Yr 13 Economics

Theme 4: A global perspective

Section 4.3: Emerging and developing economies

4.3.3 Strategies influencing growth and development – Part 1

- Market-orientated strategies:
  - Trade liberalisation
  - Promotion of FDI
  - Removal of government subsidies
  - Floating exchange rate systems
  - Microfinancing schemes
  - Privatisation

The specification:

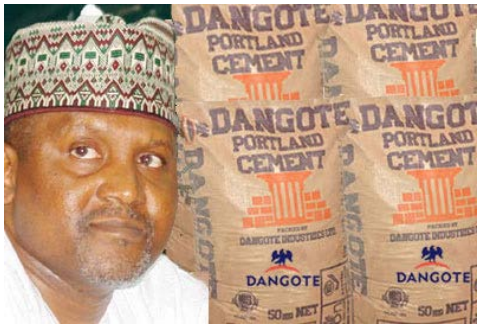
- Theme 4 – A global perspective
  - Emerging and developing economies

Subject content	What students need to learn:
4.3.3 Strategies influencing growth and development	a) Market-orientated strategies: o trade liberalisation o promotion of FDI o removal of government subsidies o floating exchange rate systems o microfinance schemes o privatisation b) Interventionist strategies: o development of human capital o protectionism o managed exchange rates o infrastructure development o promoting joint ventures with global companies o buffer stock schemes c) Other strategies: o industrialisation: the Lewis model o development of tourism o development of primary industries o Fairtrade schemes o aid o debt relief d) Awareness of the role of international institutions and non-government organisations (NGOs): o World Bank o International Monetary Fund (IMF) o NGOs

A typical development scenario…

Primary industries outward-looking stage

- Export of primary goods
  - Agricultural cash crops such as coffee, cotton
  - Minerals such as copper, bauxite
- Exchanged for imports of manufactured goods



Secondary industries inward-looking stage

- Country decides that industrialisation is the key to success
- Industrialisation focuses on **import substitution**
  - Non-essential imports discouraged through tariff barriers
  - Domestic products protected by tariff barriers

Secondary industries outward-looking stage

- Domestic demand is satisfied by domestic production
  - Manufacturing industry needs export markets in order to continue expanding
  - Tariff barriers become a hindrance to growth

Market-orientated strategies

Market-orientated strategies for development rely upon free markets to deliver economic growth. Examples of these include:

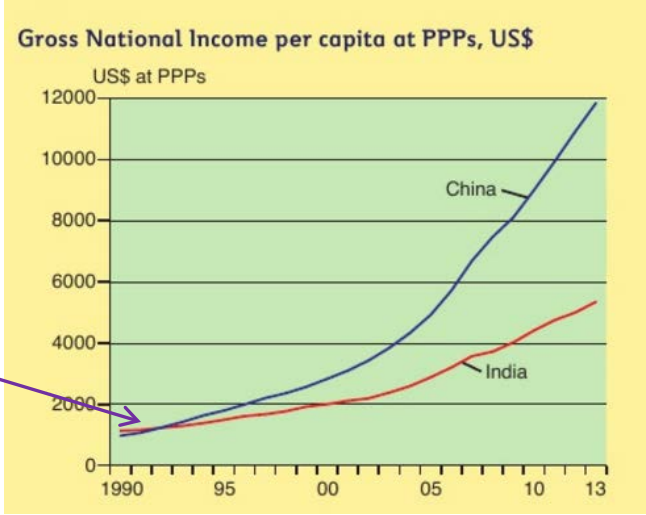
- **Trade liberalisation**
  - Enables specialisation
    - Gains from comparative advantage
- **Removal of government subsidies**
  - Scarce resources can be allocated more effectively
    - Removes source of corruption
- **Microfinancing schemes**
  - Low-income households can access loans
    - Linked to basic banking services
- **Promotion of FDI**
  - Plugging the savings-investment gap
    - Dynamic efficiencies
- **Floating exchange rate systems**
  - Governments do not have to intervene in currency markets
    - Interest rates do not have to support a fixed exchange rate
- **Privatisation**
  - Incentive to cut costs leads to productive efficiency
    - Can led to corruption

