

Perspectives on Global Development 2013

Industrial Policies in a Changing World

Shifting up a Gear

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Overview

Since the mid-1990s, economic growth rates in large and populous middle-income countries have substantially outpaced those in OECD countries (Figure 1). This has reshaped the global economy and favoured convergence in global income per capita. In the 2000s 83 developing countries doubled OECD per capita growth rates, compared with only 12 in the 1990s. The process of “shifting wealth” was led by China and India, but other countries are also contributing to it, including Brazil and South Africa. In spite of the persistence of large gaps in income per capita between OECD and non-OECD economies and the wide inequality within developing countries, most developing countries have improved their macroeconomic management and have started to address long-term structural challenges. New forms of foreign direct investment (FDI) to and from developing countries, the increase in South-South trade and the demands from the new middle classes in developing countries are helping to open up new growth opportunities. Developing countries are still accumulating capital and labour but they are also improving their capabilities and increasingly using and producing innovations. However, mastering technology and knowledge in order to move up the value chain is still a goal to be achieved for most of them.

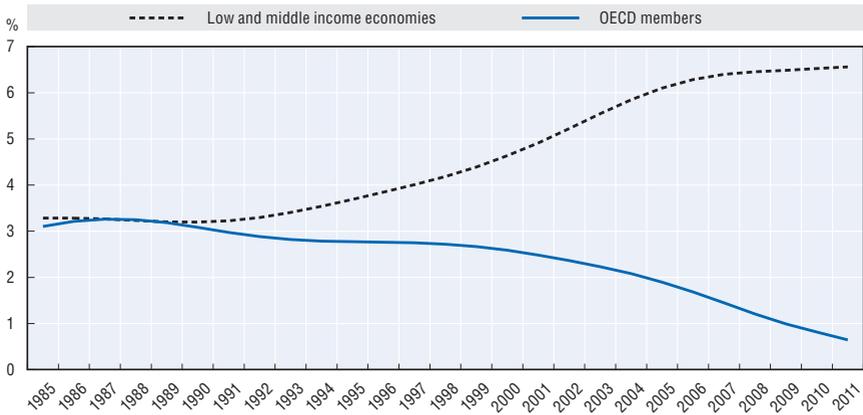
To address the new development challenges, some developing countries are implementing industrial policies to sustain growth by diversifying and upgrading domestic production. The renewed interest in industrial policy poses new challenges and opportunities for their policy makers. The new forms of FDI and the delocalisation of high-value-added activities, previously kept in-house in advanced countries, are opening up new opportunities for learning and for entering into new activities and sectors. Some developing countries are recognising the importance of well-functioning development banks to channel resources to production development, innovation and infrastructure; reducing their skills mismatch is also a key priority for many developing countries to facilitate production transformation.

The first chapter of this report presents an overview of the shifting wealth process from its surge to its persisting effects. The second discusses the different channels through which the process of shifting wealth affects developing economies. The third chapter describes the renewed interest in industrial policy in developing economies. The fourth presents the main challenges that developing economies face in implementing industrial policy. The fifth chapter analyses the skills mismatches within developing countries and the policies to reduce them. The sixth describes the difficulties developing-country small and medium-sized enterprises (SMEs) face in obtaining finance and the new policies to address them. The seventh chapter focuses on infrastructure bottlenecks in developing economies and identifies ways of improving policy cycle management. Chapter eight concludes, presenting the political economy challenges of implementing industrial policies in developing economies in the new global context.

The last two decades have seen an important change in the global economic landscape: a shift in the centre of gravity of the global economy to the East and the South.

