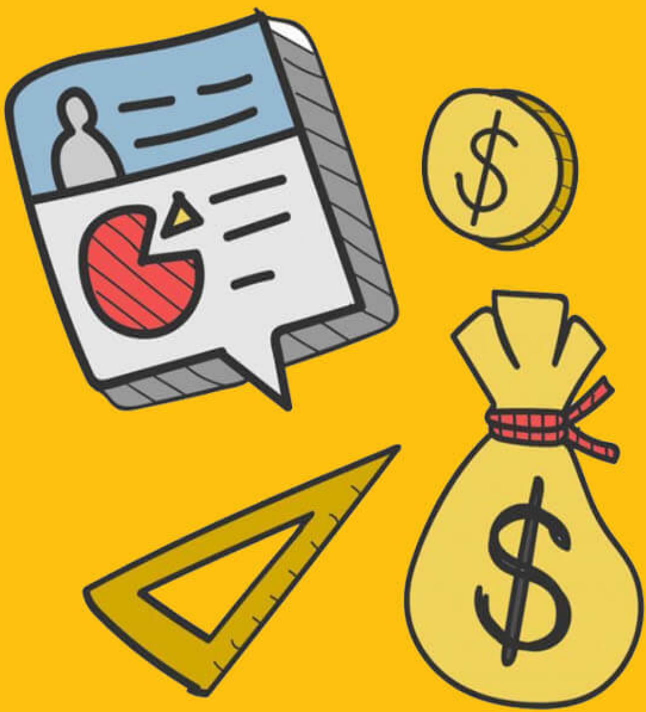
Economic Growth and Development



AQA A Level Economics Revision Notes

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The difference between growth and development

Economic growth is the increase in a country's real national output. This is caused by increases in the quality or quantity of factors of production, which cause an outward shift in the PPF.

Economic development refers to living standards, freedom (from oppression) and life expectancy. Essentially, it covers a more moral side to economic growth and it is normative. Development is also concerned with how sustainable the economy is and whether the needs of future generations can be met.

Characteristics of LEDCs

Less economically developed countries (LEDCs) tend to be characterised by the following features:

- Low life expectancies
- High mortality rates
- High dependency ratio
- Low GDP
- Fast population growth
- Low levels of education
- Poor standard of living
- Poor nutrition, lack of access to clean, safe drinking water and a lack of sanitation
- Poor or absent health care provision

Indicators of development

The three dimensions of the Human Development Index (HDI)

The components of HDI are education, life expectancy and standard of living, measured by real GNI at purchasing power parity (PPP) per capita.

It measures economic and social welfare of countries over time.

The education component combines the statistics of the mean number of years of schooling and the expected years of schooling.

The lift expectancy component uses a life expectancy range of 25 to 85 years.

The standard of living component measures GNI adjusted to PPP per capita. GDP was used instead of GNI, but to account for remittances and foreign aid, GNI is now used, since it reflects average income per person.

The average world HDI rose from 0.48 in 1970 to 0.68 in 2010. This was mainly due to the growth of East Asia, the Pacific and South Asia.

A value close to 1 is indicative of a high level of economic development. A value close to 0 suggests a low level of development.

The advantages and limitations of using the HDI to compare levels of development between countries and over time

HDI does not consider how free people are politically, their human rights, gender equality or people's cultural identity.

HDI does not take the environment into account. It could be argued that this should be included to focus on human development more.

HDI does not consider the distribution of income. A country could have a high HDI but be very unequal. This can mean many people might still be in poverty.

HDI does allow for comparisons between countries to be made, based upon which countries are generally more developed than other countries.

It provides a much broader comparison between countries than GDP does.

Education and health are important development factors to consider, and it can provide information about the country's infrastructure and opportunities. It also shows how successful government policies have been.

Other indicators of development

Human Poverty Index (HPI): measures life expectancy, education and the ability of citizens to meet basic needs. There are two types: HPI-1 and HPI-2. The former measures poverty in developing countries and the latter measures poverty in developed countries.

In HPI-1, the longevity part of the index measures the probability of living to the age of 40. The education component considers the adult literacy rate. The ability of citizens to meet basic needs is measured by the percentage of underweight children and the percentage of people not using improved water sources.

