Chapter 17 Review Questions

1. "Vicious and virtuous circles are at the heart of the problem of development." Can this view explain the different economic performance of Sub-Saharan Africa and East Asia?

Vicious and virtuous circles refer to the reinforcing nature of economic development or failure. If a country is growing well, then it will have money for investment, which drives long-run growth. If a country is performing poorly, then it will lack money for spending on education, health as well as investment. It will then be expected to perform poorly in the future. This would partly explain the different economic performance of Africa and East Asia, but not the entire picture. Other factors to consider include the approach to growth, e.g., export-led growth strategy of East Asia, institutions, managing globalisation, investment in education, strategy toward industrialisation, land ownership, etc.

2. What does the empirical evidence on cross-country growth performance tell us about the design of pro-growth policies for poor countries?

Cross-country growth performance measures tell us that a range of variables are relevant for growth. However, they tend to not say enough about how the factors interact, and how policies can pace and sequence reforms to achieve strong growth. Most of the evidence, moreover, are based on cross-sectional data so there are limitations in interpreting the findings as country-specific factors are insufficiently accounted for, e.g., historical institutions, for one.

3. Does trade liberalization by developing countries help or hinder their industrialisation?

Industrialisation can be helped by trade liberalisation if opening brings with it technical know-how and markets to which industrial products can be sold. The experience of East Asia suggests that development can be helped. The lack of industrialisation in Africa and to some extent India, however, suggests that the process is much more complex. Moreover, the former Soviet Union and China undertook industrialisation without trade liberalisation during the command period. There is the potential for trade liberalisation to help the industrialisation process, but the challenges of managing an open economy often make this a much more challenging task.

4. Do standard models of investment for developed economies adequately explain private investment in less developed economies?

Investment is a key factor in economic growth models. Applying the models to developing countries would include discussing factors such as savings rate being low due to a higher propensity to consume at low levels of income, low investment funds as a result as well as the lack of financial intermediation to translate savings into investment, lack of stock markets to underpin Tobin's q, and highlight the importance of credit constraints and informational imperfections in developing capital markets.

5. "The need for technology provides the main justification for the government of a poor country to encourage multinational investment, so any downside has to be accepted." Discuss.

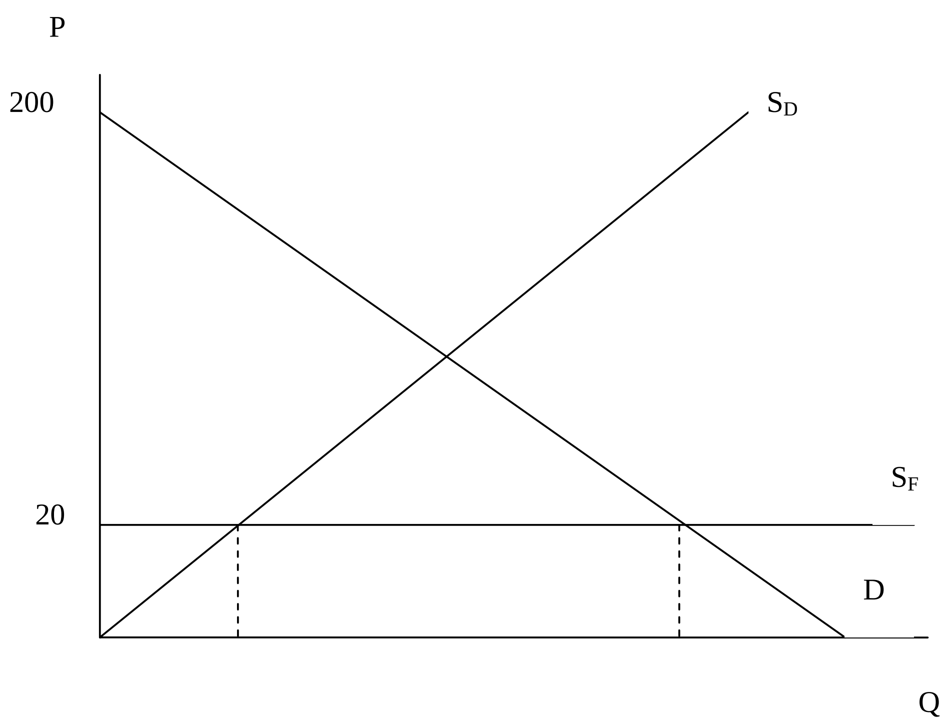
The race to the bottom to compete for foreign direct investment (FDI) has resulted in countries not benefiting very much from the potential effects of FDI. However, the low levels of savings and therefore funds for investment make FDI important for poor countries. The convergence hypothesis of the Solow model has not borne out for the most part, and neither would the expected relationship of FDI and growth.

More advanced problems

6. Demand for a product in a small open economy is given by $Q_D = 200 - 2p$, where p is the price of the product (given in £s). Domestic supply is given by $Q_S = 2p$. Initially, there are no restrictions on imports of this product, and the country faces a perfectly elastic foreign supply curve. The world market price is £20 per unit.

a. How much of the total demand of 160 units is supplied by domestic producers and how many units are imported?

Domestic producers supply 40 units. Imports account for 120 units.



Then a unit tariff is imposed, which raises the import price by 100%.

b. What is the percentage fall in imports, and the tariff revenue generated?
Imports fall by 30% and the tariff revenue is 800.