

Relative importance of sectors at different stages of development

<Vincent Palmade, FIAS Lead Economist, Andrea Anayiotos, FIAS consultant>

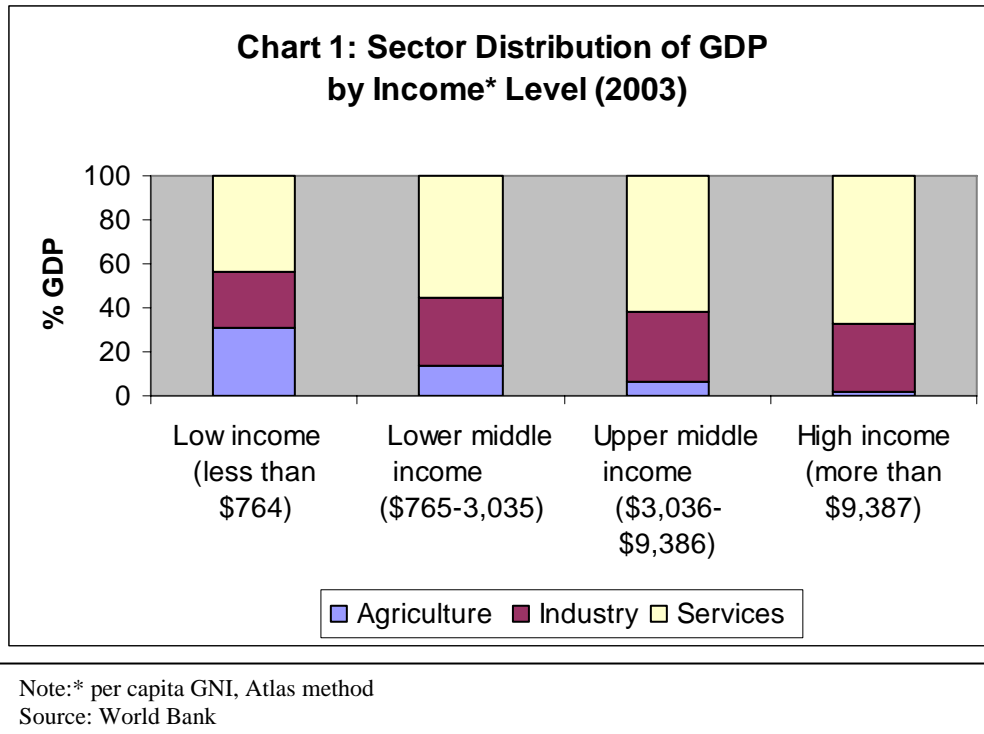
The purpose of this note is to provide some data and thoughts on the question of the relative importance of sectors at different stages of a country's economic development. Answering that question should help IFC and MIGA achieve greater development impact (by targeting the most important industries) while realizing higher returns on their investments (by investing in the high growth potential sectors).

We answer that question, differentiating between domestic and export oriented industries in sections 1 and 2. In section 3, we draw the implications for IFC and MIGA.

1. Evolution of the mix of domestically oriented industries

Interestingly enough, though countries vary greatly by size, geography and culture, they tend to follow a very similar development pattern with respect to the relative size of their domestically oriented industries. This is because consumers tend to consume the same mix of goods and services as they get richer, regardless of their culture or the country in which they live. Very poor people have little choice but to spend a large share of their income on food. As income grows, they start to spend much more on manufactured goods and housing. The higher their income, the larger the share of their revenues they will spend on services that others can provide to them – there is only so much food one can eat and only so many manufactured goods one can use.

