Academic Script

Immiserizing Growth

INTRODUCTION

Immiserizing growth is a theoretical situation first proposed by Jagdish Bhagwati, in 1958, where economic growth could result in a country being worse off than before the growth. If growth is heavily export biased it might lead to a fall in the terms of trade of the exporting country. In rare circumstances this fall in the terms of trade may be so large as to outweigh the gains from growth. If so, this situation would cause a country to be worse off after growth than before. This result is only valid if the growing country is able to influence world prices. Another economist Harry G. Johnson had, independently, worked out conditions for this result in 1955.

Following conditions that must be satisfied for a country to experience Immiserizing growth.

1) Its growth should be characterized by a more than proportionate increase in the production of its export commodity.

2) The supply of its export commodity should be price inelastic so that it is willing to export more even at reduced price.

3) The share of its export commodity in the total supply in international markets should be large enough to depress its international price. This condition applies irrespective of whether the country in question is “large” or “small” or whether it is rich or poor.

It is seen that developing countries are more prone to suffering from deterioration in terms of trade with an expansion in their exports. This is because a major portion of their exports comprise mainly minerals and other primary products which tend to have inelastic demand in the developed countries.
In addition, the developed countries have been able to create synthetic substitutes for a number of these products.

THE TRANSFER PROBLEM

INTRODUCTION

The transfer problem refers to international transfers of income from the debtor country to the creditor country. Such transfer of income is also called real transfers because the debtor country repays interests and capital in terms of goods and services (real resources) to the creditors country. In general terms, it refers to the effect of transfer of income on the donor's terms of trade. The reversal of capital flows force countries to go from a current account deficit to a current account surplus.

In the past, transfer payments were in the form of reparation payments imposed by the victorious country over the vanquished country. For example, Germany demanded reparation payments from France after it won the Franco-Prussian war in 1871 and the victorious Allies imposed heavy reparation payments on Germany after World War I. In the present, the international debt crises of the 1970s and 1980s and the Asian crisis of the 1990s have created transfer problems when the debtor Less Developed Countries (LDCs) are required to service their debts, thereby leading to international transfers of income.

The transfer problem was the subject of controversy in the 1920s between Bertil Ohlin and J.M. Keynes over the reparation payments demanded of Germany by the Allies after World War I. The issue related to the burden of these payments on the German economy. In the present, the transfer problem is related to the burden of repayment of interest and loan on the debtor LDCs. We discuss this issue in the light of the views of Ohlin and Keynes.

Keynes pointed out that the reparation payments imposed on Germany by the Allies would not only placemonetary burden but also a much larger real burden on Germany. Besides, the "money transfer Germany would have to increase its exports and reduce its imports. For this, it wouldhave to produce more exportable and reduce their prices relative to imports. This would worsen the terms of trade of Germany and increase the direct burden of its reparation payments.

Also according to Keynes the settlement of reparations due from Germany raises not only a budget problem, but also a transfer problem, because the expenditure of the German people must be reduced, not only by the amount of the reparation taxes which they must pay out of their earnings, but also by a reduction in their gold-rate of earnings below what they would other wise be.

On the other hand, Ohlin argued that when Germany would increase payments, people would reduce the demand for imported goods. When money would be transferred to the allied countries, their purchasing power would increase and a portion of it would be spent on German goods. Thus there would be reduction in imports and increase in exports of Germany without worsening its terms of trade.

The Transfer Problem

We discuss in detail the present transfer problem of LDCs in the light of the above views.

THE 0HLIN VIEW

Taking Ohlin's view first, when the debtor country levies taxes on the people to repay the interest and loan, their incomes are reduced. Their demand will partly decline for domestic goods and partly for imported goods. The diminution in demand for domestic goods will increase the quantity of these goods available for export. Thus with reduction in imports and increase in exports, the terms of trade of the LDCs will not worsen. This is the *direct effect* of the transfer problem.

Besides, Ohlin also explains an *indirect effect* of money transfer. When the debtor country repays its debt, with the reduction in purchasing power, the demand for domestic goods and imports falls. This shifts a part of the factors of production from domestic goods industries to export industries. Consequently, exports increase and imports fall. Further, the prices of domestic goods fall due to decline in demand for them. So far as the prices of exports are concerned, the extent to which they are low depends upon the relative prices of exports of the debtor and creditor countries and the direction of change in demand for them. It is, therefore, not possible to determine whether the terms of trade will be against or in favor of the debtor country.

Ohlin's analysis is unrealistic in the present context of LDCs because it considers only the income effect of the debt repayment and is based on the assumption of full employment in both the debtor and creditor countries. It also neglects the elasticities of demand and supply for exports.

