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Growth, Macroeconomic Policies and Structural Change

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I. Introduction

This study is concerned with the long run tendencies of economic growth and/or stagnation in developing economies, and in particular with the interrelationships between economic growth and structural transformation. It is divided into six sections, including this short introduction. The second section considers the aggregate growth experience of the world economy and of developing countries, with particular reference to the period since 1960. In the third section, the significance of various “engines of growth” is considered. In the fourth section, the relationship between the financial sector and growth is taken up for consideration, in terms of financing growth as well as the changing role of financial institutions given financial liberalisation. The fifth section examines the extent to which growth in developing countries tends to be associated with structural change in terms of the changing composition of output and employment. The sixth and final section is concerned with the impact of macroeconomic, trade and industrial policies, as well as development policies broadly considered, in affecting patterns of growth. The impact of stabilisation policies on growth trajectories is discussed, as well as the possible strategies for sustained growth of developing countries in the new international environment.

Since these are such central questions, they have obviously concerned analysts since well before the inception of the discipline of economics, and have remained important for most of the history of economic thought. Yet there was a period of around two decades, from the mid 1980s onwards, when the question of how to generate sustained growth was no longer seen by the mainstream economics profession and the policy makers influenced by them as an important one to study, because there appeared to be consensus on how this could be achieved. It was taken for granted that economic growth would come about on its own, once markets were deregulated and the rules for domestic and international trade and investment were liberalised, in a context of macroeconomic and socio-political stability. In this story, growth was something best left to market determination freed from “the dead hand of the state” and unfettered by government failures, which would make the resulting economic expansion both more efficient and more dynamic. The focus of government policy was therefore to be not on growth *per se* but on stabilisation and “efficiency”.

However, the reality of the past two decades has been chastening, as the promised growth did not materialise in many developing countries that wholeheartedly embraced these principles, and the most dynamic economies turned out to be those with much more flexible and heterodox approaches to economic policy. As a result, economists have begun to examine once again the basic questions of growth and development that were ignored for so long. Indeed, the process of economic growth has moved from being seen as the obvious result of “good policies”, to becoming the subject of the newest growth industry inside the economics profession. We now have a spate of academic books and reports of international organisations, exploring “the mystery of growth”. (For example, Commission on Growth and Development 2008, World Bank 2005) Many of these now accept that the earlier simplistic notions of the dynamic potential of unfettered markets could be misleading, and several have rediscovered basic truths of development economics that have been either forgotten or suppressed for the past two decades.

Ros (2001) has pointed out that the recent wave of both theoretical and empirical contributions has generally ignored the insights of earlier development theorists. But these earlier contributions in the mid-20th century, such as Paul Rosenstein-Rodan, Maurice Dobb, Michal Kalecki, Louis Lefeber, Hirschman, Nurkse and others, are not only as relevant as ever, but are probably more promising in providing empirical explanations of actual growth patterns of developing countries, than much of old or new growth theory. This is essentially because they incorporated some key features of the processes of growth and development that are now being rediscovered: the fact that static and dynamic increasing returns in a context of labour surplus can generate multiple equilibria that make the initial conditions crucial in determining the subsequent pattern of growth, the possibility of development traps and the consequent need to deal with problems of co-ordination and imbalance especially in the traverse. Many of these implications of these issues will become evident in the examination of growth trajectories and patterns in the subsequent sections.

II. Growth experiences

Global GDP growth and its distribution across regions

The second half of the twentieth century is generally perceived as the most dynamic in the history of capitalism. It is also seen as a period in which at least some developing countries managed to improve their relative position in the global income hierarchy, in different phases and through different trajectories. There are various ways in which this is supposed to have occurred. Import substituting industrialisation in the 1950s and 1960s played a role in diversifying large developing and thereby generating a higher rate of GDP growth. Oil exporting countries benefited from the oil price increases of the second half of the 1970s, which enabled some of them top move to a higher level of per capita income. According to some analysts, the most recent “globalisation” phase of the 1990s has enabled some countries – China and India in particular – to benefit from more open global trade and thereby increase per capita incomes and reduce poverty.