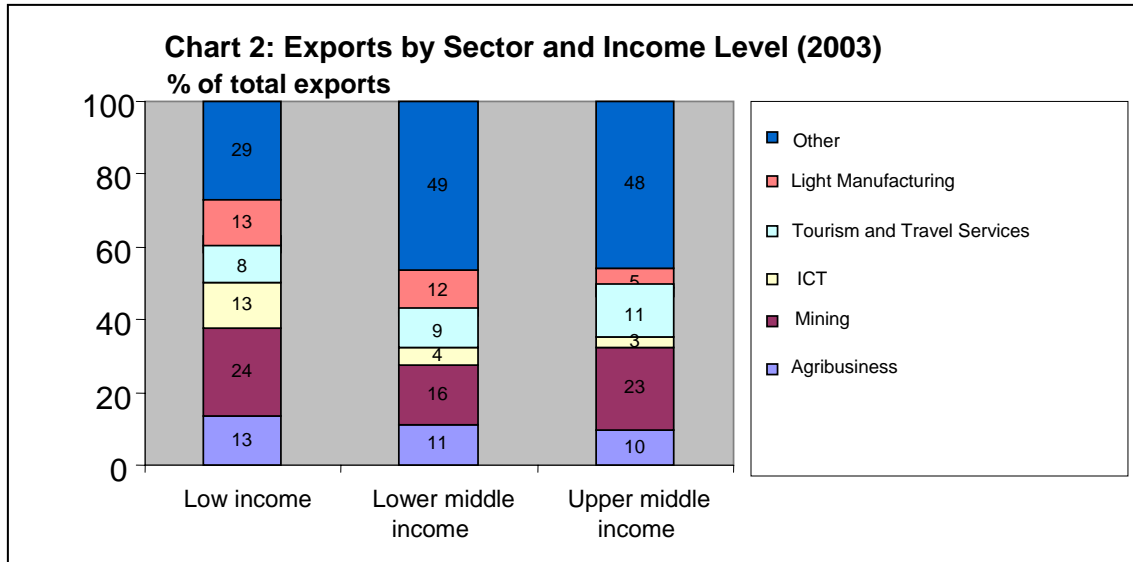
Indeed the empirical evidence shows that the share of agriculture gradually drops from more than 30% of domestic GDP (and around 80% of employment) for very poor countries to less than 2% for rich ones. The share of industry (manufacturing, construction, utilities, and mining) rises from around 25% for very poor countries to as much as 40% at the middle income stage. Then the share of industry starts to fall, while the share of the service economy continues to grow (see chart 1 below). The fact that the share of agriculture and manufacturing decreases does not mean that their output is falling. Output is in fact rising throughout the development phases – it simply means that output is growing even faster in the service sector. The main service industries that grow with development are: healthcare (around 15% of GDP in the US), professional services (11%), retail/wholesale (13%), financial services (8%), entertainment (8%) and education (5%).



2. Evolution of the mix of export oriented industries

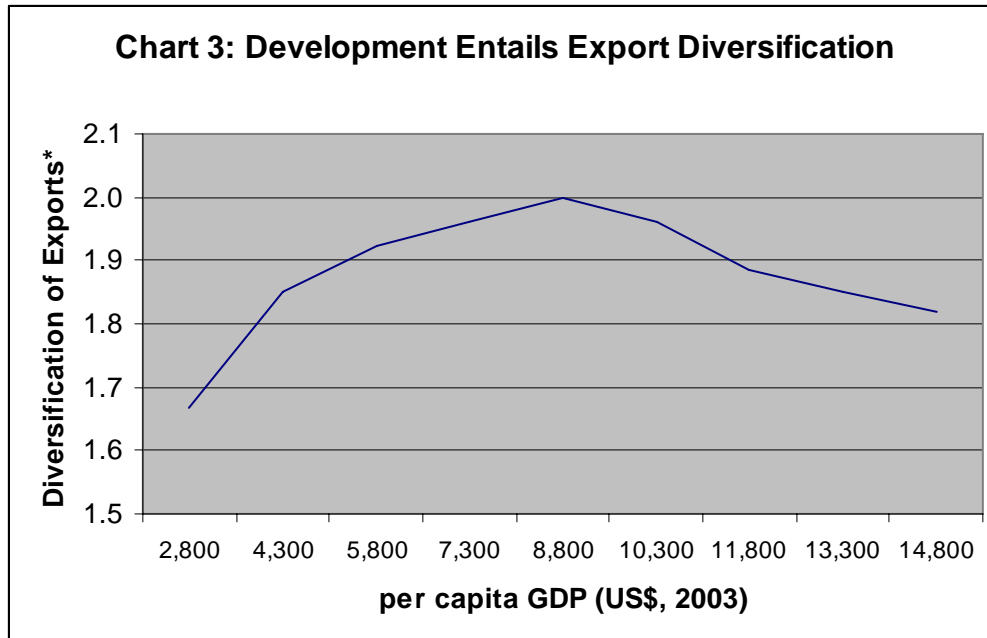
Not surprisingly, countries vary much more in terms of their mix of export oriented industries than in domestically oriented ones. This mix depends on their natural comparative advantages, as well as, even more crucially, the competitive advantages they have developed over time.

Very poor countries, by necessity, start by exporting the few goods and services in which they have a comparative advantage. These mostly consist of commodities such as mining and basic crops, labor-intensive light manufacturing goods, and in some cases ICT and tourism. In fact, these industries account for more than 70% of all poor country exports (see chart 2 below).