THE MODERN VIEW

The modem view is an extension of the Keynesian analysis of the burden of reparation payments. It has two aspects of the transfer problem. The first is what Keynes called the "pure" transfer problem when the country's resources are turned into foreign exchange for the repayment of debt. This is the *external transfer* problem. The *second* is the budgetary problem when the government acquires domestic resources for debt servicing. This is called the internal *transferproblem*.

The external transfer problem is how to raise net exports of goods and services to meet debt repayments. When a debtor (or borrower) country makes the repayment of debt, it not only transfers money to the creditor (or lender) country but also pure or real resources. The real transfer burden is the creation of export surplus in order to acquire the foreign exchange of the lender country. This requires reduction in imports and increase in exports. In order to export more, the borrowing country will have to reduce the prices of its exports relative to its imports. This will lead to worsening of its terms of trade in relation to the lending country. But there is no guarantee that the rise in exports will increase the export earnings if the volume of exports does not rise in proportion to the fall in prices. This is a common problem with the debtor LDCs that compete with each other for exporting goods to the creditor developed countries. As a result, competitive price reductions, keep their export earnings unchanged. They, therefore, reduce the consumption of import goods so that the export surplus is increased. This is at the cost of reduction in their consumption level which is already very low. This entails a real burden of transfer on the debtor countries. On the other hand, if the total trade between the debtor and creditor countries is static, increased export of goods of the former will reduce the imports of goods of the latter, thereby slowing down production in the creditor country. Consequently, its industries will suffer with the generation of export surplus in the debtor country. Thus the terms of trade of the debtor country will not worsen. It is the creditor country that will suffer due to transfer. This was Keynes' view of the German reparations transfer problem.

Terms of Trade Effect

When a debtor country repays its debt, it transfers a part of its income to the lender country. This process of transfer reduces income and expenditure in the former country and correspondingly increases income and expenditure in the latter country. These changes in income and expenditure in the two countries may change the relative demand for goods inthe two countries and thus affect their terms of trade. The effect of a transfer of income is onlythe relative demand and not on the relative supply of goods if physical resources are not being transferred.

The direction of terms of trade effect will depend upon the marginal propensity to spend on two goods A and B by the two countries. Suppose, the debtor country's marginal propensity to Spend on its export commodity A is higher than that on B. Given the relative prices of A and B, the transfer of income by the debtor country to the creditor country reduces its demand for A and increases it for B. This reduction in relative demand for A lowers its relative price in relation to B. This reduction in demand and price of A worsens the terms of trade of the debtor country in relation to the creditor country. On the contrary, if the marginal propensity to spend on export commodity A by the debtor country is relatively lower, the transfer of income will improve its terms of trade. In general, then if the debtor country has a lower marginal propensity to spend on its export good, the transfer of income improves its terms of trade. If it has a higher marginal propensity to spend on its export good, its terms of trade will worsen. The opposite will be the terms of trade effect on the lender country.

