

# **ECONOMICS OF LESS DEVELOPED COUNTRIES**

EC3040b  
Spring 2017

Lecture 2

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# Course Outline

1. Contemporary Theories of Economic Development
- 2. Policymaking: What Role for the State in Development?**
3. The Role of Institutions in Development
4. Aid: Does it Work?
5. Trade: Engine of Growth or Obstacle to Development?
6. Domestic and International Finance: Opportunities and Instability
7. Economic Growth and Environmental Sustainability



# Policy: What Role for the State in development?

1. Government Economic Planning
2. Reemphasising the Market
3. Evaluation of the Washington Consensus in Latin America
4. Towards a new consensus?



# Readings

## Required

1. Michael Todaro and Stephen C. Smith, *Economic Development* (2009) Chapter 11
2. Lindauer and Pritchett, *What's the Big Idea?: The Third Generation of Policies for Economic Growth*, *Economía*, Volume 3, Number 1, Fall 2002.

## Supplementary

1. Birdsall, de la Torre and Caicedo (2010) *The Washington Consensus: Assessing a Damaged Brand*, World Bank Policy Research Working Paper 5316.
2. Rodrik, Dani (2006) *Goodbye Washington Consensus, Hello Washington Confusion? Journal of Economic Literature Vol. XLIV (December 2006), pp. 973–987*



# Balancing Government and the Market

- Important to recognise both the strengths and weaknesses of both the private market and the public sector.
- How can public and private economic activity be made mutually supporting?



# 1962: What we knew?

- Great Depression in 30s
  - Capitalist economy was unstable.
  - Interventionism of the government was effective.
- War economy to mobilize production
  - US economy was boosted by war industry.
  - The Soviet Union based its growth on a superb military industry.
- Dramatic recovery of the industrialized world from an economically devastating war.
  - Foreign aid (Marshall Plan).
- Eclipse of the UK economy
  - A country that was the bastion of free trade and liberal economic policies was falling behind. So, they did not guarantee rapid growth.
  - No globalization: but its reversal. World was closed in 60's.



# Development Policy after 1962

- Government is the driving force of economic growth: planning and guidance
- Accumulation: large investments to industrialise a country, and consequently, to grow rapidly
- Integration to the world is neither necessary nor sufficient for rapid growth. Global trade is not important; only imports of capital goods and necessary inputs
- Government borrowing is acceptable, preferably from foreign sources (WB)



# Government Economic Planning

- In the past, few doubted the importance and usefulness of national economic plans.
- Recently disillusionment has set in since start of the 1980' s.
- But a comprehensive development policy framework can play an important role in accelerating growth and reducing poverty
- What form should this take? We will explore.





# The Nature of Development Planning

- Economic planning = a deliberate governmental attempt to coordinate economic decision making over the long run (to influence, direct and even control income, social targets, consumption, employment, investment, saving, exports and imports).
- Comprehensive and partial planning
- Rationale:
  - Market failures (lack of public goods, absence of important externalities, lack of competition, coordination failures)
  - Low equilibria (leading to low investment and employment)
  - Unstable markets
  - Attitudinal impact
  - Foreign Aid



# Components of Development Planning

- Use of domestic saving and foreign finance for high return public investment projects
- Policies to stimulate private economic activity (e.g. taxation, industrial licensing, tariffs, manipulation of prices, wages)



# The Planning Process: Some Basic Models

- Aggregate growth models
  - Focus on limited set of macroeconomic variables most critical for determination of growth and employment
  - Based on some variant of the Harrod-Domar Model
- Multisector input-output, social accounting, and CGE models
- 3 levels of planning
  - Aggregate
  - Sectoral
  - Project



# Aggregate Growth Model: Harrod-Domar

$$k(g + \delta) = (s_{\pi} - s_W) \left( \frac{\pi}{Y} \right) + s_W$$

- $g$  is the targeted rate of output growth
- $k$  is the average and marginal capital-output ratio
- $\delta$  is the depreciation rate
- Where  $s_W$  and  $s_{\pi}$  are the marginal propensities to save from wage income and profit
- $\pi$  is profit incomes
- $Y$  is income



# Example: Harrod-Domar

$$k(g + \delta) = (s_{\pi} - s_W) \left( \frac{\pi}{Y} \right) + s_W$$

- Assume 4% is the desired rate of growth
  - Depreciation rate  $\delta = 3\%$
  - Capital-output ratio  $k = 3$
  - The proportion of profit incomes in national income  $\pi/Y = 0.5$
  - Savings out of capital income  $s_{\pi}$  is 25%
- Workers must save what?



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- **Workers must save 17% of income to achieve target growth rate**



# Aggregate Growth Models: Weaknesses

- Aggregate growth models only provide a rough approximation of the general direction an economy might take.
- Doesn't constitute a operational development plan.
- Their simplicity and low cost of data collection can overshadow their serious limitations.



# Multisector Models and Sectoral Projections

- Inter-industry or input-output models
  - Set of simultaneous equations expressing the production processes of 10 – 50 industries
  - Can determine intermediate material, import labour and capital requirements for each industry
- Can be extended in 2 ways
  - Social Accounting Matrix (SAM) models where data from national accounts, BOP, and flow-of-funds databases is supplemented with household survey data.
  - Computable General Equilibrium (CGE) models where utility and production function are estimated and impacts of policies are simulated.





# Project Appraisal and Social Cost-Benefit Analysis

- Vast majority of projects are appraised by a microeconomic social cost benefit analysis
  - Profitability not a sufficient yardstick
- Basic concepts and methodology
  - Specify objective function (net social benefit)
  - Compute social measures of units (shadow prices measuring the real cost of a change)
  - Establish decision criterion
- Setting objectives
  - National cohesion, political stability, income distribution, impact on future consumption, quality of life etc.