For HPI-2, the probability of not surviving to at least the age of 60 is used. The percentage of adults which do not have literacy skills is calculated, and poverty is calculated by those living below the poverty line. This is below 50% of median income.

Gender-related Development Index (GDI): measures the relative inequality between men and women. It combines HDI with a consideration of gender. For example, it will consider differences in life expectancies, income and education between genders.

Factors that affect growth and development

Market-orientated strategies

These are measures which make the economy more free, with minimum government intervention.

- **Trade liberalisation**

  Free trade is the act of trading between nations without protectionist barriers, such as tariffs, quotas or regulations. World GDP can be increased using free trade, since output increases when countries specialise. Therefore, living standards might increase and there could be more economic growth.

- **Promotion of FDI**

  FDI is the flow of capital from one country to another, in order to gain a lasting interest in an enterprise in the foreign country.

  FDI can help create employment, encourage the innovation of technology and help promote long term sustainable growth. It provides LEDCs with funds to invest and develop.

- **Removal of government subsidies**

  Government subsidies could distort price signals by distorting the free market mechanism. A free market economist would argue that this could lead to government failure. There could be an inefficient allocation of resources because the market mechanism is not able to act freely.

For example, the government might end up subsidising an industry which is failing or has few prospects.

- **Floating exchange rate systems**

  The value of the exchange rate in a floating system is determined by the forces of supply and demand.

- **Microfinance schemes**

  Microfinance involves borrowing small amounts of money from lenders to finance enterprises. It increases the incomes of those who borrow, and can reduce their dependency on primary products. There could be a multiplier effect from the investment of the loan.

  They are small loans for usually unbankable people. It allows them to break away from aid and gives borrowers financial independence. In Bangladesh, 95% of microfinance cohorts are women.

  Microfinance loans detach the poor from high interest, exploitative loan sharks. They could help businesses to be set up, although the money could also be spent on immediate consumption, rather than investment. Since the money goes directly to SMEs, it can stimulate employment.

  However, the data collected on microfinance loans might not be reliable if there is dishonesty regarding where the money was spent.

  In Tamil Nadu, India, less than 2% of microenterprises were still operating after their establishment.

  Microfinance loans have high repayment rates.

- **Privatisation**

  This means that assets are transferred from the public sector to the private sector. In other words, the government sells a firm so that it is no longer in their control. The firm is left to the free market and private individuals.

  Free market economists will argue that the private sector gives firms incentives to operate efficiently, which increases economic welfare. This is because firms operating on the free market have a profit incentive, which firms which are nationalised do not.

Since they are operating on the free market, firms also have to produces the goods and services consumers want. This increases allocative efficiency and might mean goods and services are of a higher quality.

By selling the asset, revenue is raised for the government. However, this is only a one-off payment.

Interventionist strategies

The government intervenes in the market to try and influence growth and development using interventionist strategies.

- **Development of human capital**
  By developing human capital, the skills base in the economy would improve. This would improve productivity and allow more advanced technology to be used, since workers will have the necessary skills.

  Businesses struggle to expand where there are skills shortages. It also limits innovation.

  Primary school enrolment has increased from about 80% to around 90% of children. However, secondary and tertiary education enrolment is still low.

  By developing human capital, the country can move their production up the supply chain from primary products, to manufactured goods and to services, which can earn them more.

- **Protectionism**

  Protectionism can help reduce a trade deficit. This is because they will be importing less due to tariffs and quotas on imports.

  It can protect infant industries, which are relatively new and need support. Protectionism is usually short term until the industry develops, at which point the industry can trade freely.
  However, protectionism could distort the market and lead to a loss of allocative efficiency. It prevents industries from competing in a competitive market and there is a loss of consumer welfare. Consumers face higher prices and less variety. By not competing in a competitive market, firms have little or no incentive to lower their costs of production.

Moreover, tariffs are regressive and are most damaging to those on low and fixed incomes.

There is also the risk of retaliation from other countries, so countries might become hostile.

