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Economic Growth in Developing and Transitional Economies

21

CHAPTER OUTLINE

Life in the Developing Nations: Population and Poverty

Economic Development: Sources and Strategies

The Sources of Economic Development
 Strategies for Economic Development
 Two Examples of Development: China and India

Development Interventions

Random and Natural Experiments: Some New Techniques in Economic Development
 Education Ideas
 Health Improvements
 Population Issues

The Transition to a Market Economy

Six Basic Requirements for Successful Transition



All economic analysis deals with the problem of making choices under conditions of scarcity, and the problem of satisfying people's wants and needs is as real for Somalia and Haiti as it is for the United States, Germany, and Japan.

The universality of scarcity is what makes economic analysis relevant to all nations, regardless of their level of material well-being or ruling political ideology.

Even though economic problems and the policy instruments available to tackle them vary across nations, economic thinking about these problems can be transferred easily from one setting to another.

Life in the Developing Nations: Population and Poverty



Developing nations account for ___ of the world's population and consume ___ of the world's output:

- 1/4; 3/4.
- 3/4; 1/4.
- 4/5; 1/5.
- 1/2; 1/2.

TABLE 21.1 Indicators of Economic Development

Country Group	Population, 2011 (billions)	Gross National Income per Capita, 2011 (dollars)	Literacy Rate, 2010 (percent over 15 years of age)	Infant Mortality, 2011 (deaths before age 5 per 1,000 births)	Internet Users per 1,000 People, 2011
Low-income	0.8	569	62.9	62.8	59
Lower middle-income	2.5	1,764	71.0	46.0	160
Upper middle-income	2.5	6,563	93.6	15.9	383
High-income	1.1	39,861	98.3	5.0	767

While the developed nations account for only about one-quarter of the world's population, they are estimated to consume three-quarters of the world's output.

This leaves the developing countries with about three-fourths of the world's people but only one-fourth of the world's income.

Developing nations account for ____ of the world's population and consume ____ of the world's output :

- a. 1/4; 3/4.
- b. 3/4; 1/4.
- c. 4/5; 1/5.
- d. 1/2; 1/2.

Economic Development: Sources and Strategies

The Sources of Economic Development

Capital Formation

vicious-circle-of-poverty hypothesis Suggests that poverty is self-perpetuating because poor nations are unable to save and invest enough to accumulate the capital stock that would help them grow.

capital flight The tendency for both human capital and financial capital to leave developing countries in search of higher expected rates of return elsewhere with less risk.



The vicious cycle of poverty is an explanation of poverty that emphasizes:

- a. Income distribution and wealth accumulation.
- b. Hunger, illiteracy, and malnutrition.
- c. Consumption, saving, investment, and capital accumulation.
- d. Agriculture versus industry and imports versus exports.

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Human Resources and Entrepreneurial Ability

brain drain The tendency for talented people from developing countries to become educated in a developed country and remain there after graduation.

Social Overhead Capital

social overhead capital Basic infrastructure projects such as roads, power generation, and irrigation systems.



Which of the following statements is correct?

- a. The connection between growth and human capital is a two-way street.
- b. Development cannot proceed without human resources capable of initiating and managing economic activity.
- c. The governments of developing countries can do important and useful things to encourage development, especially in areas that the private sector would never touch.
- d. All of the above statements are correct.

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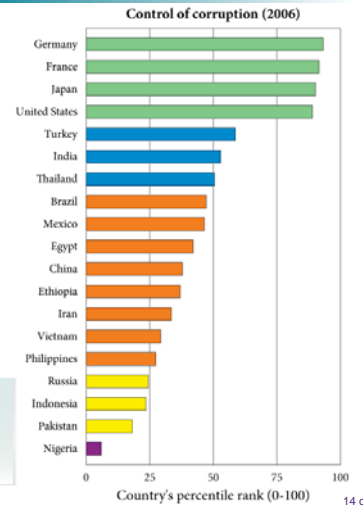
ECONOMICS IN PRACTICE

Corruption

One reason corruption is bad for an economy is that it often leads to the less efficient firms producing the goods and services in the society.

The chart shows the World Bank's rating of corruption levels in a number of countries around the world.

The countries are ranked from those with the strongest controls on corruption—Germany and France—to those with the lowest controls—Pakistan and Nigeria.



THINKING PRACTICALLY

- As corruption falls in a country, cost of production often falls. Why?

ECONOMICS IN PRACTICE

Who You Marry May Depend on the Rain

In a recent paper, several economists traced through some unusual consequences of creating embankments in Bangladesh, where marriages require dowries paid by the bride's family to the groom.

Because raising these dowries can be difficult for poor families, they often marry cousins; within an extended family, a promise to pay a dowry-by-installment later on is easier to enforce.