# The Social Rate of Discount

Net present value, or NPV is given by

$$NPV = \sum_t \frac{B_t - C_t}{(1 + r)^t}$$

where

$B_t$  is the expected benefit at time  $t$

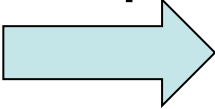
$C_t$  is the expected cost at time  $t$

$r$  is the government's social rate of discount

- A discount rate is the percentage by which the value of a cash flow in a discounted cash flow valuation is reduced for each time period by which it is removed from the present.
- Low discount rate – value highly future benefits.



# Problems of Plan Implementation and Plan Failure

- Results of development planning have been disappointing  move towards free market systems
- Theory versus practice
- Reasons for plan failure
  - Deficiencies in the plan
  - Government failure
  - Insufficient unreliable data
  - Unanticipated economic disturbances
  - Institutional weaknesses
  - Lack of political will



# 1982: What we knew?

- Failures of central planning: USSR, China, Cuba, India.
- Persistent rapid growth of East Asia: Japan, four Mini Dragons.
- Failure to recovery from commodity shocks of 1970s: only exporters recovered (Indonesia, Malaysia).
- Bad performance of import substituting industrialization (LA).
- Debt crisis because of the failure of the strategy of import-substitution industrialization



# Reemphasising the Market Development Policy after 1982

- Based on these facts, the following were the policies recommended to grow the economy of a country:
  - The Government is more the problem than the solution
  - Accumulation should not come from government investment, but from private investment
  - Exports are the engine of the growth, and imports are important to competition. And foreign borrowing is dangerous.
  - Washington Consensus



# Requirements for the Market Economy

- A well functioning market system requires special social, institutional, legal and cultural preconditions often absent in developing nations. Including:
  1. Trust in financial institutions
  2. Law and order (enforcement of contracts)
  3. Security property rights
  4. Balance between competition and cooperation
  5. Division of responsibility and diffusion of power
  6. Honesty in government
  7. Free flows of information without restrictions or favouritism
  8. Stable currency
  9. Public supervision of natural monopolies
  10. Stable monetary and fiscal policy instruments



# Latin America in the 1980s: The Lost Decade

- As the debt crisis deepened, the dark side of inward-looking industrialization and associated macro imbalances was manifested in a well-known catalogue of maladies.
  - internationally uncompetitive industries
  - severely distorted relative prices leading to inefficient allocation of resources
  - rent-seeking and corruption in the administered allocation or rationing of credit, fiscal, and foreign exchange resources
  - bottlenecks and economic overheating
  - large public deficits
  - excessive foreign borrowing by Latin sovereigns
  - rising and unstable inflation (and actual hyperinflation in several countries).
- The economic and social pain involved in the adjustment process of the 1980s was immense, so much so that the period became known as the Lost Decade.



