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Growth, Macroeconomic Policies and Structural Change

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I. Introduction

This study is concerned with the long run tendencies of economic growth and/or stagnation in developing economies, and in particular with the interrelationships between economic growth and structural transformation. It is divided into six sections, including this short introduction. The second section considers the aggregate growth experience of the world economy and of developing countries, with particular reference to the period since 1960. In the third section, the significance of various “engines of growth” is considered. In the fourth section, the relationship between the financial sector and growth is taken up for consideration, in terms of financing growth as well as the changing role of financial institutions given financial liberalisation. The fifth section examines the extent to which growth in developing countries tends to be associated with structural change in terms of the changing composition of output and employment. The sixth and final section is concerned with the impact of macroeconomic, trade and industrial policies, as well as development policies broadly considered, in affecting patterns of growth. The impact of stabilisation policies on growth trajectories is discussed, as well as the possible strategies for sustained growth of developing countries in the new international environment.

Since these are such central questions, they have obviously concerned analysts since well before the inception of the discipline of economics, and have remained important for most of the history of economic thought. Yet there was a period of around two decades, from the mid 1980s onwards, when the question of how to generate sustained growth was no longer seen by the mainstream economics profession and the policy makers influenced by them as an important one to study, because there appeared to be consensus on how this could be achieved. It was taken for granted that economic growth would come about on its own, once markets were deregulated and the rules for domestic and international trade and investment were liberalised, in a context of macroeconomic and socio-political stability. In this story, growth was something best left to market determination freed from “the dead hand of the state” and unfettered by government failures, which would make the resulting economic expansion both more efficient and more dynamic. The focus of government policy was therefore to be not on growth *per se* but on stabilisation and “efficiency”.

However, the reality of the past two decades has been chastening, as the promised growth did not materialise in many developing countries that wholeheartedly embraced these principles, and the most dynamic economies turned out to be those with much more flexible and heterodox approaches to economic policy. As a result, economists have begun to

examine once again the basic questions of growth and development that were ignored for so long. Indeed, the process of economic growth has moved from being seen as the obvious result of “good policies”, to becoming the subject of the newest growth industry inside the economics profession. We now have a spate of academic books and reports of international organisations, exploring “the mystery of growth”. (For example, Commission on Growth and Development 2008, World Bank 2005) Many of these now accept that the earlier simplistic notions of the dynamic potential of unfettered markets could be misleading, and several have rediscovered basic truths of development economics that have been either forgotten or suppressed for the past two decades.

Ros (2001) has pointed out that the recent wave of both theoretical and empirical contributions has generally ignored the insights of earlier development theorists. But these earlier contributions in the mid-20th century, such as Paul Rosenstein-Rodan, Maurice Dobb, Michal Kalecki, Louis Lefebvre, Hirschman, Nurkse and others, are not only as relevant as ever, but are probably more promising in providing empirical explanations of actual growth patterns of developing countries, than much of old or new growth theory. This is essentially because they incorporated some key features of the processes of growth and development that are now being rediscovered: the fact that static and dynamic increasing returns in a context of labour surplus can generate multiple equilibria that make the initial conditions crucial in determining the subsequent pattern of growth, the possibility of development traps and the consequent need to deal with problems of co-ordination and imbalance especially in the traverse. Many of these implications of these issues will become evident in the examination of growth trajectories and patterns in the subsequent sections.

II. Growth experiences

Global GDP growth and its distribution across regions

The second half of the twentieth century is generally perceived as the most dynamic in the history of capitalism. It is also seen as a period in which at least some developing countries managed to improve their relative position in the global income hierarchy, in different phases and through different trajectories. There are various ways in which this is supposed to have occurred. Import substituting industrialisation in the 1950s and 1960s played a role in diversifying large developing and thereby generating a higher rate of GDP growth. Oil exporting countries benefited from the oil price increases of the second half of the 1970s, which enabled some of them to move to a higher level of per capita income. According to some analysts, the most recent “globalisation” phase of the 1990s has enabled some countries – China and India in particular – to benefit from more open global trade and thereby increase per capita incomes and reduce poverty.

All this would presumably have operated to create more convergence of incomes between the developed and developing worlds, even if in fits and starts, such that the gap between per capita incomes of countries across the world would start reducing. The economic literature on the empirical evidence on income convergence (or the lack of it) is already vast, based on econometric analyses of varying degrees of sophistication. (See, for example, Dollar and Kraay, Milanovic, Sala-i-Martin, etc.)

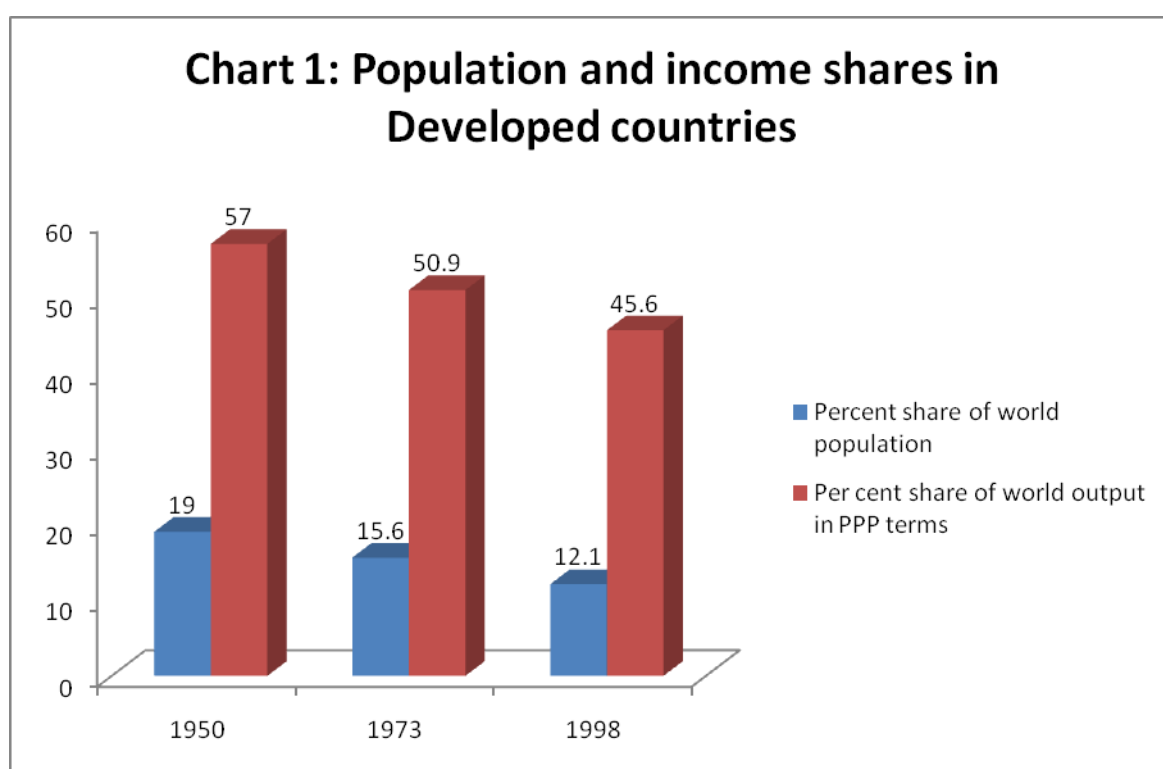
The most simple-minded way of looking at this is simply to examine the shares of global GDP of the different regions. Accordingly, Charts 1, 2 and 3 provide evidence on shares of various regions over the period 1950-1998, of global population and global GDP re-estimated according to Purchasing Power Parity (PPP), based on data provided in Maddison (2001).

PPP estimates are often used instead of nominal exchange rates to compare income across economies, because of the widely observed reality that currencies command different purchasing power in different countries, than is suggested by the nominal rates. This is because of the well-known fact that exchange rate comparisons of less-developed economies consistently undervalue the non-traded goods sector, especially labour-intensive and relatively cheap services, and therefore underestimate real incomes. In some cases this can be quite significant. For example, according to the Penn World Tables, which provide the most widely-used source of information on incomes deflated by PPP, total incomes in countries with large poor populations like India or China increased by multiples of around 3 with the PPP estimate, compared to the nominal exchange rate estimate in 2000. However, there are some well-known problems in the estimates of income using exchange rates based on PPP. One significant problem is that of how to choose comparable baskets of goods. The poor quality of the data on actual prices prevailing in different countries (including large developing countries such as China and India) that are used in such studies, which affect the reliability of such calculations. The most recent revision of the Penn World Tables, based on new information on prices in some important countries, show how dramatically PPP estimates can change with more accurate data, as the 2005 PPP-adjusted per capita income for China in US \$ terms, for example, shows a 20 per cent decline compared to the 2000 estimate. The wide fluctuations evident in the time series data for many countries provided in the Penn World Tables indicate the difficulties of using this as the basis for analysis. Further, there is a problem in using a single PPP for a long period. As Reddy (2008:) points out, “PPPs reflect the relative costs for a pattern of consumption prevailing at only one moment in time, and this pattern is constantly changing. ... they merely present a snapshot of relative prices across countries at a point in time which is no more authoritative for intervening years than similar snapshots of the relative prices across countries taken at points closer to those years.”

There is a less talked about but possibly even more significant conceptual problem with using PPP estimates. In general, countries that have high PPP, that is where the actual purchasing power of the currency is deemed to be much higher than the nominal value, are typically low-income countries with low average wages. It is precisely because there is a

significant section of the workforce that receives very low remuneration, that goods and services are available more cheaply than in countries where the majority of workers receive higher wages. *Therefore, using PPP-modified GDP data may miss the point, by seeing as an advantage the very feature that reflects greater poverty of the majority of wage earners in an economy.*

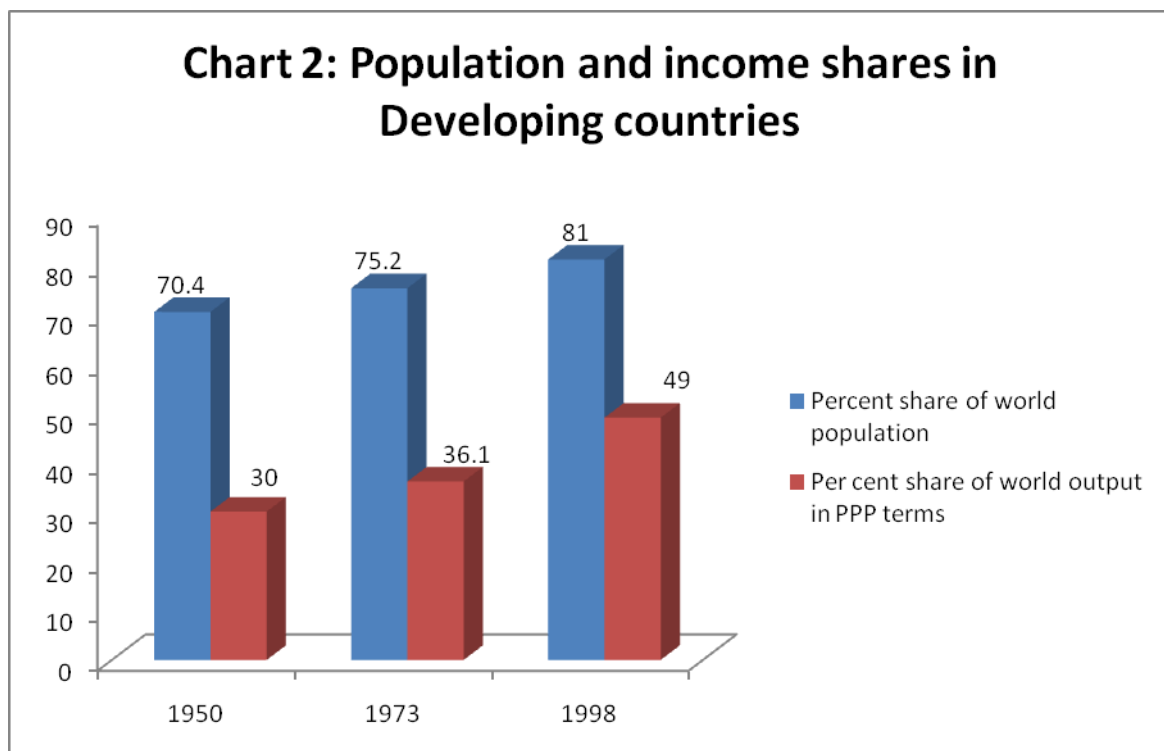
Nevertheless, PPP-based estimates have been widely used, even though they are likely to overestimate incomes of working people in lower-income countries for the reasons described above. In Charts 1 to 3, Maddison's estimates allow us to track the relative population and income shares by broad category of country for the latter half of the 20th century. Bear in mind that because these use PPPs that result from lower priced labour services, the actual disparities between rich and poor countries is likely to be larger.



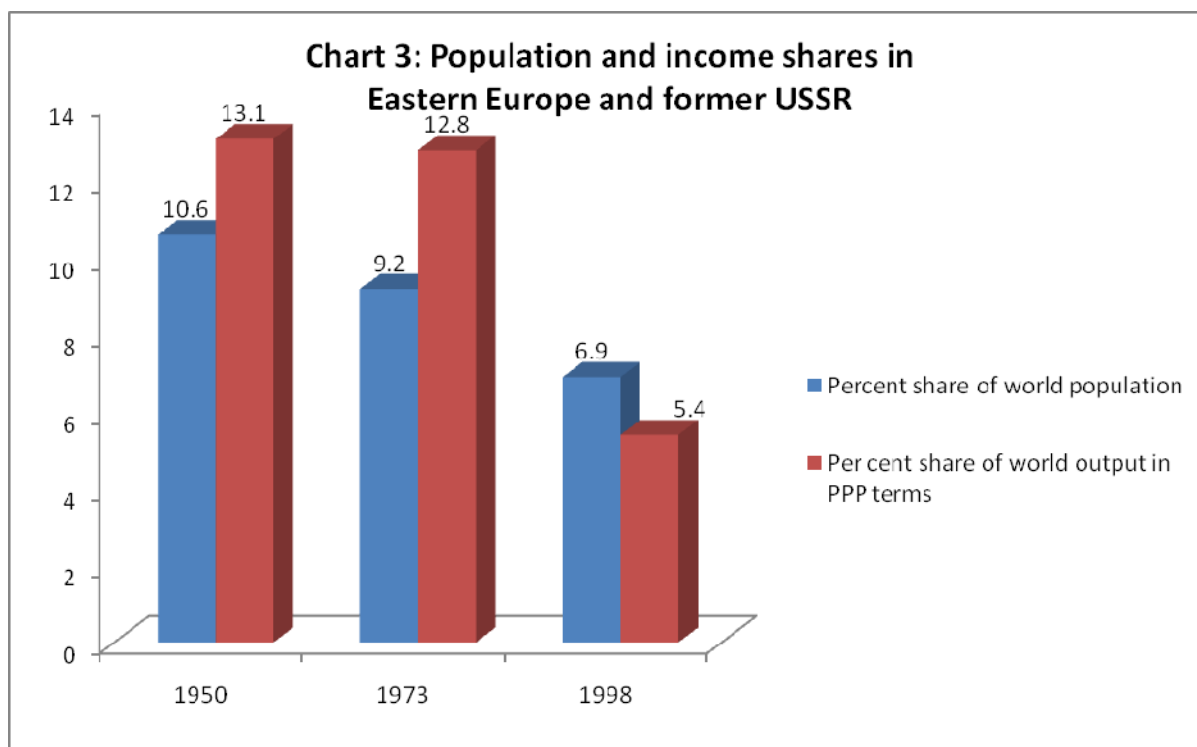
Source: Angus Maddison (2001)

It is evident that, as far as the countries that were known as “developed” in 1950 are concerned, there has been relatively little change in the per capita income position vis-à-vis the rest of the world, especially since the mid-1970s. In 1950 the developed countries received nearly 60 per cent of global income, but they also accounted for almost 20 per cent of world population. In the twenty five years after 1973, the share of the income of the developed countries fell by only 10 per cent, or 5.3 percentage points, whereas the share of population declined by 22 per cent or 3.5 percentage points. So even in PPP terms, just above one-tenth of global population in the developed countries still received nearly half the world’s income at the close of the 20th century.

Chart 2 shows the same ratios for the developing countries taken as a group. This category includes all the “success stories” of the developing world in East Asia and elsewhere, the socialist countries outside of Eastern Europe and the former USSR as well as several oil-exporting countries that have benefited from global oil price booms. There has been some improvement in global income shares for this group as a whole, but this has been far outpaced by the growing share of the developing world in global population. So, between 1950 and 1998 developing countries managed to increase their share of global income by 15 per cent, or nearly 11 percentage points, their share of global population increased by a whopping 63 per cent, or 19 percentage points, so that there was no relative increase in per capita terms.



The countries of the former Soviet Union and Eastern Europe have typically been treated as outside of both these categories, and it is interesting to note how this process worked out for these countries. This is shown in Chart 3. Between 1950 and 1973, the conditions appeared broadly stable, that is, there was a slight decline in both population and global GDP shares. However, after 1973 – or more accurately, probably after 1989 and the collapse of the Berlin Wall – there was a sharp decline in population share (35 per cent, or 4 percentage points), associated with an even sharper decline in income share (59 per cent, or 8 percentage points).