Since the mid-1990s developing economies have been growing at higher rates than OECD economies (Figure 1) and since 2003 more than half of the world’s economic growth has derived from non-OECD countries; by 2011, non-OECD economies accounted for more than 45% of world GDP (in purchasing power parity [PPP] terms). Concomitantly, most developing economies have reduced their macroeconomic vulnerabilities, rebalancing the composition of their liabilities away from foreign currency external debt and towards FDI and portfolio equity. Moreover, while world trade has expanded almost fourfold since 1990, South-South trade has multiplied more than ten times. Developing economies have also increased their global share of FDI inflows and outflows, absorbing more than half of global FDI inflows in 2010, against less than 20% in 2000. In 2010 they accounted for around 30% of global FDI outflows.

Figure 1. Annual GDP growth rates by income group, 1985-2011
Smoothed rates



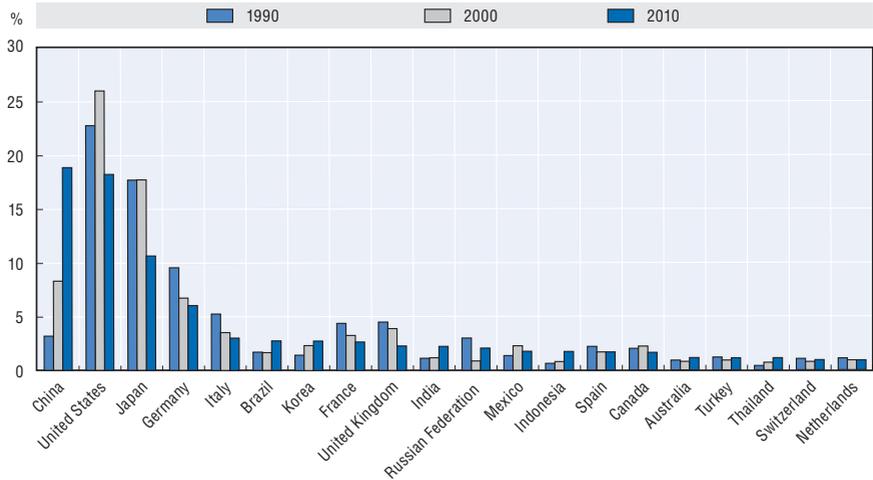
Note: Chile, Mexico and Turkey are included both in low and middle-income economies and in the OECD.

Source: OECD calculations based on World Bank (2012), World Development Indicators (database), <http://data.worldbank.org/indicator> and OECD (2012), OECD National Accounts Statistics (database), <http://stats.oecd.org/>

China is the main driver of shifting wealth but other countries are also contributing. China increased its share of world GDP from 3.5% in 1995 to 17% in 2011, and today it is also the world’s largest manufacturer. In 2010 China’s share of total world manufacturing value added (18.9%) outperformed that of the United States (18.2%) (Figure 2). Other developing economies are also playing an important role in the shifting wealth process, especially Brazil and India. India almost doubled its share

in world GDP from 3% in 1995 to 5.6% in 2010. Both Brazil and India are among the top ten world manufacturers and their share in global manufacturing output increased steadily between 2000 and 2010. South-South trade and investment are also on the rise. China, India and Brazil have emerged as new partners for Africa. In 2011, China accounted for 17% of total African imports, up from only 5% in 2000. India and Brazil increased their share in total African trade from 2.3% and 1.7% respectively in 2000, to 7% and 3% in 2011. Emerging countries are offering new forms of financing and promoting development. For example, China has been particularly active in investing in infrastructure, Brazil in knowledge and technology transfer in agribusiness, and India in generic drugs.

Figure 2. World top 20 manufacturers, 2010



Note: Manufacturing refers to industries belonging to International Standard Industrial Classification (ISIC) divisions 15-37. Value added is the net output of a sector after adding up all outputs and subtracting intermediate inputs. It is calculated without making deductions for depreciation of fabricated assets or depletion and degradation of natural resources. The origin of value added is determined by the ISIC, revision 3.

Source: UNStats (2012), National Accounts Main Aggregates Database, United Nations Statistics Division, <http://unstats.un.org/unsd/snaama/Introduction.asp> (accessed March 2012).