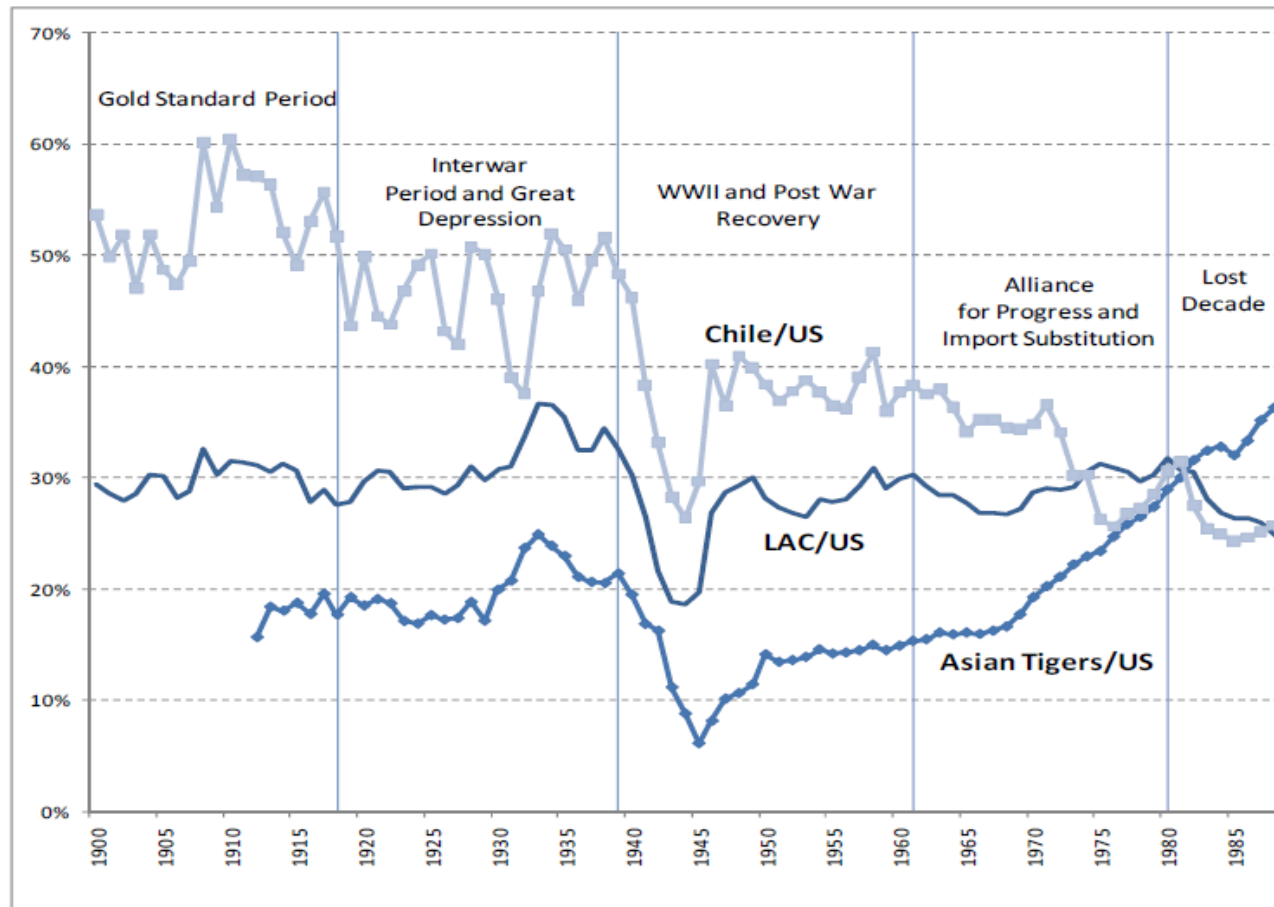
# LA Adjustment in the 1980s

- To put the fiscal accounts in order, countries embarked on deep and highly disruptive expenditure cuts, which hit disproportionately social and infrastructure investment programs.
  - Living standards collapsed—the regional average per capita income in 1985 barely exceeded that of 1975 and for some countries it fell to levels prevailing in the mid-1960s (Balassa et al., 1986).
  - Unemployment rose to more than 15 percent in many countries while underemployment swelled.
  - Inflation averaged 150 percent in the region, exploding into hyperinflation in Bolivia, Argentina and Brazil.
  - Concerted debt rescheduling and roll-overs coupled with “new money” were engineered during the 1980s but they proved woefully insufficient as the problem was one of debt overhang.
  - It was solved belatedly, as the internationally community reluctantly accepted the need for debt reduction and restructuring,





**Figure 1. Latin America and East Asia: Relative GDP per capita (1900-2008)**  
 (Ratio to US GDP per capita, in constant 1990 USD)



*Note: GDP PPP figures, LAC is the weighted average of Argentina, Brazil, Chile, Colombia, Mexico, Peru, Uruguay and Venezuela. Last two years using WDI growth rates.*

*Source: Historical Statistics of the World Economy, Maddison (2006) and World Development Indicators (2010).*



# Washington Consensus

- A worldwide consensus by the 1990, captured in John Williamson's 1989 conference paper
  - Conviction that economic prosperity could only be obtained by harnessing the power of markets.
  - Government interventionism was a fountainhead of distortions that represses creativity and causes resources to be misallocated.
  - WC focused on growth not directly on reducing poverty or inequality
- Williamson's original formulation fell short of the market fundamentalism it was portrayed as:
  - Does not mention the liberalization of the (non-FDI) capital account
  - Called for gradually allowing interest rates to be market determined
  - Steers away from the polar choices in exchange rate policy; a hard peg or a fully free floating rate



**Table 1. The Decalogue of Washington Consensus Policies (1989)**

1. Fiscal Discipline	Budget deficits—properly measured to include local governments, state enterprises, and the central bank—should be small enough to be financed without recourse to the inflation tax.
2. Public Expenditure Re-Prioritization	Public spending should move away from politically popular but economically unwarranted projects (bloated bureaucracies, indiscriminate subsidies, white elephants) and towards neglected fields with high economic returns and the potential to improve income distribution (primary health and education, infrastructure).
3. Tax Reform	To improve incentives and horizontal equity, the tax base should be broad and marginal tax rates moderate. Taxing interest on assets held abroad (“flight capital”) should become a priority in the medium term.
4. Positive Real Interest Rates	Ultimately, interest rates should be market determined. As this could be destabilizing in an environment of weak confidence, policy should have more modest objectives for the transition, mainly to abolish preferential interest rates for privileged borrowers and achieve a moderately positive real interest rate.
5. Competitive Exchange Rates	Countries need a unified (at least for trade transactions) exchange rate set at a level sufficiently competitive to induce a rapid growth in non-traditional exports, and managed so as to assure exporters that this competitiveness will be maintained in the future.
6. Trade Liberalization	Quantitative trade restrictions should be replaced by tariffs, and these should be progressively reduced until a uniform low tariff in the range of 10 percent is achieved.
7. Foreign Direct Investment	Barriers impeding foreign direct investment and the entry of foreign firms should be abolished; foreign and domestic firms should be allowed to compete on equal terms.
8. Privatization	State enterprises should be privatized.
9. Deregulation	Governments should abolish regulations that impede the entry of new firms or restrict competition, and ensure that all regulations are justified by such criteria as safety, environmental protection, or prudential supervision of financial institutions.
10. Property Rights	The legal system should provide secure property rights without excessive costs, and make these available to the informal sector.

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Sources: Williamson (1990) and Williamson (1993).



# The Washington Consensus: Did East Asia follow the template?

Elements of the Washington Consensus	South Korea	Taiwan
1. Fiscal discipline	Yes, generally	Yes
2. Redirection of public expenditure priorities toward health, education, and infrastructure	Yes	Yes
3. Tax reform, including the broadening of the tax base and cutting marginal tax rates	Yes, generally	Yes
4. Unified and competitive exchange rates	Yes (except for limited time periods)	Yes
5. Secure property rights	President Park starts his rule in 1961 by imprisoning leading businessmen and threatening confiscation of their assets	Yes
6. Deregulation	Limited	Limited
7. Trade liberalization	Limited until the 1980s	Limited until the 1980s
8. Privatization	No. Government established many public enterprises during 1950s and 1960s.	No. Government established many public enterprises during 1950s and 1960s.
9. Elimination of barriers to direct foreign investment (DFI)	DFI heavily restricted	DFI subject to government control
10. Financial liberalization	Limited until the 1980s	Limited until the 1980s

Source: Dani Rodrik, "Understanding economic policy reform," *Journal of Economic Literature* 34 (1996): 9–41. Reprinted with the permission of the American Economic Association.

