Gorbachev” question). The answer seems to be that economic growth can be achieved either with or without democracy. (This is also what much of the academic literature has found: Alesina, Ozler, Roubini and Swagel; Persson and Tabellini.) But of course democracy is to be preferred on other grounds.