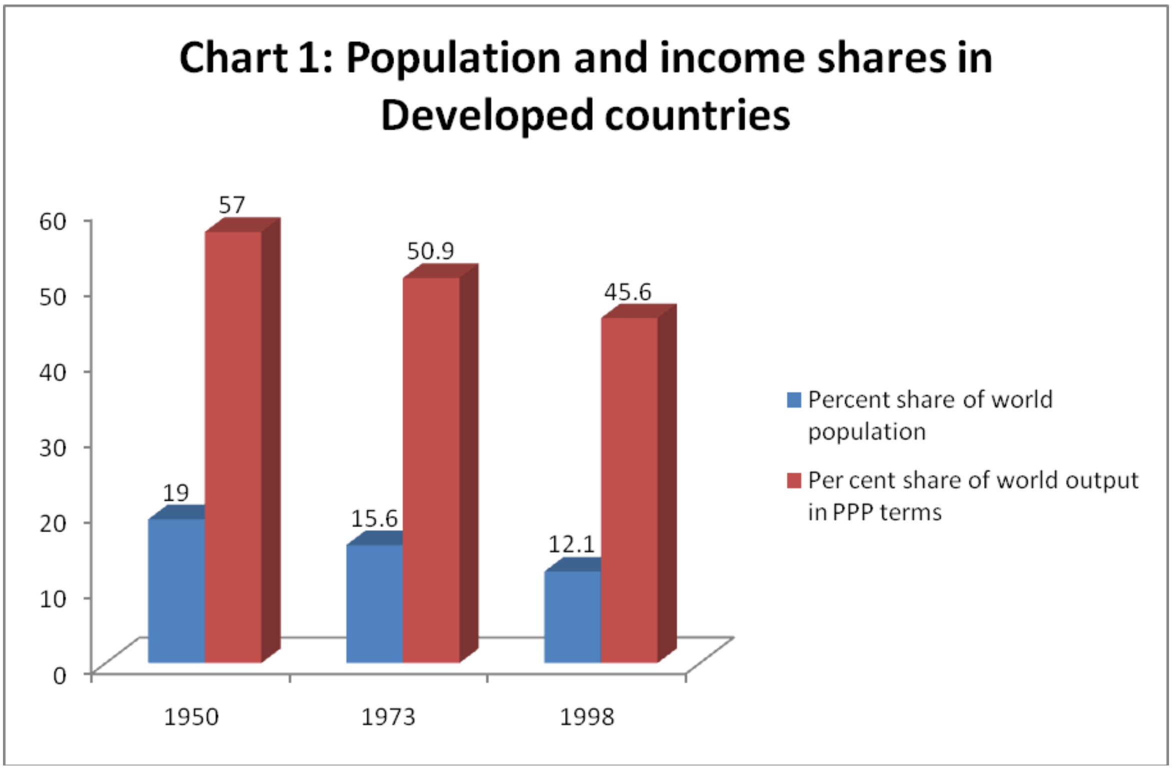
All this would presumably have operated to create more convergence of incomes between the developed and developing worlds, even if in fits and starts, such that the gap between per capita incomes of countries across the world would start reducing. The economic literature on the empirical evidence on income convergence (or the lack of it) is already vast, based on econometric analyses of varying degrees of sophistication. (See, for example, Dollar and Kraay, Milanovic, Sala-i-Martin, etc.)

The most simple-minded way of looking at this is simply to examine the shares of global GDP of the different regions. Acordingly, Charts 1, 2 and 3 provide evidence on shares of various regions over the period 1950-1998, of global population and global GDP re-estimated according to Purchasing Power Parity (PPP), based on data provided in Maddison (2001).

PPP estimates are often used instead of nominal exchange rates to compare income across economies, because of the widely observed reality that currencies command different purchasing power in different countries, than is suggested by the nominal rates. This is because of the well-known fact that exchange rate comparisons of less-developed economies consistently undervalue the non-traded goods sector, especially labour-intensive and relatively cheap services, and therefore underestimate real incomes. In some cases this can be quite significant. For example, according to the Penn World Tables, which provide the most widely-used source of information on incomes deflated by PPP, total incomes in countries with large poor populations like India or China increased by multiples of around 3 with the PPP estimate, compared to the nominal exchange rate estimate in 2000. However, there are some well-known problems in the estimates of income using exchange rates based on PPP. One significant problem is that of how to choose comparable baskets of goods. The poor quality of the data on actual prices prevailing in different countries (including large developing countries such as China and India) that are used in such studies, which affect the reliability of such calculations. The most recent revision of the Penn World Tables, based on new information on prices in some important countries, show how dramatically PPP estimates can change with more accurate data, as the 2005 PPP-adjusted per capita income for China in US $ terms, for example, shows a 20 per cent decline compared to the 2000 estimate. The wide fluctuations evident in the time series data for many countries provided in the Penn World Tables indicate the difficulties of using this as the basis for analysis. Further, there is a problem in using a single PPP for a long period. As Reddy (2008:) points out, "PPPs reflect the relative costs for a pattern of consumption prevailing at only one moment in time, and this pattern is constantly changing. ... they merely present a snapshot of relative prices across countries at a point in time which is no more authoritative for intervening years than similar snapshots of the relative prices across countries taken at points closer to those years."