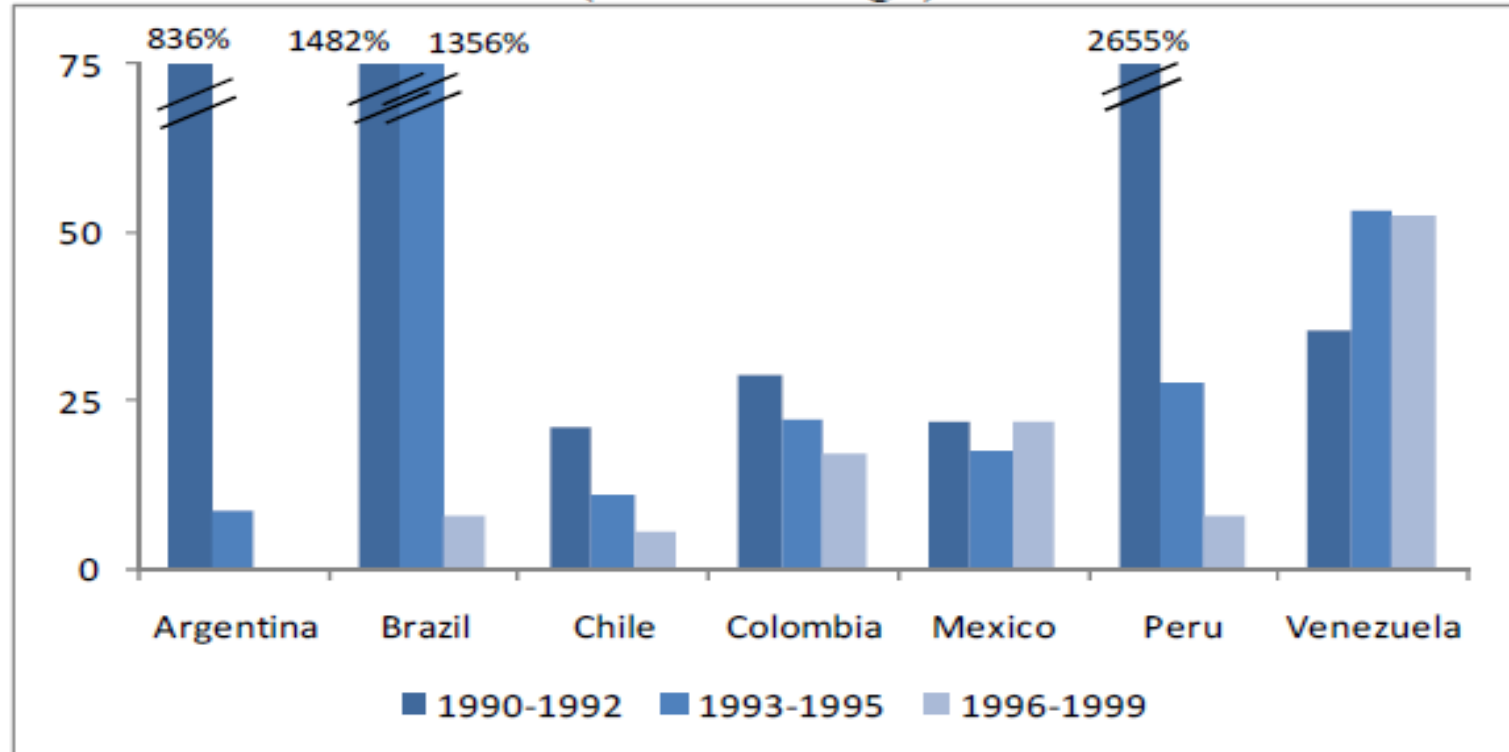


# Washington Consensus in LA (1990 - )

- Most Latin American countries enthusiastically embraced Consensus style reforms
- Actual policy implementation was much more aggressive with respect to financial liberalization and exchange rate policy
- Success: Latin America finally conquered inflation, in particular eliminated the monetary financing of fiscal deficits



**Figure 3b. LAC Inflation, Selected Countries (1990-2000)**  
(In Percentage)



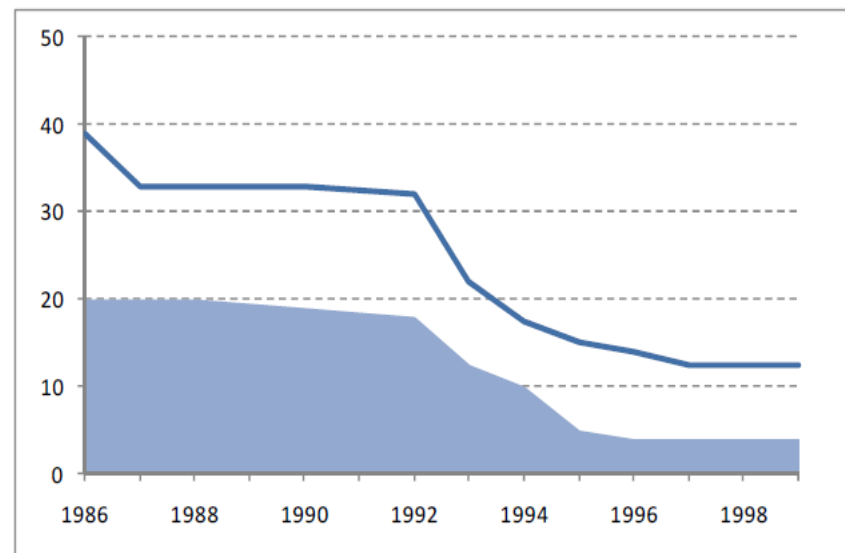
*Source: World Economic Outlook and International Financial Statistics, IMF (2010).*



# Washington Consensus in LA: Trade Reform

- Continuation of a liberalization trend that had started in the mid-1980s
  - removal of import quotas
  - reduction of average import tariffs
- The average tariff rate for the region fell from around 33% in 1990 to around 10% by 1999.