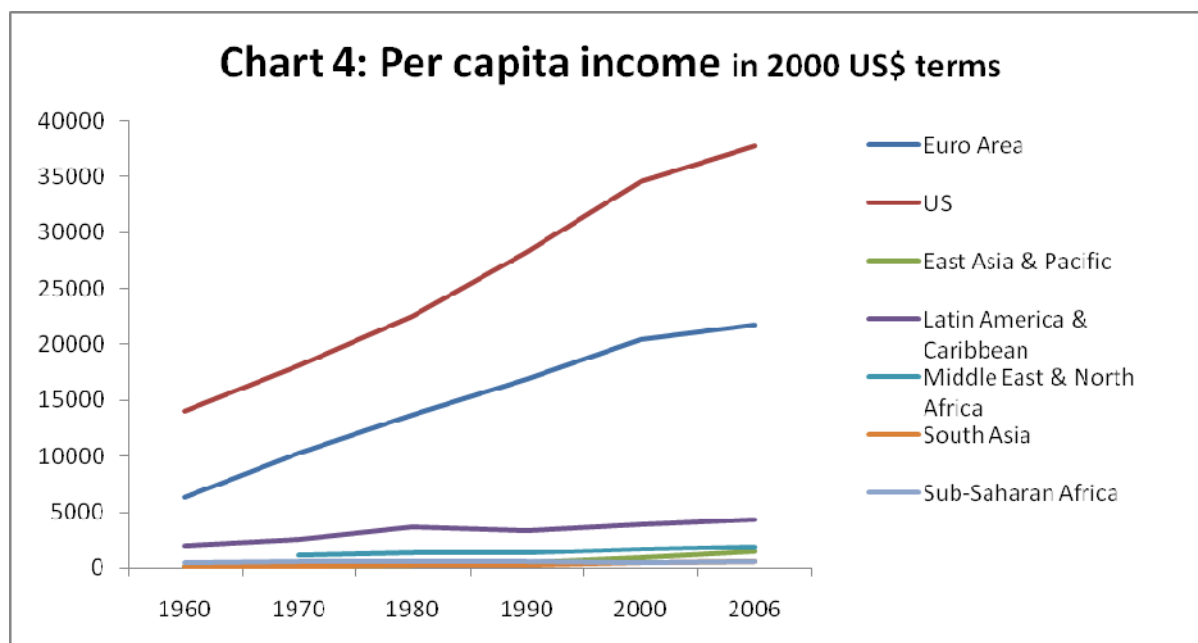


It was noted above that there are several problems, both empirical and conceptual, with basing inter-country income comparisons on PPP estimates. Therefore, while comparisons based on nominal exchange rates do have the obvious difficulty of not reflecting relative purchasing power in different economies, they do nevertheless provide some idea of inter-country income differentials especially in a world in which trade penetration is increasing. Chart 4 provides the evidence on real per capita incomes (in constant 2000 US \$ terms) across some major countries and country groupings for the period 1960-2006, based on the World Bank's World Development Indicators.

This chart shows very clearly how large the global income gaps are. The initial differences in per capita incomes (in 1960 in this case) were so large that even quite rapid increases in per capita incomes in some regions over the subsequent four and half decades have not managed to make the gap more respectable. Thus, while the per capita income of the fastest growing developing region – East Asia – increased by more than ten times over this period compared to an increase of less than three times for the US, in 2006, the average income for US was still fifteen times that of East Asia.

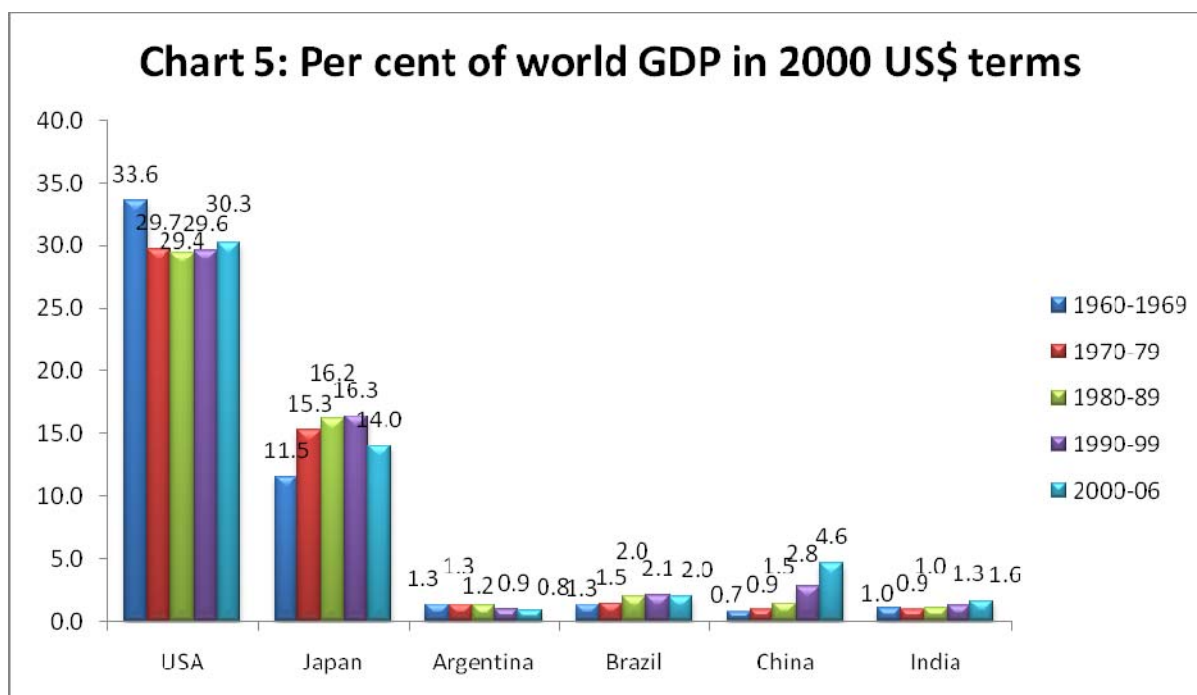
For other developing regions the per capita income gaps have been even larger and in some cases growing. Thus, the per capita GDP in the current Euro area in 1960 was 34 times that of South Asia; but by 2006, it had increased to 36 times. For Sub-Saharan Africa, the widening gap was even more stark. In 1960, the per capita income of the countries that are now in the Euro Area was 15 times that of Sub-Saharan Africa; by 2006, the difference was as large as 38 times.

Latin America was then and remains the richest developing region, yet the per capita income gaps between it and both the US and the EU have increased in the past forty six years. Even for countries in the Middle East and North Africa, which contains several major oil exporters, the income gaps have grown substantially with respect to both the US and the Euro Area countries.



Source; Calculated from World Bank World Development Indicators

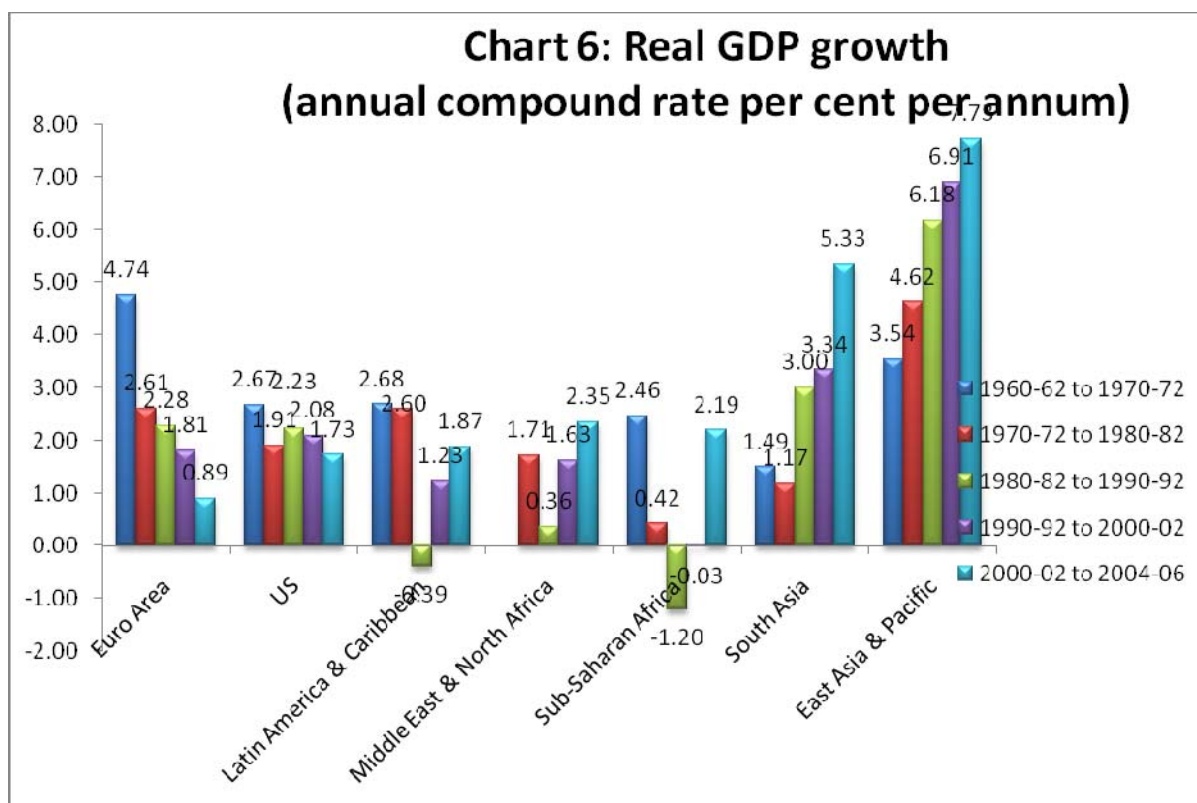
Another way of examining this is to look at the share of countries or regions in world GDP in dollar terms, rather than in PPP terms. Chart 5 provides this evidence in terms of US dollars at 2000 prices at nominal exchange rates, also based on World Bank WDI data. It is evident that at nominal exchange rates, the shares of developing countries, even the largest and most dynamic ones, remain quite puny. Even in the first six years of this century, after more than two decades of rapid growth in China and India, the two countries accounted for less than 7 per cent of global GDP, compared to 30 per cent for the US (which has changed relatively little from the 1960s) and 14 per cent for Japan. The share of China, India, Brazil and Argentina together in 2000-06 was less than 10 per cent.



This also reflects the fact that the growth performance of the developing world has been so uneven across countries. Chart 6 describes the growth performance over the decades according by country grouping, in terms of annual compound growth rates for the decades using three year averages. Within the developing world, only East Asia and the Pacific and South Asia show any significant acceleration of growth, or indeed higher growth rates than the developing world. Furthermore, it is evident that for South Asia the acceleration is relatively recent, so it is really only East Asia and the Pacific that in the aggregate has shown rapid growth over a prolonged period.

Chart 6 also shows that the other developing regions showed higher growth rates during the import substitution phase, and do not appear to have benefited much from the “globalisation” phase in GDP growth terms. If the 1980s was a “lost decade” for Latin America, with declines in real GDP, the subsequent decade was not much better, especially given the low base. Even the recent spurt has led to average growth rates of less than 2 per cent per annum.

Meanwhile Sub-Saharan Africa has experienced two lost decades, with average real GDP (in aggregate, not per capita terms) falling continuously in the 1980s and the 1990s.



So the picture of a very dynamic and rapidly changing world economy, in which developing countries are emerging as the major players, may be overplayed. A longer term perspective on growth suggests that for much of the developing world, relative positions in the international economy have hardly changed at all.

Economic growth in the developing world

Within this overall picture, it is worth examining how much economic growth there has actually been in the developing world, and the extent to which average incomes have increased over the past half century. It can be plausibly argued that analysis of growth rates alone may be misleading because of their volatility and the very different initial conditions, and that therefore it makes more sense to focus on actual changes in levels of per capita income. In this section, data from the World Bank's *World Development Indicators* are used here to provide some broad indication of actual changes in per capita income, in terms of constant 2000 US \$. Table 1 presents the results of the relatively simply exercise of comparing real per capita GDP at the end of the period (the average of the three years 2004-06) with the start of the period (the average of 1960-62) for a sample of 54 developing countries, including large and small economies. (Note: the base years are different for the following countries: Gambia 1966-68; Iran 1965-67; Jordan 1975-77; Saudi Arabia 1967-69; Turkey 1967-69.) The idea is that 46 years is a sufficiently long period to be able to capture at least whether there has been sustained growth in the countries considered, since it is long enough to judge whether growth episodes have led to sustained improvement or have been followed by slumps in which previous income gains have been eroded. The comparison of end points based on 3-year averages reduces the impact of annual fluctuations.

Table 1: Per capita GDP in 2004-06
as a proportion of per capita GDP in 1960-62
(in terms of 2000 US \$)

China	17.12
Botswana	17.02
South Korea	11.83
Singapore	10.93
Hongkong SAR China	8.86
Thailand	7.67
Malaysia	5.37
Indonesia	4.68
Egypt	3.74
Sri Lanka	3.70
Lesotho	3.50
Dominican Republic	3.30
India	3.22
Pakistan	3.15
Libya	3.11
Chile	3.01
Brazil	2.58
Costa Rica	2.56
Morocco	2.49
Mexico	2.39
Colombia	2.27
Turkey	2.14
Gabon	2.08
Paraguay	1.94
Iran	1.80
Philippines	1.79
Nepal	1.79
Guatemala	1.77
Uruguay	1.67
Honduras	1.67
Bangladesh	1.65
Jordan	1.64
Sudan	1.60
South Africa	1.53
Argentina	1.51
Syrian Arab Republic	1.51
Nigeria	1.42
Saudi Arabia	1.40

Peru	1.40
Malawi	1.38
Cameroon	1.34
Jamaica	1.33
Benin	1.21
Gambia	1.21
Bolivia	1.18
Zimbabwe	1.07
Ghana	1.05
Chad	1.05
Sierra Leone	0.98
Venezuela	0.91
Senegal	0.87
Nicaragua	0.87
Zambia	0.70
Central African Republic	0.63
Haiti	0.54
Congo, Dem. Rep.	0.28
Kuwait	0.20

In Table 1, countries are ranked according to the extent to which per capita incomes have improved over the entire period taken as a whole. The results are startling in establishing how little real economic growth has actually occurred for most developing economies, in terms of substantially improved per capita GDP over the long period. The 54 developing countries listed in Table 1 account for the vast majority of the population in the developing world, and cover large and small countries, natural resource based primary producers and semi-industrial diversified economies, countries that have adopted more or less free trade policies all through and those that have gone through phases of import substitution followed by more liberal import regimes. Yet in this large group, only a tiny handful can be said to have experienced anything like real and sustained growth of per capita incomes.

Over 46 years, a reasonable process of economic expansion – say an average of 3 per cent increase per annum – would cause per capita incomes to increase by almost 4 times. Yet only 7 countries in this list meet this very undemanding criterion. And only a small minority of countries in this list show just a doubling of per capita incomes over this long period, which can be said to cover two generations. Many countries experienced barely any increase, and a significant number experienced declines in per capita incomes over this period of nearly five decades. 12 countries in this sample experienced stagnation or retrogression of per capita incomes over this period. Because this is such a long period, the stagnation or decline does not reflect a continuous trend, but rather phases of expansion followed by contraction, or vice versa.

So clearly, sustained economic growth cannot be taken for granted. And phases of high growth are cause for celebration only if the income gains are retained over time, rather than lost in subsequent downswings. For this reason, it is worth examining the time series data on economic growth in these countries, which will go beyond a comparison of the end points. Charts 7 to 12 describe the annual per capita real GDP (expressed in terms of 2000 US \$) in developing countries from the major regions.

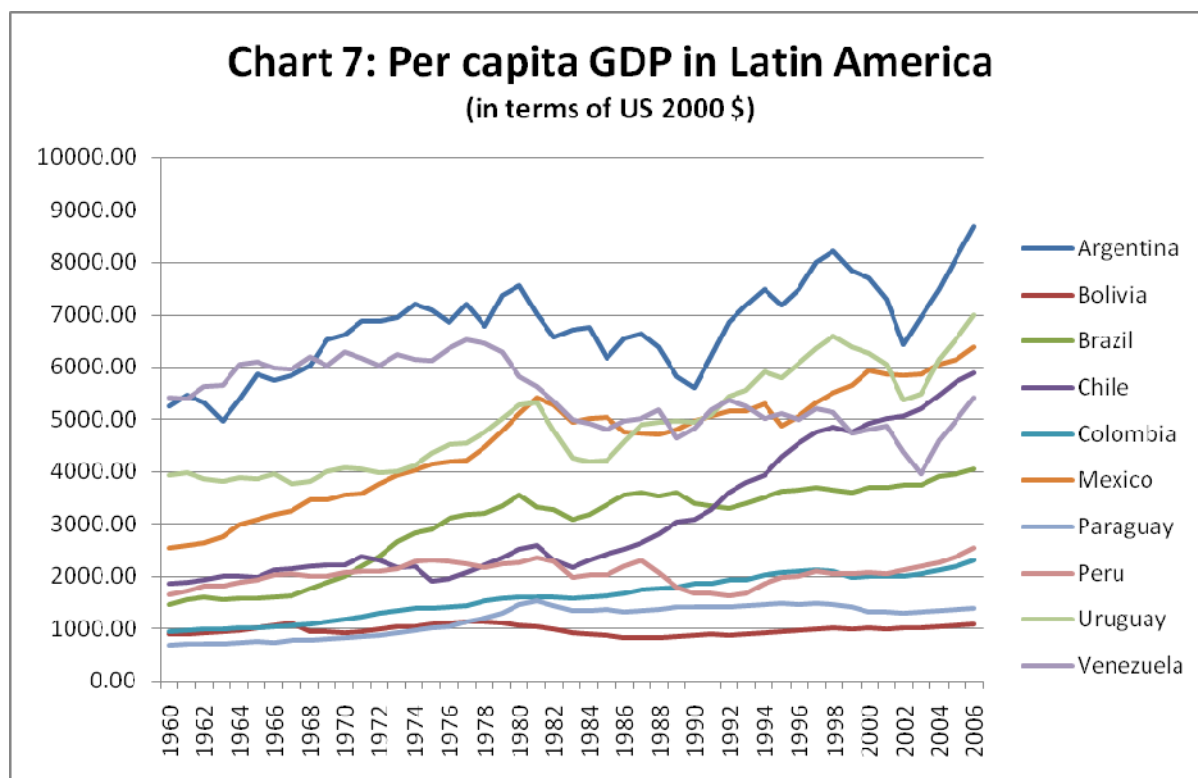


Chart 7 shows per capita GDP for each year in this period (in the aggregate rather than in per capita terms) in the ten largest economies of Latin America. The volatility of output in this regions emerges only too clearly, with the two richest countries at the start of the period – Argentina and Venezuela – experiencing some of the greatest volatility. In Argentina, the expansion (with cyclical behaviour around an increasing trend) of the “Peronist” import substituting years lasted until the debt crisis broke in the early 1980s, leading to the “lost decade” in which per capita GDP fell to below the levels achieved in the 1970s. The recovery of the 1990s was followed by yet another, even more substantial slump during the financial crisis of 2001-02. The relatively strong recovery thereafter has still meant that real per capita GDP in US dollar terms in 2006 shows only a minor increase of 5.8 per cent over the previous peak achieved in 1998. In Venezuela, which was one of the richest countries in the region because of its oil reserves, per capita incomes showed modest but more or less steady increase in the two decades 1960 to 1979, but have been declining almost continuously thereafter until 2003. Indeed, by 2003 the per capita GDP was only 73 per cent of the level in 1960! From 2004 onwards, there has been a reversal of this long term decline, led dominantly by the oil price increase but also affected by substantially increased public

spending especially on social sectors, such that per capita GDP increased by nearly 40 per cent in just the last four years. Even so, the longer period of earlier decline means that per capita GDP in Venezuela in 2006 was still somewhat below the level of 1960.