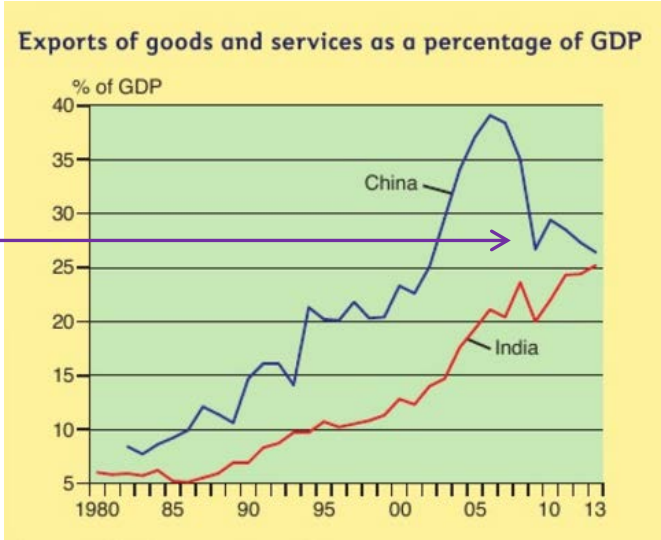
Trade liberalisation

Trade and economic growth

Integration with the global economy has been proven to be a major stimulus to growth for developing economies

- China's economy has grown faster than India's for the past 40 years
  - In terms of GNI per capita, China overtook India in 1992
    - The key difference has been China's greater level of integration in the global economy
      - With individual incomes and wealth now at much higher levels, thanks to the success of its export-led industries, China is now switching to a more consumer-based growth model
        - Economic growth in China is no longer so dependent on exports





The arguments in favour of trade liberalisation

Comparative advantage: free trade is likely to increase total world production. This is because countries will specialise in what they are relatively best at producing.

Economies of scale: Increasing the scale of production leads to a lower cost per unit of output. Trade allows economies of scale to be maximised and thus costs reduced.

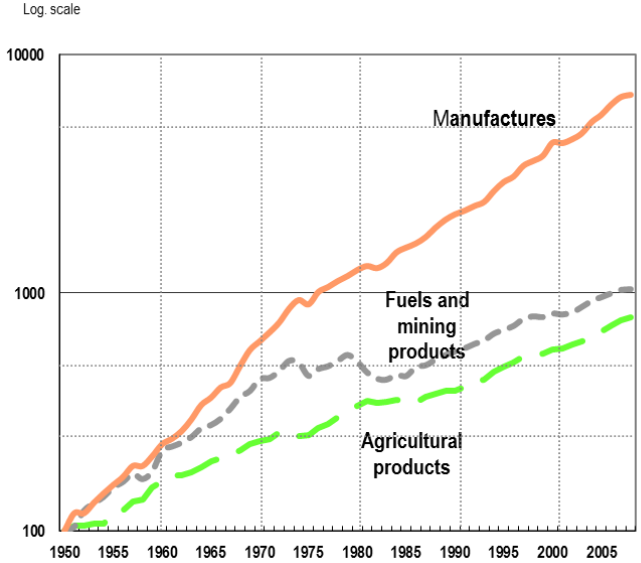
Consumer choice: Trade allows consumers greater choice: they are free to buy from the whole world and not just what is produced domestically.

Foreign direct investment (FDI): if firms are free to import and export, they are more likely to invest in that country.

Innovation: Free trade leads to a faster spread of technology. Countries that close themselves off grow stagnant and are rapidly left behind.

Fostering of political and social ties: when economies are relying on each other, this leads to more cooperation and political understanding. "No two countries which have a McDonalds have ever gone to war…" *

* Incorrect: Russia and Georgia went to war in 2008

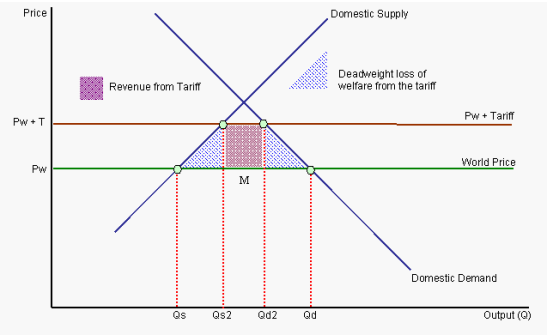


The growth in world trade since World War II

The problem with tariffs…

There a several arguments why governments should not impose tariffs

- The imposition of tariffs leads to a welfare losses for consumers.
  - Higher prices mean lost consumer surplus
  - A tariff acts as a regressive tax which hits the poor the hardest