Figure 5. Latin American Import Tariff Liberalization (1985-1999)  
(Average and Deviations in Percentages)



*Note: The solid line represents the simple average tariff rate for Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, Guatemala, Mexico, Peru, Uruguay and Venezuela. The area represents the average deviation of the tariff rate across countries. Costa Rica and Guatemala are excluded from the deviation calculations.*

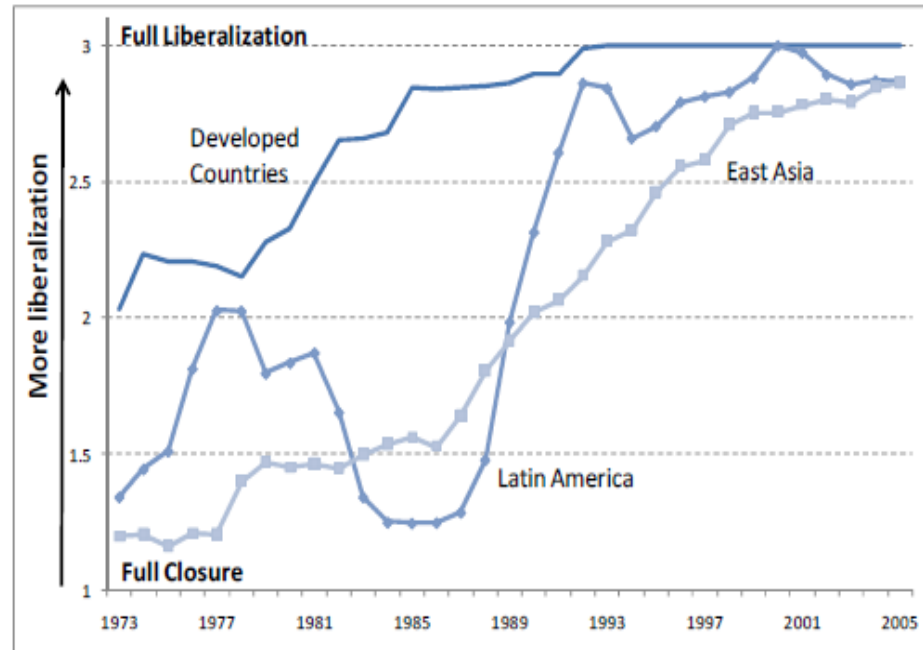
*Source: Lora (2001).*



# Washington Consensus in LA: Financial Liberalisation

Figure 6. International Financial Liberalization Index (1973-2002)

1. Direct credit controls were abandoned
2. interest rates deregulated.
3. Restrictions on foreign investment were lifted
4. Other controls on foreign exchange and capital account transactions were dismantled.
5. Foreign banks were allowed and encouraged to establish local presences.



*Note: The liberalization index is calculated as the simple average of three indices (liberalization of the capital account, domestic financial sector and stock market) that range between 1 and 3, where 1 means no liberalization and 3 means full liberalization. The regional averages are simple country averages.*

*Source: De la Torre and Schmukler (2007).*





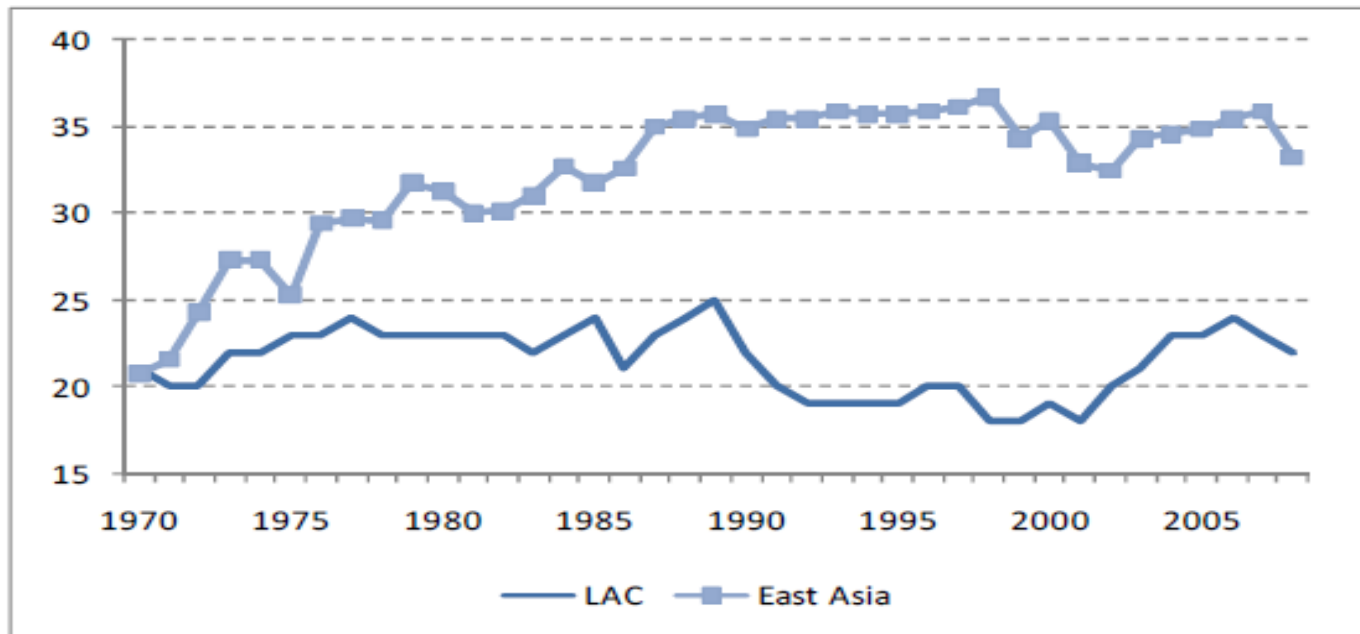
# Washington Consensus in LA: Other Reforms

