

Growth rates of poor and rich countries economics essay



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In theory, poor countries should have more incentives to grow faster than rich countries because they have scarce capital, any increasing in capital will lead to higher growth rate. However, it does not work out in that way. In William Easterly's book "The Exclusive Quest for Growth-Economists' Adventures & Misadventures in the Tropics", he gave sufficient evidence to prove that there is no convergence between poor countries and rich countries. "The United States had growth per person of 1.1 percent over the 1981 to 1998 time frame compared to 2.2 percent between 1960 and 1980. But this slowdown is nothing compared to Nigeria's change in per capita growth per year from plus 4.8 percent over the 1960-1980 period to minus 1.5 percent between 1981 and 1998." (William Easterly "The Exclusive Quest for Growth-Economists' Adventures & Misadventures in the Tropics" chapter 3 Slow's surprise p60)

Source:

As the figure shown above, "The ratio of the richest country's per capita income to that of the poorest country has risen sharply over that period. The rich have grown richer; the poor have stagnated." (William Easterly "The Exclusive Quest for Growth-Economists' Adventures & Misadventures in the Tropics" chapter 3 Slow's surprise p60) What's more, William also mentioned that Romer used the growth data between 1960 and 1981 to show that the growth rate of poor countries was not any bigger than rich countries and he demonstrated that the Solow prediction applied to tropical countries had failed.

What are the reasons that cause poor countries' growth inconsistent with Solow growth model predict?

"Growth" should be explained as each person's material standards of living and levels of economic productivity. So when we talk about the growth rate of poor countries, what we should be interested in is production per worker, say, labour productivity.

Firstly, based on Slow Growth model, there are two inputs: machines (capital) and workers (labour), if we want to increase production per worker, the way might be increasing machines faster than increasing the number of workers. Then the problem of diminishing returns should be considered, when increasing the number of machines relative to workers, the return to each additional machine will be lower and lower. In other words, increasing one ingredient of production relative to another ingredient indefinitely cannot increase production indefinitely. (William Easterly "the exclusive quest for growth-economists adventures & misadventures in the tropics" chapter 3 slow's surprise p49)

Secondly, given the amount of workers, it is possible to increase the total GDP by increasing machines per worker. However, how long this increasing can last depends on the initial amount of machines we already have.

Suppose that there is no machine at the very beginning in poor countries, increasing machines will cause total output going up for a while but still at a diminishing rate; as soon as they have enough amount of machines, then output will be raised a little due to additional machines. So it is not a feasible way to assist poor countries by buying more and more machines to achieve

long-run growth, there must be someday that the growth rate of production per worker is equal to zero.

In addition, William described an example of making pancake to state the importance of the capital in production decides how severe the diminishing returns are going to be. " My failed attempt to expand pancake production by increasing one ingredient would have been even more disastrous if I had been increasing one of the more minor ingredients, like salt, holding everything else constant. I don't think my customers would like the results if I tried to double pancake production by adding more and more salt to an unchanging amount of flour and milk." (William Easterly " the exclusive quest for growth- economists adventures & misadventures in the tropics" chapter 3 Solow's surprise p50) From this example, it is not difficult to see that if poor countries have some foreign aids, how long this help could persist may depend on what type of this aid and how important this aid is in poor countries' production. In William's book, he measured the ratio of capital income in total income to measure the importance of capital in production and the result was that the role of capital playing in production is not as significant as we thought. " Solow estimated capital income to be about one-third of total GDP in the United States in his 1957 article. It is still about one-third of total income today."(William Easterly " the exclusive quest for growth- economists adventures & misadventures in the tropics" chapter 3 Solow's surprise p50)

Concerning the three aspects above, the property of diminishing returns makes poor countries have higher growth rates much more impossible. And even there is some foreign aid acts like capital increasing, it is still difficult

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for poor countries to grow faster than before because they cannot get rid of the problem of diminishing return easily and it is hard to tell which kind of capital is exactly needed.

There is another point need to be mentioned, the Solow Growth model shows investment is equal to the total saving. In practical, the more you save, the less consumption today and the more money can be used to buy machines for tomorrow. Since increasing the amount of capital cannot be considered as the method to sustain long-run growth and the diminishing returns still exists, high-saving cannot be the key reason to the long-run growth.

Generally, people save their deposit in banks so that banks can use this part of money to make loans for investment, the precondition is that people must have enough money to cover their living cost, the rest of their earnings can be saved in the bank. But in poor countries, this precondition cannot be satisfied.

In conclusion, a temporary growth in poor countries could be obtained by increasing capital and saving, but not in the long run.

In contrast to what presented above, Mankiw, N Gregory, David Romer and David N. Weil demonstrated different view in "A Contribution to the Empirics of Economic Growth" in 1992, they improved the original Solow model to augmented one by adding human capital accumulation and stated that there is a significant tendency for poor countries to grow faster than rich countries, only on the condition that countries did not vary in investment and population growth rates. Furthermore, they found out the evidence to show "

holding population growth and capital accumulation constant, countries converge at about the rate the augmented Solow model predicts.”

Nevertheless, from where I stand, though they proved the Solow model is improved its performance by adding human-capital accumulation, the assumption is too limited to play in the real world. Practically, it seems impossible to hold population growth and capital accumulation constant, and even if the constant capital accumulation has been reached, technology is another problem that cannot be neglected.

Economists conjecture that poor countries are lack of investment, well-trained labour force, good government policy and well-managed institutions, etc. Furthermore, government plays crucial role in a country's economy growth. In “ Aid, Policies, and Growth”, Burnside, Craig and David Dollar presented that if the foreign aid is interpreted as income transfer, one possible direction is that “ That aid tends to increase government consumption, which in turn has no positive effect on growth, provides some insight into why aid is not promoting growth in the average recipient country.” (Burnside, Craig and David Dollar, 2000, “ Aid, Policies, and Growth” American Economic Review Vol. 90(4), pp. 847-68) They also concluded aid might have more impact on growth in the developing world if it were systematically allocated toward good policy environments. (Burnside, Craig and David Dollar, 2000, “ Aid, Policies, and Growth” American Economic Review Vol. 90(4), pp. 847-68) But for poor countries, sometimes the policy environments are not good enough.

William provided more detail about how the government could influence the growth in poor countries, negative real interest rates, high budget deficits, restrictions on free trade, poor public services and institutional failure, etc. All of these could create poor incentives for growth.

Although there is no consistent view towards why poor countries do not have higher growth rate than rich countries, it is still worthwhile to find out the answer, because it would be helpful not only in assisting poor countries, for instance, how to help Africa escape from the poverty trap, but also in sustaining economic growth in the long run. Furthermore, being aware of all the points above, the possibility of poverty traps still exists. If poverty traps happen on poor countries, will the foreign aid be helpful? Where will the aid go, increasing investment or government consumption? These are the unsaved questions that cannot be ignored.