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Economic Growth in Developing and Transitional Economies

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Economic Growth in Developing and Transitional Economies

- The universality of scarcity makes economic analysis relevant to all nations.
- Economic problems and policy instruments are different, but economic thinking about these problems can be transferred easily from country to country.

Life in the Developing Nations: Population and Poverty

- The United States and other industrialized economies rarely face the difficulties faced by developing nations:
 - chronic food shortages
 - explosive population growth
 - hyperinflations
 - low productivity and low GDP per capita
 - primitive shelter
 - illiteracy
 - infant mortality

Life in the Developing Nations: Population and Poverty

Indicators of Economic Development

COUNTRY GROUP	POPULATION (MILLIONS) 2002	GROSS NATIONAL INCOME PER CAPITA, 2002 (DOLLARS)	ANNUAL HEALTH EXPENDITURES PER CAPITA 2001 (DOLLARS)	INFANT MORTALITY, 2001 (DEATHS BEFORE AGE FIVE PER 1,000 BIRTHS)	PERCENTAGE OF POPULATION IN URBAN AREAS, 2001
Low-income (e.g., China, Ethiopia, Haiti, India)	2,495	430	21.5	121.7	32
Lower middle-income (e.g., Guatemala, Poland, Philippines, Thailand)	2,411	1,390	72.3	42.2	42
Upper middle-income (e.g., Brazil, Malaysia, Mexico)	331	5,040	308.9	28.6	76
Industrial market economies (e.g., Japan, Germany, New Zealand, United States)	965	26,310	2,736	7.1	79

Source: World Bank, WWW.WORLDBANK.ORG

Life in the Developing Nations: Population and Poverty

- In the year 2,002, the world population reached over 6.2 billion people. Most of the world's more than 200 nations belong to the developing world.
- While the developed nations account for only about one-quarter of the world's population, they consume about three-quarters of the world's output.
- Developing countries have three-fourths of the world's population, but only one-fourth of the world's income.

Economic Development: Sources and Strategies

- Almost all developing nations have a scarcity of physical capital relative to other resources, especially labor.
- The **vicious-circle-of-poverty hypothesis** suggests that poverty is self-perpetuating because poor nations are unable to save and invest enough to accumulate the capital stock that would help them grow.
 - Poverty alone cannot explain capital shortages, and poverty is not necessarily self-perpetuating.

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The Sources of Economic Development

- **Capital flight** is the tendency for both human capital and financial capital to leave developing countries in search of higher rates of return elsewhere.
 - Price ceilings, import controls, and expropriation are some of the policies that discourage investment.
 - The absence of productive capital prevents income from rising.

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The Sources of Economic Development

- Just as financial capital seeks the highest return, so does human capital:
 - **Brain drain** is the tendency for talented people from developing countries to become educated in a developed country and remain there after graduation.
 - Development cannot proceed without human resources capable of initiating and managing economic activity.

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The Sources of Economic Development

- **Social overhead capital** is the basic infrastructure projects such as roads, power generation, and irrigation systems that add to a nation's productive capacity.
 - In developing economies, government provision of public goods is highly deficient, and many socially useful projects cannot be successfully undertaken by the private sector.

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Strategies for Economic Development

- A developing economy with insufficient human and physical capital faces some very basic trade-offs. Three of these trade-offs are:
 - Agriculture versus industry.
 - Exports versus import substitution.
 - Central planning versus the market.

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Agriculture or Industry?

- Industry has some apparent attractions over agriculture:
 - The building of factories is an important step toward increasing the stock of capital.
 - Developed economies have experienced a structural transition from agriculture to industrialization and greater provision of services.
- However, industrialization in many developed countries has not brought the benefits that were expected.

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Agriculture or Industry?

The Structure of Production in Selected Developed and Developing Economies, 2001

COUNTRY	PER CAPITA GROSS NATIONAL INCOME (GNI)	PERCENTAGE OF GROSS DOMESTIC PRODUCT		
		AGRICULTURE	INDUSTRY	SERVICES
Tanzania	\$ 270	45	16	39
Bangladesh	360	23	25	52
China	840	15	57	34
Thailand	1,440	10	41	49
Colombia	1,890	13	30	57
Brazil	3,070	9	34	57
Korea	9,460	4	42	54
United States	34,280	2	25	73
Japan	35,610	1	32	67

Source: World Bank, WWW.WORLDBANK.ORG, 2003.

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Exports or Import Substitution?

- **Import substitution** is an industrial trade strategy that favors developing local industries that can manufacture goods to replace imports.

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Exports or Import Substitution?

- The import-substitution strategy has failed almost everywhere for the following reasons:
 - Domestic industries, sheltered from international competition, develop major economic inefficiencies.
 - Import substitution encouraged the production of capital-intensive production methods, which limited the creation of jobs.
 - The cost of the resulting output was far greater than the price of that output in world markets.

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Exports or Import Substitution?

- **Export promotion** is a trade policy designed to encourage exports.
 - Several countries including Japan, the “four little dragons,” Brazil, Colombia, and Turkey, have had some success with outward-looking trade policy.
 - Government policies to promote exports include subsidies to export industries and the maintenance of a favorable exchange rate environment.

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Central Planning or the Market?

- Today, planning takes many forms in developing nations.
- The economic appeal of planning lies in its ability to channel savings into productive investment and to coordinate economic activities that otherwise might not exist.
- The reality of central planning is that it is technically difficult, highly politicized, and difficult to administer.

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Central Planning or the Market?

- Market-oriented reforms recommended by international agencies include:
 - the elimination of price controls,
 - privatization of state-run enterprises, and
 - reductions in import restraints.