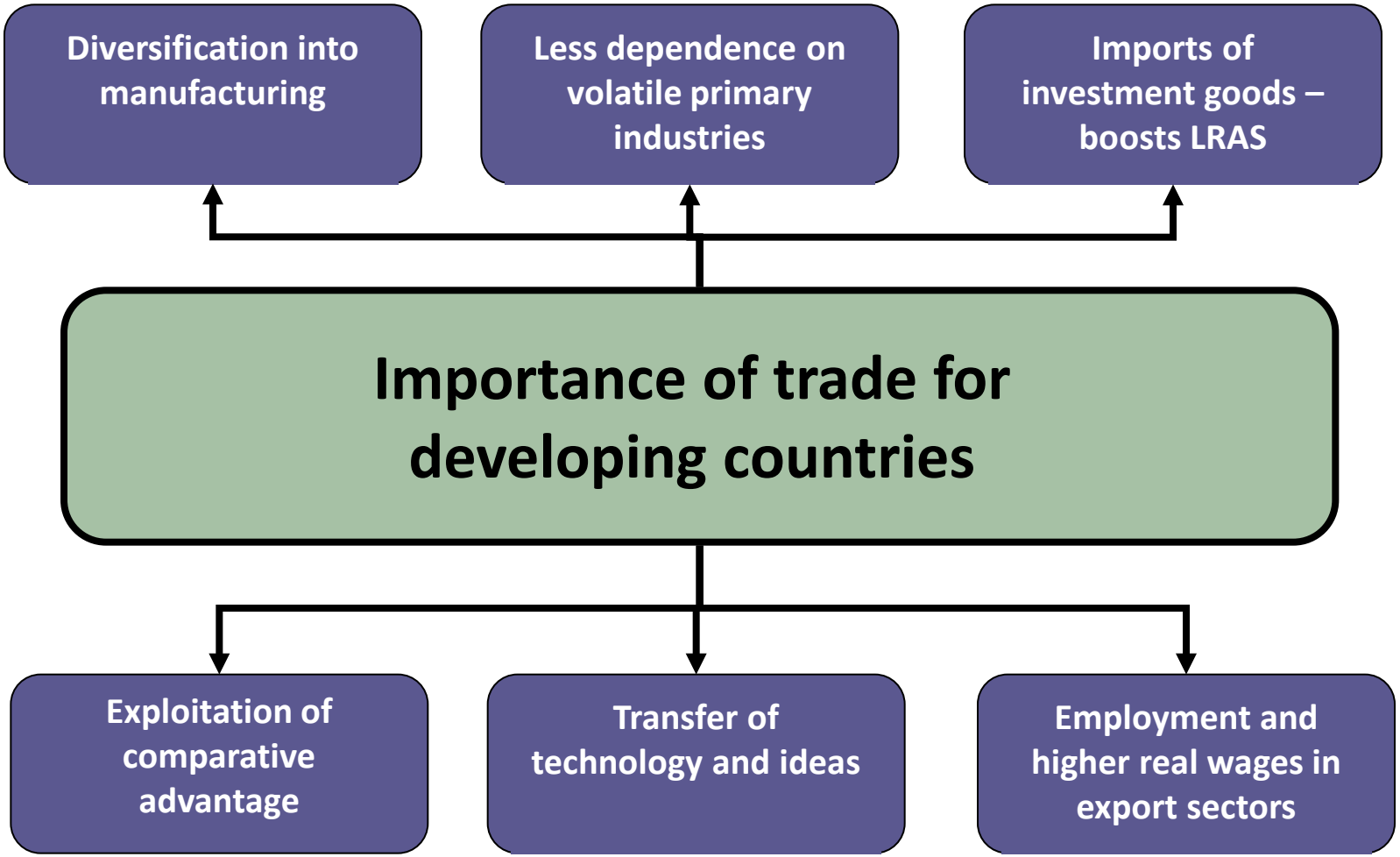
- Import tariffs lead to higher costs for business importers
  - e.g. US car makers when the US government imposed a steel import tariff

- By creating a barrier to free competition, they allow inefficiency to continue

- Tariffs lead to bureaucratic problems
  - They also encourage smuggling and corruption

- Threat of retaliation from trading partners – “beggar thy neighbour”

The importance of trade for developing countries



Promotion of Foreign Direct Investment (FDI)

Foreign Direct Investment and Multi-Nationals

Multi-Nationals have the financial muscle to make major projects a reality. They can close the savings gap in a developing country or its foreign currency gap

- Sometimes a developing country may natural resources waiting to exploited but it lacks the large amount of accumulated savings needed to provide the investment capital…
  - Or they might lack the foreign currency reserves need to import the expensive equipment…
    - Sometimes the only option is to invite in a Multi-National Corporation (MNC) to make the investment