Source: World Bank; UN COMTRADE and FIAS staff calculations

Poor countries that have graduated to higher income levels have grown by continuously re-investing their export revenues into the imports of the intermediate goods and knowledge that they will need to export higher value goods and services. This style of export-led growth fuels rapid diversification of export industries beyond commodities. Interestingly enough, that diversification tends to stop as countries go from middle to upper income levels, while exports continue to grow at a faster pace than GDP. This is because high income countries tend to specialize in a few goods and services where they become world class producers and achieve high levels of value added and productivity – e.g. airplanes, tourism and luxury goods for France. These are the sectors in which countries have managed to develop a competitive advantage. Chart 3 below shows the inverted V curve of export diversification as per the analysis completed by Dani Rodrik.



Note:*lower numbers indicate less diversification in the exports basket. FIAS staff calculations
 Source: Dani Rodrik. Harvard University. (2005)

It has now been well established that rapid and sustained economic development has to rely on sustained/increasing export performance. Achieving export driven growth has proven to be very difficult for very poor countries because:

- a) If they happen to be blessed with natural resources, they can easily fall prey to the natural resource curses of poor governance and the “Dutch disease”.
- b) If they are not blessed with natural resources – then they have to lift themselves up by their boot straps. Often, the only thing they have to offer is cheap labor, which all poor countries have by definition. So they have to go to extra lengths to mobilize their scarce resources and to invest them in skills and infrastructure as well as good institutions – easier said than done and donor support and money is far from being sufficient!

3. Implications for IFC and MIGA

The analysis above has important implications for how IFC, MIGA and, more generally the WBG, can best support the development of poor countries:

- I) Help resource-rich poor countries avoid falling in natural resource traps – e.g. mobilize the international community (including investors) on setting and enforcing new standards of government and corporate governance.
- II) Help poor countries without natural resources mobilize and focus their scarce resources strategically on the most promising “growth poles”. The idea here is to help

them complete a critical mass of complementary interventions (e.g. policy reforms, infrastructure investments, skill building, etc) to trigger a supply side response by the private sector. The good news is that the number of industries and locations from which to “pick” the potential winners is not that large – e.g. the analysis above showed that more than 70% of poor country exports are concentrated in mining, light manufacturing, agribusiness, tourism and ICT. The real challenge is to help poor countries put an end to failure-prone experiments, so as to reallocate government resources to the winning ones.

III) Help poor countries develop the domestic industries essential for exports and social development. Reliable infrastructure, affordable transportation and utilities are of course essential for manufacturing exports – the key is to help countries focus the investments and reforms in these enabling industries in ways that maximize their impact on exports and development (e.g. through good practice special economic zones). A competitive telecom sector is also increasingly important for manufacturing (e.g. just in time production), tourism and of course to support the explosive growth of remote services. The financial sector also plays an increasingly critical supporting role (e.g. trade finance, SME lending, remittances and savings mobilization). The construction industry is important for both competitiveness (e.g. infrastructure and tourism) and social reasons (housing and jobs). It is now clear that the private sector, via FDI in particular, has a key role to play in the development of these domestic industries. Recent analyses even show this to be the case in education and health, even in very poor countries (see “Private Schools for the Poor”, James Tooley – winner of IFC’s 2006 business essay competition).

In summary, the following industries are key to the development of poor countries – mining, agribusiness, tourism, ICT, light manufacturing, infrastructure (including transportation, utilities and telecom), finance, construction, education and health. Growth in these sectors will increasingly come from the private sector. IFC and MIGA should thus capitalize on this growing universe of profitable investments with high development impact. We can be a driving force in opening up and demonstrating such opportunities. The challenge is that profitable investments are still hampered by numerous institutional and policy constraints – many of them specific to each country and/or industry – especially in frontier countries.

This requires new levels of expertise and insights with respect to what it takes to invest profitably in these industries in these environments, going hand in hand with much stronger local presence – absolutely essential to help assess and monitor risks, as well as to help make things happen on the ground. Conversely, it will also require IFC, MIGA and the Bank to work much more closely through in-country cooperation, as well as through global industry groups, in the recognition that many of the binding investment constraints are industry specific policy issues.

FIAS, whose mission it is to unleash productive/competitive investments, particularly in frontier countries, and which is a joint IFC, MIGA and Bank facility, is ideally placed to help advance the process. This approach would maximize the sometimes elusive synergies between IFC, MIGA and the Bank.