ECO 403 – L0301
Developmental Macroeconomics

Lecture 10
Alternative Growth Strategies

Aggregate Demand and Growth

- Economic ***growth*** is ***demand-led*** since ***investment*** depends on lucrative investment ***opportunities***
  - But existence of ***effective demand*** is not enough
  - Efficient firms must also have ***access*** to that ***demand***
- Economic ***growth*** is driven by the growth of ***autonomous*** demand in the ***long run***
- What ***autonomous*** components of ***aggregate demand*** will drive ***long-run*** growth?
  - ***Consumption*** and ***government spending*** can drive aggregate demand only in the ***short*** and ***medium run***
  - ***Exports*** is the only sustainable source of autonomous demand growth in the ***long run***

Choice of Growth Strategy

- When discussing growth ***strategies***, determining the ***source*** of economic ***growth*** is not relevant
  - The point is how to achieve a ***higher*** rate of ***growth***

- How can the rate of ***growth*** be increased? What growth ***strategy*** should policymakers adopt?
  - ***Domestic***-led, ***export***-led, or ***balanced*** strategy?

- Definition of these ***strategies*** relates to the behaviour of the ***import*** and ***export*** coefficients
  - ***Domestic***-led strategy → decreasing ***import*** coefficient
  - ***Export***-led strategy → increasing ***export*** coefficient
  - ***Balanced*** strategy → ***stable*** import and export coefficients

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Choice of Growth Strategy (cont'd)

- Therefore, there are two main ***strategies*** to increase the ***rate*** of ***growth***
  - A ***domestic-led*** (i.e., ***wage-led***) or ***import substitution*** strategy requiring a decrease in the rate of ***import*** growth
  - An ***export-led*** strategy requiring an increase in the rate of ***export*** growth

- Once the ***higher rate*** of growth is achieved, the best ***growth*** strategy in the long run is a ***balanced*** one
  - A ***domestic-*** or ***export-led*** strategy is followed only until $\boldsymbol{\theta_{ind}}$ (and a ***stable*** openness coefficient) is achieved
  - With a ***balanced*** strategy, now GDP grows but the ***structure*** of production remains ***constant***

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Domestic-Led Strategy

- ***Domestic-led*** strategy makes sense for economies in the ***early stages*** of ***industrialization***
  - Since there are ***no exports*** of ***manufactured*** goods, currency ***devaluation*** cannot be helpful
  - In this case, ***tariff*** protection is needed to foster a ***manufacturing*** sector

- ***Domestic-led*** strategy begins with a policy of increasing those ***wages*** controlled by the government
  - This strategy can also be considered ***wage-led***
  - The basic idea is creating ***investment*** opportunities by expanding the ***domestic market***

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Domestic-Led Strategy (cont'd)

- The implicit ***assumption*** is that ***investment*** is less sensitive to ***profit margins*** and more elastic with respect to ***sales***
  - That is, ***investment*** is sensitive to degree of ***capacity utilization***
  - Therefore, ***profits*** would increase with ***output*** even if ***profit margins*** fell
  - So ***profit rate*** could be high even if ***profit margin*** was low
- But this ***assumption*** doesn't make sense in the ***long run***
  - A continue decrease in ***profits' income share*** requires a continue increase in degree of ***capacity utilization***
  - But the degree of ***capacity utilization*** can be at most **1**
  - And in the ***long run*** the productive ***capacity utilization*** remains ***constant*** at its ***"normal"*** level (u_n)

Domestic-Led Strategy (cont'd)

- ***Domestic-led*** strategy implies a continues increase in ***wages' share of income***
  - It means that ***wages*** are growing faster than ***productivity***
  - But ***unit labour costs*** are rising and thus the currency is ***appreciating*** in real terms
  - So profitable investment ***opportunities*** are reduced
- Further, relative income elasticities of ***imports*** and ***exports*** would cause a ***deficit*** to arise in the ***current account***
- Therefore, the ***government*** will need to:
  - Finance current account deficit with ***foreign indebtedness***
  - Or abandon the ***domestic-led*** strategy and ***devalue*** the currency

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Domestic-Led Strategy: Import Substitution as a Transition

- ***ISI*** proved valid for a country starting its ***industrial*** revolution but could not provide sustained ***development***
  - ***Domestic market*** was too small to provide economies of scale
  - Lack of ***competition*** prevented development of ***efficient*** firms
  - ***Foreign constraint*** was always present due to relative ***elasticities*** of imports and exports

- Countries should soon switch to ***export substitution*** industrialization
  - That is, to produce ***manufactured*** goods also for ***exports***

Export-Led Strategy

- While the ***domestic-led*** strategy is based on the expansion of consumption expenditure, ***export-led*** strategy is based on the expansion of exports
  - ***Domestic-led*** strategy implies an increase in ***wage-profit*** ratio and a decrease in the ***imports*** coefficient
  - ***Export-led*** strategy implies a (temporary) decrease in ***wage-profit*** ratio and an increase in the ***export*** coefficient

- In the ***export-led*** strategy there is no reduction in the ***profit margin***, so ***sales*** do not need to increase to keep the ***rate of profit*** stable
  - Rather, both the ***profit margin*** and the ***rate of profit*** increase

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Export-Led Strategy as a Transition

- Successful ***export-led*** strategies are only ***temporary***
  - Once the correction of the ***exchange rate*** and ***real wages*** ends, the economy grows in a ***balanced*** way
  - ***Wages*** grow now along ***productivity*** increases
  - But with higher rate of ***investment***, ***productivity*** improves faster, and ***real wages*** rise faster