Despite concerns about the recent global economic slowdown, shifting wealth is a structural phenomenon and it will continue in the future. But its nature is changing, opening up new opportunities for development. Since 2008 the global economy has struggled to recover from the crisis and it is facing rising uncertainty and volatility. Although they have slowed, China and other developing economies are still growing considerably faster than OECD countries. Between 2009 and 2011, the average annual GDP growth rate in OECD countries was only 0.3% compared with 9.6% in China, 8.2% in India, 8.5% in emerging East Asia and Pacific countries, 4% in sub-Saharan Africa and 3% in Latin America. Currently, the combined GDP

of China and India is equivalent to about one-third of that of the OECD area, but is expected to exceed it by 2060. From its initial surge, when the process of shifting wealth was mostly linked to the rise and progressive integration of China into global markets, this process is now moving towards another stage, characterised by a process of structural transformation and accumulation of capabilities, know-how, skills and financial assets in developing economies. In addition, the emergence of almost 4 billion middle-class consumers by 2025 will open new opportunities for growth and development.

Developing economies are not only accumulating capital and labour; they are also increasingly using and producing innovations.

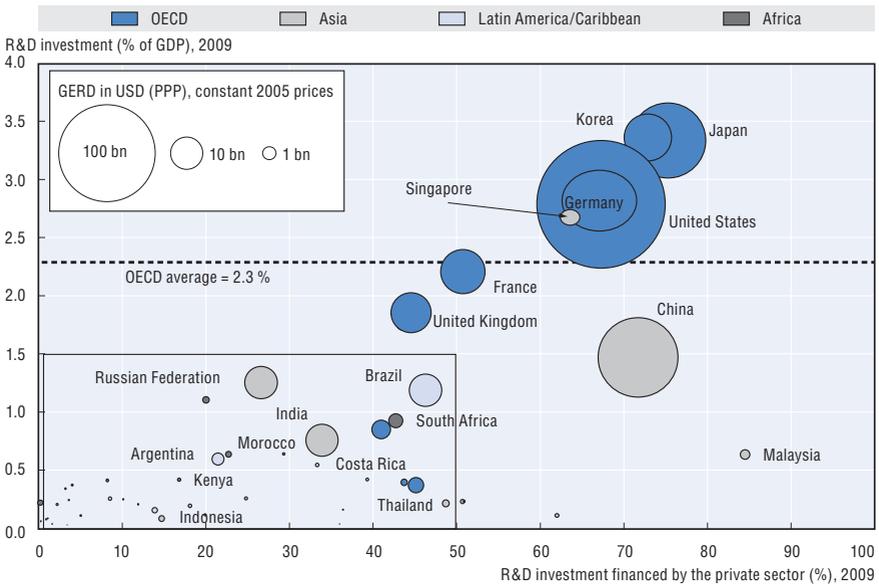
As well as continuing to accumulate capital and labour, developing economies are also increasing their innovation capabilities, though they still lag behind OECD countries. Innovation, i.e. the capacity to create new and better products and services, as well as new business models, is increasingly needed to compete effectively in global markets. In this context, China and, to a lesser extent, other developing economies have made great progress in the last decades. Nevertheless, this capacity not only to use but also to produce innovation is advancing slowly. Developing economies are introducing new business models and brands: China, for example, was among the top five countries for trademark applications and registrations in 2010. Trademark registrations are also rising in the Russian Federation, Brazil and South Africa, although on a smaller scale. However, the capacity to produce innovations has some way to go. Whereas OECD countries on average invested 2.3% of their GDP in research and development (R&D) in 2009, China invested 1.5% of its GDP, and other developing countries, including Brazil, the Russian Federation and India, invested less than 1%. In addition, private-sector involvement in innovation is low. Apart from China, the private sector in developing countries generally finances less than 50% of total R&D investment, compared with more than 60% of total R&D spending in OECD countries (Figure 3). Finally, the accumulation of innovation capabilities within developing economies is regionally unbalanced; a few regions are increasingly embedded in global innovation networks, whereas the rest of the economy operates at much lower levels of productivity or even in the informal sector.