- Privatisation
  - More than 800 public enterprises were privatised between 1988 and 1997.
- Tax Reform
  - Very modest
- Labour Markets
  - Non existent



# Savings Rates in LA

**Figure 7. Latin America and East Asia: Gross Domestic Savings (1970-2008)**  
(Percent of GDP)



*Note: East Asia is the un-weighted average of Hong Kong, Singapore, South Korea, Taiwan, Indonesia, Thailand and Malaysia, while LAC covers the whole Latin American and Caribbean region.*

*Source: World Development Indicators (2010).*

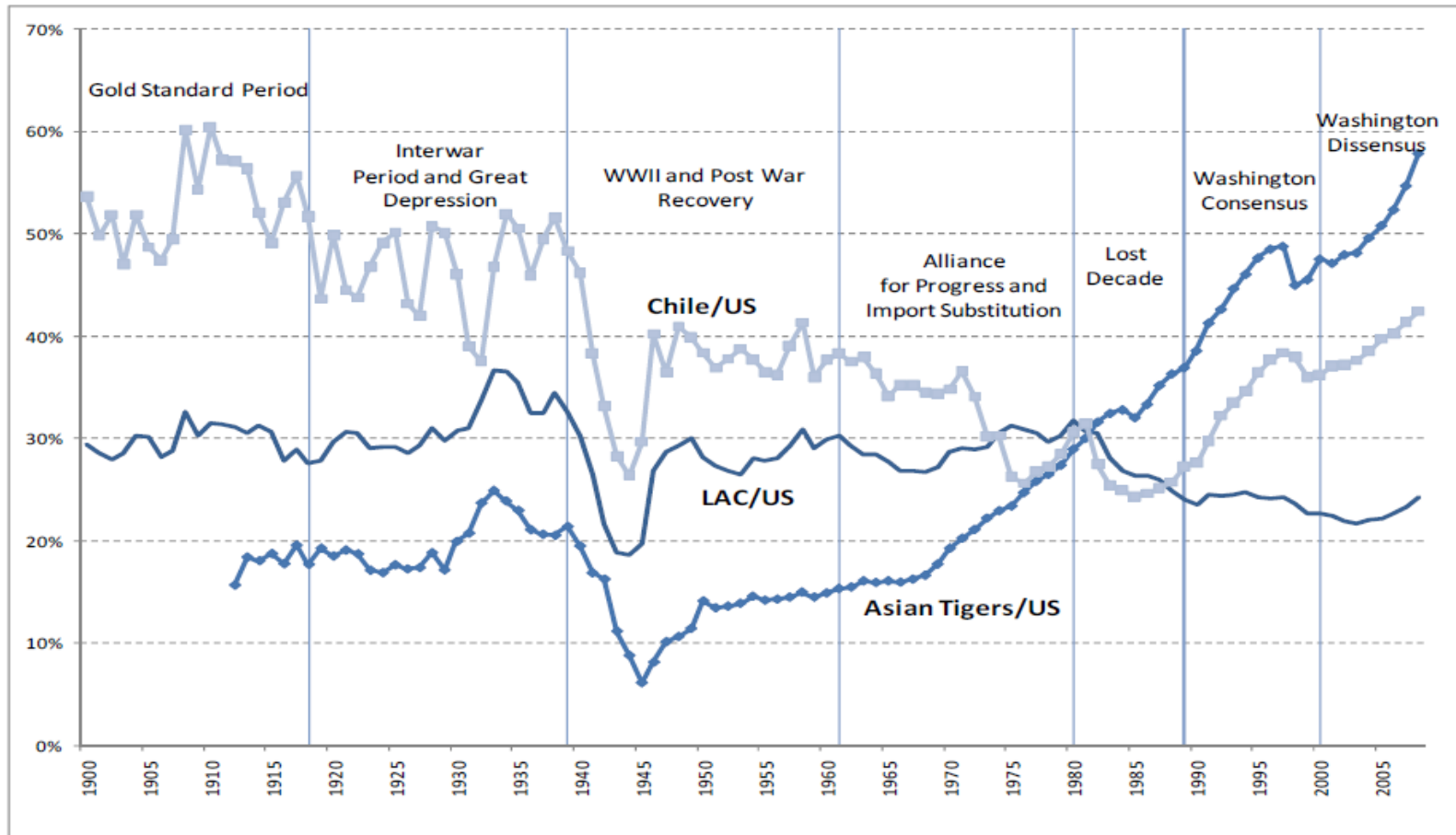


# Outcomes of WC Reform in LA

- Major surge in net private capital inflows to the region, rising from US\$14 billion in 1990 to \$86 billion
- But Washington Consensus yielded little progress during 1990s for per capita income, poverty and equality:
  - Regional growth did recover modestly—from 1.1 percent per year in 1980-1990 to 3.6 percent in 1990-1997
  - But ratio of per capita income in Latin America relative to the US, which had fallen during the “lost decade” of the 1980s, continued to decline, albeit marginally, throughout the 1990s.
  - Poverty rate (measured at 4 dollars a day in PPP terms) did not decrease.
  - The non-weighted average Gini coefficient for income distribution in the region increased somewhat, from 50.5 in the early 1990s to 51.4 in 2000



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*Source: Historical Statistics of the World Economy, Maddison (2006) and World Development Indicators (2010).*



# But maybe things would have been worse without the WC reforms?

- What would have happened in the absence of Consensus-style policies?
  - Likely that per capita income and output in the 1990s would have been lower and poverty deeper.



# Three Perspectives on the Washington Consensus (1)

- Assuming you remain of the view that the private sector is the key driver of development, three perspectives exist:
  1. Nothing wrong with the Consensus. Problem was the faulty implementation and impatience for results:
    - Recent study by the IMF (2005) blames the poor post-reform outcomes on uneven and incomplete reform implementation.
    - Where reforms were implemented more deeply and consistently (i.e., Chile) they were associated with impressive growth and poverty reduction outcomes.
    - Expectation of a rapid payoff was justified for some first-generation reforms—especially macroeconomic stabilization but unrealistic for the more complex structural reforms.