- **Managed exchange rates**

  Managed exchange rate systems combine the characteristics of fixed and floating exchange rate systems. The currency fluctuates, but it does not float on a fully free market. This is when the exchange rate floats on the market, but the central bank of the country buys and sells currencies to try and influence their exchange rate.

- **Infrastructure development**

  Examples of physical infrastructure include transport, energy, water and telecommunications.

  Higher supply costs delay businesses and it reduces the mobility of labour.

  For example, India's poor irrigation system makes it difficult to sustain food grain production if there is low rainfall. It hurts the poorest communities and it leads to rising food prices. There are also regular power cuts. The lack of a continuous supply of electricity affects transport, communication and healthcare. It is estimated that $400 billion needs to be invested in power to meet the development goals.

  The Asian Infrastructure Investment Bank (AIIB) is led by China and it funds Asian energy, transport and infrastructure. The UK is one of the founding members, along with Germany, Australia and South Korea. The UK's involvement should give British firms an opportunity to invest in fast growing economies.

  Infrastructure development is a top priority for the Chinese government. From the late 1990s to 2005, 100 million Chinese people benefited from improved power and telecommunications. Employment can be boosted with improved roads, railways and airport constructions. However, some remote areas still have non-mechanised means of transport.

  Some economists argue that the development gap between China and other emerging economies is due to its focus on infrastructure projects. China invested 9% of their GDP in infrastructure in the 1990s and 2000s, whilst most emerging economies only invested around 2%-5% of GDP.

China has the first and only high speed Maglev train system in the world between the city centre in Shanghai and its international airport. Some economists might argue that is it unnecessary to build more airports, since there are already almost 200 airports in China and about 80% of people live within 100km of an airport in China. There is an opportunity cost of not investing funds elsewhere.

More information on the AIIB can be found here:

http://www.bbc.co.uk/news/business-31867934
http://www.bbc.co.uk/news/business-31921011

- **Promoting joint ventures with global companies**

  This occurs when a partnership is formed between two firms based in multiple countries.

  They allow the firm to participate in international trade, without the responsibilities involved of it. They help technological knowledge to be transferred, which can help improve and develop small companies.

  Joint ventures open up new markets for small firms, so they can distribute their products to customers. This saves them time and funds. It also spreads their risk, which is important in industries where developing a product is expensive.

  A joint venture with a global company also helps firms penetrate a foreign market, which is usually difficult because of barriers to entry.

- **Buffer stock schemes**

  In the agriculture market, governments might intervene with a buffer stock system to reduce price volatility. Governments buy up harvests during surpluses and then sell the goods onto the market when supplies are low. However, historically, these have been unsuccessful.

  It helps incomes of farmers to remain stable, because fluctuations in the market are reduced and it increases consumer welfare by ensuring prices are not in excess.

  However, governments might not have the financial resources to buy up the stock. Moreover, storage is difficult and expensive, since agricultural goods do not last long, and there are administrative costs.

Other strategies

- **Industrialisation: the Lewis model**

  The Lewis model is an explanation of how a developing country which focuses on agriculture could move towards manufacturing.

  It is based on the assumption that in agriculture, there is a surplus of unproductive labour in developing economies. The model assumes that in the manufacturing sector, wages are fixed. Workers from agriculture are attracted to the higher wages in the manufacturing sector.

  In the manufacturing sector, entrepreneurs charge prices above the wage rate, which allows them to make profits. It is assumed these profits are invested into more fixed capital for the business.

  The demand for labour increases since the productive capacity of firms has increased. Since there is surplus labour in the agricultural sector, this labour is employed in the manufacturing sector.

  This grows the manufacturing sector to the extent that the economy moves from agriculture to manufacturing. This is from a traditional state to an industrialised state.

  However, in reality, profits might not be reinvested into the firm. Moreover, the capital investment might replace labour, so the demand for labour could fall instead. Also, it is not always easy for labour in the agricultural sector to move to the manufacturing sector.

- **Development of tourism**

  Tourism can create thousands of jobs and help shift a developing country away from dependency on primary products. Developing countries tend to have a marginal propensity to consume, which could create a multiplier effect.

  It helps to diversify the economy and it could make the country more attractive to FDI, as well as developing their infrastructure.