The only three countries for which it can be said that there has actually been an increase on per capita GDP that has sustained over the entire period are Mexico, Brazil and Chile. For the first two, the real growth phase was clearly before the early 1980s. In other words, Brazil and Mexico grew during the period of import substituting industrialisation. Subsequently per capita incomes have barely increased, showing that these two countries have just about managed to hold on to the income gains achieved earlier, without much further growth. In Mexico, the most recent decade does show an acceleration of growth compared to the previous decade, but this has been concentrated in the period after 2003, suggesting that even for Mexico, the aggregate growth may have been affected by global oil prices, since Mexico remains a large oil producer. Brazil's per capita income in real US dollar terms increased by two and a half times in the period 1960 to 1980, fell by around 8 per cent between 1980 and 1992, and thereafter has been largely flat, showing less than ten per cent increase over the entire decade up to 2006.

Indeed, the only large Latin American economy that shows a continuous rise in per capita incomes even after the 1980s is Chile, where the growth story is evident from about 1992 onwards. Chile is often described as a poster boy for neoliberal economic orthodoxy, but the reality is that, notwithstanding the fairly conservative macroeconomic stance, Chile has followed quite heterodox economic policies in several other areas, including in capital account management and active state promotion of agro-processing industries.

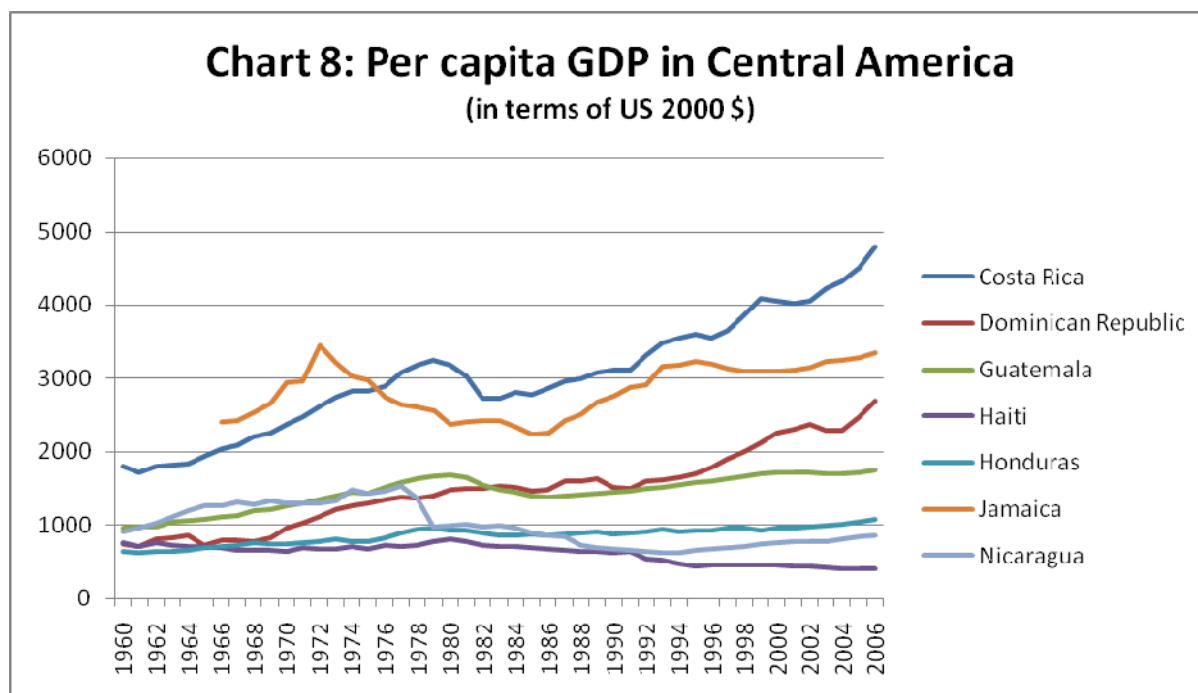


Chart 8 describes the experience of several Central American and Caribbean countries. Once again, only a small minority of countries – Costa Rica and the Dominican Republic – show any sustained increase in per capita incomes in US dollar terms over the entire period. Costa Rica grew in the ISI phase, was stagnant during the lost decade and has grown again since 1992. The greatest acceleration has come after 2000, with per capita incomes growing by 20 per cent between 2000 and 2006. In the Dominican Republic as well, the real economic growth occurred after 1990, with per capita incomes increasing by nearly half over the 1990s and another 20 per cent thereafter.

Other countries in that region indicate a less positive trajectory. After some growth in the 1960s and early 1970s, Jamaica underwent continuous economic decline followed by stagnation, such that even in 2006 per capita income was still below the peak achieved in 1972. Guatemala grew up to 1980 and has been almost stagnant thereafter. Nicaragua's slump after 1978 has been so prolonged that per capita income in 2006 was almost 40 per cent below that achieved in 1978. In Haiti economic retrogression over the past two decades has meant that GDP per capita in 2006 was only 58 per cent of that in 1984.

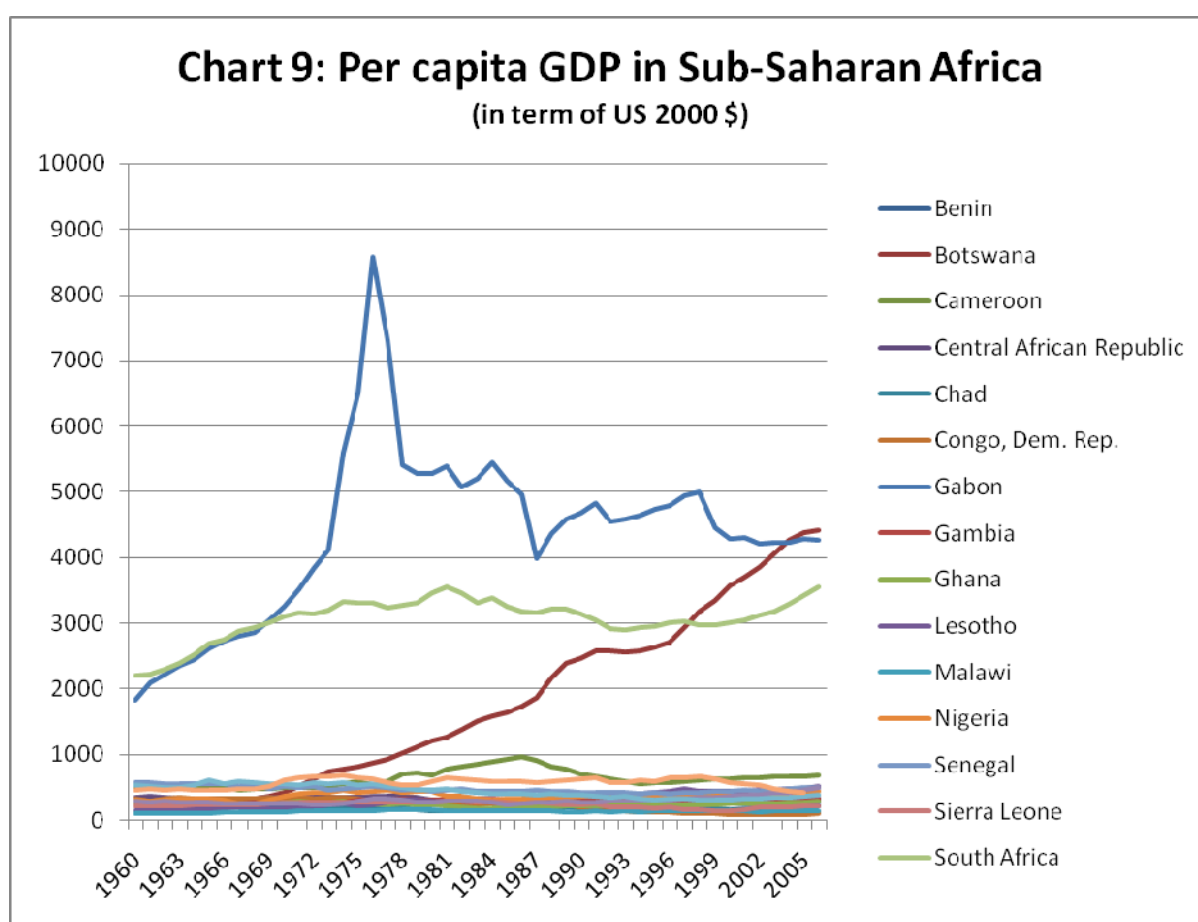


Chart 9 describes per capita incomes in Sub-Saharan Africa. The story is almost uniformly depressing in terms of per capita incomes in this region, which have been stagnant

or increased relatively little and then fell again, for almost all the countries. Once again, the relatively more closed period of the 1960s was when most of these economies actually grew, while the more market-oriented policies that followed the publication of the Berg Report and policy pressure from external donors and multilateral agencies were associated with deceleration in growth or even absolute declines in per capita income. Thus in Ghana there was economic growth in the 1960s, but thereafter more than three decades of decline or stagnation have ensured that per capita GDP in 2006 was barely above the 1971 level. A similar story holds for most of the other countries described here, and in some countries the regression from the early 1970s was so extreme as to cause per capita incomes to be significantly below the level achieved in the early 1970s. [Note: Gabon??]

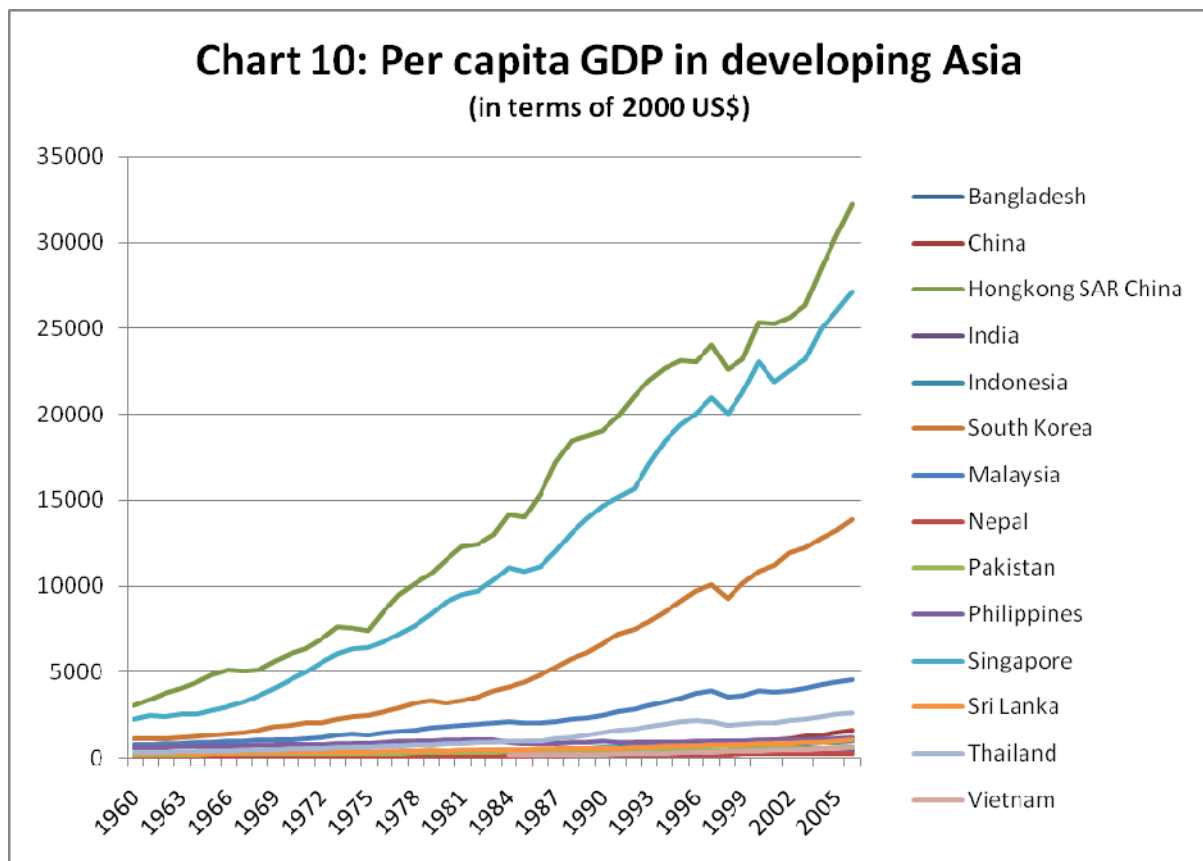
The two significant exceptions are South Africa and Botswana. South Africa was the richest (and largest) economy in the region in the early 1960s, and also grew most rapidly – during the apartheid years! This was probably because the external sanctions forced South Africa to undertake its own version of import substituting strategy. This tends to correspond with the experience of the import-substituting economies of Latin America during the 1960s. Thus, whatever quarrels there may be with the quality of the growth (and in apartheid South Africa there were many obvious reasons to be unhappy with this pattern of growth), clearly some degree of separation from the world economy, whether voluntary or enforced, assisted in the aggregate expansion of these economies.

Botswana is the other, and remarkable, outlier in Sub-Saharan Africa, with a dramatic increase in per capita income of more than 17 times over the entire period. But while Botswana is regularly presented as the African success story, its experience is also the classic sobering reminder that economic growth alone need not be enough to deliver better material conditions to most of the population. Botswana's growth has been based on its diamond resources, which have greatly benefited the elite and created a prosperous enclave economy. However, this "enclavity" (Mhone 2000) has had its consequences in terms of the actual impact of such growth on the people. As Good (2005) notes, diamonds have promoted certain forms of economic development and restricted or limited others. Thus, the growing revenues from minerals exports promoted infrastructural growth, especially in communications, health services and education. The revenues were managed in such a way as to establish a strong currency, build very large foreign exchange reserves, maintain balanced budgets and achieve high per capita incomes and eventually upper-middle-income-country status. But at the same time these revenues also restricted agricultural development, as liberal trade rules allowed the elite to spend them on food imports from cheaper neighbouring countries. The diversification of the economy into manufacturing industry was not seriously attempted, and definitely not achieved. As a result, Botswana's spectacular growth has been accompanied by sharply worsening income distribution, associated with continued high poverty rates that persist at more than half of the population, and even falling life expectancy because of the adverse impact of the AIDS epidemic on a poor population without access to adequate health care and clinical treatment. In human development indicators it is among the poorer performers even

in sub-Saharan Africa. So the pattern of growth, while striking, is obviously not one worth emulating elsewhere.