- China is now exporting its surplus capital all over the world, and is a particularly large investor in Africa
  - It is keen to invest in resource-based industries to supply raw materials for its manufacturing industries back in China

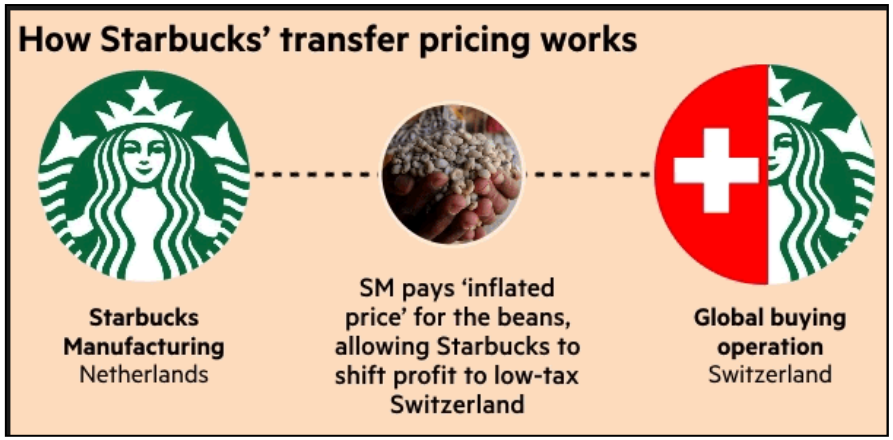
Problems with FDI and MNCs

But this injection of capital by MNCs does not come without a cost…

- MNCs may quickly achieve power and control over the host government
  - There is competition between developing countries to attract MNCs
    - MNCs play off one government against another

- MNCs may drive local firms out of business

- There may only be limited demand for local components – the rest will be imported



- MNCs will repatriate profits out of the country
  - They may try to reduce their tax liability through transfer pricing

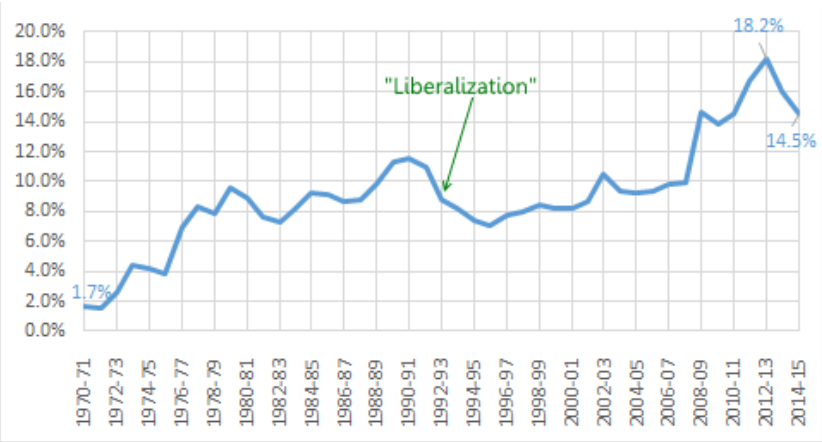
Removal of government subsidies

Removal of government subsidies

Subsidising essential items, such as food or fuel, can be an effective way of minimising absolute poverty. However, they bring with them a number of problems

- Subsidies are poorly targeted
  - How do you stop wealthy people from taking advantage of the subsidised prices too?
    - Fuel subsidies bring down the cost of public transport and freight transport but also benefit the owners of private cars – and car owners are often the wealthiest people in society

Subsidies as % of Indian Government Expenditure

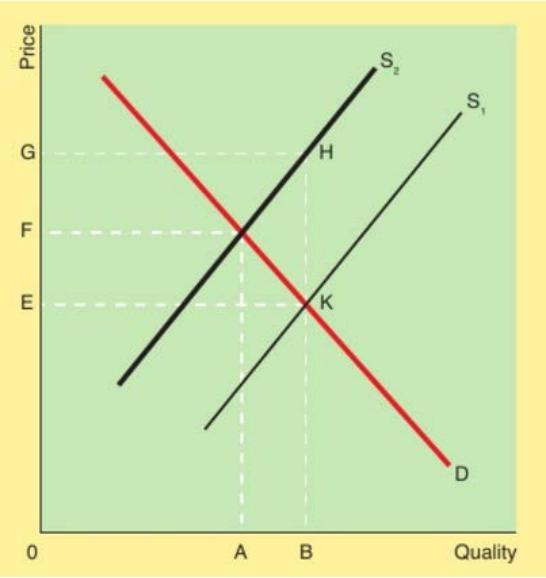


- The longer a subsidy is given, the less likely it is to increase economic development
  - Subsidies can take up a significant proportion of government spending
    - They become a large opportunity cost: money used in subsidies is not available for spending on education, health-care or building infrastructure