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Central Planning or the Market?

- The **International Monetary Fund** is an international agency whose primary goals are to stabilize international exchange rates and to lend money to countries that have problems financing their international transactions.

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Central Planning or the Market?

- The **World Bank** is an international agency that lends money to individual countries for projects that promote economic development.

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Growth Versus Development: The Policy Cycle

- Structural adjustment** is a series of programs in developing nations designed to:
 - reduce the size of their public sectors through privatization and/or expenditure reductions,
 - decrease their budget deficits,
 - control inflation, and
 - encourage private saving and investment through tax reform.

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Issues in Economic Development

- The growth of the population in developing nations is about 1.7 percent per year, compared to only 0.5 percent per year in industrial market economies.
- Thomas Malthus, England's first professor of political economy, believed populations grow geometrically. He believed that due to the diminished marginal productivity of land, food supplies grow much more slowly.

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The Growth of World Population, Projected to 2020 A.D.

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Population Growth

- Population growth is determined by the relationship between births and deaths.
- The **fertility rate**, or birth rate, equals:

$$\frac{\text{number of births per year}}{\text{population}} \times 100$$
- The **mortality rate**, or death rate, equals:

$$\frac{\text{number of deaths per year}}{\text{population}} \times 100$$

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Population Growth

- The **natural rate of population increase** is the difference between the birth rate and the death rate. It does not take migration into account.
- Any nation that wants to slow its rate of population growth will probably find it necessary to have in place economic incentives for fewer children as well as family planning programs.

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Developing-Country Debt Burdens

- **Debt rescheduling** is an agreement between banks and borrowers through which a new schedule of repayments of the debt is negotiated; often some of the debt is written off and the repayment period is extended.
- A **stabilization program** is an agreement between a borrower country and the International Monetary Fund in which the country agrees to revamp its economic policies to provide incentives for higher export earnings and lower imports.

Political Systems and Economic Systems: Socialism, Capitalism, and Communism

- **Democracy and dictatorship** refer to political systems.
 - A **democracy** is a system of government in which ultimate power rests with the people, who make governmental decisions either directly through voting or indirectly through representatives.
 - A **dictatorship** is a political system in which ultimate power is concentrated in either a small elite group or a single person.

Political Systems and Economic Systems: Socialism, Capitalism, and Communism

- Two major *economic* systems have existed: socialism and capitalism.
 - A **socialist economy** is one in which most capital—factories, equipment, buildings, railroads, and so forth—is owned by the government rather than by private citizens. *Social ownership* is another term that is used to describe a socialist economy.

Political Systems and Economic Systems: Socialism, Capitalism, and Communism

- Two major *economic* systems have existed: socialism and capitalism.
 - A **capitalist economy** is one in which most capital is privately owned.

Political Systems and Economic Systems: Socialism, Capitalism, and Communism

- **Communism** is an economic system in which the people control the means of production (capital and land) directly, without the intervention of a government or state.

Political Systems and Economic Systems: Socialism, Capitalism, and Communism

- Comparing economies today, the real distinction is between centrally planned socialism and capitalism, not between capitalism and communism.
- No pure socialist economies and no pure capitalist economies exist.
- The United States supports many government enterprises, including the postal system, although public ownership is the exception.

Political Systems and Economic Systems: Socialism, Capitalism, and Communism

- Whether particular kinds of political systems tend to be associated with particular kinds of economic systems is debatable.
- There are capitalist economies with democratic political institutions; socialist economies that maintain strong democratic traditions; and democratic countries with strong socialist institutions.
- At the heart of both the market system *and* democracy is individual freedom.

Central Planning Versus the Market

- Just as there are no pure capitalist and no pure socialist economies, there are no pure market economies and no pure planned economies.
- A **market-socialist economy** is an economy that combines government ownership with market allocation.

The Transition to a Market Economy

- Economists generally agree on six basic requirements for a successful transition from socialism to a market-based system:
 1. macroeconomic stabilization;
 2. deregulation of prices and liberalization of trade;
 3. privatization of state-owned enterprises and development of new private industry;

The Transition to a Market Economy

- Economists generally agree on six basic requirements for a successful transition from socialism to a market-based system:
 4. the establishment of market-supporting institutions, such as property and contract laws, accounting systems, and so forth;
 5. a social safety net to deal with unemployment and poverty; and
 6. external assistance.

The Transition to a Market Economy

- The **tragedy of commons** is the idea that collective ownership may not provide the proper private incentives for efficiency because individuals do not bear the full costs of their own decisions but do enjoy the full benefits.

The Transition to a Market Economy

- **Shock therapy** is the approach to transition from socialism to market capitalism that advocates rapid deregulation of prices, liberalization of trade, and privatization.
- Advocates of a **gradualist** approach believe that the best course of action is to build up market institutions first, gradually decontrol prices, and privatize only the most efficient government enterprises.

Review Terms and Concepts

<u>brain drain</u>	<u>mortality rate</u>
<u>capital flight</u>	<u>natural rate of population increase</u>
<u>capitalist economy</u>	<u>shock therapy</u>
<u>communism</u>	<u>social overhead capital</u>
<u>debt rescheduling</u>	<u>socialist economy</u>
<u>export promotion</u>	<u>stabilization program</u>
<u>fertility rate</u>	<u>structural adjustment</u>
<u>import substitution</u>	<u>tragedy of commons</u>
<u>International Monetary Fund (IMF)</u>	<u>vicious circle of poverty hypothesis</u>
<u>market-socialist economy</u>	<u>World Bank</u>