The growth of “middle classes” in developing countries is opening new consumer markets. Developing products and services tailored to them, and adapting existing solutions to local needs, will provide powerful incentives to diversify and upgrade domestic production. But competition to gain access to this potential demand is intense and it will increase. Already established companies, especially multinationals, are looking at these new “middle classes” as potential consumers and it is likely that they will deploy strategies to tap into them. Domestic companies in developing countries will need to increase their innovative capabilities rapidly to capture these new demands.

The changing global economic context opens new opportunities for learning and innovation in developing economies, depending on their endowments, size,

integration in world markets and targeted policies. Natural resource-rich economies are benefiting from rising terms of trade, but are also facing difficulties in investing in new activities and in fostering production and export diversification. Some countries are profiting from the rise in revenues from natural resource extraction to establish new mechanisms to finance industrial and regional development. Small economies integrated into global value chains can take advantage of these new forms of FDI and generate linkages with the local economy, provided that they implement effective policies to develop adequate infrastructure and skills. Some large economies are shifting towards a new growth model that increasingly relies on growing domestic demand as an additional source of growth. Therefore these economies are on the one hand trying to identify new forms of partnership with foreign companies to enhance technology transfer and linkages with domestic companies; on the other hand they are investing in supporting the development of small and medium-sized enterprises (SMEs) and innovation to better adapt to the changing economic landscape.

Figure 3. R&D investment and private-sector commitment in selected countries, 2009



Note: 2009 or latest available year.

Source: OECD calculations based on OECD (2012), Main Science and Technology Indicators (database), <http://stats.oecd.org/> for OECD countries, RICYT (2012), Red de Indicadores de Ciencia y Tecnologia (database), Ibero-american and Inter-american Network of Science and Technology Indicators, www.ricyt.org/ for Latin America and the Caribbean, and UNESCO (2012), UNESCO Institute for Statistics Database, www.uis.unesco.org/Pages/default.aspx for other countries.

However, developing countries are facing multiple challenges to maintain high growth rates. To face the new global economic context they are implementing industrial policies to upgrade and transform their production structures and keep growing.

Since the early 2000s, some developing economies have started to implement industrial policies. In Latin America the pioneer has been Brazil, where the return of industrial policy dates back to 2003. South Africa made a serious commitment to relaunching industrial policy in 2007 and Morocco embarked upon an initiative for industrial development in 2005. Increasing the competitiveness of existing firms, supporting the creation of new firms and entering into new sectors and activities are three major goals for industrial policy in developing economies. Each country has a specific institutional setting that shapes the process of policy design and implementation. Ministries of industry are often responsible for policy planning. Development banks are regaining ground as key institutions in strategy setting (Brazil) and in financing (South Africa). In some cases, sovereign wealth funds are also increasingly used to finance production development. Regions and local governments play different roles; for example in Brazil and China industrial policy is managed by both national and regional institutions, while in South Africa it is more centralised. Industrial policies in developing economies increasingly include territorial inclusion and social cohesion as priorities, in addition to growth and job creation. A major challenge for developing economies is to articulate actions in the different fields that are determinant for achieving production transformation, including skills, infrastructure and finance and to define the appropriate mechanisms to monitor implementation and evaluate the effectiveness of these policies to increase their impact or redefine their nature and scope. In addition, it is interesting to note that these issues are not only confined to developing economies: in the aftermath of the 2008 financial and economic crisis OECD countries have re-opened a debate on industrial policies to address job and competitive challenges.