Removal of government subsidies

It would be much more efficient for governments to replace subsidies with cash payments to poor households. But it is very difficult politically to remove subsidies

- Removing a subsidy will lead to an inward shift in the supply curve
  - This inward shift will cause an increase in the equilibrium price
    - Because the subsidised good is likely to be an essential item, the demand curve will be relatively inelastic
      - The increase in price is therefore likely to be quite large, causing a sharp increase in the cost of living



- So many people have a vested interest in the subsidy continuing that removal is never an easy option
  - In some countries, criminal gangs buy subsidised items and sell them for vast profits in neighbouring countries
    - The best time to remove a subsidy is when the free market price of an item is falling close to the subsidised price of the item

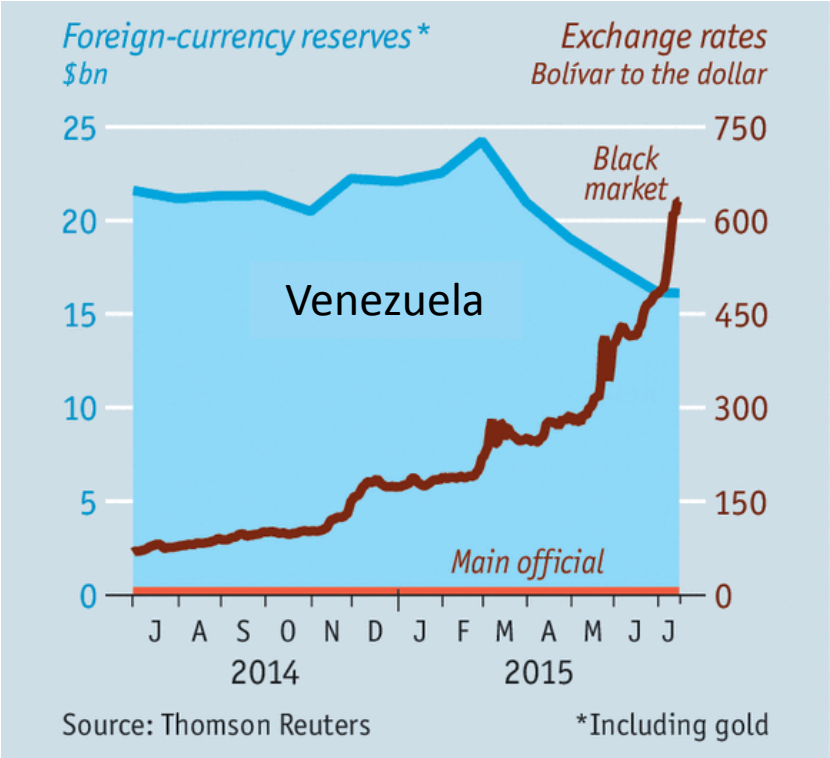
Allowing exchange rates to float

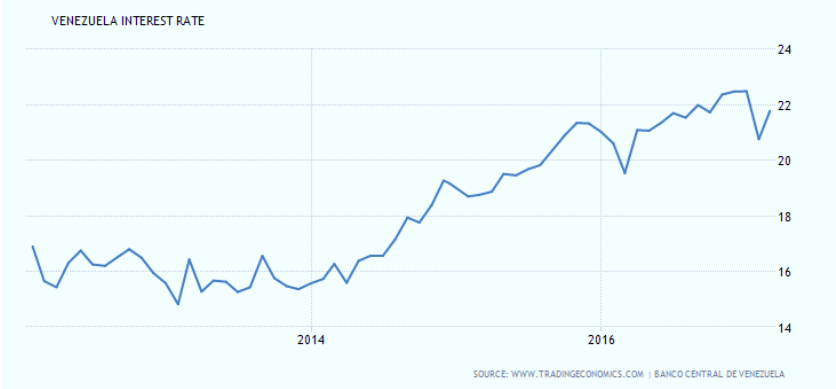
Allowing exchange rates to float

Governments might be tempted to fix their currency's exchange rate to help their BoP. However, there are significant advantages from allowing it to float freely

