

Economics 216

FINAL EXAMINATION

Instructions:

1. This is a closed book examination.
 2. Please answer all questions. All questions carry equal weight. Please budget your time accordingly.
 3. Please start every question on a new page.
 4. Please sign the honor code. Good luck!
-
-

1. What is the relative importance of the different sources of growth for the industrialized and newly industrialized economies in the postwar period? What implications does the experience of the newly industrialized economies have for the economic policies of currently developing economies?
2. Explain briefly the "two-gap" model. Identify the possible channels through which the existence of each of the two gaps may impede economic growth. Can you suggest a way through which the difficulties caused by the two gaps can be alleviated?
3. Explain the differences between an export promotion strategy and an import substitution strategy for economic development. What are the potential benefits and pitfalls of the two strategies? What are the factors that may affect the relative desirability of the two strategies for an economy?

Sketches of sample answers:

1. For industrialized countries except Japan, technical progress is the most important source, accounting for more than 50%; for newly industrialized countries, growth in tangible capital is the most important source, accounting for approximately three-quarters. The absence of measured technical progress in the newly industrialized countries is the most glaring difference between the industrialized and newly industrialized economies. Labor is not an important source of growth for the industrialized countries (the growth of labor has been negative for the European countries) except for Japan and the United States whereas it is a significant source of growth for the newly industrialized economies. The importance of capital as a source of growth for the newly industrialized economies means that a developing economy must have a high investment rate and that in turn implies that the economy must have a high savings rate (in the long run) in order to begin to move onto a path of self-sustaining economic growth. Thus, currently developing economies should pursue policies that promote a high domestic savings rate (stable macroeconomic environment, low inflation, positive real interest rate, tax incentives, secure financial institutions, capital markets, etc.) and an efficient allocation of investment to the different sectors and industries (market-directed investment allocation, competition at home and from abroad, etc.). Because of

complementarity, the returns to investment in intangible capital may be low until a sufficient quantity of tangible capital per unit labor has been accumulated.

2. The two gaps are the savings gap and the foreign exchange gap. Investment in the long run is constrained by domestic savings. If there is insufficient savings, investment will be low, and growth will be slow and unable to become self-sustaining. The foreign exchange gap is important if the economy does not manufacture capital goods or some necessary intermediate goods domestically and must import them from abroad. Thus, domestic savings cannot be translated directly into domestic investment if there is insufficient foreign exchange earnings to finance the imports. Foreign exchange can be generated in general mostly through exports (including invisible exports such as tourism and more recently such services as data entry and software design, which can be delivered electronically). Foreign aid in the form of grants or long-term loans (concessionary or otherwise) and foreign direct investment can help alleviate both the savings gap and the foreign exchange gap in the short and intermediate run.

3. Export promotion implies that the economy will focus on the development of the industries in which it has a comparative advantage. Import substitution implies that the economy will attempt to produce domestically what it imports. Export promotion potentially enables a country to earn the foreign exchange to support the imports of necessary capital and intermediate goods. It also allows a country to take advantage of the economies of scale and of specialization. It also subjects the exporting firms to the discipline and competition of the international marketplace. An export promotion strategy in general implies a more open economy and trade regime. The pitfall is that the economy may become too vulnerable to disruptions in the world economy, including both demand shocks as well as exchange rate shocks resulting from unexpected inflows and outflows of short-term capital. Import substitution enables a country to be self-reliant. It also economizes on a country's foreign exchange. It has the advantage that there is already an established domestic demand for the goods to be produced. The pitfall is that the cost of domestic production may turn out to be much higher than the world price, leading to inefficiency and waste, and necessitating protection. Moreover, protection shields the domestic industries from the competition that provides the incentive for firms to be efficient. Import substitution also does not allow a country to take advantage of either economies of scale (except for very large countries) or of specialization. The size of the domestic market and the nature and magnitude of the initial endowments of the economy may affect the relative desirability of the two strategies. Domestic industrial organization policies and the degree of competition in domestic markets are also relevant considerations.