Among many puzzles in economic history, the crucial and most intriguing is the “Great Divergence,” the gap in productivity and per capita income between Western and developing countries that started to emerge from the sixteenth century and widened until at least the mid twentieth century. The USSR in the 1920s-60s was the first major non-Western country to experience successful catch-up development and to narrow the gap with the West, although afterwards (1970-80s) the gap stopped narrowing and later (1990s) widened. Japan, South Korea, Taiwan, Hong Kong, and Singapore in the 1950-80s were the only developing states that successfully caught up with the West and became developed. In recent decades, a similar process is underway in Southeast Asia and China. Together with the recent acceleration of growth of India and some other developing countries, it could mean that we have reached a tipping point in the Great Divergence and that from now on the world will gradually experience global convergence in the level of income.

The goal of this book is to provide a non-technical interpretation of the “Great Divergence” and “Great Convergence” stories – the widening of the gap in 1500-1950 and the narrowing of this gap afterwards. The usual explanation is that countries that we now call developed, or the West, acquired in the 16th century and afterwards some features that were absent in more traditional societies. The list of these features ranges from abolition of serfdom and protestant ethics to protection of property rights and free universities. The problem with this reasoning is that it is assumed that these features emerged initially only in North-Western Europe and only in the 16th -18th century. However, in fact, there were many countries before the 16th century with social
structures that possessed or were conducive to many of these same features, but they never experienced productivity growth comparable to the one that started in Britain and the Netherlands in the 16th century and later – in the rest of Europe (0.2-0.3% a year in 1500-1800 and 1% and more a year afterwards).

After reviewing the existing explanations in the literature, I present a different interpretation. Western countries exited the Malthusian trap by dismantling traditional collectivist institutions: this was associated with increased income inequality and even decreased life expectancy, but allowed the redistribution of income in favour of savings and investment at the expense of consumption. The elimination of collectivist (community) institutions was a risky experiment that put masses of population below the subsistence minimum and caused a reduction or slow down of growth of the population – the foundation of the military might (number of people – number of soldiers) in the Malthusian growth regime.

“A great civilization is not conquered from without until it has destroyed itself within” – said Will Durant about the Roman Empire (Durant, 1980), but apparently this diagnoses could explain the collapse of many ambitious civilizations. Early attempts to ensure the priority of the rights of individual over the rights of the community at the expense of collective interests and low inequality (Greece, Rome, Byzantine) led to the impoverishment of the masses, higher mortality and foreign conquest. Only in Northwest Europe in the 16-18th centuries this policy somehow succeeded for the first time in history.

It is not the abundance of competition or entrepreneurship or ideas for technological innovations that allowed the West to accelerate the growth rates of productivity by the order of magnitude, it is first and foremost the abundance of savings and investment that resulted from growing income inequalities and allowed to increase the capital/labor ratio and to cast in metal the ideas for new products and technologies. To pit it differently, the West became rich not due to its inventiveness and entrepreneurial spirit, but due to cruel and merciless dismantling of community that previously provided social guarantees to the poorest.
When the same pattern was applied to developing countries (colonialism—Latin America, Sub-Saharan Africa – SSA, or voluntary Westernization in an attempt to catch up – Russian Empire), it resulted in the destruction of traditional institutions, increase in income inequality, and worsening of starting positions for catch-up development. This group of countries replicated the Western exit from the Malthusian trap – they experienced immediate increase in income differentiation, the rise in savings and investment and in the growth of productivity, but at a price of rising social inequality and deterioration of institutional capacities.

Other developing countries (East Asia, South Asia, and Middle East and North Africa – MENA) were less affected by colonialism and managed to retain their traditional institutions. This delayed the transition to modern economic growth (Kuznets, 1966) until mid 20th century, but allowed to preserve good starting position for economic growth – low inequality and strong institutions. Eventually slow technical progress allowed them to find another (and less painful) exit from the Malthusian trap—increased income permitted to raise the share of investment in GDP without major increase in income inequality, without worsening of institutional capacity and decrease in life expectancy.

