Yr 13 Economics

Theme 4: A global perspective

Section 4.3: Emerging and developing economies

4.3.3 Strategies influencing growth and development – Part 3

- Other strategies:
  - Industrialisation: the Lewis Model
  - Development of tourism
  - Development of primary industries
  - Fairtrade schemes
  - Aid
  - Debt relief

The specification:

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

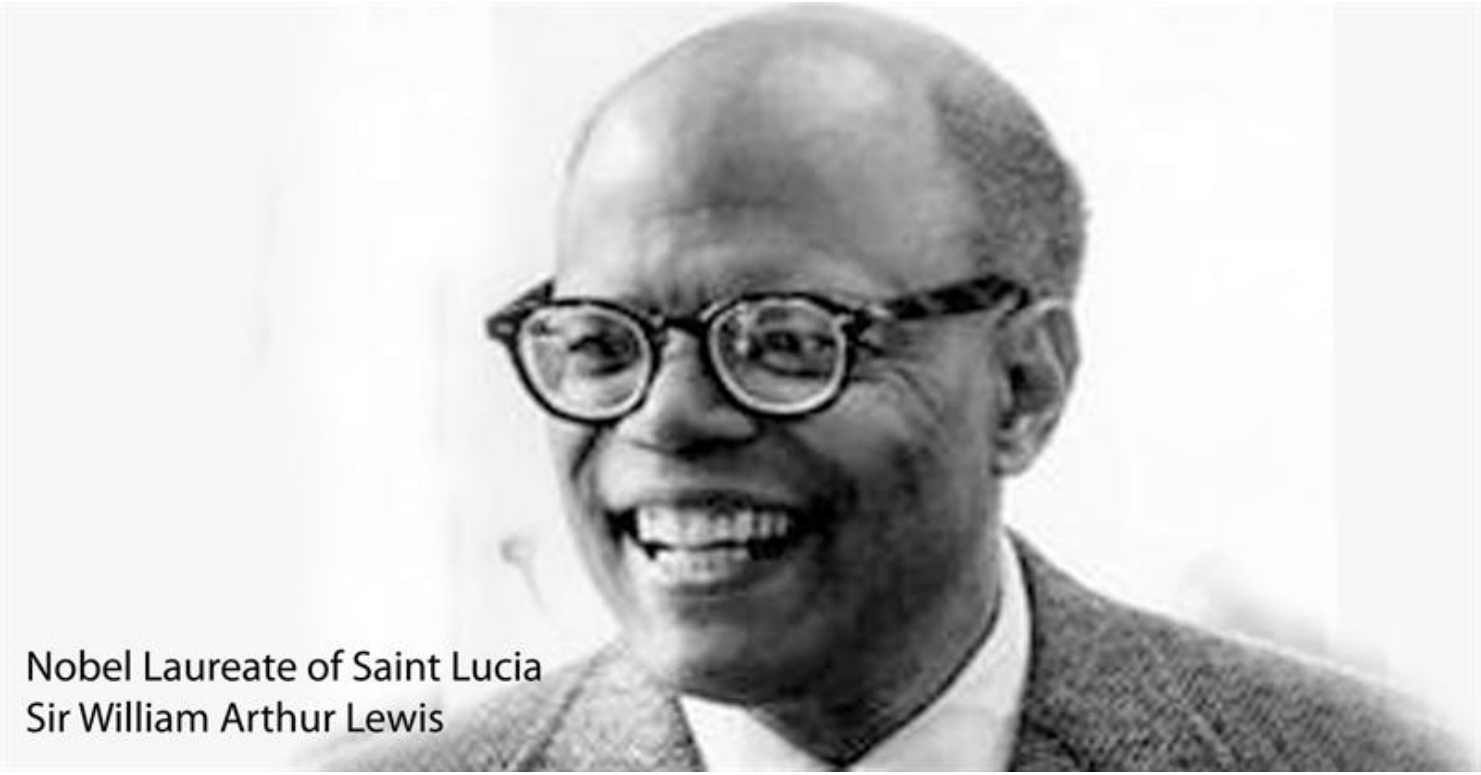
Subject content	What students need to learn:
4.3.3 Strategies influencing growth and development	a) Market-orientated strategies: o trade liberalisation o promotion of FDI o removal of government subsidies o floating exchange rate systems o microfinance schemes o privatisation b) Interventionist strategies: 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

Other strategies

Some development strategies do not fall neatly into the categories of free market-based strategies or interventionist strategies. We must consider a few of these…