  Tourism accounts for 6% of world trade and 9% of global GDP. For LDCs, about 8% of exports are from tourism. It is one of the largest and fastest growing sectors in the world. Since it is an outward-looking policy, it is considered a more modern way to grow an economy, and the benefits are similar to those of free trade.

Tourism can also be a way of earning foreign currency for developing countries. The low technology and labour intensive work in tourism is suited to LDCs.

However, little revenue is retained in the country, since travel agents and hotel owners are likely to repatriate their profits. Moreover, there is the issue of overcrowding and the loss of habitats.

Income from tourism is likely to be unstable, since it relies heavily on the business cycle in developed countries.

Investing in tourism can be risky and expensive, however. States have to focus where tourism is attracted, such as transport, land availability and improving infrastructure.

Locals could feel stigmatised by tourism, especially if they cannot afford the luxuries that the tourists have. There could also be some environmental damage, such as pollution.

Sri Lanka is trying to develop its tourism industry by building more hotels. It is expected that $1 billion of revenue could be made. It requires very good infrastructure, such as roads and electricity.

- **Development of primary industries**

Some developing countries have an abundance of raw materials, so some governments might choose to exploit this advantage and develop the industry so the country can have a comparative advantage in its production.

Moreover, primary industries, especially those allied to farming, form the livelihoods of the bulk of the population. It is sometimes the only source of income for most families. Therefore, it is important that the industry is supported.

- **Fairtrade schemes**

Fairtrade schemes ensure that farmers can receive a fair price for their goods. Supermarkets buy a guaranteed quantity at a price above the market equilibrium. This helps farmers since they have a guaranteed income and certainty about their sales, so they can plan for the future.

Fairtrade can help support community development and social projects, as well as ensuring working conditions meet a minimum standard.

It encourages sustainable production, promotes environmental protection, and stops the use of child labour.

Critics say the impact of Fairtrade schemes is insignificant. They argue that Fairtrade is simply a psychological influence on consumers in developed countries, who believe they are helping by buying Fairtrade goods. Fairtrade could distract from other policies and development, and it could make producers not part of Fairtrade worse off. This is since it divides the market into Fairtrade and non-Fairtrade markets. It could be argued that by distorting price signals, Fairtrade is less efficient.

Fairtrade increases the price of goods such as Cocoa and bananas. This encourages farmers to produce more, which increases their supply. The Fairtrade farmers still get their minimum price, but those not on Fairtrade have to deal with a lower market equilibrium price, due to the increase in supply.

Fairtrade could make farmers reliant on the sale of their produce, but it promotes self-sufficiency and encourages them to be independent. It has its limitations, but it provides a sense of community, working with farmers, rather than for them.

- **Aid**

Africa has been a top recipient of Chinese aid. By the end of 2009, it received 45.7% of China's cumulative foreign aid. It is important as a policy instrument for China with engagement with Africa.

Consumers in LEDCs have a higher propensity to consume than save, due to their limited incomes. Capital inflows, including those in the form of aid, can help fill this savings gap.

Aid provides temporary assistance to a country, such as humanitarian aid offered to countries after conflicts or natural disasters. Aid could also be a grant for a project that a country might not have the funds for.

Aid could be used to reduce human capital inadequacies or to pay off debt. It can improve infrastructure, which can help make the country more productive.

However, the benefits of aid are limited by corrupt leaders, the size of the aid payment and the potential for the recipient country to become dependent on aid.

Dambisa Moyo and Jeffrey Sachs are two prominent economists who have looked at the effects of foreign aid. Dambisa Moyo is generally against aid, whilst Jeffrey Sachs is generally pro-aid. It is worthwhile to have a look at some of their research and ideas. To briefly summarise, two of Moyo's arguments are that corruption means aid does not go where it is intended and that dumping goods, such as mosquito nets, into a country means private firms cannot compete and are forced out of business. Sachs suggests that it is possible for rich countries to meet the UN MDG of investing 0.7% of GDP into developing countries, which can help them improve infrastructure, yet this target is not being met.

- **Debt relief**

  Debt relief is the partial or total forgiveness of debt.