When the government built an embankment, farmers on one side could till the land over most of the year, while those on the other side had to face flooding for six months.

Farmers on the flooded side of the river continued to use marriage within the extended family as a strategy to essentially provide dowries on credit. For those farmers on the more stable side of the river, cousin marriages fell quite substantially.

THINKING PRACTICALLY

- What do you think happens to the overall marriage rate as a result of the embankment?

Agriculture or Industry?

TABLE 21.2 The Structure of Production in Selected Developed and Developing Economies, 2008

Country	Per-Capita Gross National Income (GNI)	Percentage of Gross Domestic Product		
		Agriculture	Industry	Services
Tanzania	\$ 460	30	23	47
Bangladesh	570	19	29	52
China	3,040	11	47	40
Thailand	3,640	12	44	44
Colombia	4,640	8	35	57
Brazil	7,490	6	28	66
Korea (Rep.)	21,430	3	36	61
Japan	37,840	1	27	71
United States	47,890	1	21	78

Experience over the last three decades suggests that some balance between industrialization and agricultural reform leads to the best outcome.

The Chinese have referred to this dual approach to development as "walking on two legs."

Strategies for Economic Development

Governments or Markets?

International Monetary Fund (IMF) An international agency whose primary goals are to stabilize international exchange rates and to lend money to countries that have problems financing their international transactions.

World Bank An international agency that lends money to individual countries for projects that promote economic development.

industrial policy A policy in which governments actively pick industries to support as a base for economic development.

Exports or Import Substitution?

import substitution An industrial trade strategy that favors developing local industries that can manufacture goods to replace imports.

export promotion A trade policy designed to encourage exports.



When imports of manufactured goods become relatively expensive in the domestic market while exports become relatively inexpensive in world markets, a country would naturally tend to choose:

- Import substitution over export promotion.
- Export promotion over import substitution.
- Both import substitution and export promotion.
- Neither import substitution nor export promotion.

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Microfinance

In the mid 1970s, a young economist, Muhammad Yunus, created the Grameen Bank in Bangladesh to introduce microfinance—a practice of lending very small amounts of money with no collateral and accepting very small savings deposits—to the developing world, even lending his own money to poor households with entrepreneurial ambitions.

Thirty countries and thirty U.S. states have microfinance lending copied from the Grameen model.

Relative to traditional bank loans, microfinance loans are much smaller, repayment begins very quickly, and the vast majority of the loans are made to women (who, in many cases, have been underserved by mainstream banks).

While it has changed considerably since Yunus's introduction, the field of microfinance has impacted many people's views about the possibilities of entrepreneurship for the poor of the world.

Two Examples of Development: China and India

China and India provide two interesting examples of rapidly developing economies.

While low per-capita incomes still mean that both countries are typically labeled developing as opposed to developed countries, many expect that to change in the near future.

In the 25-year period from 1978 to 2003, China grew on average 9 percent per year, a rate faster than any other country in the world.

While India's surge has been more recent, in the last 8 years, it too has seen annual growth rates in the 6 to 8 percent range.

Many commentators expect India and China to dominate the world economy in the twenty-first century. Both have embraced free market economics and remain densely populated. In terms of sector, most of China's growth has been fueled by manufacturing, while services have led growth in India, particularly in the software industry.

ECONOMICS IN PRACTICE

Cell Phones Increase Profits for Fishermen in India

Kerala is a poor state in a region of India, where the fishing industry is a major part of the local economy.

Beginning in 1997 and continuing for the next several years, mobile phone service was introduced to this region of India, virtually eliminating waste that had averaged 5 to 8 percent of the fishermen's total catch.

Fish prices across the various villages along the fishing market route were closer to each other than they were before. Fishermen's profits rose on average by 8 percent, while the average price of fish fell by 4 percent.

In fact, cell phones are improving the way markets in less-developed countries work by providing price and quantity information so that both producers and consumers can make better economic decisions.

THINKING PRACTICALLY

- Use a supply and demand graph to show the impact of cell phones in India on prices in the fishing market.

Development Interventions

Random and Natural Experiments: Some New Techniques in Economic Development

random experiment (Sometimes referred to as a randomized experiment.) A technique in which outcomes of specific interventions are determined by using the intervention in a randomly selected subset of a sample and then comparing outcomes from the exposed and control group.

natural experiment Selection of a control versus experimental group in testing the outcome of an intervention is made as a result of an exogenous event outside the experiment itself and unrelated to it.

Education Ideas

As we move from traditional agrarian economies to more diversified and complex economies, the advantages to an individual from education rises. If we want a nation's poor to benefit from growth, improving their educational outcomes is key. Unfortunately, absenteeism—both teacher and student—is a serious problem throughout the developing world.