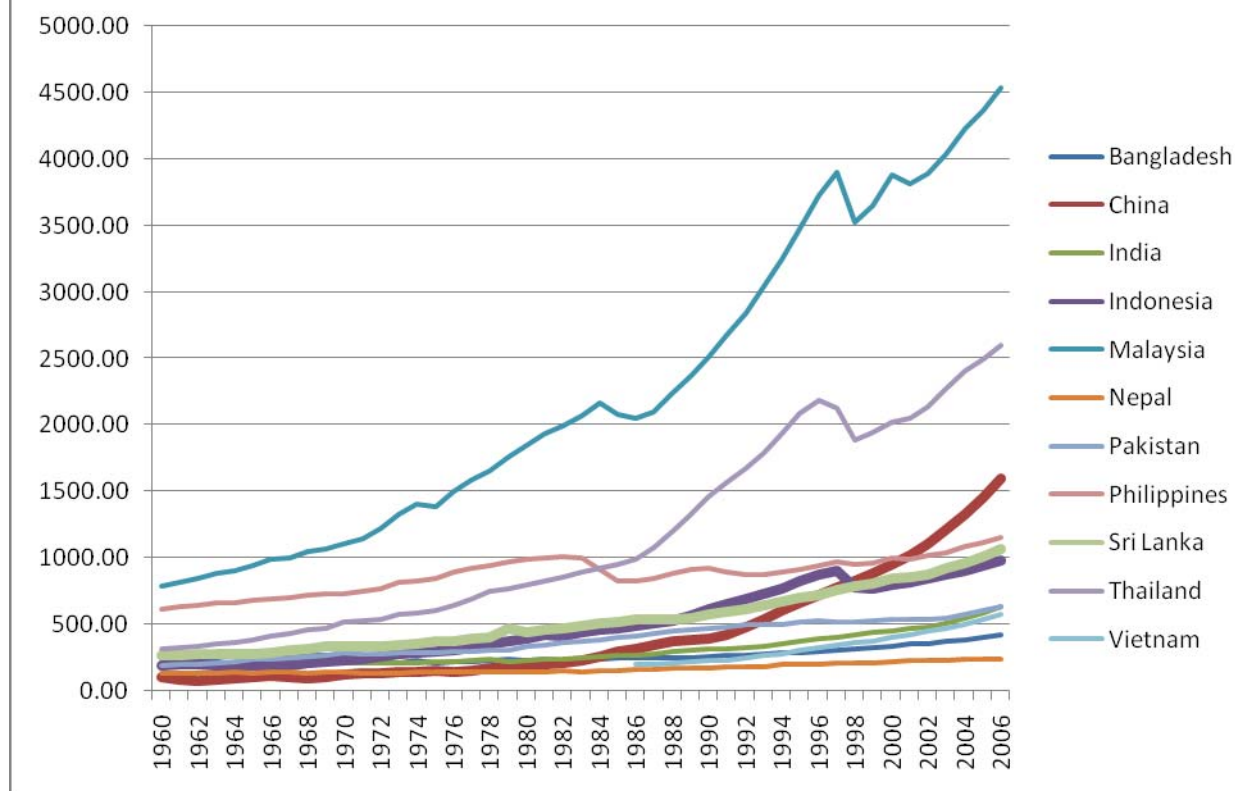
Developing Asia shows a very contrasting picture, not only of aggregate growth trends but even with respect to the overall policy context within which growth has occurred. This is the region that has been the most dynamic in growth terms over the past two decades, and therefore per capita incomes in this region are expected to be rising rapidly, in contrast to Latin America and Africa. Chart 10 shows per capita income trends for several countries in this region, including some that are generally regarded as the most dynamic.

Several points emerge from this chart. First, most countries in the region started from a very low base of per capita income, similar to Sub-Saharan African countries. Second, the economies that were richer to start with also grew more rapidly, so that intra-Asian per capita income gaps increased dramatically over this period. It should be noted, of course, that the four countries with the most evident absolute increase in per capita GDP over the entire period are the Asian “NICs” of which two are essentially city-states (Singapore and Hong Kong SAR) while the third, Taiwan China, has not been shown here because of lack of comparable (WDI) data. It is worth noting that among larger countries the fourth NIC, South Korea, has shown much larger absolute increase in per capita income than other countries, and this increase has been almost continuous, although the period of fastest growth from the mid 1980s to the mid 1990s was preceded and followed by external debt crises. Third, the recent growth success stories of developing Asia that are most often talked about – China, India, Vietnam - barely appear as significant in comparison to the absolute increases in per capita GDP of the NICs and Malaysia.



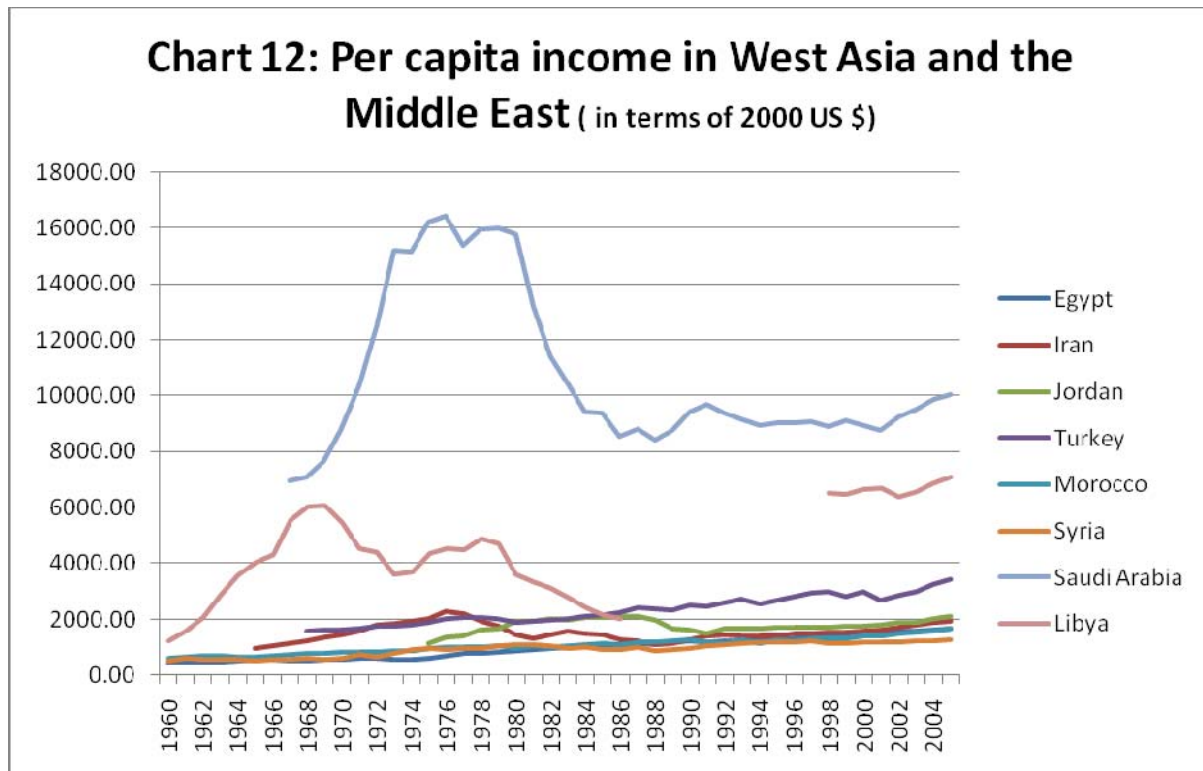
Of course, this may be because of fact that their experience is dwarfed by the sheer size of the income expansion in the NICs. Therefore Chart 11 shows data for these countries, excluding South Korea, Hongkong SAR and Singapore.

Chart 11: Per capita GDP in some countries of developing Asia
(in terms of 2000 US \$)



However, even among this group of 11 countries in dynamic Asia, significant and sustained expansion of per capita incomes seems to be more the exception than the rule. Malaysia is very clearly the best performer in terms of absolute increases in per capita income. But the most notable experience in this group of countries appears to be that of Thailand, where the very rapid growth of the 1980s and early 1990s led to very substantial income gains. It is true that these were partly destroyed by the Asian financial crisis, but thereafter there has been some recovery. While the Chinese growth story is what is most widely talked about, also because of the sheer absolute size of the Chinese economy, it is evident that China still remained significantly below the other two in terms of per capita income in the 2000s, even though its recent growth has caused it to reverse its per capita income gaps with all the other countries considered here.

For most of the other countries the income changes have been more modest, and cannot be described as real “success stories” over the long term even though that is how they are now increasingly viewed. Thus, there have been some increases in per capita incomes in Sri Lanka and Indonesia over the entire period, and in India and Vietnam since the 1980s. The Philippines started out in 1960 as the second richest country, and grew moderately until the 1980s, but subsequent volatility and stagnation have meant hardly any increase in per capita incomes thereafter.



The other region considered here is West Asia and the Middle East. This is a region with a large number of oil-exporting countries, and it is generally believed that such countries have been able to benefit from their oil rents by increasing aggregate incomes. Chart 12 shows that this is actually not the case, and that even in West Asia, hardly any economy has shown a substantial increase in per capita income over the entire period. Kuwait and Iraq have been excluded from this analysis because of the impact of conflict on their economies; as it happens they both show much worse GDP trends than the other countries of the region. The largest oil exporter, Saudi Arabia, experienced a substantial decline in per capita GDP from the early 1980s, and had still not recovered from this to reach earlier levels by 2006, despite the recent increase in oil prices. Other countries show stagnation of per capita incomes. The only country that actually shows a significant rise in per capita GDP over the entire period is Libya, although there is some increase evident for Turkey as well.

The general conclusion that emerges from this brief consideration is that sustained growth in the developing world has actually been a rarity, confined to a small handful of countries. Indeed, this is probably the more significant research question – not just why growth occurs, but why, despite adhering to the economic orthodoxies prescribed by donors and others, so many countries in the developing world have not been able to achieve even relatively moderate increases in per capita income over this relatively long period.

III. Engines of growth

At the most basic level, it appears that there can be little disagreement on the proximate determinants of the pace of economic growth in a country, since the simple arithmetic of growth equates it to the product of the incremental output-capital ratio and the rate of investment. However, even this simple identity captures in rudimentary form the divide that characterises development economics. On one side of the divide are those who emphasise the role of the investment rate in raising the rate of growth, following the classical tradition of explaining output growth through accumulation and productive investment in physical capital. This was the approach adopted by the immediate post-World War II consensus on measures to be adopted to ensure the economic progress of developing countries. (Rosenstein-Rodan 1943, Dobb , Sen , Kalecki) These arguments have received some more recent confirmation from endogenous models of growth that highlight not only the direct impact of investment but also its spillover effects.

On the other side, economists inspired by the neoclassical economic tradition have focused on raising the efficiency of investment, typically measured by the incremental capital output ratio (ICOR), as the basis for growth. An improvement in the efficiency of investment is usually seen to be the result of allowing market signals to determine the volume of savings that then determine investment, the allocation of investment across sectors and the technical form in which such investment is embodied in each sector. There are also the “manna from heaven” perceptions of long run growth, which attempt to quantify the process through the nebulous and somewhat problematic concept of total factor productivity, stemming from the growth accounting studies pioneered by Denison (1972).

There is the related issue of whether growth is powered by savings or investment. In this regard, Deaton (1998) argued that “the international correlation between growth and saving rates comes from the response of growth to investment, as predicted by a variety of growth models. Saving responds passively to investment through mechanisms that are at present not well understood.” Of course, there is a wide debate on the determinants of savings and the relationship between savings and growth. On the one hand there are arguments that develop on life-cycle and permanent income models to argue that demographic composition and changing rates of population growth are the primary determinants of savings rates over time. In contrast, Deaton (1998) argues that dynastic motives – the urge to bequest - are more important in explaining national saving rates than are life-cycle retirement motives. In turn, this implies that if most households are not saving for retirement, changes in the rate of population growth will not change private saving rates. These are still largely unresolved questions, especially as the recent period has witnessed a growing divergence between savings rates and investment rates in both developed and developing countries, as the earlier close relationship observed by Feldstein and Horioka (1980) appears to have broken down at least to some extent in the era of globalisation and significantly expanded capital flows (Coakley, Fuertes and Spagnolo 2004, Georgopoulos and Walid Hejazi 2005). Nevertheless, the Commission on Growth and Development (2008) echoes the position that the two should

be strongly correlated, by stressing that investment has to be predominantly financed by domestic savings.

In the work of the classical economists, accumulation and distribution were interconnected because of the different use made by the various classes, of their share of the total income. This was in turn reflected in models such as those of Kaldor (1956) and Pasinetti (1960), whereby, since workers consumed all of their income and capitalists saved all or most of theirs, income distribution, or more particularly the share of profits, determined savings and thereby investment and thereby growth. Arthur Lewis' famous model (Lewis 1957) also made the rising savings rate, which he attributed to an increasing share of profit during the labour surplus phase, the centre of the development process.

Ros (2001) using WDI data for 30 countries over the 1980s and early 1990s, found that while savings rates increased whenever there was an increase in profit shares, a rise in profit share was not a sufficient condition to ensure increasing savings rates. In fact he found that countries with falling savings rates also had marginally rising profit shares. Rapid industrialisation characterised those countries with both rising profits and sharply rising savings rates.

Recently there has been some discussion of the association of savings rates, and therefore growth, with demographic changes in the economy. The argument is usually formulated as follows: Savings is determined by the life cycle, according to some version of the permanent income hypothesis. Therefore countries' savings rates change as they go through demographic cycles, and a higher proportion of the middle age cohort in the population leads to a higher savings rate as this group saves for retirement. Such an age composition is also associated with a lower dependency ratio (the ratio of non-workers to workers) which permits a higher rate of savings. (Reference) As societies age, therefore, savings rates and therefore potential growth both decline. And countries with younger populations or lower dependency ratios therefore have more potential for future growth. This leads to the argument of the "demographic dividend" that can be reaped by dominantly young societies, and is the basis for the prediction in the BRIC Report (reference) that Brazil, Russia, India and China will be the most dynamic economies of the first half of the 21st century. However, Deaton (1998) suggests that life-cycle retirement motives are less important in explaining national saving than are bequest and dynastic motives. If this is correct and most households do not actually save for retirement, then changes in the rate of population growth will not affect private saving rates.

The argument that higher growth has typically been associated with higher rates of investment is empirically verifiable, and has therefore been the focus of much recent econometric investigation. De Long and Summers (1991, 1992) based on a sample of OECD and developing economies over the period 1960-85, argue that investment in machinery and equipment is the most important factor in explaining growth. While this particular conclusion has been contested, almost all cross-country studies have found that initial conditions –

represented by various measures of the level of development such as output per capita, labour productivity, stocks of physical capital or stocks of human and knowledge capital – have very significant predictive power over subsequent growth (Dowrick 1995).

By way of contrast, Easterly and Levine (2001) present “stylised facts” emerging from a growth accounting exercise using Penn World Tables, which according to them indicates that the “residual” (also called Total Factor Productivity) rather than factor accumulation accounts for most of the income and growth differences across nations. While income does diverge over the long run, factor accumulation is persistent while growth is not persistent. In fact, growth paths exhibit remarkable variation across countries. Economic activity is highly concentrated, with all factors of production flowing to the same places, that is, the already richest areas, suggesting important externalities.

The theme of spatial concentration of global incomes – something which is no more than a restatement of one aspect of Lenin’s law of uneven development – is confirmed by Durlauf and Quah (1998) who point out that most of the world’s economies are small (or, another way of putting it, that incomes are geographically concentrated and a few economies account for most of the world’s income). They also find that over a long period, the percentiles associated with the distribution of population across countries have been remarkably stable. This is something that was already described in Section II on the basis of Maddison’s dataset, and can be relatively easily explained once static and dynamic increasing returns and externalities are allowed to enter the analysis.

The strong association between investment rates and growth, despite going through a phase of interrogation, has once again come to be accepted in both academic and policy circles. As the Commission on Growth and Development (2008: 34) puts it: “Strong, enduring growth requires high rates of investment. By investing resources, rather than consuming them, economies make a trade-off between present and future standards of living. That trade-off is quite steep. If the sustained, high-growth cases are any guide, it appears that overall investment rates of 25 percent of GDP or above are needed, counting both public and private expenditures.”

A central concern then becomes: what determines the rate of investment? Some early development economists characterised the problem of underdevelopment as reflecting not only relative lack of capital, compounded by the low capacity to save in a low-income economy, but also low rates of return to capital (Nurkse 1953) because of the weakness of investment incentives. The problem of generating growth can then be seen as one of ensuring higher investment, either directly or by affecting the private inducement to invest. The inducement to invest can be increased through different forms of public intervention, directly through public investment that should then have a positive linkage with private investment, or indirectly through fiscal and monetary incentives that alter the relation between the projected costs and returns of private investment. But there are also other stimuli for investment that have been discussed, such as the possibility of new or expanding export markets, the

beneficial effects of technology spillovers, changing demographics that create bulges of the working age population, and so on. Some of these factors that influence investment, and therefore aggregate output growth, are considered below.

Public and private investment

Two questions that have generated intense discussion and debate are the relative importance of public and private investment in ensuring growth and the degree to which these two types of investment are complementary or competitive. The marketist position, besides favouring private over public investment, has held that public investment tends to crowd out private investment by either absorbing a part of a “given” volume of financial savings or by increasing the cost of capital or the rate on interest by competing for a share of a “given” volume of savings. Besides the fact that the notion of a given volume of savings is theoretically indefensible when unutilised resources exist (since investment can increase output and therefore the volume of savings generated by the system) this argument ignores a number of roles that public investment plays in developing economies.

To start with, public investment in developing countries is crucial to ensure investments in infrastructural areas characterised by lumpy investments, long gestation lags and relatively lower profits, all of which make the private sector unwilling to enter these areas. However, unless these infrastructural gaps are closed, the process of growth can run up against a range of infrastructural constraints such as inadequate roads, shipping capacities and air transportation, power shortages, poor communication and so on. Secondly, besides infrastructure, several basic industries required for industrialisation have characteristics similar to infrastructure even though they are tradeables, which make them unattractive to private investors. Examples include steel, machine tools and basic chemicals. Unless the government invests and enters the production of these areas, the process of industrialisation may be limited because of limited possibilities of transformation through trade and therefore the inadequacy of foreign exchange to import these commodities. Thirdly, in developing economies with a limited home market, the private sector may lack the inducement to invest unless the state expands its expenditure through public capital formation which directly increases the demand for private sector products (because of the purchases made by the state) or generates indirect demands because of the employment created by public expenditure and the multiplier effects of such expenditure. For these and other reasons public investment can be seen as “crowding-in” rather than “crowding-out” private expenditure (Aschauer 1989, Erenburg 1993).

Of course, the allocation of such investment remains important. Most developing countries do not have the luxury of allowing public investment to increase in all the areas in which it is needed, and some prioritisation is inevitable. The theoretical literature on planning typically tended to place greater emphasis on infrastructure and capital goods industries, as noted above. A counter position has emphasised public expenditures in activities that would generate more employment and demand, thereby kick-starting macroeconomic processes that would create enhanced supply as well.