- **Industrialisation: the Lewis Model**
  - The role of worker migration
    - The transfer of workers from low-productivity agriculture
- **Development of tourism**
  - Exporting services to rich countries
    - Labour-intensive
- **Development of primary industries**
  - Exploiting a comparative advantage in primary resources
    - Earning income and creating employment
- **Fairtrade schemes**
  - Guaranteed prices for producers
    - Also linked to community development
- **Foreign aid**
  - Filling the savings gap
    - Grants, loans and "tied" aid; bilateral and multilateral
- **Debt relief**
  - Writing off debts owed by developing countries
    - Debt "forgiveness"

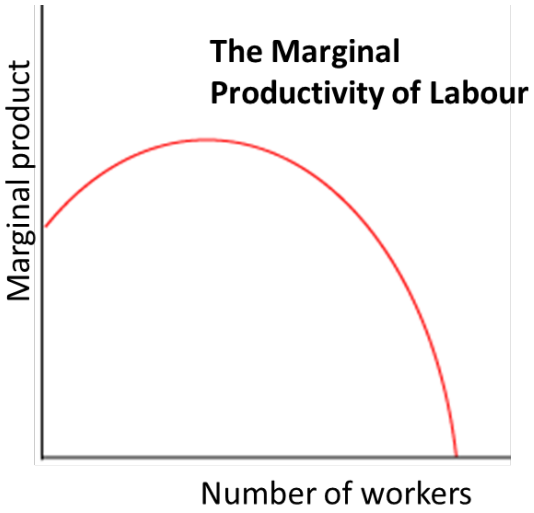
Industrialisation: The Lewis Model



Poor productivity in subsistence farming economies

Development economist, Arthur Lewis, argued that subsistence agriculture was bound to achieve lower and lower productivity

- Rural subsistence sector comprises:
  - Labour (variable, but usually increasing, because of fast-growing populations)
  - Two other factors of production are which are usually fixed, i.e.
    - Land and Capital equipment

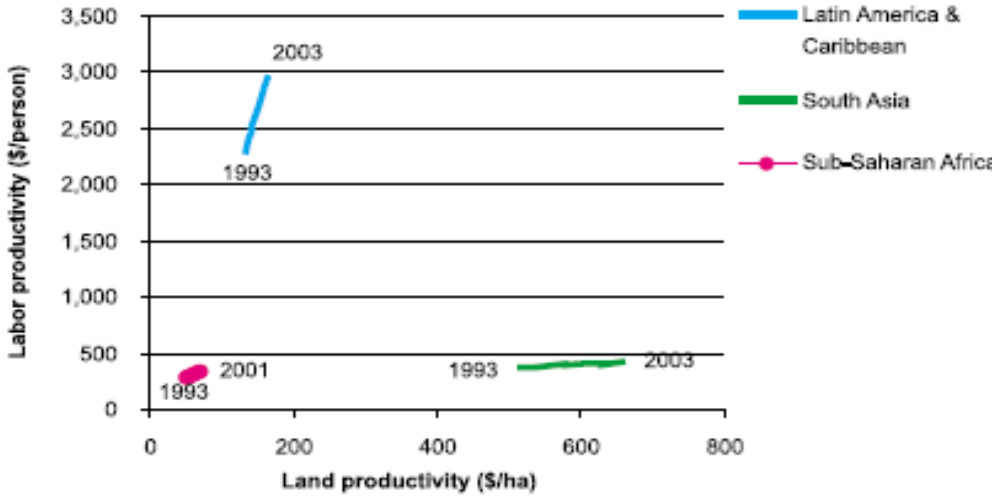


- The law of diminishing marginal returns dictates that there are limits to the gains to be had from specialisation as more labour is used
  - If ever-increasing quantities of labour are used , the marginal product of that labour will eventually decline to zero.

Key definition:
Law of diminishing marginal returns: As more of a variable factor of production is added to a given stock of fixed factors, there will come a point where the marginal product of the variable factor will decline.