There is a less talked about but possibly even more significant conceptual problem with using PPP estimates. In general, countries that have high PPP, that is where the actual purchasing power of the currency is deemed to be much higher than the nominal value, are typically low-income countries with low average wages. It is precisely because there is a significant section of the workforce that receives very low remuneration, that goods and services are available more cheaply than in countries where the majority of workers receive higher wages. *Therefore, using PPP-modified GDP data may miss the point, by seeing as an advantage the very feature that reflects greater poverty of the majority of wage earners in an economy.*

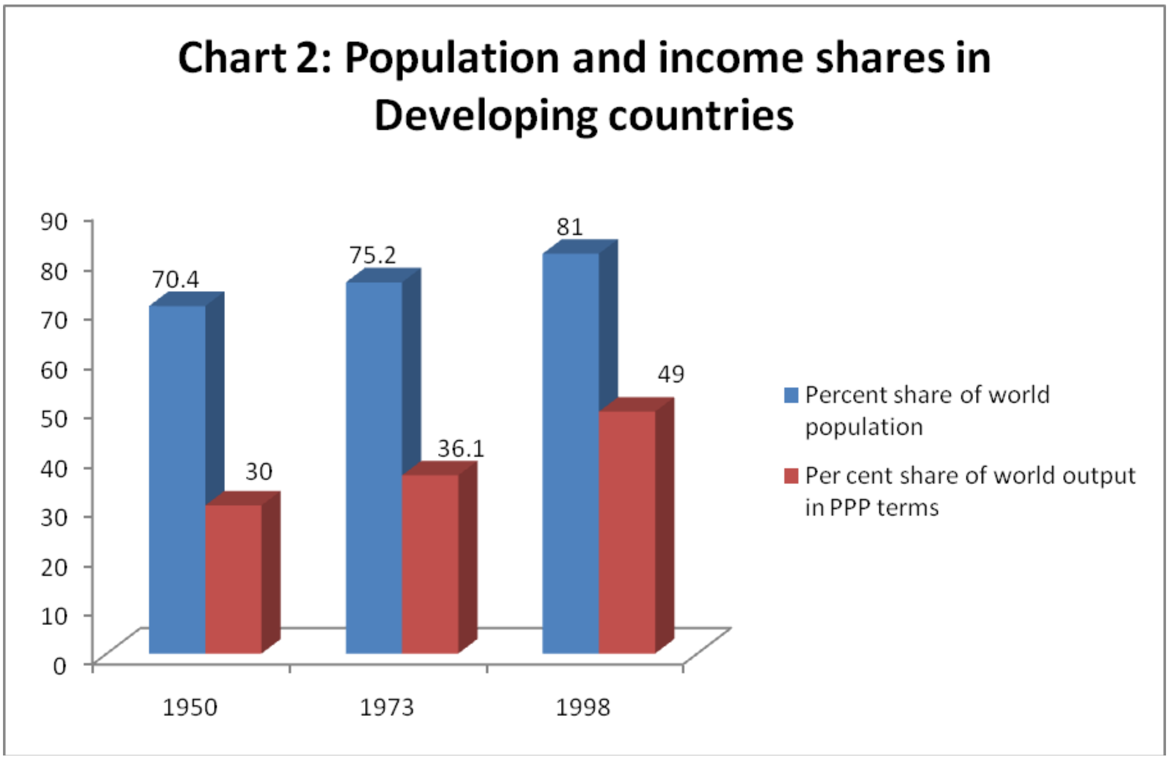
Nevertheless, PPP-based estimates have been widely used, even though they are likely to overestimate incomes of working people in lower-income countries for the reasons described above. In Charts 1 to 3, Maddison's estimates allow us to track the relative population and income shares by broad category of country for the latter half of the 20th century. Bear in mind that because these use PPPs that result from lower priced labour services, the actual disparities between rich and poor countries is likely to be larger.