However, an emphasis on the role of public investment in developing countries has been undermined over the past two decades, by widespread perceptions of government failure, not only in terms of mistakes in “picking winners” but also the greater inefficiency of public economic activity. It has been argued with growing vehemence that governments should stay out of any areas which the private sector is willing and able to invest in, and instead provide an appropriate mix of fiscal and other incentives and regulation to ensure that the private provision is socially optimal. According to this view, instead of focussing on economic activities in what were earlier seen as natural monopolies and now appear to be contestable markets, developing country governments should focus at most on social sector expenditures alone, where it is (almost) universally accepted that there will be private underprovision.

While this became the received opinion, it is now clear that this argument was probably accepted too uncritically. It is difficult to solve the co-ordination problems identified by Rosenstein-Rodan and others when the process is determined by several private agents operating on their own and responding to market stimuli (even if these are altered by government incentives) rather than through some planning mechanism. It has been found only too often that when governments have reduced investment in certain areas, private agents have not been forthcoming in sufficient measure, despite very large concessions that are provided and which become a large burden on the exchequer. For investment that involves large initial outlays and long gestation periods, there may be many factors which inhibit private investment, including multinational investment, even if numerous incentives are provided. This is particularly the case in small countries that are prone to political upheavals or economic instability for reasons outside the government’s control. So private investment in important areas that are “freed” for private players stays at levels that are inadequate to meet the requirements of the economy, and turns out to be even more expensive for the taxpayer than public investment because of the fiscal costs of meeting various incentives, such as guaranteed rates of return on investment.

This means that governments need to take a more inclusive approach to public investment and not necessarily exclude those areas where it is assumed that private players may be interested. The point is that public investment is not just complementary to private sector investment in several ways, but may also be a necessary addition. Griffin (1996) has noted that government investment in physical capital can be made much more labour intensive, thereby increasing employment, saving on foreign exchange and raising the overall rate of return. It can raise the profitability of private investment and stimulate private savings and domestic resource mobilisation more generally.

The empirical literature on the relationship between public and private investment in general tends to support this argument. While some studies have tried to separate public and private investment and assess their growth impact separately (Khan and Kumar 1997), most empirical investigations have focussed on assessing the extent of “crowding-out” versus “crowding-in”. A number of studies have found positive linkages between public and private

investment, or crowding-in, for developing countries (Serven and Solimano 1986, Greene and Villanueva 1991, Gupta, Powell and Yan 2005).

However, several studies have found that the type of public investment matters. Blejer and Khan (1984) studied 24 developing countries in Latin America and Asia and found that government investment in infrastructure crowds-in private investment, while non-infrastructure public investment tends to crowd-out private investment. Similar results were reported for a later period and a different sample of 48 developing countries by Odedokun (1997). Easterly and Rebelo (1993) used a large dataset for over 100 developing and developed countries to get mixed results: crowding-out effects of total government investment, but different results by sector and by level of government. Ahmed and Miller (2000) used a sample of 39 countries (once again both developed and developing) to find that while total government investment crowds-out private investment over the entire set of countries, public expenditure in transportation and communication crowds-in private investment in developing countries.

Other studies have found that the effects vary across regions. Thus Ghura and Goodwin (2000) found that government investment stimulates private investment for their sample of countries in Sub-Saharan Africa, but crowds-out in Asia and Latin America. Hadjimichael and Ghura (1995) similarly found strong crowding-in for 41 Sub-Saharan African countries, with important roles for macroeconomic and other public policies in encouraging both more private investment and faster growth. Ramirez (1996) found similar positive effects of public investment for Mexico and Chile and for Latin America generally (2000).

Some work has been based on econometric procedures that pay attention to the dynamic interrelationships among public investment, private investment and gross domestic product. Using such methods, Belloc and Vertova (2004) examined a group of highly-indebted poor countries and found empirical support for both the crowding-in hypothesis and a positive effect of public investment on output. Therefore most empirical studies find an overall positive linkage between public investment (especially in infrastructure) and private investment, although obviously the relationship varies by country and also over different periods of time in the same country.

Given this background, it may not be so surprising that, as was evident from the data provided in Section II, relatively few countries have experienced sustained high growth, especially after the 1980s. This was the period when public investment generally got a bad press and was sought to be reduced in scope and ambition across the developing world. If public investment does indeed provide a positive impetus to private investment, as common sense and much empirical evidence both suggest, then reduction of rates of public investment implies a substantial reduction of the inducement to invest by private players. If investment rates, and therefore growth, were not to suffer, this would have to be counteracted by other factors.

Among the more obvious other factors are various government incentives for private investment. It is increasingly recognised by economists – several decades after East Asian governments provided the practical examples - that government fiscal, monetary, trade and credit policies can change the structure of incentives in ways that promote high rates of private investment. Griffin (1996) had argued that an investment-led strategy of adjustment requires an appropriate structure of incentives: a set of relative prices that reflects social costs and benefits; attention to feature such as lack of access to resources, barriers which exclude people from some markets, discrimination in the labour market and the effect on incentives of widespread missing markets. The well-known “success stories” of East Asia were typically based on systematic government intervention, in the form of trade protection, domestic industrial regulation, directed and subsidised credit, tax incentives and the like, that generated high rates of industrial growth and diversification (Amsden 1989, Wade 1990, Evans 1995). While this process definitely provided rents that are generally decried in the rent-seeking literature, it can be argued (Khan and Jomo 2002) that these were actually significant in promoting a certain pattern of accumulation and rapid growth.

Hausman and Rodrik (2002) have argued that in addition to promoting entry, governments also need to actively encourage exit, because according to them economic development is a process of self-discovery of the activities that a country will be most successful in, especially in open economies. They identify two failures of the laissez-faire outcomes: too little investment and entrepreneurship ex ante, and too much production diversification ex post. Therefore, they suggest that governments need to play a dual role in fostering industrial growth and transformation: they need to encourage entrepreneurship and investment in new activities ex ante, but push out unproductive firms and sectors ex post.

Investment, exports and growth

High investment rates seem to matter even in countries which have grown largely on the basis of exports. This comes through from cross-country correlations of investment ratios, output growth rates and export growth rates. An analysis (Patnaik and Chandrasekhar, 1996) based on twenty years (1968-88) data for 25 developing countries showed a close correlation between output growth and the investment rate (or the ratio of investment to income). Similarly there was an extremely close relationship between output growth and export growth. If it is investment which drives output growth then the high correlation between output growth and export growth must make itself visible in terms of a high correlation between the investment ratio and export growth, which it does. The results of a similar analysis for a more recent period (1996-2005) for a larger group of 48 similarly placed developing countries is provided in Table 2. This corroborates the existence of the same kind of relationships between investment, output and exports.

Table 2: Investment-exports-growth relationships for 48 countries, 1996-2005

	Coefficient	Intercept	R-squared
GDP growth vs Average I/Y	0.18	0.36	0.22
Goods export growth vs Average I/Y	0.34	2.69	0.08
GDP growth vs Goods export growth	0.17	2.60	0.31

Source: Chandrasekhar 2008,

Calculations based on data from World Bank, *World Development Indicators Online*.

There are good theoretical reasons why a high investment ratio *ceteris paribus* should give rise to a strong export growth performance. International trade in the different commodities grows, over any period, at different rates. Given these growth rates in world trade, the rate at which a particular developing country's exports grow depends to a very significant extent upon its production structure and the rate at which that structure is changing. Since developing countries tend to have or at least had production structures that specialise in commodities with relatively stagnant world trade, success on the export front obviously depends crucially upon the ability to transform such a production structure rapidly towards commodities where world trade grows faster. Clearly, the rapidity of this transformation is linked to the investment ratio: the higher the investment ratio, the faster the transformation of the production structure and hence the greater the ability to participate in the faster-growing segment of world trade, and therefore the faster the rate of export growth.

What this means is that even for export-orientation to be successful, it cannot simply be based on market signals, including those emanating from the world economy. This would generate a basket of goods determined by static comparative advantage, which would not generate the requisite diversification that would allow for high export growth. There is a significant theoretical literature on dynamic comparative advantage, that emphasises the dangers of being locked into low-value added activities as a result of comparative advantage based on trade openness (Krugman , Pasinetti , Ros 2001). As El-Arian and Spence (2008) have noted, successful high-growth economies have had policies that were designed to help start and accelerate the process of export diversification and structural transformation. This is something that has to be created, nurtured and promoted through policies that stimulate investment in particular areas.

Once this is realised, it also becomes obvious that the traditional policy dichotomy between import substitution and export promotion is a false one. Growth requires diversification of both production and domestic demand, since exports too must be based on the “representative demand” posited by Linder (1961). Import substitution policies may well be required to enable a country to achieve the production capabilities that allow it eventually

to export, and it is possible for both or neither to be associated with higher aggregate growth, depending upon how and the context in which they are implemented.

Institutional change as engine of growth

It used to be widely accepted that a major stimulus to growth could come from a transformation of institutional conditions, in particular property relations, which could operate on both supply and demand forces to enable a shift to a higher growth trajectory. Specifically, land reforms have been cited as means whereby the supply of wage goods would be enhanced (and therefore the financial constraint on economic expansion posed by the supply of wage goods within the economy would be relaxed) because they would lead to greater supply of agricultural goods, including food. In addition, land reforms widen the domestic market and create a mass market for consumer goods, which provides an incentive for investment as well as allows such investment to benefit from economies of scale.

The argument that, given limits on the possibilities of transformation through trade, the institutionally-determined maximal rate of growth of production of agricultural necessities sets a ceiling on the non-inflationary rate of growth of the system was explicated, among others, by Michal Kalecki (1972). This was one of the ways in which the availability of surplus real resources was seen to constrain the pace of development in predominantly agrarian economies. In this seminal work, Kalecki demonstrated how the exogenously given rate of growth of agriculture, the principal supplier of commodities that enter the wage basket, determined the maximum rate of non-inflationary growth a country could achieve. Within the assumptions of the model, any attempt to raise the rate of growth above this rate results in inflation in the prices of essentials, which violates the objective of non-inflationary growth. The rate of growth of agriculture itself was exogenously given because Kalecki saw that rate as being institutionally determined. One implication was that countries that relaxed the institutional constraint by implementing land reforms would record higher rates of agricultural and overall growth. This they achieved because land reform (i) increased agricultural supplies by undermining land monopoly and semi-feudal relations that left the actual tiller with little means and little incentive to invest and thereby increasing land-augmenting investments; (ii) expanded the mass market for manufactures by raising incomes in a more egalitarian rural setting; and (iii) unleashed the energies of the peasantry.

The evidence from countries such as South Korea and Taiwan do support the argument that land reforms, even when implemented under US occupation, provided the backdrop for episodes of high growth. As Cristobal Kay notes (2002: 1081): “The state played a key role in the development process of South Korea. The state was strong and had a high degree of autonomy from the domestic classes in deciding what specific forms of capital accumulation to promote. Through the land reform a relatively egalitarian farming system was created but at the same time the state greatly increased its control over the countryside. About half of the total farmland was transferred to the beneficiaries and two-thirds of all farm households received land under the land reform. Practically no landless peasants or agricultural proletariat exists and socioeconomic differentiation is limited. However, the state

subordinated the rural sector to the over-riding goal of industrialisation. Thus rural-urban disparities widened as the fruits of the country's spectacular economic growth were only shared to a limited extent with the peasantry. It is thus not surprising to find that the peasantry voted with their feet by emigrating en masse to the urban sector, providing the necessary cheap labour for rapidly growing labour-intensive industries. It could be argued that South Korea's phenomenal economic success was achieved on the back of the peasantry."

In Taiwan too: "The extraction of various surpluses from agriculture undoubtedly made a major contribution to the initial stage of industrial development. The provision of cheap rice kept industrial wages low, boosted industrial profits and enhanced industrial exports. Taxes on agriculture provided the state with domestic financial resources that could be used for investment in industry. The export of sugar and rice, which were acquired through the monopolistic state procurement system of these agricultural commodities, on the one hand, allowed the terms of trade to be turned against the farmers and, on the other hand, generated valuable foreign exchange earnings which the state could channel towards the import of the necessary machinery, equipment and raw materials for industry. The manipulation of the terms of trade also ensured that agricultural labour was willing to work for a lower wage in the industrial sector than would have been the case otherwise, as the returns to agricultural labour were lower than they would have been without agriculture's unfavourable terms of trade." (Kay, 2002: 1082-83).

Thus, the experience of these countries illustrates the key role that land reforms and institutional change in agriculture plays even within the framework of capitalist growth. It needs to be noted that land reforms need not always be the prelude to the exploitation of a fragmented peasantry to generate surpluses for financing development. Rather, if the egalitarianism resulting from land reforms is combined with a fair terms of trade between industry and agriculture, it can help generate a large mass market for manufactures in the rural areas. This is what seems to have happened in the early stages of the Chinese economic reform in the 1980s. A similar trajectory was not pursued in Korea and Taiwan because the "developmentalist state" in these economies adopted a mercantilist industrial growth strategy based on export markets rather than a strategy primarily based on expanding the domestic market.

More recently, there is evidence that other types of institutional change, rather than only land redistribution, can have significant effects on output. These changes can have different effects and implications in different phases of development. Thus, in China, the movement towards co-operativisation/collectivisation as a means of consolidation in order to overcome the problems created by excessive fragmentation of peasant holdings played a role in a certain stage of Chinese agrarian development and was crucial in generating a surplus for industrial development. Subsequently, from 1979 onwards there were institutional changes that moved away from a strict adherence to commune-based production, to allow peasant participation in markets for agricultural produce from 1979 onwards and then gradually recognised and increased their usufruct rights over their individually holdings. This in turn led to a dramatic increase in agricultural production and incomes in the early 1980s, which

was followed by a concomitant expansion of rural non-agricultural economic activity as demand for such goods increased.

Technological change as impetus for growth

[To be completed.]

IV. Financing growth¹

Given the importance of investment in ensuring higher growth, development theory had traditionally been concerned with identifying the factors that enable the “financing” of higher growth by raising the rate of investment. However, the issue was not seen as merely that of mobilising financial surpluses to expend on investment. Conventionally, the issue of financing for development has been concerned with the question of mobilising real resources, in the sense of restricting consumption and setting aside an adequate share of national output to finance investment.

One conclusion that was often arrived at by those who saw the problem purely in monetary terms was that since poor countries with low per capita incomes were already characterised by low levels of per capita consumption, they were not in a position to raise the rate of savings significantly by squeezing consumption. This was seen as trapping them in a vicious circle of poverty, since low per capita income meant low saving, which kept investment and growth low and therefore income and saving low. Escaping from this vicious circle, it was argued, required injection of surpluses from outside in the form of foreign aid and/or foreign investment. As was pointed out quite early in the debate, this view underestimated the ability of poor countries with substantial inequality to limit the “unnecessary” luxury consumption of the rich and generate surpluses for investment. It also tended to ignore the fact that for various reasons foreign savings, instead of adding to domestic savings proved to be a substitute for domestic savings in practice, contributing little to increasing investment.

Moreover, it was argued that shifting the focus to mobilising real resources seemed to offer various innovative alternatives for financing development. To start with, since many poor developing countries were characterised by the availability of unemployed or underemployed surplus labour, if this surplus labour population could be mobilised and put to work on building capital stock, surplus labour was a potential surplus available for investment. This was a point emphasised by Nurkse (1966), Kalecki (1972) and others.

While the validity of this argument was unquestioned, it was recognised that realising this potential required ensuring that agricultural output does not fall when surplus labour is

¹ This section is largely based on Chandrasekhar (2008).

drawn from the agricultural sector where it normally resides and that when there are less mouths to feed in the rural areas the surplus food available there does not result in higher consumption of the remaining peasantry but is available for feeding workers now being put to work in building capital stock. That is the potential surplus residing in a surplus workforce can be successfully mobilised only if it is supported with the mobilisation of surplus wage goods needed to feed these workers. *In sum, it is not only the volume of surplus that matters, but the physical forms in which this surplus is available.*

This would be all the more true if we take account of the fact that there are limits to building capital with the “bare hands” of surplus labourers, who need to work with some capital equipment. So a part of the surplus mobilised to undertake new investment must be in the form of capital goods, a fact take account of in the Feldman/Mahalanobis model, which emphasised the need to allocate a higher share of the surplus to the production of investment goods, especially early stage or investment goods or the “machines to produce machines”. The higher is that allocation the higher would be the rate of growth of the system.

[Issue of intersectoral terms of trade and resource extraction from agriculture to be taken up here.]

The investment goods constraint

As noted earlier, it is not enough to have a part of the surplus available for investment in the form of wage goods. Since commodities cannot be produced with bare hands, if the possibilities for transformation through trade are limited, it would be necessary to have the surplus partly in the form of investment goods.

The macroeconomic strategy formalised in the model developed independently by Feldman (Domar 1972) and Mahalanobis (1955) reflected this concern and was fundamentally influenced by a presumption that dominated much of development thinking of the time. This was that the binding constraint on growth in the underdeveloped world was the inadequate access to capital stock to employ the available labour force in full. There were two grounds on which that presumption was normally justified. First, that the possibilities of transformation through trade were limited, which in turn limited the imports of capital goods to sustain late industrialisation. Second, that since countries like India had launched on an accelerated industrialisation strategy at a point in time when industrial technology had already evolved in the capital intensive direction for decades, the notion that capital could be constructed from scratch, “with bare hands”, in a short period of time, was not warranted.