  In developing countries, debt is considered to be a principal cause of poverty, since it causes human suffering and misery, and it hampers development.

  With high levels of debt, financial resources are diverted from infrastructure, education and healthcare. The country's ability to pay the debt, not the size, is most important. If a country defaults on its debt, it can make it hard to borrow more money in the future.

  Debt forgiveness can allow a country to import more and increase the population's standard of living. It improves government finances, so public services could be funded instead.

  However, if debt is forgiven, it could encourage more borrowing in the future. Moreover, there could be corruption.

Barriers to growth and development

Primary product dependency

Primary products are raw materials in industries such as agriculture, mining and forestry. Mining accounts for just over 60% of South Africa's exports. Their ability to pay foreign debts and for imports relies on this.

Several developing countries rely on these primary products as a significant part of their economy. One issue with this is the v**olatility of commodity prices** that can make it hard for workers to plan for the future, and it means incomes of farmers are fickle and hard to predict.

A fall in the price leads to a fall in export incomes, which can make it hard to fund their infrastructure and education. Moreover, relying on primary products is not necessarily sustainable, since they could be over extracted and run out.

Savings gap: Harrod-Domar model

In many developing countries, there is only limited wealth, which means money cannot be put aside for the future, and they can only afford to spend in the short run. Consumers have to focus on their immediate needs, including food and safe water, to ensure they can survive. Without sufficient savings, there is inadequate capital accumulation.

Africa's saving rate is around 17%, whilst the average for middle income countries is around 31%. This makes it more expensive for the African public and private sectors to get funds since they have higher borrowing costs. This impedes capital investment.

The Harrod-Domar model states that investment, saving and technological change are required in an economy for economic growth. The rate of growth increases if the savings ratio increases. This leads to increased investment and technological progress, which leads to higher productivity.

The rate of growth is calculated by the savings ratio / capital output ratio in the Harrod-Domar model. Growth increases with more saving or a small capital output ratio.

The limitations of the model are that there is a low marginal propensity to save in some countries, or that there might be a poor financial system. Funds might not lead to borrowing and investment. There could also be inefficiency in the workforce.

Moreover, the paradox of thrift could be considered. An increase in savings could lead to an increase in investment. However, an increase in savings means there is a reduction in spending, which leads to a fall AD.

Foreign currency gap

A foreign currency gap exists when the country is not attracting sufficient capital flows to make up for a deficit in the capital account on the balance of payments. In other words, the value of the current account deficit is larger than the value of capital inflows.

Capital flight

This is when capital and money leave the economy through investment in foreign economies.

It is triggered by an economic threat, such as hyperinflation or rising tax rates. It can worsen an economic crisis and cause a currency to depreciate.

Demographic factors

The population can impact the growth and development of a country. There is a link between keeping birth rates down and fighting hunger, poverty and environmental damage. Rapid population growth has complicated efforts to reduce poverty and eliminate hunger in Africa. The current population of 1.1 billion is expected to double by 2050, which is not sustainable.

Debt

The debt crisis emerging in the developing world threatens the fight against poverty and inequality.

Access to credit and banking

Without a safe, secure and stable banking system, there is unlikely to be a lot of saving in a country.

Infrastructure

Poor infrastructure discourages MNCs from setting up premises in the country. This is since production costs increase where basic infrastructure, such as a continuous supply of electricity, is not available.

Education/skills

This is important for developing human capital. Adequate human capital ensures the economy can be productive and produce goods and services of a high quality. It helps generate employment and raise standards of living.

Absence of property rights

Weak or absent property rights mean entrepreneurs cannot protect their ideas, so do not have an incentive to innovate.

Corruption

In sub-Saharan Africa, the money lost from corruption could pay for the education of 10 million children per year in developing countries.

Poor governance/civil war

This could hold back infrastructure development and is a constraint on future economic development. It could destroy current infrastructure and force people into poverty.

Vulnerability to external shocks

For example, an earthquake prone country is likely to find it hard to develop their infrastructure, and people might be pushed into poverty. Nepal was already one of the poorest countries in the world, but the Nepal earthquake in 2015 pushed more people into poverty.