Key definition:
Marginal product: the addition to output when one extra unit of the variable factor is added to the production process

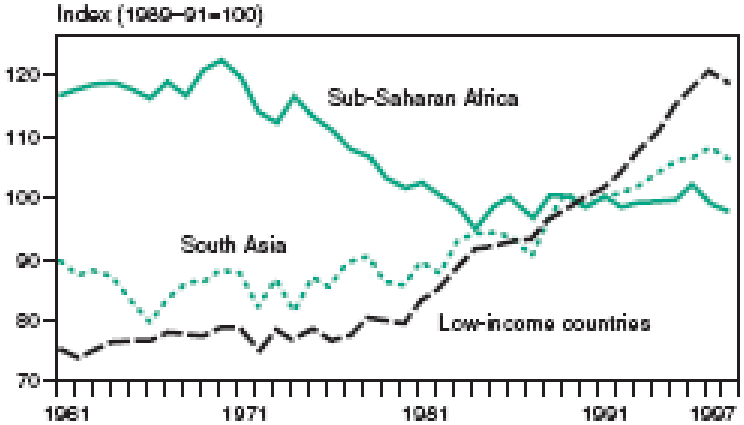
Africa: a poor record of productivity growth



Land and labour productivity, 1993–2003. Source: FAAP 2006

Low growth rates in cereals yields and production in Africa have translated over the years into falling per-capita food production and increased imports, contributing to high levels of food insecurity at both national and household levels (20% of African cereal consumption depends on imports, including food aid).

"Consultations with agricultural leaders, agricultural professionals, agri-business, and farmers shows substantial agreement that institutional issues such as capacity weaknesses, insufficient end-user and private-sector involvement, and ineffective farmer support systems persist in most of Africa's agricultural productivity programmes and organizations."
Source: FAAP, 2006



Net per capita agricultural production 1961-97
Source: FAOstat

The Lewis Model

Arthur Lewis argued that growth could be sustained by the gradual transfer of workers from low-productivity agriculture to higher productivity urban industries

- Lewis argued that marginal workers added nothing to the output of the rural economy
  - There was a large amount of under-employment in the rural economy
    - Marginal productivity was zero

- Lewis argued that agriculture has low productivity while the modern industrial urban sector is far more productive
  - So, workers should be transferred from agriculture to industry
    - In other words, the industrialisation of the economy should be the objective of development

Problems with the Lewis Model

Lewis said that governments should push industrialisation but what if the industries chosen by the government fail to take off? And is the relationship so simple?

- There is no simple relationship between poverty in the countryside and affluence in the towns
  - It could be argued that industrialisation is the result of economic development rather than a cause
    - Migration from the countryside to the town is the result of higher incomes and growth in urban jobs
      - Encouraging rural depopulation will simply lead to urban poverty, not increased affluence

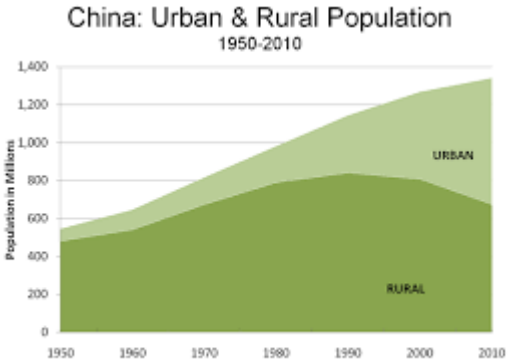
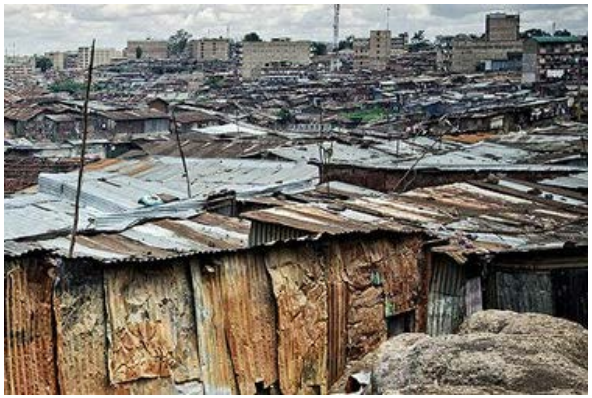


Figure 2



Problems with the Lewis Model (cont.)

- The model ignores the costs of educating and training rural workers for employment in the urban sector
- The profits from expansion may not be re-invested locally – they may be sent abroad to shareholders and investors
- Profits may be invested in labour-saving capital

- High levels of rural-urban migration can be dangerous:
  - Lack of sufficient housing --> shanty towns & squatters
  - Pressure on social infrastructure (schools, hospitals etc)
  - Increases in disease – clean water, sanitation
  - Increased crime
  - Pollution, traffic, environmental problems
  - Qualification inflation

Development of tourism

Why do developing countries promote tourism?