- Adoption of a ***export-led*** strategy implies a real ***devaluation*** of the currency towards its ***industrial*** equilibrium
  - ***Real wages*** and the ***wage-profit*** ratio fall while the expected ***profit rate*** rises
  - Profitability and rate of ***investment*** rise and so do ***employment*** and ***output***
  - ***Wages*** soon increase beyond pre-devaluation level

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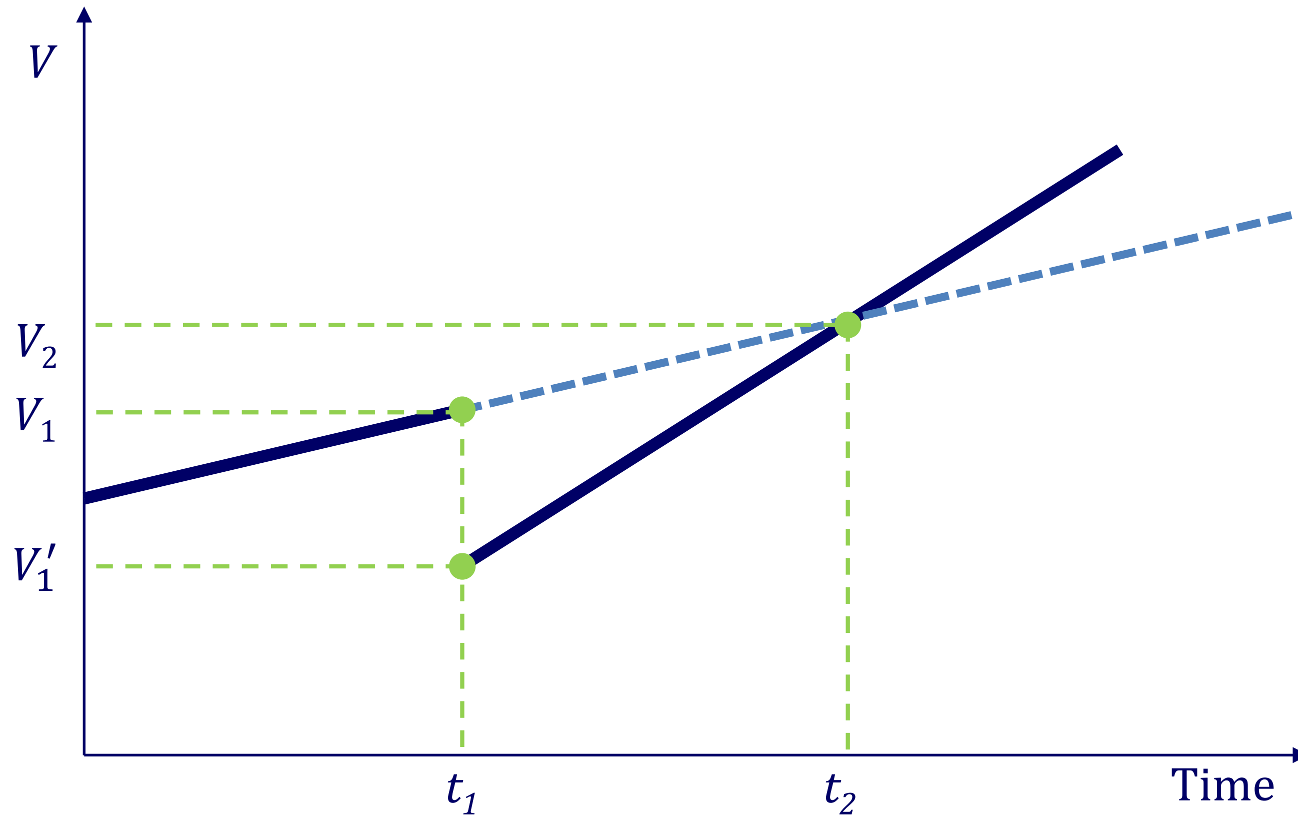
Real Wages and Currency Devaluation



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Reducing Inequality without Reducing the Profit Rate

- If there is excess ***productive capacity***, ***wages*** can increase above ***productivity*** without reducing the rate of ***profit***

- But in the ***long run*** the degree of ***capacity utilization*** is the ***normal*** one and ***full employment*** is achieved
  - A decrease in ***profit*** rate due to an increase in ***wages*** cannot be offset by an increase in the degree of ***capacity utilization***
  - Therefore, the ***wage-profit*** ratio must remain ***constant*** in the ***long run***

- Is it possible to improve ***income distribution*** without reducing ***profit*** expectations?

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Reducing Inequality without Reducing the Profit Rate (cont'd)

- Consider the national income equation:

$$\boldsymbol{Y = W + P,}$$

where $\boldsymbol{W}$ is wages and $\boldsymbol{P}$ is entrepreneurs' profits

  - Here, if $\boldsymbol{W}$ rises, then $\boldsymbol{P}$ definitely falls

- Consider now the national income equation:

$$\boldsymbol{Y = W + G_W + P + R + B,}$$

where $\boldsymbol{G_W}$ is social spending of the state (or indirect wages), $\boldsymbol{R}$ is revenues from rentier capitalists, and $\boldsymbol{B}$ is high wages and bonuses of top executives

  - Here, there are three ways of reducing ***inequality*** without reducing ***investment*** and ***growth*** rates

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Reducing Inequality without Reducing the Profit Rate (cont'd)

$$\boldsymbol{Y = W + G_W + P + R + B}$$

- Is it possible to improve ***income distribution*** without reducing ***profit*** expectations?

- Without affecting $\boldsymbol{P}$, ***inequality*** could be reduced through:
  - A reduction in $\boldsymbol{R}$
  - Higher taxation of $\boldsymbol{B}$
  - An increase in $\boldsymbol{G_W}$ (i.e., expansion of the welfare state)

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