

MECHANISMS FOR IMPROVING ECONOMIC AND INDUSTRIAL GROWTH IN DEVELOPING COUNTRIES

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Summary

In the search for sound and efficient economic development, many economists have built up a succession of models of economic growth, some of which have played a very important role in the policy decision process of developing countries.

This article tries to analyze the main economic development theories historically, in order to find an internal chain that links different economic mechanisms that economists have proposed for developing countries.

In a classical linear development model, the lack of capital and hard currency was considered the biggest obstacle that prevents developing countries taking off economically. Thus, based on this hypothesis, the developed world decided to give some public assistance to developing countries, to give them an initial momentum for their economic take-off.

The hypothesis about the link between savings rates, investment, and economic growth produced the Kuznets U-shaped curve hypothesis, which presumes that for promoting economic growth, government should allow rich people to become richer because they will contribute to national savings and thus to investment. Although incessantly criticized, this theory continues to influence current leaders in their policy decisions.

The development of some East Asian countries and the birth of new growth theories have changed the traditional view of mechanisms of economic growth. People have realized that the proper formation of human capital in developing countries and the exposure of their economies to the world market may help them speed up the pace of

their economic development. But whatever the foundation of different mechanisms for economic growth, traditional wisdom should not be neglected because it is crucial for conducting successful economic policies, such as sound budget policy, stable monetary policy, etc.

1. Introduction

For a long time, the problem of development has been considered equivalent to the problem of economic growth. So the biggest concern of most development economists has been how to promote the growth rate. Although classical economic growth models show that capital accumulation is the key factor to growth, and many economic studies focus on how to facilitate the accumulation of capital, more recent studies have demonstrated that without technological progress the return on investment is diminishing. So to maintain a sustained growth rate, an economy has to build up and develop its human capital by investing in education and professional training.

However, the demand for technical skills (human capital) in an economy is closely related to its openness to outside markets. The more an economy is exposed to international trade, the more it needs a skilled and high quality workforce to make its products competitive in international markets, and the more it can benefit from the technological advances of developed countries through the import of capital goods and other techniques. Hence, in the long process of catching up with developed countries, successful emerging economies participate actively in international trade and emphasize mass education. The public authorities in these countries attempt to implement sound budget and public spending policies, which contributes to the creation of a stable economic environment, giving confidence to local consumers and attracting significant flows of foreign investment. They thus set up a virtuous cycle of economic growth.

2. Linear Growth Model and Stages of Development

For a relatively long period, orthodox economists have considered economic growth as a linear process. In this respect, Walt Rostow's theory of economic take-off is a classic reference that has influenced many researchers into development.

Rostow elaborated a theory of economic take-off in the 1950s. In his *The Stages of Economic Growth, a Non-Communist Manifesto* he portrayed development as an essentially linear historical process composed of five consecutive stages.

According to Rostow's analysis, economic development occurs when a society is moving away from its traditional model of subsistence agriculture. In a traditional society, production is characterized by low level of technology and productivity. The first phase of economic development is a series of preconditions for take-off: an entrepreneurial elite emerges, there is a relationship to political units, the public authorities invest in transportation and other infrastructures, and people want to invest in production. Then the above-mentioned society enters a second phase, that of take-off. The second stage of development is characterized by sustained growth, an increasing rate of investment, the appearance of new industries, and people learning to use resources better. The third phase drives on to maturity, modern technologies are

widespread, products are diversified, and the economy is becoming more self-sufficient. The fourth phase is the age of mass consumption where consumer goods and services become so abundant that they rival heavy industry as the leading economic sectors. At this stage, consumption no longer rests on basic needs. The final phase depicted by Rostow concerns the post-industrial period, where services are replacing manufacturing industry as the principal sector of the economy, and information is taking the place of energy as a key productive resource.

Rostow emphasized the importance of capital accumulation, leading to investment. He argued that a decisive characteristic of his third stage, the key “take-off” period, is a rise in the rate of productive investment, which should go from 5% or less to over 10% of national income. In fact, Rostow took this idea from the Harrod-Domar model.

During the 1930s and 1940s, economists were looking to clarify the delicate balance between income, savings, investment, and output required to maintain stable growth and full employment. In April 1939 H.R. Harrod published *An Essay in Dynamic Theory*, and in April 1946 E.D. Domar published *Capital Expansion, Rate of Growth and Employment*. The Harrod-Domar model was quickly considered a classical explanation of the relationship between investment and growth. Although it originally applied to a developed economy, their model was used by many development economists who tried to identify the savings and investment rates needed to achieve self-sustained growth in a developing economy. The emphasis placed on capital accumulation by a major 1951 United Nations (U.N.) report on measures for the economic development of underdeveloped countries is very significant in this regard:

In most countries where rapid economic progress is occurring, net capital formation at home is at least 10 per cent of the national income, and in some it is substantially higher. By contrast, in most underdeveloped countries, net capital formation is not as high as 5 per cent of the national income, even when foreign investment is included . . . How to increase the rate of capital formation is therefore a question of great urgency.

In developed countries, Rostow’s approach gave rise to a widespread expectation that financial assistance to countries ready to take off would last only a short period, say about 20 years. After that period, an underdeveloped country, having received foreign aid, should be able to rely on its own financial capability to support a self-fulfilling growth cycle. This optimistic approach led to a politically attractive notion of foreign aid, that a massive dose of aid and foreign capital to less developed countries would rapidly bring the recipient country to a point where aid would no longer be needed (**see *The International Poverty Trap***).

Rostow’s theory had a significant influence on U.S. aid policy and on the development plans of some developing countries. Rostow served as president of the United States National Security Council under the Kennedy and Johnson administrations. During this period, U.S. aid policy was closely tied to his overall strategy. It is noteworthy that the Egyptian nationalist leader Gamal Nasser was reportedly very enthusiastic about Rostow’s work, and that the first plan of the United Arab Republic elaborated in 1959/60 was deeply influenced by Rostow’s theory.

In addition to its focus on industrialization, an important aspect of Rostow's study is its view, explicit or implicit, of the relationships between economic growth and overall societal development, and between capital investment and economic growth. Regarding the growth-development relationship, Rostow's position reflects the approach prevalent in orthodox development thinking at least until the 1970s that considers growth and development virtually inseparable, if not equivalent, and concentrates on requirements for and obstacles to growth.

Rostow's view has nevertheless been criticized for overstating the case. Certain observers have argued that it is impossible to identify any unique and relatively short historical phase as the take-off period, while others have attacked Rostow for his contention that history is a sequence of stages through which all countries must pass.

In the late 1950s and early 1960s, when rapid growth and industrialization in many underdeveloped countries began to slow down, several empirical studies were undertaken to test the hypothesis that a significant increase in domestic savings was correlated with rapid industrial growth. The correlation was found to be positive in some cases, but insignificant in others, and negative in a few. The results of these empirical studies gave rise to a "two-gap" model.

We know that underdeveloped countries are short of capital, the gap between developed countries and underdeveloped countries being determined to some extent by the difference between them in terms of savings, and so of investment. With external assistance, underdeveloped countries can get the initial capital required for their industrialization. Once industrialization is well under way, domestic savings are no longer the main obstacle to growth. But, why were industrialization and growth suddenly slowing in certain developing countries? The two-gap model hypothesizes that to maintain the pace of industrialization and a high rate of growth, developing countries need foreign hard currency to import the capital equipment, intermediate goods, and perhaps even raw materials used as industrial inputs. This foreign-exchange gap may thus supersede the savings gap as the principal development constraint.

Indeed, many countries in Latin America and South Asia attempted to carry out their industrialization in the 1950s and 1960s by following a policy of import-substituting industrialization, which is a strategy based on the production of consumer goods for the home market as a substitute for import. These countries planned to replace imports of intermediate and capital goods by home production at a later stage. Import-substituting industrialization is conceived as a whole strategy, but there is a point at which an economy does not produce enough capital goods or industrial inputs and imports of intermediate goods and capital goods tend to be increasing, which exerts pressure on foreign exchange, eventually leading to balance-of-payments difficulties.

Compared with the highly simplified view of the savings-investment-growth model, the two-gap model represented a significant improvement in analysis. But regarding its implications for the role of aid, the two-gap model reinforced Rostow's approach, insofar as it also focused the attention of aid users on the need for investment resources.

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Biographical Sketch

Yifan Ding, deputy director of the Institute of World Development, Development Research Center under the State Council, People's Republic of China, graduated from Beijing Foreign Language Institute (now Beijing University for Foreign Studies). He was awarded a Ph.D. in political science from Bordeaux University in France before returning to teach at Beijing University for Foreign Studies as assistant and associate professor. He later moved into journalism, becoming editor of Xinhua News Agency, and was sent by *Guangming Daily* to Paris as bureau chief for more than five years. Returning once again to China, he was appointed to his present position.

Dr. Ding has published many articles in various magazines and newspapers, translated several books from English and French into Chinese, and written four books about globalization and the challenges facing China, the European single currency, the knowledge-based economy, and the international financial system.