Tourism is an increasingly important source of income for developing countries. Over 40% of global tourism arrivals are in developing countries

- Tourism is labour-intensive, much of it low-skilled
- When handled sensitively, tourism development enhances or creates value from the existing natural and human resources
  - Landscape and scenery
  - Local culture and customs
- The Internet makes it relatively cheap for developing countries to promote their tourism destinations and to take bookings
- As global prosperity increases, foreign travel becomes affordable to many
  - Demand for tourism is income-elastic
  - Air travel is becoming progressively cheaper
- Tourism creates opportunities for FDI (from international hotel chains) and generates foreign exchange from personal spending

	Developing countries value in US$bn	Growth in % 1990-2000	Rank in 2000
Manufactures	900.65	208	1
Food	120.26	58	2
Tourism	113.9	154	3
Fuels	73.62	16	4

Tourism: an alternative or a complement to agriculture?

- Infrastructure for tourism tends to generate positive externalities for other economic sectors of the country – in particular, agriculture
  - Roads
  - Water
  - Electricity
- Land and marine resources can be adapted to tourism usage with relatively disruption to the natural environment
- When agricultural prices are low, tourism income can offset the shortfall

Oil palm plantations give way to golf courses

Dayak fishing village...

...or 5-star resort hotel?

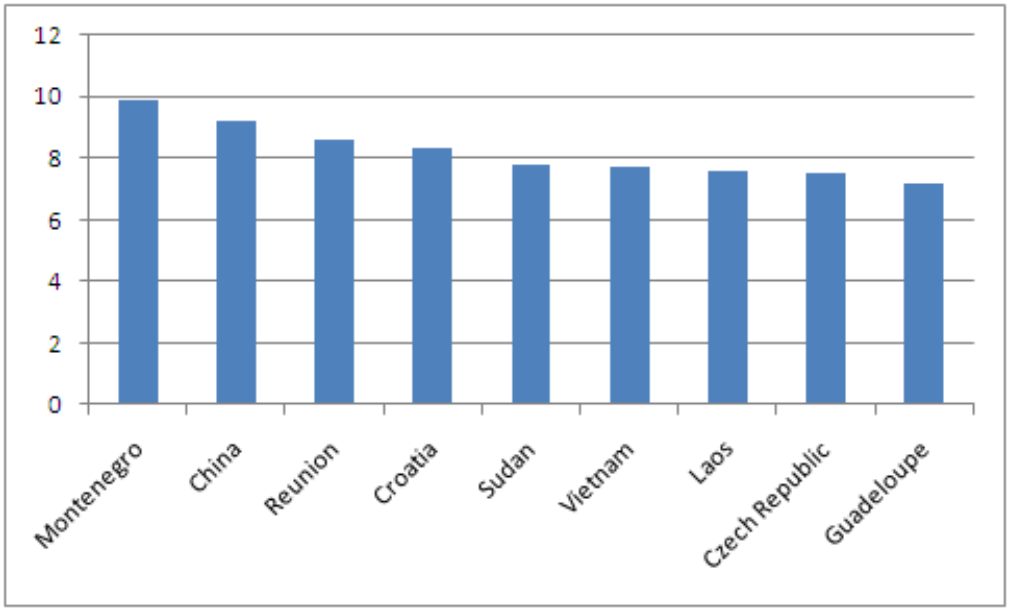
Tourism: which countries are benefiting most?

Country grouping	Increase in international arrivals 1990 - 2000	Increase in tourism expenditure 1990 - 2000
OECD	39%	64%
EU	38%	49%
Developing countries	94%	133%
Least Developed Countries	79%	154%

When global tourism really took off in the 1990s, developing countries and LDCs experienced massive growth rates in visitor arrivals and expenditure.

Low income countries are expected to enjoy some of the highest growth rates in their tourist industries up to 2015. However, this growth is exaggerated by the fact that it is coming off a low base. Middle income countries are, in fact, the main beneficiaries of the tourism boom.

Travel and Tourism Demand 2006-2015 (projected)
Ten highest % annualised real growth rates (by country)



Source: World Travel and Tourism Council (extracted by Peter Cramp)

Tourism: negative externalities

Noise and air pollution from aircraft

Disruption or abuse of wild-life

Tourist litter in areas of natural beauty

Visiting ships put pressure on water supplies

Need to import food and wine for tourist needs

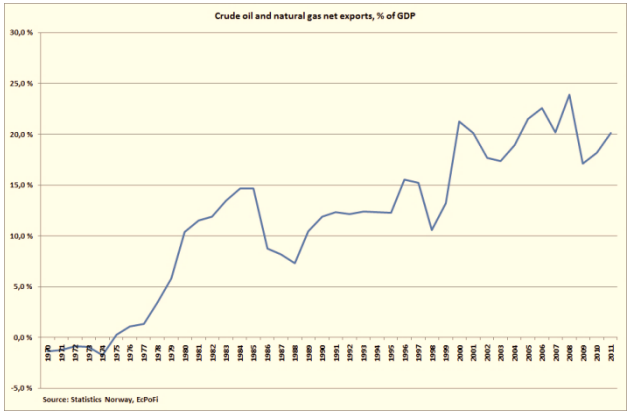
Insensitivity of foreign visitors to local customs