If in addition the capital stock available at any point in time is “non-shiftable”, pre-empting the transfer of machines meant for producing consumption goods to the task of producing machines, then the capacity of the investment goods sector determines the level of investment that could be undertaken in any period. Since for any given average capital-output ratio in the economy, the addition to output depends on the level of investment, the rate of growth of the economy would be higher the greater is the rate of accretion of capital stock. This meant that the task of realising a higher rate of growth is best served by the allocation of

a higher share of investment to the investment goods sector, and within it to concentrate on the production of "machines to produce machines" rather than "machines to produce consumption goods". For example, India's immediate post-Independence industrialisation success was related to its pursuit of a strategy of this type. However, the failure to meet a number of associated prerequisites meant that this success could not be sustained after the mid-1960s.

Does "finance" matter?

If the development finance problem is thus essentially one of utilising the potential surplus embodied in unemployed and underemployed workers, while overcoming the wage goods constraint and dealing with the lack of adequate capital stock to employ the labour force in full, where does the question of finance in the sense of monetary resources and fiscal and financial policies come in? Does finance matter at all? "Finance" does matter because, in all modern economies, incomes in the form of wages, profits, rent and interest accrue to those who receive them in money form. These recipients also make decisions as to how much to spend and how much to save in terms of money.

If a growth trajectory has to be stable, the physical volume and the physical forms in which output is allocated between investment and consumption along that trajectory must correspond with the financial allocation made by savers and investors to consumption and savings/investment, and the actual allocation of savings to investment in different sectors. That is, decisions in the financial realm made by households, firms and the government must correspond to the physical pattern of investment and output that decisions of firms and the public sector imply. Otherwise the system would be characterised by excess demand for some commodities and excess supplies of others, with consequences for the level of growth.

One way in which the system can ensure a higher rate of investment in both physical and financial terms and a higher rate of non-inflationary growth is by having the government use a combination of direct taxes on the rich and indirect taxes on luxuries to restrict inessential consumption and mobilise the surplus for investment. The other is for the financial system to intermediate between savers and investors in ways which it channelizes savings to those sectors to which investment has to be directed if the physical form in which a particular rate of investment has to be embodied is to be realised. It is in these two ways that the monetary form of the problem of financing investment presents itself.

The Mahalanobis strategy, which sought to implement a Feldman-type model in a mixed economy like India with an important role for private savings and investment decision, was premised on the ability of the state to impose the necessary taxes to align the financial sphere with the real parameters chosen by the planner to realise the investment-led growth strategy. The failure of the government to actually impose such taxes and influence savings and investment was an important factor behind the failure of that strategy.

Further, realising a growth-oriented pattern of production of goods and services requires the state to guide the allocation of investment. Since independent and atomistic

decision makers cannot have the economy-wide and “social” seeing power to undertake such coordination and targeting, the state must play a role in overcoming market failure resulting from inadequate coordination. One way to do this is to use the financial sector as an instrument for investment coordination and targeting. Even in developing countries that choose outward-oriented strategies or are forced to choose a more mercantilist strategy of growth based on rapid acquisition of larger shares in segments of the world market for manufactures, the relevant segments have to be identified by an agency other than individual firms. Experience indicates that the state has the capacity to assess and match global opportunities and economy-wide capabilities.

Hence, through its financial policies, the state must ensure an adequate flow of credit at favourable interest rates to these entities so that they can not only make investments in frontline technologies and internationally competitive scales of production, but also have the means to sustain themselves during the long period when they expand market share. The state must not merely play the role of investment coordinator; it needs to use the financial system to direct investment to sectors and technologies at appropriate scales of production. Equity investments and directed credit are important instruments in such a state-led or state-influenced development trajectory.

Neither of the financial prerequisites for development noted above conflicts with the notion popularised by the Keynesian Revolution that the lack of adequate financial savings cannot be the constraint on investment and growth. In that framework the role of the financial sector in mobilizing and channelling savings was secondary and inevitably fulfilled. As Joan Robinson (1952) once put it, “By and large ... where enterprise leads, finance follows.” The financial sector is merely seen as adjusting to the requirements of the real sector.

However, if the financial sector is left unregulated, in economies with substantial private assets and an important role for private agents in investment decision-making, market signals would determine the allocation of financial resources. This could mean that the demand for financial resources from crucial sectors would not be matched by supply because uneven development and inequality may imply that inadequate collateral is on offer, transaction costs are high and/or private returns in particular activities to financial entities are lower-than-expected even though the social returns from such activities are high.

Unregulated allocation of financial resources inevitably leads to the problems conventionally associated with a situation where private rather than social returns determine the allocation of savings and investment. To start with, the allocation of investment may not be in keeping with that required to ensure the profile of production needed to raise the rate of saving and investment. Further, certain sectors such as the rural sector in general or agriculture in particular and the small industrial sector may be largely excluded from formal sector credit provision on the grounds that the transaction costs associated with such lending are high or that default risk is greater. But the problem could go deeper. Unregulated financial entities could direct their investment financed with the savings of depositors to “sensitive” or risky sectors such as real estate and stock markets. Loans to these sectors can be at extremely high interest rates because the returns in these sectors can touch very high

levels. Since banks accept real estate or securities as collateral, borrowing to finance speculative investments in stock or real estate can spiral. These activities thrive because of the belief that losses if any can be transferred to the lender through default, and lenders are confident of government support in case of a crisis. This could feed a speculative spiral that can in time lead to a collapse of the bubble and bank failures.

These kinds of tendencies affect real investment in two ways. First, inasmuch as speculative bubbles lead to financial crises, they squeeze liquidity, result in distress sales of assets and deflation that adversely impact on employment and living standards. Second, inasmuch as the maximum returns to productive investment in agriculture and manufacturing are limited, there is a limit to what borrowers would be willing to pay to finance such investment. Thus, despite the fact that social returns to agricultural and manufacturing investment are higher than that for stocks and real estate, and despite the contribution that such investment can make to growth and poverty alleviation, credit at the required rate may not be available.

While factors such as these could limit the rate of growth, the private-profit driven allocation of savings and investment could also affect variables such as the balance of payments, the employment elasticity of output growth, and the flow of credit to poverty-prone sectors. It could aggravate the inherent tendency in markets to direct credit to non-priority and import-intensive but more profitable sectors, to concentrate investible funds in the hands of a few large players and direct savings to already well-developed centres of economic activity.

These features have important implication for financial policies. They imply that if the government wants to influence the sectors and agents to whom credit is directed and the prices at which such credit is to be provided, in order to realise a particular allocation of investment, a given rate of investment, and an income-wise and region-wise redistribution of incomes, it must impose restrictions on the financial sector to realise these goals. In fact, if certain sectors can survive and prosper only if credit is offered at lower than “market” interest rates even if the transaction costs associated with credit provision is higher, then cross-subsidisation may be required and profits from lending may be lower than otherwise. The subordination of the profit principle that this implies, may require state ownership of crucial financial intermediaries.

Further, even in developing countries which choose or are forced to choose a more mercantilist strategy of growth based on a rapid acquisition of larger shares in segments of the world market for manufactures, these segments have not only to be identified by an agency with greater seeing power than individual firms, but that agency must ensure an adequate flow of cheap credit to these entities so that they can not only make investments in frontline technologies and internationally competitive scales of production, but also have the wherewithal to sustain themselves during the long period when they build goodwill in the market, which is a function of time. The state must not merely play the role of investment coordinator, but use the financial system as a means to direct investment to sectors and

technologies at scales of production it considers appropriate. Equity investments, directed credit and differential interest rates are important instruments of any state-led or state-influenced development trajectory as the experience of countries like South Korea, Brazil and India illustrate.

The role of development banks

As noted elsewhere (United Nations, 2005), left to themselves, private financial markets in developing countries usually fail to provide enough long-term finance to undertake the investments necessary for economic and social development. As a result, firms in developing countries often hold a smaller portion of their total debt in long-term instruments than firms in developed countries. Private institutions may fail to provide such finance because of high default risks that cannot be covered by high enough risk premiums because such rates are not viable. In other instances, failure may be because of the unwillingness of financial agents to take on certain kinds of risk or because anticipated returns to private agents are much lower than the social returns in the investment concerned (Stiglitz 1994).

This creates a shortfall in funds for long-term investments. One way to deal with this problem is to encourage the growth of equity markets. This is attractive because, unlike in the case of debt, risk is shared between the financial investor and the entrepreneur. This enhances the viability of the firm in periods of recession. However, the evidence shows that even in developed countries equity markets play a relatively small role in mobilizing capital for new investments.

To cover the shortfall in funds required for long-term investment, developing countries need to and have created *development banks* with the mandate to provide long-term credit at terms that render such investment sustainable. According to an OECD estimate quoted by Eshag (1983), there were about 340 such banks in some 80 developing countries in the mid-1960s. Over half of these banks were state-owned and funded by the exchequer; the remainder had mixed ownership or were private.

Handicapped by colonial legacies, international inequalities and various systemic biases, these kinds of institutions are a ‘must’ for developing countries. Any national strategy of modernisation in a mixed-economy framework must provide for the establishment of institutions of this kind. However, it is best to create separate development banks to provide long-term capital at near-commercial rates and “policy banks” to provide credit to special areas such as agriculture or the small scale sector where interest rates have to be subsidized and grace periods have to be longer. This allows different criteria to be applied to the evaluation of the performance of these banks, with profitability a more important consideration in the case of the former.

What is more, the financial sector in backward countries may have to undertake entrepreneurial functions such as determining the scale of investment, the choice of technology and the markets to be targeted by industry, and extension functions such as offering technical support to the farming community. Stated otherwise, although financial

policies may not help directly increase the rate of savings and ensure that the available ex ante savings are invested, they can be used to influence the financial structure in a manner that ensures that lending leads to productive investment that makes such lending sustainable.

Growth requires not just an adequate volume of credit but an appropriate distribution of such credit. For example, certain sectors – infrastructure being the most obvious – are characterised by significant “economy-wide externalities”. That is, their presence is a prerequisite for and a facilitator of growth in other sectors. But the infrastructure sector is usually characterised by lumpy investments, long gestation lags, higher risk and lower profit. Banks would be wary of lending to such projects, given the maturity and liquidity mismatch involved. Such reticence would be greater in economies with a predominantly private banking system. If private – rather than social – returns drive the allocation of financial savings, these sectors would receive inadequate capital, even though their capital-intensive nature demands that a disproportionate share be diverted to them. Given the “economy-wide externalities” associated with such sectors, inadequate investments in infrastructure obviously constrain the rate of growth. Hence, specialised policy development banks are needed, with sources of finance other than deposits by small savers. While such institutions can be funded by the government or the central bank, government guarantees on borrowing by these entities is needed if adequate capital is to be mobilised.

To provide an example, in Vietnam, the government has continued with targeted lending for specific purposes even after the adoption of financial liberalization policies. This involved the creation of a special Development Assistance Fund (DAF), separate from the commercial banking system, which had as its objectives: (i) the provision of subsidized state loans for medium to long-term investments in priority sectors such as infrastructure, heavy industry and public services, (ii) provision of interest-rate support and investment guarantees for chosen projects, and (iii) provision of short-term export promotion credit. Support in these forms can go to both private and state-owned enterprises, taking account of both commercial and policy criteria, such as encouraging investment in underdeveloped areas, preferential sectors, and projects related to health, education, culture and sport. The DAF has branches in all sixty-one provinces. Initially, the Office of the Prime Minister determined allocation of funds. Funds came from the Social Insurance Fund, the Sinking Fund, the Vietnam Postal Service Savings Company (VPSC), the government budget, loan repayments, and official development assistance (ODA). Subsequently, the DAF has been expected to mobilize its own resources. It continues to draw funds from the sources mentioned above, through negotiation. If funds come from the government budget, this usually involves issuance of investment bonds.

Overall, in developing countries adopting a mixed economy framework where private initiative and investment are significant, the financial sector would have to play a major role in: (i) channelling large volumes of cheap capital to purposefully chosen units and agents; (ii) using the leverage provided by this activity to coordinate and influence investment decisions and ensure that production occurs as per guidelines provided; (iii) ensuring that financial

flows are inclusive and reach sectors and sections that would otherwise be bypassed or neglected; and (iv) regulating the sector so as to guard against financial fragility and failure.

To play these roles the state would have to choose an appropriate institutional framework and an appropriate regulatory structure. That is the financial structure—the mix of contracts/instruments, markets and institutions—is developed keeping in mind its instrumentality from the point of view of the development policies of the state. The point to note is that this kind of use of a modified version of a historically developed financial structure or of a structure created virtually anew was typical of most late industrializing countries. Financial structures in these countries were created to deal with the difficulties associated with late industrial entry: capital requirements for entry in most areas were high, because technology for factory production had evolved in a capital-intensive direction from its primitive industrial revolution level; competition from established producers meant that firms had to concentrate on production for a protected domestic market or be supported with finance to survive long periods of low capacity utilisation during which they could find themselves a foothold in world markets. Not surprisingly, late industrialisers created strongly regulated and even predominantly state-controlled financial markets aimed at mobilising savings and using the intermediary function to influence the size and structure of investment. This they did through directed credit policies and differential interest rates, and the provision of investment support to the nascent industrial class in the form of equity, credit, and low interest rates. Developing countries attempting to catch-up with their developed counterparts have and must do the same.

V. Growth, structural change and employment

Kuznets (1973) identified six features of what he called “modern” economic growth. These were (1) high rates of growth of both per capita output and of population; (2) rapid increase in productivity; (3) a high rate of structural transformation in the economy, including a shift from agriculture to non-agriculture and subsequently from industry to services, as well as a shift from self-employment to wage employment in what he saw as “the impersonal organisation of the firm”; (4) related changes in the structure of society and its ideology; (5) a propensity of the developed countries to use technology to “reach out to the world – thus making for one world in the sense in which this was not true in any other epoch”; (6) its limited nature, such that the economic performance of countries accounting for three-quarters of the population still falls far short of the minimum feasible levels that could be achieved with current technology. He also noted that these characteristics are inter-related, in that one induces another in a cause and effect sequence, with technical innovations in particular providing a positive feedback.

Kaldor (1966, 1967) brought in structural change as not only a results of growth, but in effect a cause of it, since demand and supply conditions vary across sectors. He saw the causality running from manufacturing growth to GDP growth, and to growth of labour

productivity. In terms of demand, this is because manufacturing (along with services) was seen to have higher elasticity of demand for its products than agriculture. On the supply side, manufacturing was seen to play a special role, even relative to services, because of two processes. The first reflects Verdoorn's Law, whereby the growth rate of productivity in manufacturing industries rises with the growth rate of manufacturing output (but with a coefficient less than unity, so as to ensure continued employment growth in manufacturing). So productivity growth is higher in manufacturing than in services, and tends to have a greater impact on aggregate output and productivity. A corollary of this is that the growth of manufacturing will be faster than that of aggregate output and therefore the share of manufacturing. The second process is a Lewisian mechanism of employment growth in industry increasing the rate of productivity growth in other sectors.

Through either analytical route, it is evident that growth and structural change (in terms of the composition of both output and employment) are - or at least should be - closely intertwined. Indeed, this is typically seen as the essential process of development, whereby industrialisation generates not only higher per capita incomes but also less inequality. As noted by Galbraith (2008:11), "The very essence of development lies in industrialization, which is to say the emergence of a stable, middle-class working population, paid at rates which vary only by the range of skills in the workforce and the permissible extent of monopoly power in an urbanized, technologically sophisticated, and possibly democratic society. Correspondingly, the very essence of underdevelopment is not poverty *per se*. It is rather the gap between an extractive or plantation sector serving a small rentier and landlord elite, and a large peasant population that exists on the margins of the monetary economy."

The process by which different processes of structural change and trade combine to produce uneven development across countries is succinctly described by Kaldor (1986:197). "Industrial growth leads to both higher real wages and a higher volume of employment, which will mean a higher concentration of the population in urban areas. This may entail cumulative advantages through the spread of knowledge and education with favourable repercussions on progress through the application of scientific knowledge to industry. These go well beyond the economies of large-scale production, though these economies, through their need for geographic concentration, may have been instrumental in creating them. The reverse side of this (of which we have heard much recently) is found when the industrial sector, due to falling market shares in relation to other centres, becomes stagnant and then goes into a decline, causing unemployment which tends to be concentrated in the inner cities of large towns which fall into decay.

In the primary producing regions, by contrast, technical progress involves a combination of rising production and of falling demand for labour, resulting in both open and disguised unemployment, the natural corrective for which is the movement of populations from agricultural to industrial areas. However, actual mobility has never been large enough to even out the differences in the level and the rate of growth of real wages between agriculture

and industry—not even within the same country, and much less so when the required movement is across political boundaries.

There is thus no effective tendency to level out the differences between the advanced industrial areas and the surplus-labour agricultural areas; on the contrary, if our analysis is correct, the benefits of technical progress of *both* sectors tend to accrue to the *industrial* sector. This means that the faster the growth of technical knowledge the more the "the terms of trade" will turn against the primary producing areas and the greater will be the inequality between rich and poor countries."