Multiple factors explain the renewed interest in industrial policy in developing economies. In addition to globalisation and a booming China, the 2008 financial and economic crisis reopened the debate about the institutions and rules governing markets. Successful cases of catching up have been associated with the design and implementation of policies to sustain learning by experience; Korea and Chinese Taipei followed different models, but both had strong government incentives to foster the development of domestic production capabilities. Growth in developing economies has opened fiscal space for proactive policies that were not available in the 1980s and 1990s. For example, rising prices of raw materials have benefited natural resource-rich economies, and have encouraged some countries to identify new mechanisms to channel funds from natural resource extraction to innovation and regional development, as in Chile, Colombia, Peru and South Africa. However, other such countries have faced difficulties in investing in new activities and fostering production and export diversification.

Developing countries are exploring new ways to enter into new sectors and develop new activities. Most of them are implementing new schemes to finance innovation, including sectoral technology funds. Public procurement is also seen as a tool to promote innovation and production upgrading in priority areas, as in Brazil, China, India and South Africa. Developing economies are also fostering the creation of new firms, especially start-ups in areas related to information and communication technology. In addition, developing countries such as Brazil, Morocco and India are increasingly using FDI as a tool to foster innovation and industrial upgrading by promoting linkages and technology transfer. Some developing countries are also prioritising sustainable development: they are investing in developing new technologies and in fostering the creation of new environmentally friendly business models. Development banks are often playing a key role in financing green innovations.

Developing countries are also exploring new mechanisms to strengthen the competitiveness of existing sectors. Cluster support contributes to both diversification and specialisation by fostering interaction and strengthening backward and forward linkages. Instruments to promote cluster development differ from traditional tools because they target the network of agents operating in a given geographical location, rather than individual firms. Promotion of clusters often includes incentives to strengthen linkages between firms, research centres, and provision of real services instead of subsidies. Public policies contribute to cluster development by favouring trust building between actors, by helping create linkages and collaboration, and by fostering innovation in products, processes and business models. Cluster promotion entails improving co-ordination with regional governments.

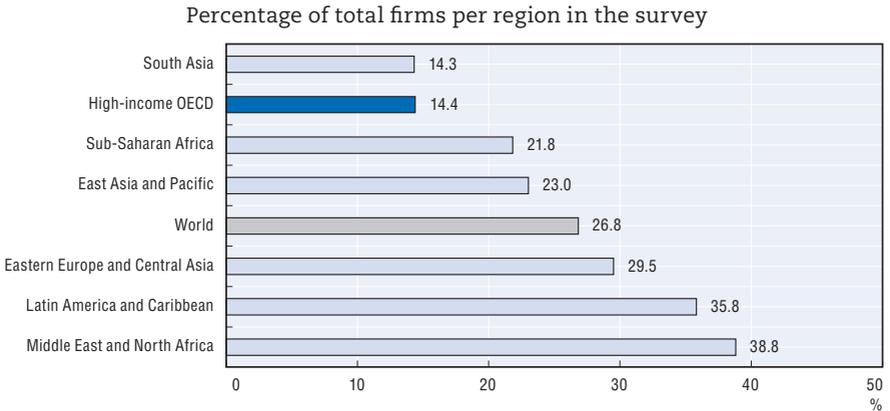
Creating jobs for the young and reducing the skills mismatches faced by developing countries are essential to improve the competitiveness of companies.

Skills development is part of the overall strategy for most countries actively engaged in industrial policy. A skilled workforce is necessary for industry upgrading; it stimulates innovation and helps countries move up the global value chains. However, high investment in education does not guarantee that the acquired skills will correspond to the demands of the production structure, or that the human resources will be productively employed. Skills mismatches hamper labour productivity and reduce the opportunity to profit from participating in global production networks. This problem is exacerbated when high-skilled workers migrate permanently from lower to higher-income countries.

In spite of improvements in recent decades, job creation and investment in skills development are still major challenges for developing countries. Skills shortages are particularly marked in Latin America and in Middle East and North African countries, even though governments there have invested significant amounts in education, in particular at the tertiary level (Figure 4). The lack of co-ordination between the main actors of the skills market, namely the public authorities in charge

of education and employment, education institutions and students, employers, but also workers and job-seekers, contributes to explaining this gap.