Development of primary industries

Development of primary industries

Countries such as Saudi Arabia, Chile, Australia and Norway have enjoyed major success due to comparative advantage in production of certain primary commodities

- Rich factor endowments in certain primary commodities can be a blessing or a curse depending on the economic policies pursued by the government
  - If the government uses the commodity revenues to diversity the economy, the heavy dependence need not be a problem
    - The smaller the proportion of GDP from commodities, the less vulnerable the economy is to commodity price fluctuations



- Exporters of commodities also need to prevent their currency from strengthening so much that their other export industries are destroyed
  - A way round the problem is to use commodity export revenues to create sovereign wealth funds
    - These buy assets overseas, thus increasing the supply of the currency and thus keeping its value down

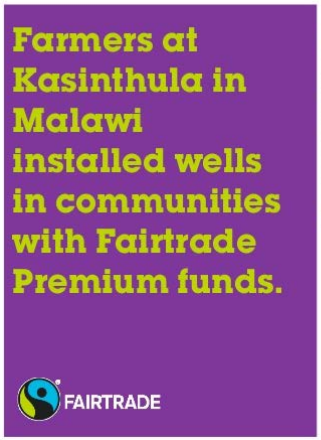
Fairtrade schemes

Fair trade

In recent years sales of "fair trade" products have grown very rapidly. Various international organisations certify that these products conform to key principles

- Producers should receive a "fair" price for their products which enables them to make a living
  - Usually this means that Western firms guarantee to buy a minimum amount of the commodity at a price above the prevailing market price
    - This enables farmers to plan their crop production and raise loans to buy machinery

- Purchase agreements are linked to community development projects
  - Farmers also have to follow fair working conditions, and agree not to use child labour
    - Farming must also be conducted on a sustainable basis and not degrade the environment

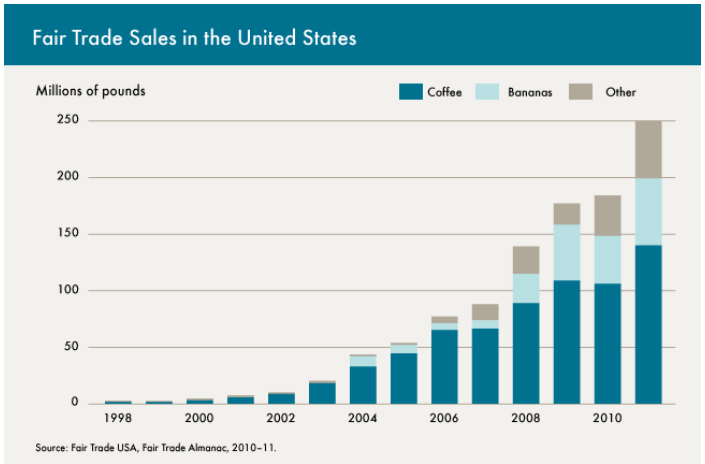


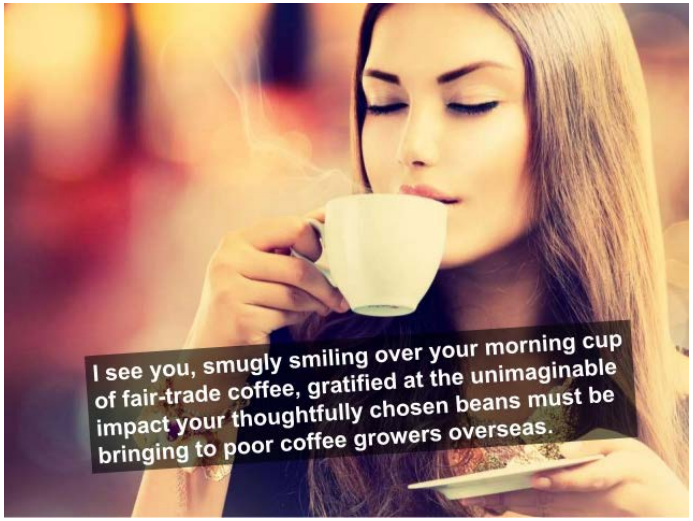
The farmers of Kasinthula in Malawi have invested in water projects for their community.