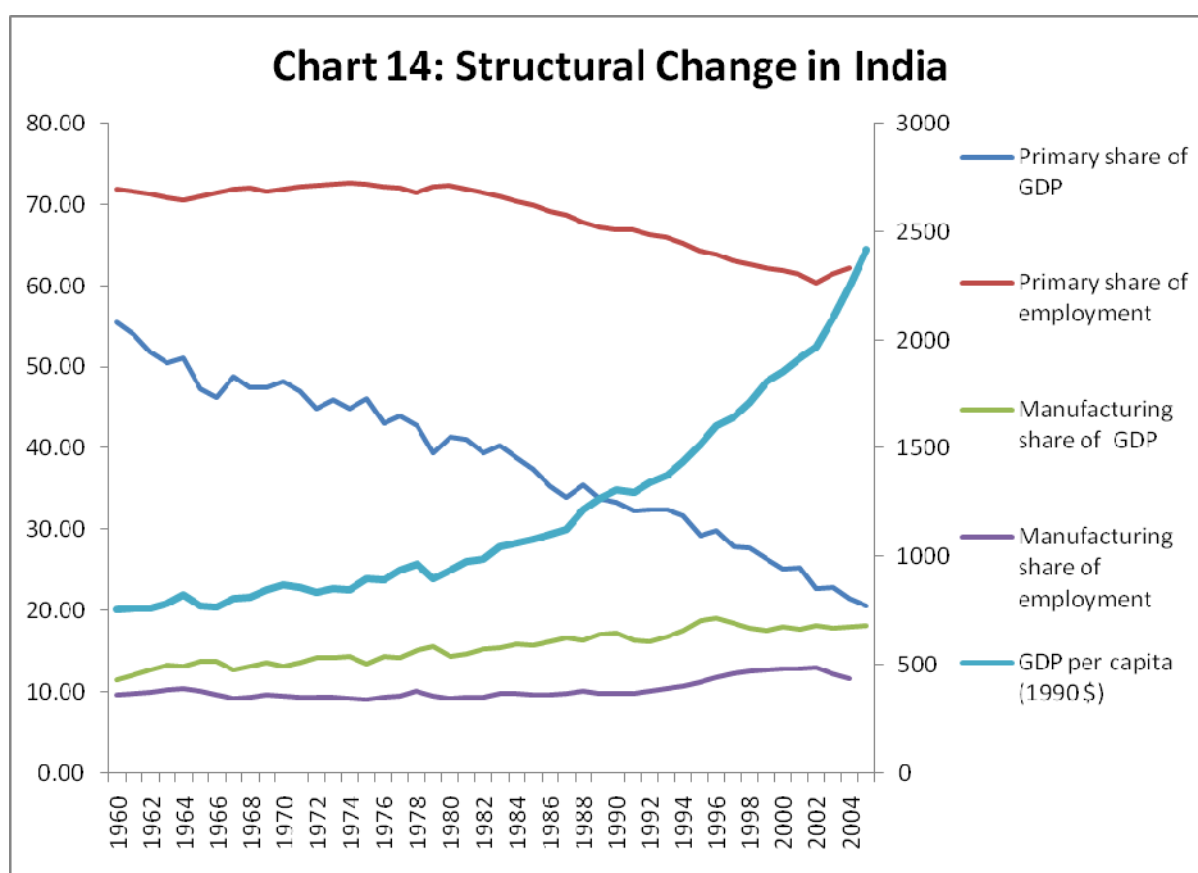
This may be one of the reasons why even a relatively "slow-acting process of structural change" has not always operated in traditional (or even augmented) Kuznets fashion. While the share of agriculture in output has generally tended to decline, this has not always been accompanied by a commensurate decline in employment in agriculture, as evident from Kum (2008). This process can also be assessed with reference to some examples. Charts 13 to 16 describe trends in employment shares of the primary and manufacturing sectors, along with changes in per capita GDP in four developing countries. The data used in these charts differ from those in earlier charts because they are based on the Groningen Development Centre's 16-sector database. The output shares are derived using the estimates based on national currencies in constant price terms, while the GDP per capita is in constant US dollar terms.

Chart 13 shows the case of South Korea, which can be described as the "classic" Kuznets style structural change, whereby the share of the primary sector in both output and employment declines continuously over the process of economic development, with employment shares falling faster. Manufacturing rises in both output and employment in the early phase of fairly rapid and sustained growth, from the early 1960s to the late 1980s. By then, South Korea has reached the level of a middle-income developing country, and while the share of manufacturing in GDP continues to increase, its share of employment begins to fall as labour productivity gains in manufacturing are greater than in other sectors. Therefore, employment grows essentially in services, which by the end of the period described here account for as much as 73 per cent of total employment and 54 per cent of GDP.

By contrast, the experience of India (described in Chart 14) is rather different, not least because the increases in per capita GDP have been less buoyant and significantly lower than in South Korea. Per capita income increases relatively slowly until the mid-1990s, and faster thereafter. The share of the primary sector in GDP declines from 55 per cent in 1960 to 21 per cent in 2004, although in a cyclical fashion that reiterates the continued dependence of Indian agriculture on the vagaries of the monsoon. However, employment in the primary sector continues to dominate total employment throughout this period, and hardly changes at all for the first two decades, such that over the entire period it declines by only ten percentage

points, from 72 per cent in 1960 to 62 per cent in 2004. The share of manufacturing in GDP increased only very slowly, and was still below one-fifth at the end of the period, suggesting that the Kaldorian process of aggregate output dynamism being generated by this sector has not occurred in India. Further, the share of manufacturing in total employment has barely changed at all, going from 10 per cent to only 12 per cent over this entire period.

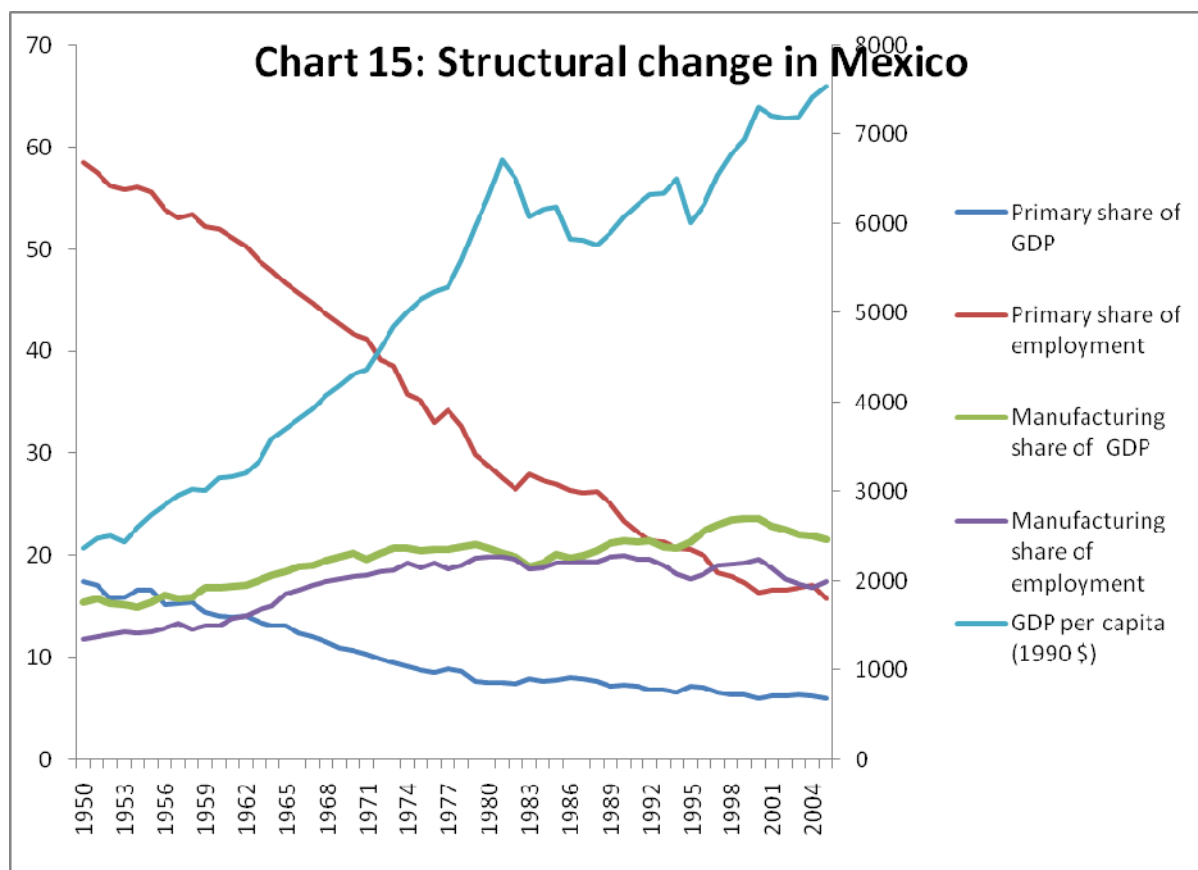
This obviously means that the more recent period of faster growth in India is one that has been dominated by services, which have accounted for nearly 70 per cent of the incremental GDP between 1991 and 2004, and by 2004 employed around one quarter of the work force to produce more than half the GDP. The question of the extent to which this can be called service-led growth is still moot, however.



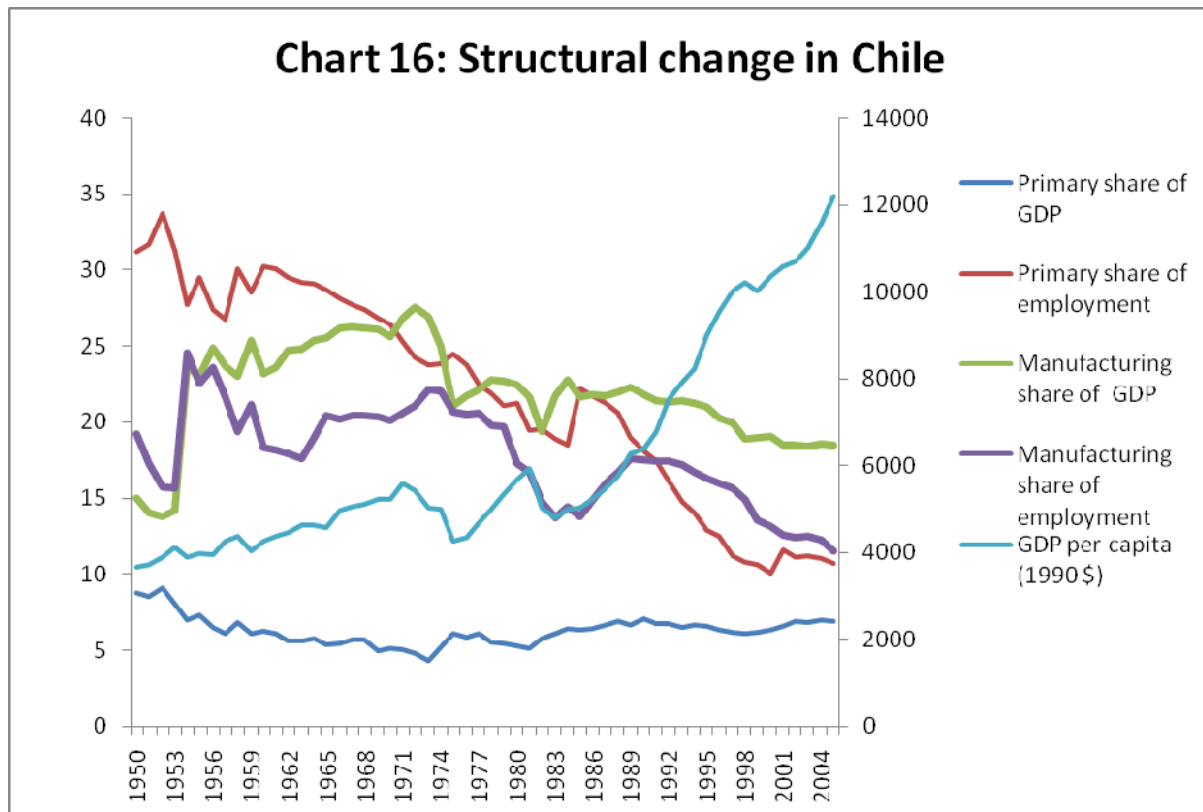
Two examples from Latin America are different again, and particularly interesting because they are both economies that have been known as primary product exporters, but have obviously achieved a notable degree of economic diversification.

Mexico is a petroleum exporter, yet the share of the primary sector in GDP fell from nearly 20 per cent in 1950 to less than 10 per cent in 2004 (Chart 15). The decline in the primary sector in employment has been even more dramatic, falling from nearly 60 per cent at the start of the period to less than 20 per cent at the close. It is evident, as was noted in the second section, that Mexico's rapid growth occurred during the phase of import substitution until the late 1970s, and that the subsequent trajectory of output has been much more uneven

with sharp volatility and no clear trend until the most recent few years. The import substituting years were the ones during which the most rapid growth and the greatest economic diversification (in both output and employment) took place. However, the manufacturing sector does not appear to have played a positive Kaldorian role through the entire period. Even in the most recent phase, when the export-oriented expansion led by the *maquila d'oras* and enhanced by NAFTA are supposed to have led to a manufacturing revival, the share of manufacturing in GDP barely increased, fluctuating between 22 and 24 per cent between 1994 and 2004, while the share of manufacturing in total employment actually fell.



Chile provides an even more complicated example. Chile too has been known as a primary exporter – of copper and agricultural products – but has diversified especially into agro-processed exports. Unlike Mexico, Chile’s real growth spurt started in the early 1990s, and has been associated with declining shares of the primary sector. However, this is also the period when manufacturing declined as well, as a proportion of output and of employment, although the decline was less sharp, and far more volatile, than that of the primary sector. The question is whether Chile could be said to have achieved the level of per capita GDP at which the services sector comes to dominate in economic activity and employment.



What is evident is that, even for these few case studies, the classic pattern of structural change in the course of development seems to be more the exception than the norm. Developing economies are being dominated by service activities well before they reach the levels of per capita income at which this was estimated to happen. Various studies have suggested that this is true for a wider range of developing countries, and that the turning point for the share of manufacturing output and employment is now taking place at a much lower level of per capita income than hitherto (Rowthorn and Coutts 2004, Palma 2005, Pieper 2003).

The phenomenon of rapid expansion of the service sector rather than manufacturing at relatively early stages of development, and the associated “premature de-industrialisation” has been much discussed. Dasgupta and Singh (2006) note that this need not always be a pathological sign, and that the service sector may also play a role as a positive engine of growth through the mechanism of raising productivity because of the rapid technological progress in the “new services”. The IT industry in India is cited as the example in this context, as a contrast to the more pathological deindustrialisation that occurred in Latin America in the wake of the Washington Consensus policies that led to the abandonment of industrial policy.

However, Chandrasekhar (2007) provides a somewhat different interpretation. He accepts that that services growth, especially that of modern services such as communication

services, financial services and IT and IT-enabled services, has not been accompanied by a proportionate growth in employment, reflecting an increase in labour productivity. This makes India's trajectory more acceptable from the productivity angle, even if not the most advantageous from the point of view of unemployed and underemployed workers in a labour-surplus economy. Moreover, technological changes and developments have made a number of services exportable through various modes of supply, including cross-border supply through digital transmission. Thus, in the case of IT and IT-enabled services in India, the expansion of output is driven by the expansion of exports, with positive balance of payments implications.

However, despite rapid growth, the absolute size of the sector in India remains small, and India was and remains a small player in the global market taking account of both domestic supply and exports. The contribution of the business services sector which includes both software services and IT-enabled services, and is the driver for export-led services growth in India is even smaller, having risen from 2.6 to 3.3 per cent of GDP between 1985 and 1995, and then to 4.3 per cent in 2005. In fact, the share of business services in total valued added revenues in market oriented services fell from close to 50 per cent in 1985 to 36 per cent in 2005. This does not suggest that the software and IT-enabled services boom has been the prime driver of growth in India. Rather, the vast mass of differentiated but largely low productivity unorganized services still accounts for half the GDP and most of the employment in the services sector. This makes the argument that services are reflective of a new dynamism in India that much less convincing.

VI. Macroeconomic policies for sustained and more equitable growth

The changing discussion on growth

Even though the "new" neo-classical economics has emphasised the importance of incomplete markets, information asymmetries and the like in real world economies, development economists from the neoclassical tradition have tended to adopt a micro-theoretic approach that presumes that it is possible to approximate an ideal market in real economies. Based on that presumption, they have advanced the argument that the allegedly interrelated phenomena of "inward orientation", "price-distortion", and "inefficiency" had eroded the surplus available for investment and limited growth in economies pursuing interventionist growth strategies that used protection to create domestic policy space. Much has been written on the errors inherent in this critique. "Outward orientation" as manifested for example in successful export-performance has been accompanied by highly State-interventionist neo-mercantilist policies rather than any attempt to "get prices right" in the conventional sense. The alleged "inefficiency" of dirigiste industrialization is established through statistical exercises involving dubious concepts such as "total factor productivity" (which is predicated upon the perennial absence of any demand constraint). And there is complete silence on the role of the domestic investment effort in explaining growth

performance, notwithstanding the overwhelming evidence which exists on its importance. The neglect of these and other theoretical and empirical arguments helps justify the preference for achieving allocational efficiency as opposed to realising increases in the investment rate in the policy prescriptions of those ostensibly influenced by neoclassical theory.

However, the central point of much recent literature on economic growth is that orthodox stabilisation and liberalisation policies are not only insufficient, but may even be counterproductive in terms of generating growth. This marks a very significant shift from the received wisdom that has dominated policy making. The field is now therefore wide open in terms of both understanding and explaining growth processes, as well as in suggesting economic strategies to ensure sustained growth and development.

Two recent contributions to this burgeoning literature merit special attention. In 2005, the World Bank, which in several publications over the previous four decades had espoused the application of free market principles as the inevitable formula for all economic contexts and requirements, came up with a volume entitled “Economic growth in the 1990s: Learning from a decade of reform”. Some of the conclusions of this study include the following:

- It is overly naïve to expect that simply reducing tariffs or liberalising finance will automatically increase growth.
- Stabilisation and macroeconomic management need to be growth-oriented.
- Governments need to be made accountable, not bypassed.
- Governments should abandon formulaic policymaking.