While many reform ideas have proven helpful in improving educational outcomes in different developing countries, it has proven hard up to now to find simple answers that work across the globe. Nevertheless, new techniques appear to offer considerable promise as a way to tackle issues of improving education for the poor of the developing world.

Health Improvements

Poor health is a second major contributor to individual poverty. In the case of many interventions to improve health, human behavior plays an important role, and here is where development economics has focused.

As with the area of education, much remains for development economists to understand in the area of health and human behavior.

Population Issues

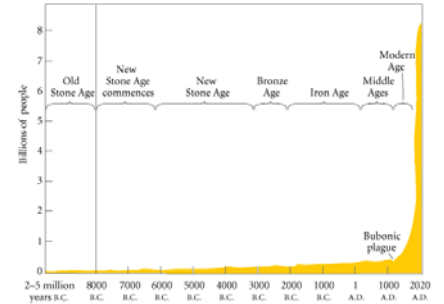
The population growth of many developing countries has been and remains very high. For poor nations, rapid population growth can strain infrastructure and may impede development. For this reason, population control has at times been part of the development strategy of a number of countries.

► **FIGURE 21.1 The Growth of World Population, Projected to A.D. 2020**

For thousands of years, population grew slowly.

From A.D. 1 until the mid 1600s, population grew at about .04 percent per year.

Since the Industrial Revolution, population growth has occurred at an unprecedented rate.



Prior to the Industrial Revolution, what was the growth rate of the world population?

- More than 3%.
- About 2.5%.
- Less than 1%.
- Equal to today's rate.

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The Transition to a Market Economy

Six Basic Requirements for Successful Transition

Economists generally agree on six basic requirements for a successful transition to a market-based system:

- Macroeconomic stabilization.
- Deregulation of prices and liberalization of trade.
- Privatization of state-owned enterprises and development of new private industry.
- Establishment of market-supporting institutions such as property and contract laws and accounting systems.
- A social safety net to deal with unemployment and poverty.
- External assistance.

Macroeconomic Stabilization

To achieve a properly functioning market system, prices must be stabilized.

To do so, the government must find a way to move toward a balanced budget and to bring the supply of money under control.

Deregulation of Prices and Liberalization of Trade

An unregulated price mechanism ensures an efficient allocation of resources across industries.

Ultimately, as the theory of comparative advantage suggests, liberalized trade will push each country to produce the products it produces best.

Privatization

Private ownership provides a strong incentive for efficient operation, innovation, and hard work that is lacking when ownership is centralized and profits are distributed to the people.

tragedy of commons The idea that collective ownership may not provide the proper private incentives for efficiency because individuals do not bear the full costs of their own decisions but do enjoy the full benefits.

In addition to increasing accountability, privatization means creating a climate in which new enterprises can flourish while many protected enterprises unable to compete at world prices will go out of business.



Which of the following are market supporting institutions?

- a. Investment banks.
- b. Insurance companies.
- c. Law firms.
- d. All of the above.

External Assistance

Very few believe that the transition to a market system can be achieved without outside support and some outside financing.

The basic skills of accounting, management, and enterprise development can be taught to developing nations, but there is little agreement about the extent of *financial* support that should be given.

Shock Therapy or Gradualism?

shock therapy The approach to transition from socialism to market capitalism that advocates rapid deregulation of prices, liberalization of trade, and privatization.

Advocates of a *gradualist* approach believe the best course is to build up market institutions first, gradually decontrol prices, and privatize only the most efficient government enterprises first.

In theory, stabilization and liberalization can be achieved instantaneously, but to enjoy the benefits, a good deal of privatization must have taken place—and that takes time.

Market-Supporting Institutions

The capital market, which channels private saving into productive capital investment in developed capitalist economies, is made up of hundreds of different institutions.

Many market-supporting institutions, such as those based on intellectual and private property rights, enforcement of contracts, generally accepted accounting principles (GAAP), and insurance, are so basic that Americans take them for granted.

Social Safety Net

Transition to a free labor market and liberalization of prices means that some workers will end up unemployed and that everyone will pay higher prices for necessities.

As more and more people experience unemployment, popular support for reform is likely to drop unless some sort of social safety net is erected to ease the transition.

This social safety net might include expensive programs such as unemployment insurance, aid for the poor, and food and housing assistance.

Which of the following are market supporting institutions?

- a. Investment banks.
- b. Insurance companies.
- c. Law firms.
- d. **All of the above.**

REVIEW TERMS AND CONCEPTS

brain drain	random experiment
capital flight	shock therapy
export promotion	social overhead capital
import substitution	tragedy of commons
industrial policy	vicious-circle-of-poverty hypothesis
International Monetary Fund (IMF)	World Bank
natural experiment	