Criticism of Fair trade

Critics say that Fair trade is insignificant in relation to total world-wide trade, it is just good PR for supermarket chains and will lead to global over-production

- Critics say that raising the price of commodities will encourage producers to grow more
  - This will lead to a fall in the price of non fair-trade products
    - This will leave other producers worse off





- Critics say that Fair trade is a distraction from the real issues of development
  - It enables consumers in the West to pretend that they are making a difference when in fact the impact is minimal
    - Supermarkets like the scheme because it makes them look ethical

Aid and debt relief

Filling that savings-investment gap

Developing countries need money to invest for two main reasons:

- To stimulate growth
  - By creating physical capital, like factories, roads, ports, etc
- To alleviate poverty
  - By providing safe water, improving crop yields, etc

But without sufficient domestic savings, developing countries are obliged to borrow from abroad in order to make those investments:

- Soft loans from **multilateral** agencies like the World Bank
- Soft loans negotiated on a **bilateral** basis with another government (usually **tied** to an obligation to buy goods and services from the donor)
- Commercial loans from foreign banks

Very poor countries can apply for grants (i.e. gifts) from other governments. Soft loans and grants are called Overseas Development Aid (ODA)

Foreign debt management

One of the biggest challenges facing developing countries is how to manage their debt burden. Interest payments use up valuable foreign exchange.

- Most developing countries have large debt burdens
- Caused by several factors: declining terms of trade, rising oil prices, misuse of previous loans
- Countries can try re-negotiating their loans; seeking IMF assistance; defaulting on the debt; and pursuing a tight domestic policy

Aid

- Tied aid may limit countries' ability to make their own decisions, whilst untied aid could be abused or intercepted by corrupt officials
- But aid can be a good idea – especially if it's untied aid, used for investment projects which increase productive capacity
- Non-Governmental Organisations are very good at targeting aid at those who need it most

Forms of Overseas Development Aid (ODA)