While these may appear to be obvious and commonsensical points, the very need to state them suggests how far away from common sense the mainstream consensus had moved. It can be argued that uncritical acceptance of this consensus resulted in policies that created patterns of production and specialisation in developing countries that destroyed existing livelihoods without generating enough new employment, did not allow enough public investment in physical and social infrastructure to sustain future growth, and reduced the access of the poor to basic goods and services, thereby reducing the quality of whatever growth did occur. These arguments are considered in more detail in the final section. The moot point here is that these arguments are being questioned even in international institutions where they were earlier championed.

An even more recent consideration of the elements making for sustained economic growth is the Report of the high-profile Commission on Growth and Development, chaired by Nobel Prize-winning economist Michael Spence, and including some extremely distinguished economists and policy makers. While this report has been criticised for saying little more than what undergraduate students in economics could come up with (Easterly 2008), it is significant in its avoidance of market fundamentalism and genuine acceptance of ignorance and acceptance of past mistakes in declarations about growth, admitting that “orthodoxies apply only so far.”

The Report identifies 13 countries that are described as “high growth” because they have grown at an average rate of 7 per cent a year or more for 25 years or longer: Botswana, Brazil, China, Hong Kong, Indonesia, Japan, South Korea, Malaysia, Malta, Oman, Singapore, Taiwan and Thailand. On the basis of these “success stories”, the likely elements that generate such a sustained growth process are identified. According to the Growth Commission, therefore, the elements for success are as follows:

- investment rates of at least 25 per cent of GDP, including 5-7 per cent of GDP in infrastructure, with such investment predominantly financed by domestic savings;
- spending by private and public sectors of another 7-8 per cent of GDP on education, training and health;
- inward technology transfer, facilitated by exploitation of opportunities for trade and inward foreign direct investment;
- acceptance of competition, structural change and urbanisation;
- competitive labour markets, at least at the margin;
- the need to bring environmental protection into development from the beginning;
- equality of opportunity, particularly for women.

Similarly, the Report provides a list of policies to be avoided if sustained high growth is to be achieved:

- subsidising energy;
- using the civil service as employer of last resort;
- reducing fiscal deficits by cutting spending on infrastructure;
- providing open-ended protection to specific sectors;
- using price controls as a way to curb inflation;
- banning exports, to keep domestic prices low;
- under-investing in urban infrastructure;
- underpaying public servants, such as teachers;
- allowing the exchange rate to appreciate too far, too quickly.

Of course, some of these arguments are unexceptionable, and in a general consideration of growth processes it is perhaps inevitable that there will be some degree of over-simplification and generalisation. A more detailed consideration of these and other arguments for growth is provided in the final section. Two points may be briefly noted here. First, the basic presumption that growth will necessarily lead to improved economic conditions of the majority of the population is questionable, as is discussed in Section VI. Second, even if growth *per se* is uncritically accepted to be the goal, each of the positive and negative conditions mentioned by the Growth Commission can be questioned and counter examples can be provided, and indeed, the Report does accept that it cannot provide a formula for policy makers to apply, since no generic formula exists.

But what may be most interesting about the Report of the Growth Commission is what it does *not* say, since that reflects a substantially changed recognition of reality, compared to past mainstream discussion. Crucially, there is no mention of financial liberalisation as a necessary condition for growth. Nor is there a blanket recommendation for trade and investment liberalisation: exploiting opportunities for trade and foreign direct investment can be done as much and probably more effectively under relatively regulated circumstances, as in China. The Report's silence is deafening on the Washington Consensus conditions for growth such as "prudent" macroeconomic policies and fiscal discipline, which it barely mentions. Indeed, it even argues that it is not desirable to reduce fiscal deficits by cutting public infrastructure spending, which is a far cry from the earlier emphasis on reducing public deficits at all costs and using all means.

A much more interesting perspective from an international organisation on the macroeconomic policies that generate sustained growth comes from the latest *Trade and Development Report* from UNCTAD. It focuses on the important macroeconomic policies that will allow developing countries to continue to pursue goals of industrialisation and diversification, in what is now emerging as a context of turmoil in international financial markets, slowdown of growth in developed economies and sharply rising and very volatile prices of important primary commodities including food and of universal intermediates such as fuel.

This Report provides a different perspective from that of other international organisations, such as the World Bank, IMF or WTO, on the significance of certain prices. The emphasis of these institutions in the past, as expressed in the "Washington Consensus", was on "getting prices right" in the microeconomic sense of aligning domestic relative prices of goods and services with international relative prices. But UNCTAD (2008) focuses on a different set of prices: the macroeconomic prices that determine both internal economic conditions and external competitiveness. The most significant prices in this sense are defined as the exchange rate, the interest rate and the wage rate. What is significant is that all of these are seen as policy variables, or in some sense being if not directly determined then at least strongly affected by government policy.

With respect to exchange rates, it is noted that the recent strategy of many developing countries has been to create and defend external competitive positions by undervaluing their exchange rates. This promotes exports and allows them to avoid the dependence on capital markets that results from current account deficits. Because such a strategy typically requires central bank intervention in foreign exchange markets, it has led to a rapid accumulation of foreign exchange reserves (and therefore capital outflows) in developing countries. This strategy has stemmed from the recognition that a "competitive" exchange rate can be a key factor in increasing aggregate demand (in this case, export demand) in the short run, and achieving more rapid growth in the long run. This positive effect of the exchange rate cannot be denied. But it is also true that this focus on keeping the exchange rate low is similar to other strategies to maintain external competitiveness, such as wage compression and lower taxes and more subsidies for corporates. Such essentially mercantilist policies may well be

counter-productive if many countries adopt them, because it is obviously impossible for all countries to achieve increasing market shares and have current account surpluses at the same time. The damage that can be caused by rounds of competitive devaluation was evident in the inter-War period of the 20th century, and the dangers are just as present today.

The second crucial macroeconomic price is the interest rate, or more precisely the availability of adequate, reliable and cost-effective financing of investment. UNCTAD (2008) notes that this can actually be undermined by many measures of financial liberalisation that are directed at strengthening market forces. Overly restrictive monetary conditions can constrain growth and even become prohibitive for development. The Keynes-Schumpeter tradition argues that the financing of investment depends primarily on savings from corporate profits and the ability of the banking system to create credit. This in turn requires the recognition of the positive effects of demand and profit expectations and incentives for domestic entrepreneurs, and emphasises the need for reliable and affordable financing for enterprises of all sizes. This is in sharp contrast to the standard neoclassical model as expressed in the standard Washington Consensus, which talks of raising savings of private households and attracting foreign savings to raise domestic investment. According to this position, an increase in savings is not a prerequisite for either higher investment or an improvement in the current account. Instead, the causation is the other way around: changes in the current account lead to changes in the level of investment and savings.

The final important macroeconomic price is the wage. Wage compression is both unreliable and undesirable as a method of trying to achieve external competitiveness. Indeed, sustained growth requires that domestic wage incomes grow (ideally at the same rate as productivity) so as to generate domestic demand and create the virtuous cycle of more demand – more profits – more investment – more output – more employment – more demand. Obviously, money wage increases have to be such as to preserve price stability. But the pendulum has probably swung the other way in the recent past, such that even the accelerating inflation in food and other commodities has not really generated greater money wage pressures, because of the much weakened bargaining power of the working class almost everywhere in the world. Therefore UNCTAD (2008) highlights the need for “appropriate wage and incomes policies that can be used to support an investment-led development process without risking an acceleration of inflation.” (page 74)

It is actually surprising that all this sounds so fresh and different: after all, as noted above, these are old insights that were well known to development economists more than half a century ago. But the miasma created by the relatively simplistic market-oriented policy paradigm has been so effective that these basic truths have been forgotten or dismissed. So such a revival within the international policy discussion of the basic questions regarding the macroeconomics of development is welcome.

Bringing back the essentials: Strategies for developing countries in the early 21st century

The previous sections have highlighted that growth has been far below potential for most developing countries, and only a relatively small set of countries have managed to

achieve a sustained expansion of real per capita incomes since the middle of the last century. Much of this can be traced to macroeconomic, trade and investment policies that have not provided either the requisite public investment or created the appropriate incentives for private investment and ensured that such investment provides balanced sectoral expansion along with aggregate social productivity growth. So the obsession of the past few decades with very rigid fiscal and monetary targets, reduction of government spending and the like, may have been counterproductive in terms of reducing the capacity for sustained growth and equitable development in many countries.

Short run macroeconomic policy and longer term growth strategies are inextricably linked, not separate and independent. In particular, public investment affects growth directly, by improving the supply conditions of infrastructure, etc., thereby expanding the capital base of the economy and the potential for further accumulation, and indirectly, through its positive linkage effects with private investment. For developing countries, the paramount concern is to access a more growth-oriented, employment-generating macroeconomic stance, and public investment is a critical factor in achieving this. However, it should also be recognised that macroeconomic policies are not the only factor determining the rate and pattern of growth, and that the investment climate in general (including for both public and private investment) has a significant role to play. Microeconomic interventions and other policies can influence the incentives to invest and the distribution of investment in important ways.

In addition to growth associated with productive employment generation, a major concern of macroeconomic policy is the reduction of economic volatility. Economic instability is undesirable for many reasons. There are direct costs of income variability in the presence of imperfect capital and insurance markets, so that income smoothing over the economic cycle is imperfect and downswings are associated with consumption falls especially among the poor. In general, in all countries, the poor bear the brunt of economic fluctuations: they suffer most in slumps, through higher unemployment and lower real wages; and they tend to gain relatively less from booms which, especially in recent times, have been more associated with higher returns to capital and not necessarily with higher employment generation.

Successful macroeconomic management in open developing economies requires pragmatism, within a growth-enhancing framework, and flexibility to deal with the specific requirements of each country's context. A dogmatic "one size fits all" approach should be avoided, but the following points provide some guiding principles:

- Macroeconomic policy needs to be developed within a co-ordinated medium-term framework, so that fiscal, monetary, exchange rate and capital management policies are consistent with growth objectives and public investment strategies.
- Economic growth, livelihood stability and employment generation must be given significance, and should not be "crowded out" by an overly narrow focus on macroeconomic stability and inflation control.

- It is not just the aggregate rate of economic growth, but the pattern of that growth, which is crucial. A moderate but sustainable rate of growth which involves employment generation and poverty reduction is preferable to a higher rate of growth that is based on greater income inequalities and has more potential for volatility and crisis.
- A primary goal should therefore be productive employment generation providing “decent work”, and improvement of the living standards of the bulk of the people. This also requires industrial policies providing carefully considered incentives to promote desired investment and financial policies including directed credit will play a role.
- Public expenditure is crucial in sustaining and expanding the productive human resource base of the country, so macroeconomic policies must ensure that public expenditure in the social sectors is maintained at adequate levels.
- There can be enormous positive growth effects of appropriately expansionary fiscal policy and, in particular, public investment.
- Public resources should preferably be raised in ways that do not adversely affect the poor, for example through effective implementation of progressive direct taxation, (flexible) trade taxes and taxes on capital movements and capital gains.
- Monetary policy should accommodate to fiscal policy, rather than the other way around. Both should be targeted to real economic goals such as employment generation, livelihood protection and expansion and poverty reduction. This has implications for the kind of independence to be given to central banks. It also means that inflation targeting, *in itself*, cannot be the central goal of monetary policy.
- Exchange rates should be flexibly managed, even to the point of creating a band within which market forces are allowed to work. This requires some control over capital account movements, preferably through a range of flexible instruments.
- All macroeconomic policies must take full account of distributional impacts and incorporate equity considerations.

Some examples of progressive and growth-oriented macro-economic policies for developing countries are described below:

I. Stable and progressive tax policies:

- Improving tax administration and enforcement by making available more public resources for such activities, and by reducing or eliminating exemptions and loopholes.
- Diversifying sources of tax revenue instead of relying on a single indirect tax such as VAT.

- Relying as far as possible on rule-based and non-discretionary tax instruments which are corruption-resistant and have lower transaction costs.
- Increasing personal income tax collection from the rich.
- Targeting luxury consumption in raising taxes.
- Taxing capital more effectively without affecting investment.
- Using trade taxes creatively and flexibly.

II. Using ODA effectively:

In many developing countries today, aid inflows are not put to good use because of the fear of the adverse effects of currency appreciation and the felt need to keep higher levels of foreign exchange reserves to guard against potential financial crises. So a common tendency is to combine such inflows of foreign exchange with deflationary domestic policies. In some cases in recent years, this tendency has gone so far that ODA is effectively not used at all. It is important to ensure that ODA translates into higher public investment, preferably in areas where there are shortages or which form bottlenecks for production, or in areas where existing levels of provision are socially sub-optimal.

III. Recognising the crucial role of public investment:

Public investment can play an important role in increasing growth and domestic employment both over the cycle and in the medium-term, by increasing demand in the short run and also enlarging the capital base of the economy. The nature, direction and efficacy of such investment are important, as the multiplier effects and long-term growth implications will differ accordingly. Of course, it is still important to be attentive to other structural features such as technology choice, asset inequalities and institutional conditions, and to create incentives within the economy that encourage more productive employment generation.

IV. Putting fiscal discipline into context:

Fiscal sustainability is a crucial medium term issue, but there should be some flexibility with respect to fiscal targets, especially when the deficits are the result of productive public expenditure, and during economic downswings. Rigid rules on fiscal deficits in the short run reduce the possibility of effective countercyclical policies by governments, including in open developing economies. Fiscal deficits will lead to inflation only if public expenditure does not create multiplier effects that cause output to expand, because of supply bottlenecks. Such supply constraints do exist in many developing countries, but they are less evident in a world where imports can be used to bridge the gap temporarily. It is certainly possible for developing countries to use the fiscal stance to address short-run situations of excess capacity or cyclical downswing, without such adverse effects. There is also a case for a fiscal deficit composed entirely of public capital investment, *as long as the social rate of return from such investment exceeds the rate of interest*. There are many crucial areas, for example in physical and social infrastructure, where public investment is

essential since the presence of externalities means that the private sector is not likely to invest at socially optimal levels.

V. Development-oriented monetary policy and financial policies:

Monetary policy is not only about price stabilisation and inflation control, much less inflation targeting, but should be an integral part of macroeconomic and overall development strategies. It should aim expanding supply in strategic sectors, improving livelihood conditions in sectors employing a large proportion of the labour force such as agriculture and generating more productive employment by providing institutional credit to small scale producers in all sectors. The primary function of financial markets in terms of providing financial intermediation for development should never be forgotten.

It is true that macroeconomic instability can kill growth, but macroeconomic stability (when it is broadly defined so that it is not focussed on a narrow target such as inflation) is only a necessary condition for growth, **not** a sufficient one. Periods of accelerated growth can be associated with moderate or even intense inflation when supply constraints are encountered. In such cases, the focus of policy makers must be to prevent inflation from becoming excessive by addressing actual and potential supply bottlenecks, and correcting sectoral imbalances that may add to inflationary pressure, for example in agricultural production; to ensure the growth process is not adversely affected by policies to control inflation; to counter possible regressive effects of inflation through specific measures directed at the poor, such as public provision of certain basic needs; and to ensure that inflationary expectations and speculative tendencies are not built up in the system thereby causing higher rates of inflation over time.

An alternative to inflation targeting is a macroeconomic strategy that targets those real variables that are important for a particular country. These can include aggregate growth, productive investment, employment generation or poverty reduction. Monetary policy must be part of the overall macroeconomic policy directed towards these targets, rather than operating on a separate track of addressing monetary variables only. It should be aligned to and accommodate fiscal and exchange rate policies. Since the chosen target must be met within other constraints, interest rate management will not suffice and other instruments must be used by the central bank, including directed credit. Policy makers should avoid excessive rigidity over any one target and be prepared to be flexible in adjusting targets and instruments depending upon the requirements of changing situations.

VI. Managing economic cycles

While fiscal and monetary policies remain the basic levers to ensure changes in aggregate economic activity over the course of a cycle, there are other measures that can be quite effective. In particular there are some “automatic stabilizers” that developing countries can and should use, such as:

- Progressive taxation, which reduces the negative fiscal impact on the poor. (It should be noted that some economic reforms that move away from progressive tax systems, including moving to a VAT system, can weaken such an automatic stabilizer.)

- Welfare programmes and social protection policies, including unemployment insurance schemes, worker protection, special access to non-collateral based credit, public distribution systems for food and other necessities, income support for female-headed worker households, and so on. All these operate to ensure that consumption does not fall as much as it otherwise would during a downswing.
- Automatic adjustments of tariffs to external prices, such as a variable tariff system.
- Pension plans that do not involve defined contribution, since such programmes may lead to more volatility in consumption in response to a shock to the stock markets.

In addition to automatic stabilizers that are particularly important in times of downswing, there are ways of responding to booms that could dampen cyclical processes. Some of these include:

- A counter-cyclical tax such as an export tax that allows the government to generate more revenue during periods of an export boom, to be set aside for a price stabilisation fund for future exports.
- A tax on capital inflows, limited to, say, equity and portfolio capital as opposed to “green field” investment, in periods when such inflows are high.
- In situations of clear overheating and build-up of speculative bubbles, restricting activities that are likely to be associated with boom/bust, e.g. speculative real estate, through measures such as imposition of higher capital gains taxes and bank regulations that restrict the extent of lending to the real estate sector.

VI. Managing exchange rates

For developing countries, intermediate regimes, such as managed floats or crawling pegs, work best. They allow governments to adjust the level of the exchange rate to external conditions as well as to the current policy priorities for the domestic economy. These managed floats are best maintained through a combination of capital account and banking policy measures, along with the more usual open market operations of the central bank purchasing or selling currency in the foreign exchange market. To make such a regime successful, capital flows need to be “managed” through a range of market-based and other measures, and in terms of both inflows and outflows, so as to prevent excessive volatility and possible crisis.

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