Figure 4. Firms identifying an inadequately skilled workforce as a major constraint, 2010



Notes: The indicator represents the percentage of firms per region identifying labour skills level as a major constraint. The computation of the indicator is based on the rating of the obstacle as a potential constraint to the current operations of the firm.

Source: OECD calculations based on World Bank (2012), World Bank Enterprise Survey, World Bank, Washington, DC.

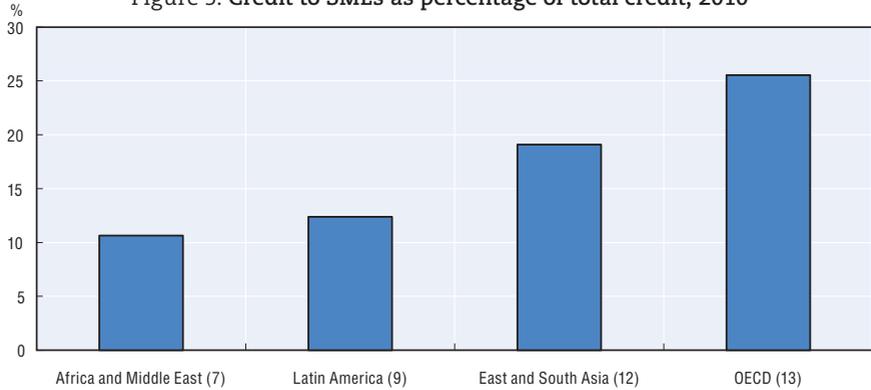
Many developing economies have already implemented reforms to improve both the quantity and quality of skills, and to reduce skills mismatches. Skills policies oriented towards industry upgrading should not only aim at investing in more and better skills, but also at aligning education with labour market needs, improving the school-to-work transition, encouraging the long-term adaptability of skills and promoting the international mobility of skilled workers. Co-ordination between the main stakeholders in the skills market helps achieve the targets of industrial policy. For instance, in the countries that are targeting FDI inflows and participation in global value chains as ways to upgrade production, initiatives are needed to train young people in the fields demanded by the private sector (e.g. engineering in Costa Rica and technical staff in Morocco).

Developing economies are introducing new mechanisms to increase access to finance for companies, especially SMEs.

Companies in developing economies face more difficulties than those in OECD members in gaining access to long-term credit. The gap is particularly large for SMEs, even though they account for 85% of total employment. In 2010, SMEs received less than 7% of total credit in sub-Saharan Africa, 12% in Latin America and 20% in Southeast Asia, compared with nearly 25% in the OECD (Figure 5). Furthermore, while a large proportion of SMEs have no access to formal credit, long-term credit is

even scarcer. Developing economies have put in place new instruments to increase access to finance for SMEs, including adapted banking tools (e.g. leasing, factoring) and instruments for distinct stages of business development (e.g. incubators, seed capital, risk capital). In addition, micro-finance has enhanced credit to micro and small firms and served as an intermediary step towards more formal financing channels.

Figure 5. Credit to SMEs as percentage of total credit, 2010



Notes: SME definitions differ for each country; therefore ratios are not always comparable. Variables used for SME classification include number of employees, annual sales and loan size. For more information see Financial Access Report (CGAP). Africa and Middle East: Botswana, Cape Verde, Liberia, South Africa; Iran, Jordan, Morocco. Latin America: Argentina, Brazil, Costa Rica, El Salvador, Ecuador, Guatemala, Panama, Peru, Uruguay. East and South Asia: China; Hong Kong, China; Mongolia; Chinese Taipei; Afghanistan, Bangladesh, India, Indonesia, Malaysia, Pakistan, Singapore, Thailand. OECD: Australia, Belgium, Estonia, France, Hungary, Italy, Japan, Netherlands, Poland, Portugal, South Korea, Turkey, United States.