Donor / lender

- ❑ Bilateral
  Country to country
- ❑ Multilateral
  International agencies

Recipient

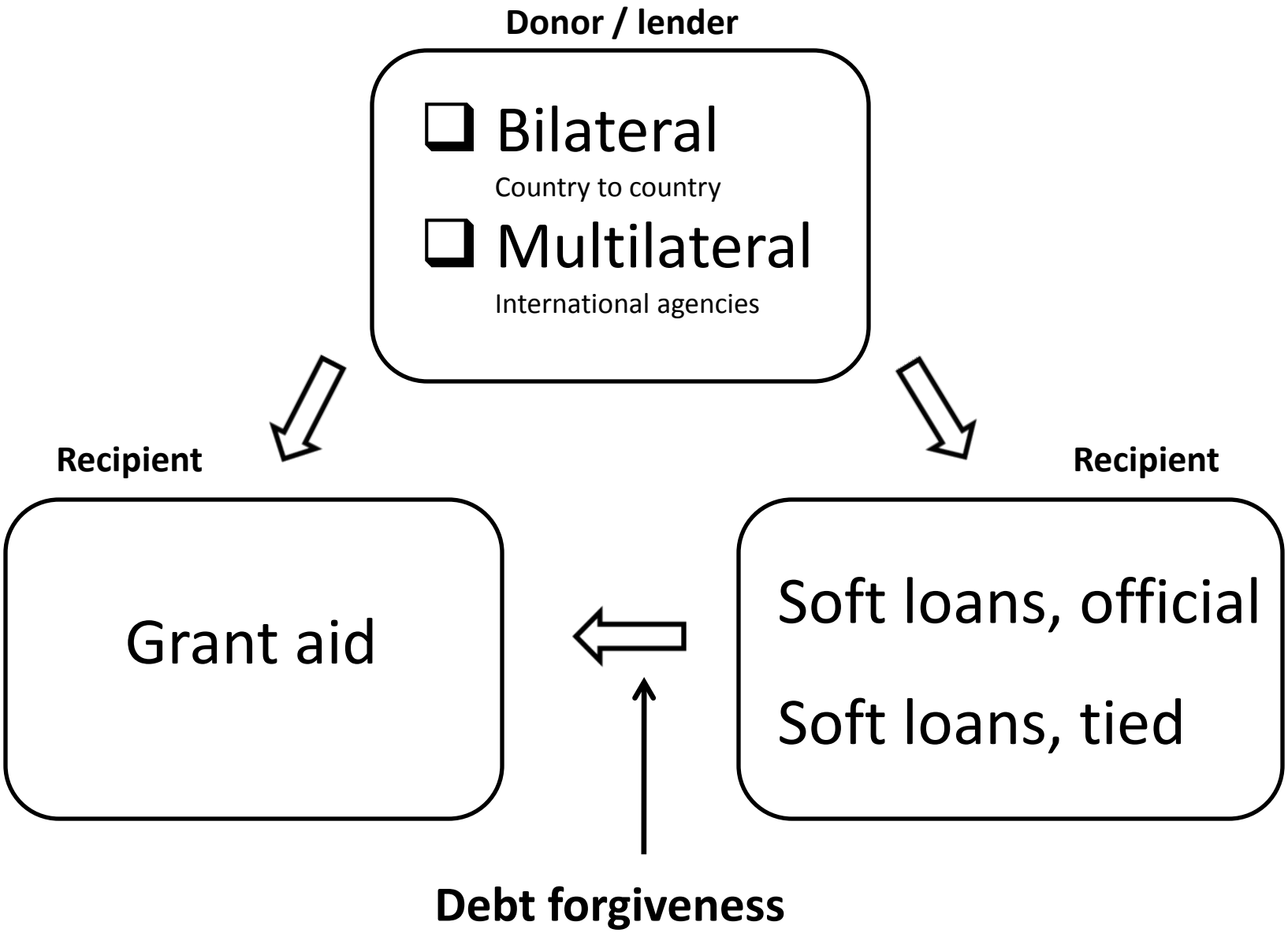
Grant aid

Recipient

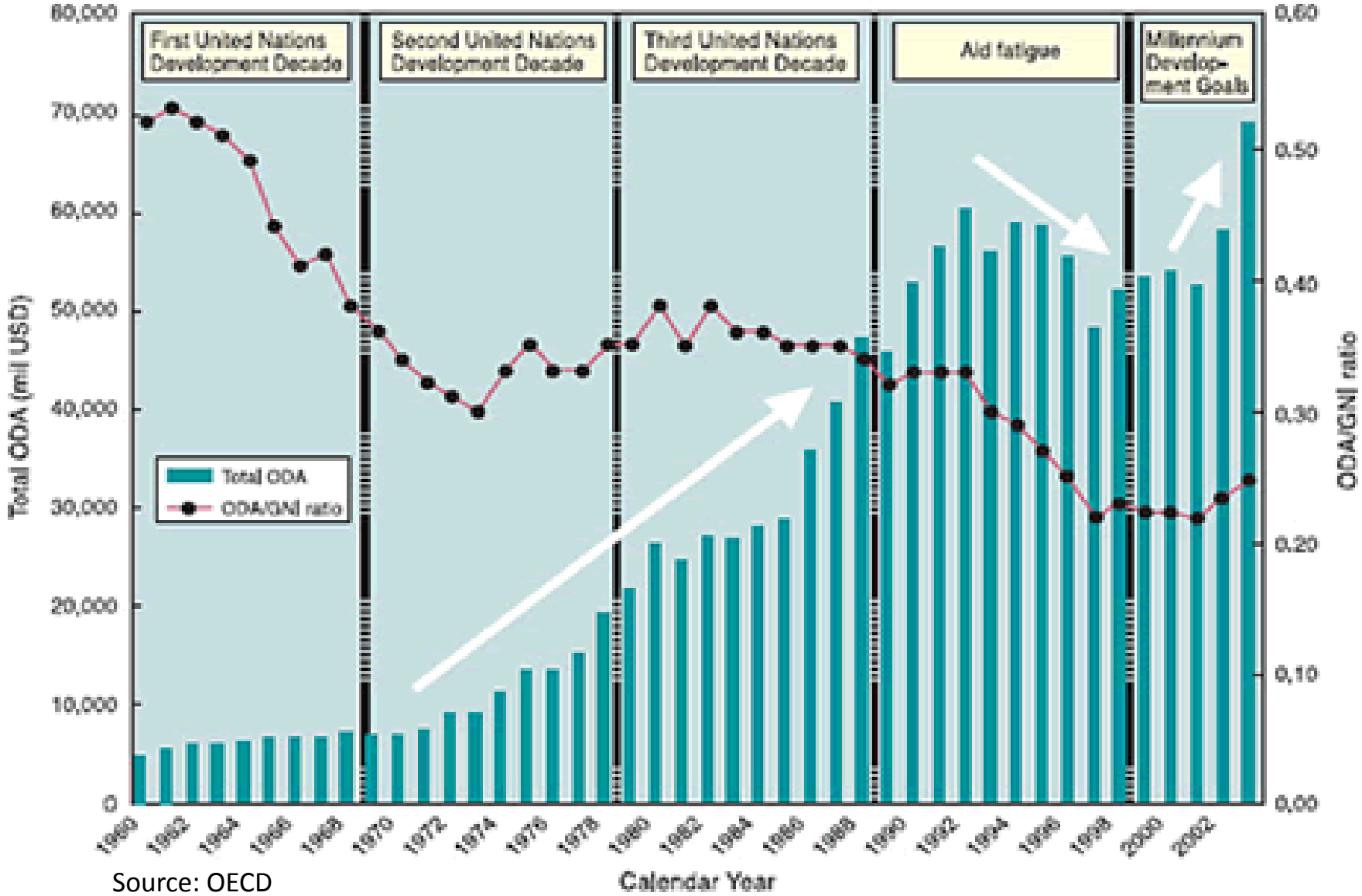
Soft loans, official
Soft loans, tied

Definition of Soft Loan:
Extended term project financing made at below-market rates, especially in loans to developing countries. Typically, soft loans have extended grace periods in which only interest or service charges are due, longer (up to 50 years) repayment schedules, and lower interest rates than conventional bank loans.

Forms of Overseas Development Aid (ODA)



Trends in total ODA relative to GNI (1960 – 2003)



Source: OECD

The “Washington Consensus”

Two big multilateral aid agencies, World Bank and IMF, are based in Washington

- Their common stance in favour of trade liberalisation and globalisation has been dubbed “The Washington Consensus”.
  - Over the past 20 years, this term has come to take on a negative connotations.

World Bank:

- Encourages countries to lift import and export barriers, cut subsidies and remove price controls

IMF:

- The IMF only lends money to countries if they agree to sell their resources at the world market price and to cut public spending

These conditions are imposed in the form of a **“Structural Adjustment Programme”** to which debtor countries must adhere if they want development aid.

The case <u>for</u> Structural Adjustment Programmes

So aid from the World Bank and the IMF comes with strings attached…why?

- Loans from the World Bank and IMF are intended to promote economic growth, to generate income, and to pay off the debt which developing countries have accumulated.
  - Structural adjustment programmes (SAPs) are designed to ensure that the loans have a chance to be effective in the developing country and not used to fund wasteful spending by governments.

- The aim is to reduce the borrowing country's fiscal imbalances.
  - SAPs therefore require the borrowing country to adopt “free market“ policies, such as privatisation and deregulation, and to reduce trade barriers.

- Countries which fail to enact these policy changes may be subject to severe financial sanction by the World Bank or IMF.

The case against Structural Adjustment Programmes