More Westernized countries of the global South (LA and Russian Empire) raised their savings-investment rate and exited Malthusian trap earlier that the rest, in the 18th century, but at a price of undermining necessary conditions for future growth – low inequalities and strong institutions. So LA and Russian growth afterwards was not enough to catch up with the West. Colonization of SSA (except for South Africa), unlike colonization of LA and Westernization of Russia, did not result in any considerable transfer of technology and human capital, but only increased inequalities and undermined institutions. So SSA countries were disadvantaged on all counts and had the worst growth record in

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1 The notion of state institutional capacity is discussed later in the book. It is understood as the ability of the state to enforce rules and regulations and is measured by such objective indicators as crime rate, murder rate, the share of shadow economy. The weakening of the institutional capacity during the dismantling of collectivist institutions and increase in income inequalities results from the polarization of the society which is not contained by the community already and is not yet contained by the state.
the world. On the contrary, most of less Westernized countries of East and South Asia and MENA managed to preserve low inequality and efficient collectivist institutions. Their savings-investment ratios stayed at a level below 10% until mid 20th century, so they did not grow before that, but once saving increased it turned out they have all preconditions for fast growth. Some of them became economic miracles, rapidly catching up with the West (East Asia), others were speeding up their development in recent decades (South Asia), while others (MENA countries) can probably become in economic miracles in the future.

To have a closer look at two trajectories of the catch-up development of non-Western countries, I examine in greater detail differences in institutional and economic development of China and Russia in the long term – the period of socialism and before – and in the short term (since market type reforms). The roots of the impressive long-term performance of China lie in the exceptional continuity of the Chinese civilization — the oldest in the world that managed to preserve its uniqueness and traditions without major interruptions. It is argued that institutional continuity (East Asia, India, and MENA) is more conducive to growth than attempts to replace existing institutions by allegedly more advanced institutions imported from abroad (Latin America, Russian Empire, and SSA). Like Russia in 1917, China re-established collectivist institutions in 1949 as a response to the failure of Westernization. Unlike Russia after 1991, China in 1979-2012 managed to preserve “Asian values” institutions that are based on a priority of community interests over the interests of the individual. However, the rapid increase in income inequality since 1985 could be a factor leading to weakening of collectivist institutions, which is the single most important threat to the continuation of fast economic growth.

Socialism in Russia and in China contributed to the restoration of the collectivist institutions – income inequalities decreased and institutional capacity of the state improved. But, as argued in a book, socialism and centrally planned economy (CPE) could be viable only for 25-30 years because CPE can make new investment, but cannot replace retiring fixed capital stock efficiently and because without democracy the leadership lacks control from below. Once physical capital and human capital start to retire, problems emerge and
dynamism is lost. In China 30 years of socialism were allegedly enough to return the country back to the trajectory of strong collectivist institutions. In Russia the CPE and bureaucratic apparatus started to malfunction in the 1960s, but even another 3 decades of socialism proved out to be not enough to return the country to the strong institutional trajectory: once market reforms were carried out in the 1990s, inequalities increased greatly, as did corruption, crime, and shadow economy.

Whether we try to explain differences in Chinese and Russian economic performance under central planning (China in 1949-79 and Russia in 1917/29-91) or recently, since the start of market reforms in China (1979) and Russia (1989), various trajectories of institutional development turn out to be the crucial factor. This is not to say that these trajectories totally pre-determine all economic outcomes; other factors, including good and bad policies, certainly do play a role. But, as the saying goes, there is nothing more endogenous than the government policy – it is not easy to have good policies with bad institutions. In practice there are only so many historical junctions, where there is a chance to change policies and to move to a different trajectory of institutional development.

This analysis allows formulating the main arguments about implications of China’s rise for the world. Usually these implications are seen in forthcoming geopolitical shifts (China as new rising superpower together with or instead of the US), in emerging shortage of resources leading to the new increase of raw material prices, etc. But there may be less expected and more far reaching consequences as well.

