Debate 4: Economic Diversification: Must countries diversify to develop?

When I heard the term "economic diversification" from the economic literature, it reminded me of the term "Diversification strategy", which is part of the corporate strategy in the business landscape. Coincidentally the term diversification played a vital in the growth of the country and corporates. Economists always debate about the best bet, capitalism-based or socialistic economy. Similarly, to attain the country's growth, the debate is on whether economic diversification, or concentration(specialization) is most suitable for the Global North or South countries. (Cadot et al., 2013) emphasized an old school of thought supported the principle of specialization in production and trade of the nations according to comparative advantage is optimal; however, the idea of concentration or specialization led to focus on available natural resources or human skills, which restricted to selected trade activities which endorsed the scenario of artificial constraints on growth. (Imbs & Wacziarg, 2003) work supported the relationship between growth, and economic diversification is not linear. However, in a U-shaped relationship. with the support of UNDO and ILO data, the study showed that initially, countries focused on specialization based on resources they inherited further to expand the growth, and they started diversifying the trade. However, after attaining a particular level of per capita income, they started concentrating more; the pattern highlighted the U-shaped relationship between economic diversification and per capita income.

Two critical hypotheses

The "natural-resources curse" and "Prebisch-Singer" both oppose economic concentration. Until the 1950s, low and middle-income countries' export baskets contained only commodities, and too much dependence on natural resources or limited trade crippled the growth factor of the countries. Two hypotheses showed that economic concentration led to export earnings instability and subsequently affected economic growth. The recent policy fiasco of Sri Lanka revealed how the country's trade depends on selected sectors like Tourism and Tea exports, putting a halt to the day-to-day economy of the country post covid pandemic. On the other hand, South Korea is an apt example which showed decent growth when it embraced economic diversification.

What matters to growth

There is an argument in literature that what matters to growth is the mere export or type of export baskets of the country. It is not the mere quantity of export is matters, but also the diversification of the export basket is essential to enhance economic growth (Gozgor, G & Can, M, 2016). Mere exporting the commodities like grapes from Chile may not fetch an increase in growth compared to providing the value added to the grape in the form of finished products like wine. (Gözgör & Can, 2017) study supported the hypothesis that economic diversification and globalization are positively related to economic growth for upper-middle-income countries. (Hausmann, R et al., 2007) Every country can produce and export based on the fundamentals of what it inherited in terms of resources; however, when a country attempts to alter the system beyond the fundamentals, it disturbs the trade. With the support of globalization, the country learned how to produce quality products and add the quality export basket, and optimal production with high-level productivity matters to export than mere export. However, economic complexity features such as quality, productivity, regulations, technology, and specific employee skills cannot be imported. It can be learned from other countries through networks and interaction, fostered through globalization. The economic complexity of a country is determined by the country's capabilities and industrial policy, which ensures the country's eco-system of an excellent and optimal trade system. (Hidalgo & Hausmann, 2009) the study showed empirically that a country's economy's level of development and complexity is highly related.

Further, the study recommends the combination of two processes, that is, explored and unexplored – product and geography combination, where capabilities played a vital role in getting new products to explored and new nations. The economic complexity is achieved through government policy intervention, which is attempted by employing the Washington consensus in the East Asian and Latin American countries to some extent. However, there is an avalanche of criticism on industrial policy. Despite the industrial policy, a reasonable number of nations have not attained economic growth. The answer is that the kick-started reforms are dented because of political interventions in the various nations. For example, after the 1991 trade liberalization, India attained GDP growth of eight per cent for a brief period, but it would not be sustained due to reforms that are not continued in the excellent phase as expected.

Why Industrial Policy is not the panacea

Hausmann is excellent advocacy for Industrial policy to bring diversification and enhance the nation's economic growth. However, there is a critical view against Hausmann's argument. (Pack, 2006) come out with criticism against the industrial policy. His critical survey pinpointed the triumphant story of India's software Industry, Bangladesh Textile industries and Chinese multi-sector growth without much government intervention. The study advocated the private firms learning strategies, extensive marketing networks and core competence which made firms to gain a competitive advantage in their Industry and attracted massive FDI. The culmination of all lifted the Industry more than any old or new Industrial policy; however, Pack agreed the government-sponsored cluster might bring change in the system, for instance: in Taiwan, China's Hsinchu Science Park.

Right Blend of Industrial Policy and Natural Endowments

Surprisingly, the industrial policy would not enhance the country's growing number, especially in Eurasia. For instance: Russian silicon valley, Skolkovo Innovation Center, Moscow did not come out with flying colours as expected. (Gill et al., 2014) showed three different countries, namely, Finland, Saudi Arabia and Chile, who employed various Industrial policies with corners stone of innovation and clustering still outcome is mixed. The study showed that the right blend of industrial policy with inherited natural endowments could do a better job. For instance: Saudi Arabia's oil resources, coupled with Industrial policy, helped oil-related industries such as Petrochemical, Fertilizer and Oil refineries. Diversification of production and export of natural resources with apt industrial policy worked very well. The scenario applied to Finland and Chile too. (Gill et al., 2014 a) emphasized that less government intervention and calibrated regulation of the Industry bring good growth; too much government intervention in the business in the name of Industrial policy without innovation is detrimental and brings moral-hazardous economic growth. The country's Industrial policy should align with the country's resources, which may challenge the hypothesis of the natural-resource curse. With the support of a well-thought Industrial policy coupled with natural endowments, the country can be an enabler rather than an extractive.

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