Critics of the Washington Consensus argue that poor countries are effectively being blackmailed into changing their national policies

- In particular, critics allege that imposing free market policies in developing countries leads to:
  - Rapid increase in the price of goods in the country adopting the SAP
  - An actual increase in poverty
  - Lower investment
  - Cuts in social spending

Critics also argue that there is little evidence that these free market policies advocated by the Washington Consensus actually work

The World Bank's recipe for growth: policy choices

1. **Encourage the formation of competitive domestic markets**
   i. Ensure that resources are being allocated efficiently
2. **Create a stable macro-economic climate**
   i. Contain inflation
   ii. Keep a steady balance of payments
   iii. Maintain sound government finances
3. **Develop human capital**
   i. Economic growth requires a skilled work-force
4. **Foster an effective and secure financial system**
   i. Encourage savings
   ii. Mobilise savings for investment
5. **Limit price distortions**
   i. Allow the market to fix prices
   ii. Do not subsidise prices: it just distorts the market
6. **Be open to foreign technology**
   i. Encourage domestic firms to use foreign technology
   ii. Encourage foreign firms to locate
7. **Don't ignore the development of agriculture**
   i. Improve yields
   ii. Reduce inefficiencies

The World Bank's recipe for growth: summary

Policy choices

Fundamentals
- Stable macro-economy
- High human capital
- Effective and secure financial systems
- Openness to foreign technology
- Agricultural development policies

Selective interventions
- Export push
- Directed credit
- Selective promotion

Institutions
- Technocratic insulation
- High quality monitoring of the civil service

Competitive discipline

Market based
- Export competition
- Domestic competition

Contest based
- Export credit
- Investment co-ordination
- Information exchange

Growth functions

Accumulation
- Increasing human capital
- High savings
- High investment

Allocation
- Effective use of human capital in labour market
- High returns of investment

Productivity change
- Productivity-based catching up
- Rapid technology change

Sustained growth