# Three Perspectives on the Washington Consensus (2)

2. Consensus reform program fundamentally flawed. Two variants.
  - a) Consensus failed to consider sequencing issues.
    - Deregulation of the domestic financial system and opening of the external capital account ahead of adequate regulatory strengthening.
    - Weak banking systems ill-prepared to operate prudently in freer financial markets and properly intermediate surges in capital inflows – prone to instability.
    - Recommendation: Reforms should be ordered to ensure certain preconditions are put in place first to enhance the likelihood of success of reforms.
  
  - a) Consensus was wrong.
    - Assumption that a one-to-one mapping exists always and everywhere between reforms and economic outcomes.
    - As noted by Hausmann, Rodrik and Velasco (2008), reforms that “work wonders in some places may have weak, unintended, or negative effects in others.”
    - Rudy Dornbusch, good reformers like good “country doctors”: Can develop good diagnoses and suitable cures for individual patients whom they know well.
    - This interpretation has many supporters.



# Three Perspectives on the Washington Consensus (3)

3. Consensus reform program incomplete. Left out:
- a) volatility
  - b) institutions
  - c) technological innovation
  - d) equity.
- What these areas have in common is the presence of significant market failures (due to externalities, coordination problems and imperfect information) which markets themselves cannot repair and that thus require active policy.

On property rights specifically:

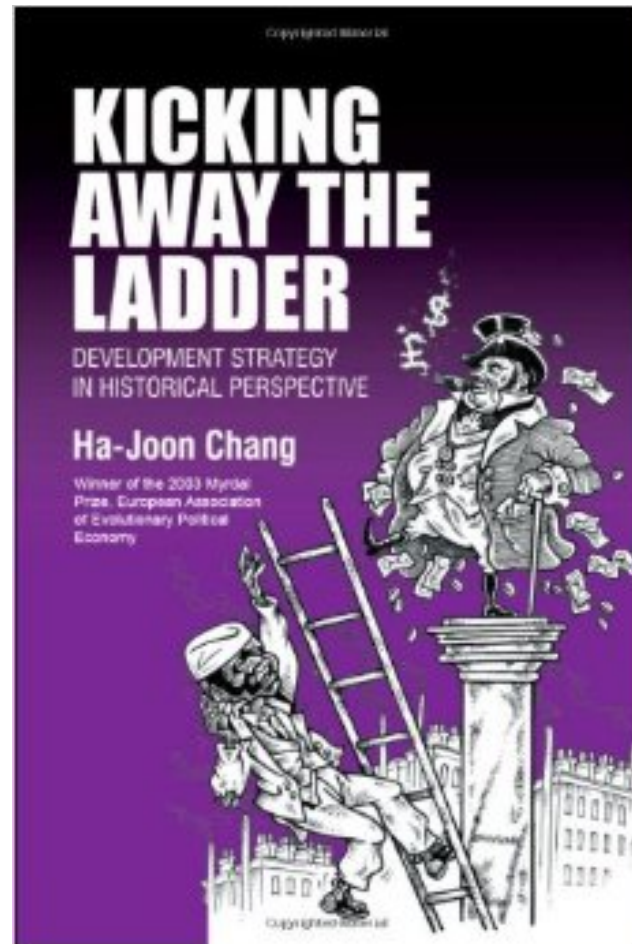
- Quoting Rodrik (2006), property rights “was the last item on the list and came almost as an afterthought.”
- Williamson himself shared the view that property rights were added “mostly to get to a total of 10 items.”





# Kicking Away the Ladder

- Published in 2002 by Ha-Joon Chang



- **Britain: From Mercantile Struggle to Kicking Away the Ladder**
- Britain was highly protectionist up until it established and cemented its global industrial predominance by the middle of the 19th century.