First, the rise of China, if continues, would become the turning point for the world economy because for the first time in history the successful economic development on a major scale is based on indigenous, not Western-type economic model. Because Chinese growth model became so successful in ensuring catch-up development, there is no surprise it becomes extremely appealing in developing world. The attractiveness of the Chinese model of economic growth today could be compared with the popularity of the Soviet
model of catch up development in the “third world” in the 1960s. Even though the Soviet model collapsed, the Chinese model became the logical and natural heir of the Soviet model – it is no longer a centrally planned economy, but it is by no means a model of a liberalized market economy that is recommended by the advocates of Washington and even post-Washington consensus.

Second, the rise of China can lead to the profound reform of world economic order and international relations. Trade protectionism, industrial policy, undervaluation of the exchange rate via accumulation of foreign exchange reserves (also, as argued later, a variety of export-oriented industrial policy), control over the international capital flows (not only short-term, but FDI as well) can become legitimate tools of the catch up development. There may be new regime of protection of intellectual property rights and technology transfers, new regulations for international trade in energy and resources, new rules for international migration, new agreements about cutting emissions of pollutants (reconsideration of Kyoto protocol), etc. (Montes, Popov, 2011).

Besides, the principles of international relations can change radically as well. “Beijing consensus” may not yet be a rigorous term (Ramo, 2004), but it is clear that the Chinese approach to international politics (no interference into domestic affairs, no military interventions, no trade embargoes) provides the developing world with the real alternative of building relations with other countries. China rejects the use of force, embargoes and sanctions in international politics nearly as a matter of principle. Even in its relations with Taiwan China was always pushing for wider economic and cultural exchanges, whereas Taiwan authorities resisted. The new rules of the international relations may (1) explicitly limit the use of force only to cases of severe violations of non-political rights (i.e. mass repressions, hunger, ethnic violence, etc.) and prohibit the use of force against liberal authoritarian regime (just for the sake of “establishing democracy”) and (2) prohibit unilateral military interventions (without the consent of the UN).

These “less expected” consequences of China’s rise are probably creating already more favorable conditions for the catch up development of the South. The result may be the bridging of the gap between the world rich and the world
poor, the West and developing countries. Overall, this gap was expanding in
1500-1900, reaching 6:1 ratio in terms of per capita GDP, and it was not closing
in the XX century – in 2000 the ratio of per capita GDP in the West and in
developing world was still 6:1. Even in the last two decades of the XX century
this gap in fact was widening for all developing countries as a group, if China is
excluded (Wade, 2004). Now, in the XXI century, the rise of China could make
the dirigisme-based model of catch up development not only attractive, but also
legitimate, and will create new international economic climate favoring such a
catch up. We may well witness “the triumphal march” of the Chinese model in
the South. Not all developing countries have the same institutional capacity as
China – the necessary component of the successful non-Western growth model,
but many do and those who do not would be eventually compelled to move in
the direction of limiting inequality and strengthening institutional capacity.

There could be far reaching implications for the development economics as
well. Development thinking of the second half of the XX century can hardly be
credited for “manufacturing” development success stories. It is difficult, if not
impossible, to claim that either the early structuralist models of the Big Push,
financing gap and basic needs, or the later neo-liberal ideas of Washington
consensus that dominated the field since the 1980s have provided crucial inputs
to economic miracles in East Asia or elsewhere. On the contrary, it appears that
development ideas, either misinterpreted or not, contributed to a number of
development failures. USSR and Latin America of the 1960s-80s demonstrated
the inadequacy of import-substitutions model (debt crisis of the 1980s in Latin
America and dead end of the Soviet type economic model in the 1970s-80s).
Later every region of developing world that became the experimental ground for
Washington consensus type theories, from Latin America to Sub-Saharan Africa
to former Soviet Union and Eastern Europe, revealed the flaws of neo-liberal
doctrine by experiencing a slowdown, a recession or even a severe depression in
the 1980s-90s.