- A freely floating currency does not require any intervention from the government
  - Gold and/or foreign currency reserves do not need to be spent supporting the domestic currency at a pre-determined rate

- With a freely floating currency, governments are free to direct their monetary policy at other macro-economic objectives…



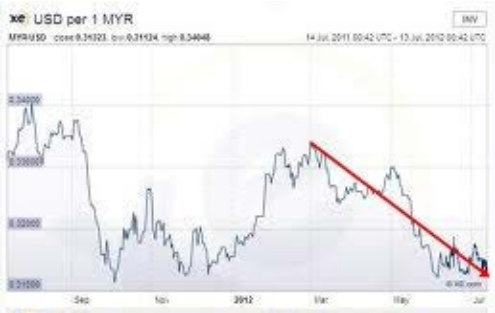


- If a government has to raise interest rates to support the domestic currency, this can choke off consumer spending or investment

Problems with a floating exchange rate

The exchange rate can lead to imbalances in a country's balance of payments. An imbalance can be a surplus or a deficit, and both create problems for an economy

- Too strong a currency can cause exports to fall and imports to rise, leading to a deficit in the merchandise account of the current account of the BoP
  - If a country belongs to a single currency area, it has to improve its competitiveness and bring down its ex-factory prices



  - If a country has its own currency which is freely floating, it should adjust downwards automatically over time, thus restoring competitiveness

- Too weak a currency can cause exports to rise and imports to fall, leading to a surplus in the merchandise account of the current account of the BoP
  - This can lead to excessive demand in the economy, leading to higher inflation

Micro-finance

Microfinance as a solution

Microfinance is centuries old, but arose in its modern form in the 1970s when Mohammed Yunus, an economics professor in Bangladesh, began providing very small loans to poor Bangladeshi women living in rural areas.

GRAMEEN™
Banking for the poor

- These women used their loans to expand their businesses, often by buying more stock or employing an additional staff member. The provision of working capital to people with no alternative sources of finance enabled many of these women to raise themselves out of poverty.

- Traditional microfinance has worked predominantly with the **group lending** methodology, as the poor frequently do not have the hard collateral required in a traditional credit model.
  - Rather than relying upon collateral to guarantee their loans, Micro-Finance Institutions (MFIs) call for people to group together and guarantee each others' loans in order to minimize the risk. This has proved to be effective.

Credit group meeting in East Africa

The growth of micro-finance

Grameen's idea has since mushroomed into a huge industry serving millions of people around the world. Microfinance can now be defined as the provision of financial services to the unbanked.

MFIs now offer credit and savings services as well as more advanced products such as micro-insurance and money transfer services. Traditional banks have been unwilling to provide these services to the unsalaried and those working in the informal sectors.

"70% of adults in the developing world do not use formal financial services" *(CGAP Finaccess 2009)*

Muhammad Yunus and the Grameen Bank were joint winners of the 2006 Nobel Peace Prize . Grameen Bank has now disbursed US$6.6bn.

CGAP (Consultative Group to Assist the Poor) is an independent policy and research centre dedicated to advancing financial access for the world's poor. It is supported by over 30 development agencies and private foundations who share a common mission to alleviate poverty. Housed at the World Bank, CGAP provides market intelligence, promotes standards, develops innovative solutions and offers advisory services to governments, microfinance providers, donors, and investors.

Privatisation

Privatisation

From the start of the 1980s, governments (led by the UK and the US) started to sell off state-owned enterprises to the private sector. This was called privatisation

- Privatisation assumes that the size of the state must be reduced in order to increase efficiency in the economy
  - State-owned enterprises (and the civil servants who run them) have no incentive to cut costs to the minimum
    - Market forces cannot have their normal disciplinary effect of forcing state firms to cut their costs in order to compete
      - If a firm is not operating at its lowest possible cost, it cannot be productively efficient

- Private firms have to be allocatively efficient as well
  - This means providing the markets with goods that consumers want to buy
    - State-owned firms do not have to do this because they have a monopoly of the market

Problems with privatisation

Privatisation is not without its problems – particularly in developing countries

- If a state-owned firm is a monopoly, a straight-forward privatisation is not going to stop it being a monopoly when under private control
  - The privatised monopoly will be just as inefficient as it was when under state ownership
    - It will be neither productively nor allocatively efficient

- Privatisation in developing countries can be associated with corruption
  - An easy way for politicians or government officials to get rich is to sell a state-owned company to a family member or friend at a price which is well below market value
    - Large bribes can change hands at the time of privatisation