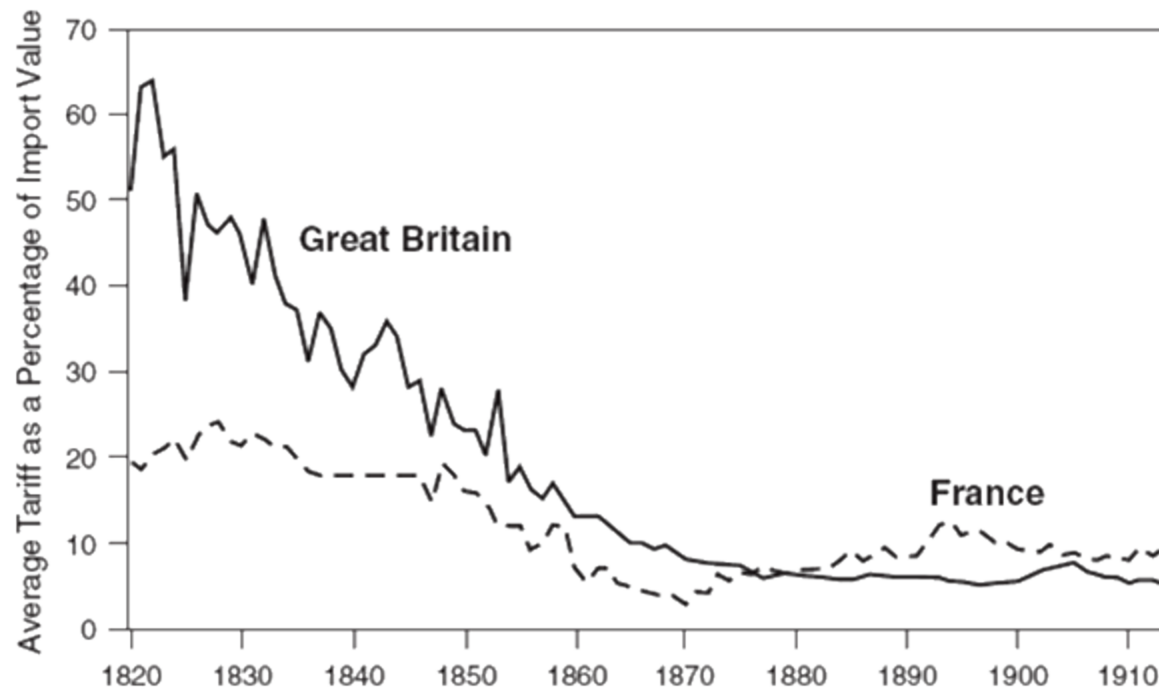
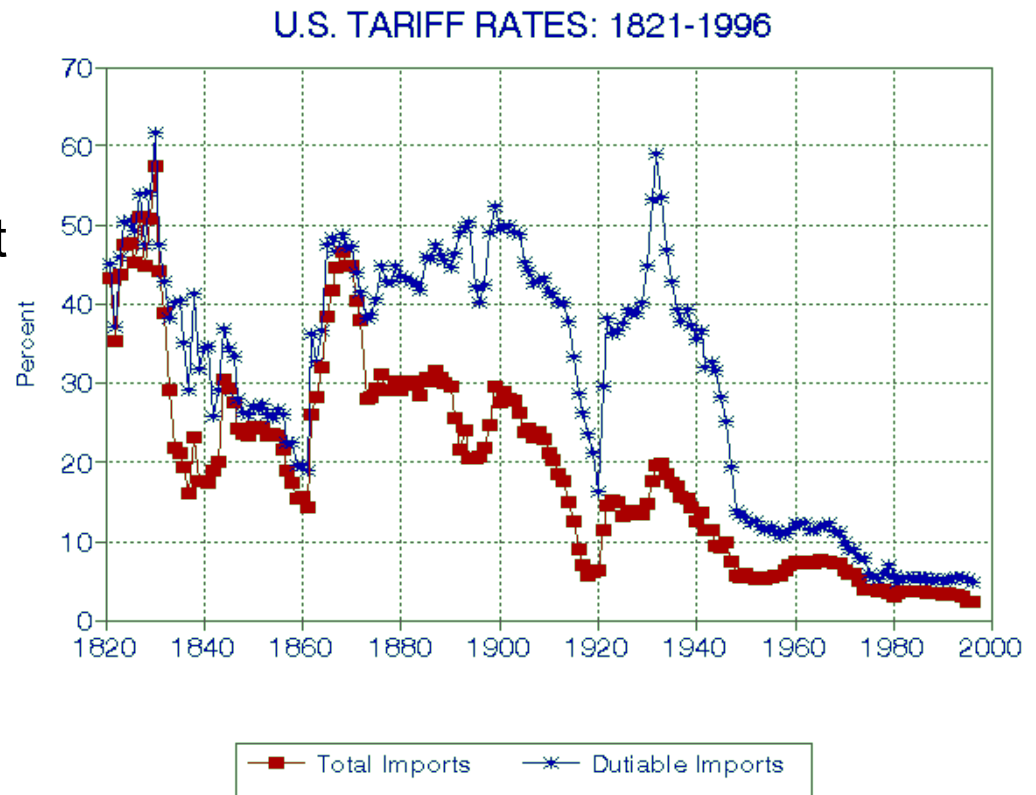


Figure 1.1. Average Tariff Rates: Tariff Revenue as a Fraction of All Imports (Imlah, 1958; Lévy-Leboyer and Bourguignon, 1985).



- What about the US, then, today's champion of free trade?
- This is an ironic position for it to take up, given that in the years after the Civil War and prior to the Second World War, America was the protectionist nation *par excellence*.



# 2002: What we knew?

- India and China grew rapidly, in spite they are slow "reformers" and remain among the more "closed" economies
- Transition from Marxist central planning to a capitalist economy was worse than expected
- Lost decade of LA and weak performance of WC policies
- Collapse of Sub-Saharan Africa: political chaos in many countries, and bad performance of politically stable countries. Furthermore: AIDS crisis
- Financial crises of the 90s in Mexico, Thailand, Korea, Indonesia, Russia, Brazil, Ecuador, Turkey, Argentina.



# Poverty Reduction Strategy Papers (2000 - )

- Describes the macroeconomic, structural, and social policies and programs that a country will pursue over several years to promote growth and reduce poverty, as well as external financing needs and the associated sources of financing.



# Principles of PRSPs

- **Country-driven:** National ownership of strategies through broad-based participation of civil society.
- **Result-oriented** and focused on outcomes that will benefit the poor.
- **Comprehensive:** Recognising the multidimensional nature of poverty.
- **Partnership-oriented:** Coordinated participation of development partners (government, domestic stakeholders, and external donors).
- **Long-term perspective** for poverty reduction.



# Toward a New Policy Consensus?

- Some argue that the Washington Consensus should be binned and we should start again.
- But many of the elements of the WC are not controversial.
- While there is no consensus anymore, that is not the same as turning against many of the elements of the Washington Consensus.



# Toward a New Policy Consensus?

- A New consensus would build on the non-controversial elements of the WC and include:
  - New emphasis on government's responsibility toward poverty alleviation, reducing inequality, health and education.
  - A recognition that markets can fail.
  - A focus on building basic institutions.
  - Recognition of the importance of civil society (NGOs etc).
  - Persistence with good policies.
  - A focus on the reduction of economic volatility.
  - A focus on technological advancement.
  - Understanding of the failure of basic institutions.
  - More active industrial policy.
  - Perhaps open to the strategic use of tariffs.
  - And perhaps most importantly that policies need to be adapted to the local setting (Growth diagnostics).