The policy of multilateral institutions – GATT/WTO, IMF, WB – could have
been coherent in its own way: in different periods it was based on relatively
coherent, even though not necessarily the same, set of economic theories (Toye,
2009). But this policy, as well as development theories, cannot be held responsible for engineering development successes, let alone economic miracles. Japan, Hong Kong and Taiwan, Singapore and South Korea, South East Asia and China achieved high growth rates without much advise and credits from IMF and the WB (and in case of Hong Kong, Taiwan and China – without being members of GATT/WTO for a long time).

Economic miracles were manufactured in East Asia without much reliance on development thinking and theoretical background – just by experimentation of the strong hand politicians. The 1993 World Development Report “East Asian Miracle” admitted that non-selective industrial policy aimed at providing better business environment (education, infrastructure, coordination, etc.) can promote growth, but the issue is still controversial. Structuralists claim that industrial policy in East Asia was much more than creating better business environment (that it was actually picking up the winners), whereas neo-liberals believe that liberalization and deregulation should be largely credited for the success.

It is said that failure is always an orphan, where as success has many parents. No wonder, both neo-classical and structuralist economists claimed that East Asian success stories prove what they were saying all along, but it is obvious that both schools of thought cannot be right at the same time.

Why there emerged a gap between development thinking and development practice? Why development successes were engineered without development theories, whereas development theoreticians failed to learn from real successes and failures in the global South? It appears that development thinking in the postwar period went through a full evolutionary cycle – from dirigiste theories of Big Push, financing gap and import substitution industrialization (ISI) of the 1950-70s to neo-liberal deregulation wisdom of “Washington consensus” (1980-90s), to the understanding that catch up development does not happen by itself in a free market environment, but with a lack of understanding what particular kind of government intervention is needed for manufacturing fast growth (2000 – onwards).
The confusion in development thinking of the past decade may be a starting point for the formation of new paradigm. There is an emerging understanding that without mobilization of domestic savings and industrial policies there may be no successful catch up development. National Development Strategies (NDS, 2008) for countries at a lower level of development should not copy economic policies used by developed countries; in fact, it was shown more than once that Western countries themselves did not use liberal policies that they are advocating today for less developed countries when they were at similar stages of development (Chang, 2002; Reinert, 2007; Findlay, O’Rourke, 2007).

This general principle – that good policies are context dependent and there is no universal set of policy prescriptions for all countries at all stages of development – is definitely shared by most development economists. But when it comes to particular policies, there is no consensus. The future of development economics may be a theory, explaining why at particular stages of development (depending on per capita GDP, institutional capacity, human capital, resource abundance, etc.) one set of policies (tariff protectionism, accumulation of reserves, control over capital flows, nationalization of resource enterprises – to name a few areas) is superior to another (Polterovich, Popov, 2006). The art of the policymakers then is to switch the gears at the appropriate time not to get into the development trap. The art of the development theoretician is to fill the cells of “periodic table of economic policies” at different stages of development.

The emerging theory of stages of development would hopefully put the pieces of our knowledge together and will reveal the interaction and subordination of growth ingredients. Successful export oriented growth model à la East Asian tigers seems to include, but is not limited to:

- Building strong state institutions capable of delivering public goods (law and order, education, infrastructure, health care) needed for development
- Mobilization of domestic savings for increased investment
- Gradual market type reforms
• Export-oriented industrial policy, including such tools as tariff protectionism and subsidies

• Appropriate macroeconomic policy – not only in traditional sense (prudent, but not excessively restrictive fiscal and monetary policy), but also exchange rate policy: undervaluation of the exchange rate via rapid accumulation of foreign exchange reserves.

If this interpretation of development experience is correct, the next large regions of successful catch up development would be MENA Islamic countries and South Asia – these regions seem to be most prepared to accept the Chinese model. But eventually Latin America, Sub-Saharan Africa and Russia would be catching up as well. If so, it would also become obvious in the process of successful catch up development that the previous policies that the West recommended and prescribed to the South (deregulation, downsizing the state, privatization, free trade and capital movements) was in fact hindering rather than promoting their development.