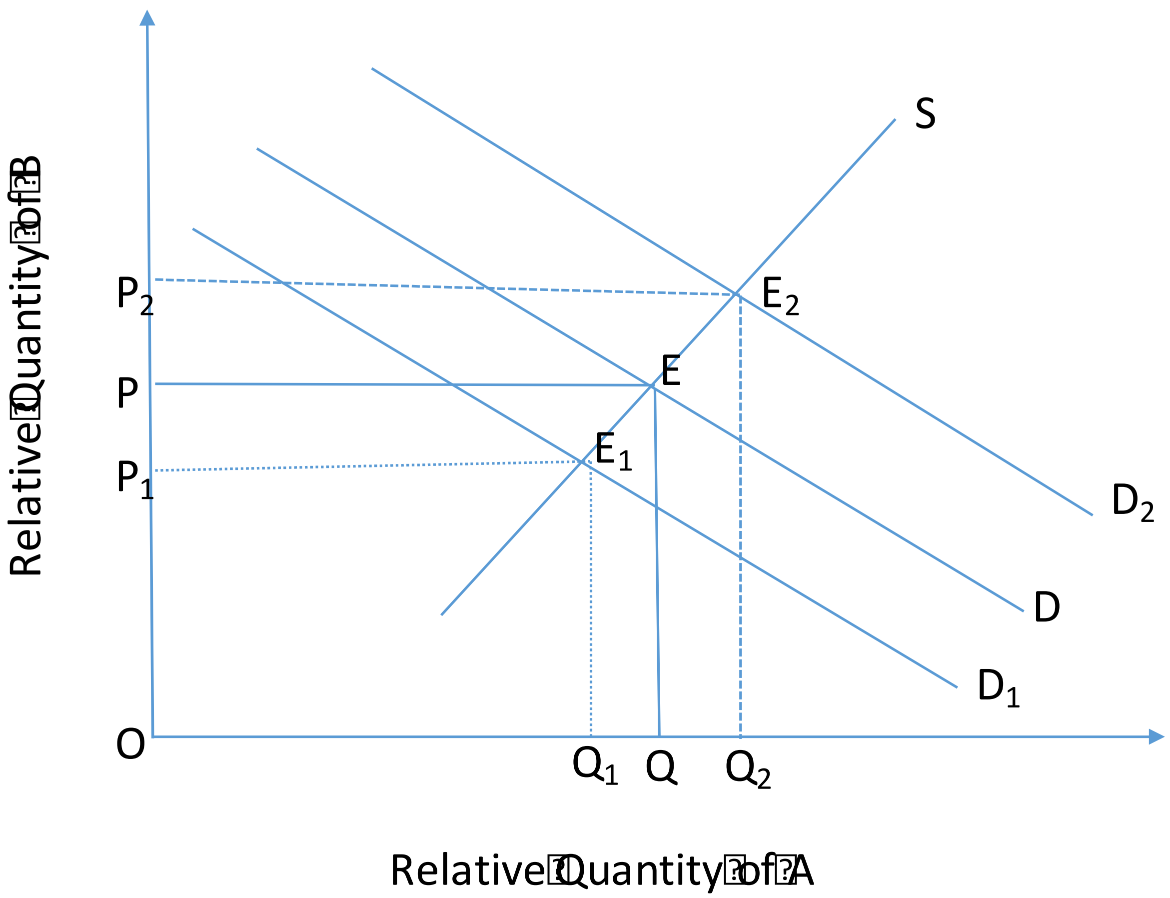

FIG.1

The effect of a transfer on the terms of trade of a debtor country is illustrated in Fig. 1. The curveDis the demand curve for good A relative to good B. S is the given supply curve. The higher marginal propensity to spend on the export good A relative to B with transfer of income to the creditor country, reduces its demand for A. This is shown by the leftward shift of the D curve to D_1. The new equilibrium is at E_1. The relative quantity of A has fallen from OQ to OQ_1 and its relative price from OP to OP_1.This shows worsening of its terms of trade. On the other hand, if the debtor country has a lower marginal propensity to spend on A, the transfer of income to the creditor country would raise and shift the relative demand curve to the right from D to D_2 and increase the relative price of A from OP to OP_2 and the relative quantity of A has increased from OQ to OQ_2. This shows improvement in the terms of trade.

To take the budgetary aspect of the external transfer problem of the debtor country, it requires some type of expenditure reducing policies such as exchange rate depreciation, cutting fiscal deficits or direct control. These policies reduce imports and increase the debtor country's exports thereby generating export surplus which is used for repayment of debts.

So far as the internal aspect of the transfer problem is concerned, it involves cut in expenditure and increase inrevenues. If the reduction in public expenditures and increase in revenues are not carried out through budgetary policies, inflation results which makes it difficult to repay the debt. For high inflation reduces the marginal propensity to save and invest in an LDC.Exports are reduced and imports rise. Fiscal deficit increases which leads both to a crowding out of private investment and to cut in government expenditures that reduce public investment. Under, the circumstances an LCD can solve its transfer problem of debt repayment by controlling inflation, increasing exports and reducing imports through various external and internal policy measures.

CONCLUSION

The concept of Immiserizing growth, introduced by Professor Jagdish Bhagwati, refers to that situation where an increase in a country's export commodity leads to such deterioration in its terms of trade that there is a net decline in its export earnings and social welfare.

By transferring resources from one country to another, the goal is generally to make the receiving country better off. It follows from the theorem that quirks in the market mechanism render that goal impossible to achieve at equilibria.In the past, transfer payments were in the form of restitution payments imposed by the winning or conquering country over the repressed country.

Nowadays, the transfer-problem controversy is very much alive in the context of the ongoing debate on current account rebalancing at both regional and global levels. While there is considerable uncertainty about the timing and drivers of current account movements, the basic mechanism of adjustment requires a transfer of real resources from debtor countries to surplus countries. Such transfer involves a decrease in domestic spending relative to production in the debtor countries, accompanied by a simultaneous relative increase abroad.

From the perspective of comparative statics, it is noteworthy that the transfer problem can be observed only for sufficiently large volumes of trade.