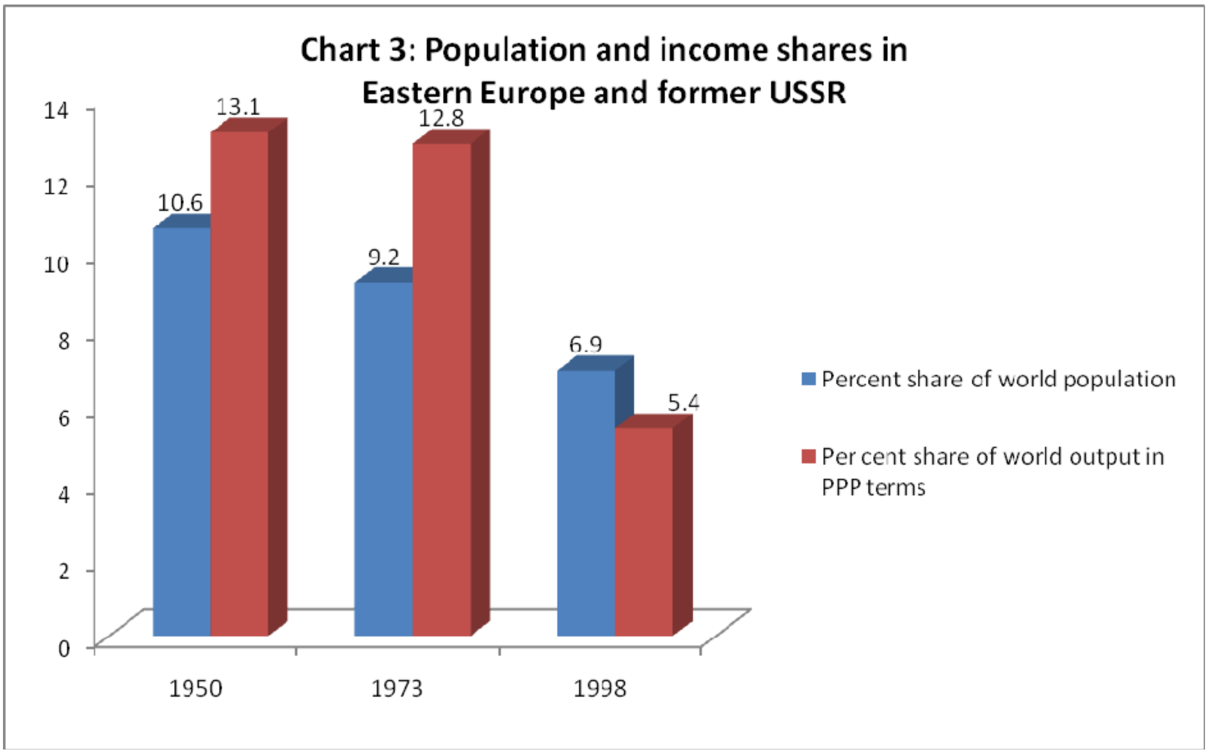
Source: Angus Maddison (2001)

It is evident that, as far as the countries that were known as "developed" in 1950 are concerned, there has been relatively little change in the per capita income position vis-à-vis the rest of the world, especially since the mid-1970s. In 1950 the developed countries received nearly 60 per cent of global income, but they also accounted for almost 20 per cent of world population. In the twenty five years after 1973, the share of the income of the developed countries fell by only 10 per cent, or 5.3 percentage points, whereas the share of population declined by 22 per cent or 3.5 percentage points. So even in PPP terms, just above one-tenth of global population in the developed countries still received nearly half the world's income at the close of the 20th century.

Chart 2 shows the same ratios for the developing countries taken as a group. This category includes all the "success stories" of the developing world in East Asia and elsewhere, the socialist countries outside of Eastern Europe and the former USSR as well as several oil-exporting countries that have benefited from global oil price booms. There has been some improvement in global income shares for this group as a whole, but this has been far outpaced by the growing share of the developing world in global population. So, between 1950 and 1998 developing countries managed to increase their share of global income by 15 per cent, or nearly 11 percentage points, their share of global population increased by a whopping 63 per cent, or 19 percentage points, so that there was no relative increase in per capita terms.



The countries of the former Soviet Union and Eastern Europe have typically been treated as outside of both these categories, and it is interesting to note how this process worked out for these countries. This is shown in Chart 3. Between 1950 and 1973, the conditions appeared broadly stable, that is, there was a slight decline in both population and global GDP shares. However, after 1973 – or more accurately, probably after 1989 and the collapse of the Berlin Wall – there was a sharp decline in population share (35 per cent, or 4 percentage points), associated with an even sharper decline in income share (59 per cent, or 8 percentage points).



It was noted above that there are several problems, both empirical and conceptual, with basing inter-country income comparisons on PPP estimates. Therefore, while comparisons based on nominal exchange rates do have the obvious difficulty of not reflecting relative purchasing power in different economies, they do nevertheless provide some idea of inter-country income differentials especially in a world in which trade penetration is increasing. Chart 4 provides the evidence on real per capita incomes (in constant 2000 US $ terms)across some major countries and country groupings for the period 1960-2006, based on the World Bank's World Development Indicators.

This chart shows very clearly how large the global income gaps are. The initial differences in per capita incomes (in 1960 in this case) were so large that even quite rapid increases in per capita incomes in some regions over the subsequent four and half decades have not managed to make the gap more repsectable. Thus, while the per capita income of the