Source: CGAP (2010), Financial Access 2010: The State of Financial Inclusion Through the Crisis, Consultative Group to Assist the Poor, CGAP, Washington, DC.

Public financial institutions, particularly development banks and credit guarantee schemes, are increasing their support to firms to foster innovation and production development. The National Development Bank of Brazil and the Industrial Development Corporation in South Africa are active players in implementing industrial policies and have introduced new financial mechanisms to stimulate innovation in specific fields of national interest. Credit guarantee schemes have grown significantly over the last decade. Among them, public guarantee schemes, which are publicly funded, represent the main type of guarantee instrument. Institutionally, public financial institutions have learned from past experiences of repeated recapitalisations and losses. In many countries development banks have introduced management reforms to improve their financial performance and reduce their exposure. For example, they have established more independent and accountable boards of directors, clarified mandates and implemented new procedures for risk evaluation.

Infrastructure remains a major bottleneck to increasing competitiveness in developing countries.

Inadequate infrastructure hampers growth and harms competitiveness in developing economies. About 60% of the world's infrastructure stock is located in high-income countries, 28% in middle-income countries and 12% in low-income countries. In developing countries in 2009 there were about 1 billion people with no easy access to all-weather roads, about 1.5 billion people living without electricity, 800 million without access to safe drinking water and 4.7 billion people without access to the Internet. These infrastructure gaps jeopardise the efforts of domestic companies to raise their competitiveness.

To advance, developing countries need not only to invest more intensively in infrastructure but also to improve the management of the policy cycle. Governments should ensure that the budget preparation and authorisation phases are consistent with the country's development priorities. The prioritisation and planning phases are the most challenging issues in developing economies. Developing countries need to clarify the mechanisms for prioritising investment in infrastructure, as well as the forms for managing the necessary public-private partnerships. Building infrastructure requires better co-ordination between national and regional authorities, as well as clear predictability of budget execution. Co-ordination between different agencies in charge of infrastructure policies is essential to overcome the multiple gaps such as coverage, access and costs.

The evolving global economic context opens new challenges and opportunities for developing economies. Transforming their production structures is crucial to maintain high and inclusive growth.

Investing in transforming and upgrading the production structure is important for developing economies today, but industrial policy per se is no guarantee of success. That depends on a good plan, the resources to implement it, and long-term commitment and implementation capabilities. It also requires the ability to co-ordinate actions in multiple fields and to reorient actions when goals are not achieved, and to create permanent spaces for dialogue with the relevant stakeholders (including firms, universities and civil society).

Many developing countries face strong internal pressures that prevent or delay otherwise desirable changes. For example, rising prices of raw materials enable traditional sectors to enjoy higher rents than technologically advanced sectors; therefore, market incentives to engage in new activities will be relatively low. In addition, the risks of failure in implementing industrial policies are high. Information asymmetries reduce state planning capacities, governments face obstacles in quickly fine-tuning actions and withdrawing support is difficult because lobbies will try to prevent change. However, empowered institutions and incentive management schemes based on performance help in dealing with the risks of capture and allow to increase the impact of policies.

Countries learn to implement policies through trial and error and by sharing knowledge with others. Industrial policy is highly specific to context and time, but common requirements for designing and implementing industrial policies in developing countries include:

- improved domestic institutional capacities, at the national and regional levels.
- enhanced capacity to generate and process information to carry out diagnoses of domestic and foreign trends with the aim of defining performance indicators and carrying out foresight exercises.
- spaces for dialogue with the private sector to build partnerships, create synergies in investments, and favour information flows to identify priority areas for action; targeted mechanisms to channel resources in the medium and long term, matched with monitoring and evaluation.
- co-ordination capacities to align actions across levels of governments and in different fields, including upgrading skills for current and future needs, improving infrastructure and ensuring a supply of long-term financing.

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Notes:

