4.3.2 Factors influencing growth and development

- *Impact of economic factors in different countries:*
  - *Primary product dependency*
  - *Volatility of commodity prices*
  - *Savings gap: Harrod-Domar model*
  - *Foreign currency gap*
  - *Capital flight*
  - *Demographic factors*
  - *Debt*
  - *Access to credit and banking*
  - *Infrastructure*
  - *Education/ skills*
  - *Absence of property rights*
- *Impact of non-economic factors in different countries*

- Factors which affect growth and development:
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  - Infrastructure
  - Education/ skills
  - Absence of property rights
  - Inequality
  - Gender inequality
  - Inadequate competition
  - Geography
  - Non-economic factors- including natural disasters
- Primary product dependency: when the value of production of primary products accounts for a large proportion of GDP
- Strategies to reduce primary product dependency:
  - Stablisation/ sovereign wealth fund
  - Higher taxes of natural resource profits
  - Buffer stock schemes
  - Diversification
- Importance of primary product dependency:
  - Vulnerable to volatile global prices
  - Risk of over-specialisation
  - Dutch disease- inflows of money from natural resources cause currency appreciation which makes exporting more expensive
  - Education is neglected
- Growth is a necessary but insufficient condition for economic development
- Two broad types of primary product:
  - Hard commodities: those that are mined or extracted e.g. copper
  - Soft commodities: usually agricultural goods, e.g. rice

- Reasons for strong growth in emerging markets:
  - Urbanisation
  - Industrialisation
  - Population growth (demographic dividend)
  - Focus on supply side reforms to drive more competition and productivity
  - Technological innovation (Korea)
- Issues of primary product dependency:
  - Extreme price fluctuations: the supply and demand tend to be inelastic so any change in them will cause large price fluctuations
  - Fluctuations in producers' revenues resulting from price fluctuations: these make it difficult to plan investment and output
  - Fluctuations in foreign exchange earnings: revenues from exports of primary products will also fluctuate, making it more difficult for the government to plan economic development
  - Protectionism by developed countries
  - Shortages of supplies for domestic consumption: cash crops are usually exported, meaning there is little left for domestic consumption
  - Finite supplies of hard commodities
  - Appreciation of the currency: demand for a particular commodity will cause an increase in demand for the country's currency
  - Falling terms of trade
- Prebisch-Singer hypothesis:
  - The demand for primary products tends to be income inelastic whereas the demand for manufactured goods is income elastic
  - Therefore, as real incomes rise, the demand for manufactured goods will increase at a faster rate than the demand for primary products
  - Decline in primary product prices and increase in manufacturing good prices
  - So the terms of trade of developing countries will fall relative to those of developed countries
- Criticisms of the Prebisch-Singer hypothesis:
  - The developing country may have a comparative advantage in the primary product
  - The real price of primary products might increase over time with rising world incomes and population
  - Manufacturing goods have seen reduced prices due to globalisation, technological improvements and economies of scale
  - FDI has increased significantly in recent years in countries dependent on primary products
- Savings gap: the Harrod-Domar model:
  - It says rate of GDP growth= savings ratio/ capital output ratio
  - Illustrates the problem of how countries with a low GDP per head will experience low savings ratios.
  - Low savings mean that it will be difficult to finance investment and, therefore, capital accumulation will be limited
- Criticisms of a Harrod-Domar model:
  - It focuses on physical capital and ignores the significance of human capital
  - It assumes a constant relationship between capital and output

  - The savings gap may be filled be means other than domestic savings e.g. from FDI
  - Doesn't consider the effect on AD of increased savings
- Foreign currency gap: currency outflows persistently exceed currency inflows
- Causes of a foreign currency gap:
  - Dependency on the export of primary products and imports of oil and manufactured goods (CA deficit)
  - Interest payments on debt to foreign countries
  - Fall in the value of remittances
  - Capital flight: cash deposits are transferred to foreign banks, or to buy shares or assets in foreign countries
- To avoid a foreign currency gap, the country may have insufficient foreign currency to purchase imported capital goods which would be needed to increase its productive capacity
- Many developing countries have low foreign exchange reserves so there is a high risk of a balance of payments/ currency crisis
- Capital flight: the uncertain and rapid movement of large sums of money out of a country
- Causes of capital flight:
  - Political turmoil
  - Exchange rate uncertainty
  - Fears over the stability of the banking system
- Impact of capital flight:
  - Undermines the stability of the financial system
  - Creates a weaker currency which increase the price of imports and makes it harder to finance external debts
- Inadequate competition in markets:
  - Many markets, especially in Sub-Saharan Africa have low levels of contestability
  - Widespread evidence of cartel behaviour
  - Higher prices reduce real incomes which has a regressive effect on the poorest households
- Savings gap: high levels of poverty make it impossible to generate enough savings to fund infrastrucuture
- (S-I) = (X-M) + (G-T): this shows the total resources gap of an economy is dependent on the internal balance (government budget) and the external gap (balance of trade)
- Importance of demographic factors:
  - Thomas Malthus predicted that famine was inevitable because population grows in geometric progression whereas food production grows in arithmetic progression.
  - Where population growth is greater than the growth of GDP, then GDP per head would decline
  - Ageing populations result in smaller working populations, who will have to support much larger proportions of elderly people
  - Rapid population growth has increase the number of people in extreme poverty in Africa
- Causes of debt:
  - Dependency on primary products and falling terms of trade

  - Developing countries borrow money at times of low interest rates, but struggle to service the debt when interest rates increase
  - Countries must borrow to pay for imports when oil prices increase
  - Loans taken to finance prestigious investment projects
  - Depreciation in the value of the currencies of developing countries, which increases the burden of the debt
  - Loans taken to finance expenditure on military equipment
- Sources of internal finance for developing countries:
  - Savings
  - Tax revenue
- Sources of external finance for developing countries:
  - International aid
  - FDI
  - Remittance inflows
  - Private sector debt inflows
- Geographical limitations to growth:
  - Land locked countries find global trade harder and air travel is much more expensive
- Gender inequality as a barrier to development:
  - 62 million girls are not in school globally due to cost of schooling, the effects of early marriage and social/cultural norms
  - 232 million women live in economies where they can only get a job with their husbands permission
  - Women struggle to open bank accounts in Africa and are locked out of land ownership
  - However, women also have an important role in the informal economy
- Importance of access to credit and banking:
  - Allows new entrepreneurs who need to borrow money to finance their start-up expenses and for existing businesses which may need money to finance expansion and for cash flow reasons
  - 2 billion working-age adults don't use formal financial services
- Importance of infrastructure:
  - Allows for an efficient operation of society and its enterprises
  - Affects the cost of doing business and the mobility of labour
  - If a country's infrastructure is poor, it is likely to deter both domestic investment and FDI
- Importance of education/ skills:
  - If school enrolment is low then the levels of literacy and numeracy are likely to be low
  - Bad education means productivity is likely to be low which will deter FDI
  - Possible brain drain from developing countries
- Disadvantages of a brain drain:
  - Loss of human capital hurts the supply-side
  - Loss of enterprising individuals and innovation
  - Fall in AD
  - A country is less attractive for inward investment
- Possible advantages of a brain drain:
  - Remittances from emigrants
  - May offset population growth

    - Increase human capital of emigrant from better education
- Importance of property rights:
    - Hernando de Soto has argued that strong market economy depends critically on property rights and the rule of law
    - It will be difficult to secure a bank loan if a person owns no assets because they will not have collateral
    - Entrepreneurs need to protect their ideas
- Importance of poor governance, political instability and civil wars:
    - Weak or inefficient government means resources are likely to be allocated inefficiently
    - Government intervention may result in market failure so a net welfare loss
    - Civil wars can have a devastating effect on the infrastructure of the country, deter investment and so hinder growth and development
- Importance of inequality:
    - Causes a self-perpetuating poverty cycle: low incomes lead to low investment which keeps income low
    - Misallocation of scarce resources- capital investment is skewed towards the preferences of the rich
    - Social and political unrest
    - More pressure on welfare systems
    - Rise of the informal economy
- Negative impacts of corruption:
    - An inefficient allocation of resources
    - An increase in the costs of doing business in the country
    - A decrease in foreign direct investment
    - Allocative inefficiency- diverting public resources for private gain
    - Loss of trust
    - Capital flight