

# BSM906

# Economic Environment of Business

Lecture 2  
Economic growth

Dr Sumon Bhaumik  
<http://www.sumonbhaumik.net>

# Basic growth story

## Harrod-Domar I

- Standard assumption
  - Output is generated using capital and labour
- Harrod-Domar assumption
  - Capital and labour have to be combined in a fixed proportion; one cannot be traded off for the other
- Implications
  - Increase in savings rate will increase growth rate
  - Improvement in the efficiency of capital use will increase growth rate

# Basic growth story

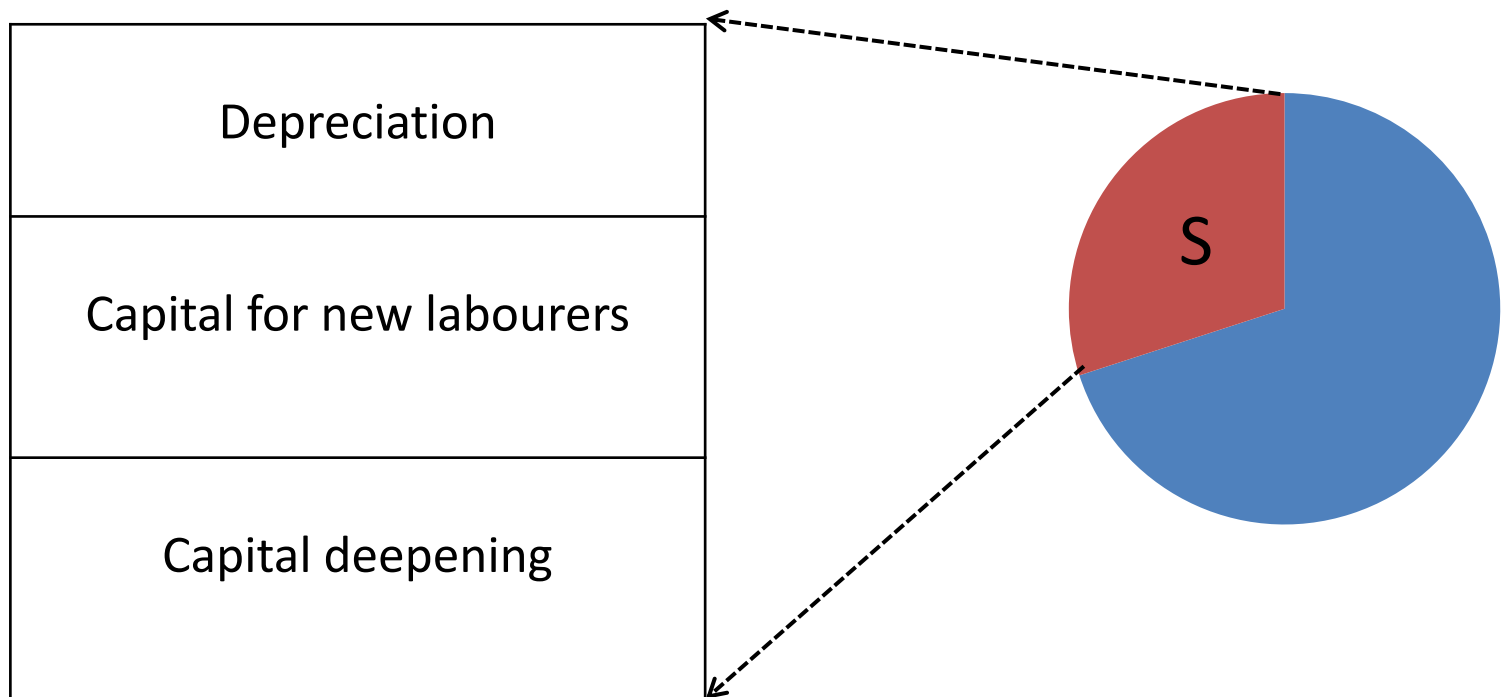
## Harrod-Domar II

- Application
  - 2<sup>nd</sup> Five Year Plan in India
- Problem
  - If capital and labour can only be used in some fixed proportion, then capital and labour must grow at the same rate, if they are to be utilised fully
  - No role for technology
  - No role for human capital
  - No role for the economic environment
  - If savings can be raised by reducing consumption, how will we have demand for the output?

# Introducing technology

## Solow I

- Assumptions
  - Labour and capital can be substituted for each other
  - There is diminishing returns to capital



# Introducing technology

## Solow II

- Implications
  - If savings rate increases, there can be capital deepening even after accounting for depreciation and growth in labour force, and hence growth increases
  - Increasing savings would have progressively smaller impact on growth, because of diminishing returns, and hence mature developed countries will grow slower than developing economies
  - As the impact of savings slows down, growth would have to be driven by technology
- Problem
  - Still does not tell us anything about human capital
  - Still does not have a role for the economic environment

# Introducing human capital

- Assumption
  - Individual labourers not only have labour power, but also human capital
  - Human capital offsets the problem of diminishing returns associated with physical capital
- Implication
  - Developing countries may find it difficult to catch up with developed countries where the stock of human capital is larger and where the quality of human capital is generally better
- Problem
  - Still no role for economic environment

# Determinants of economic growth

## Empirical evidence

Country characteristic	Impact
Initial income level	Negative
Savings and investment	Positive
Education level	Positive
Life expectancy	Positive
Political instability	Negative
Geography	No impact *
Trade and exchange rate policies	No impact
Natural resource endowment	No impact

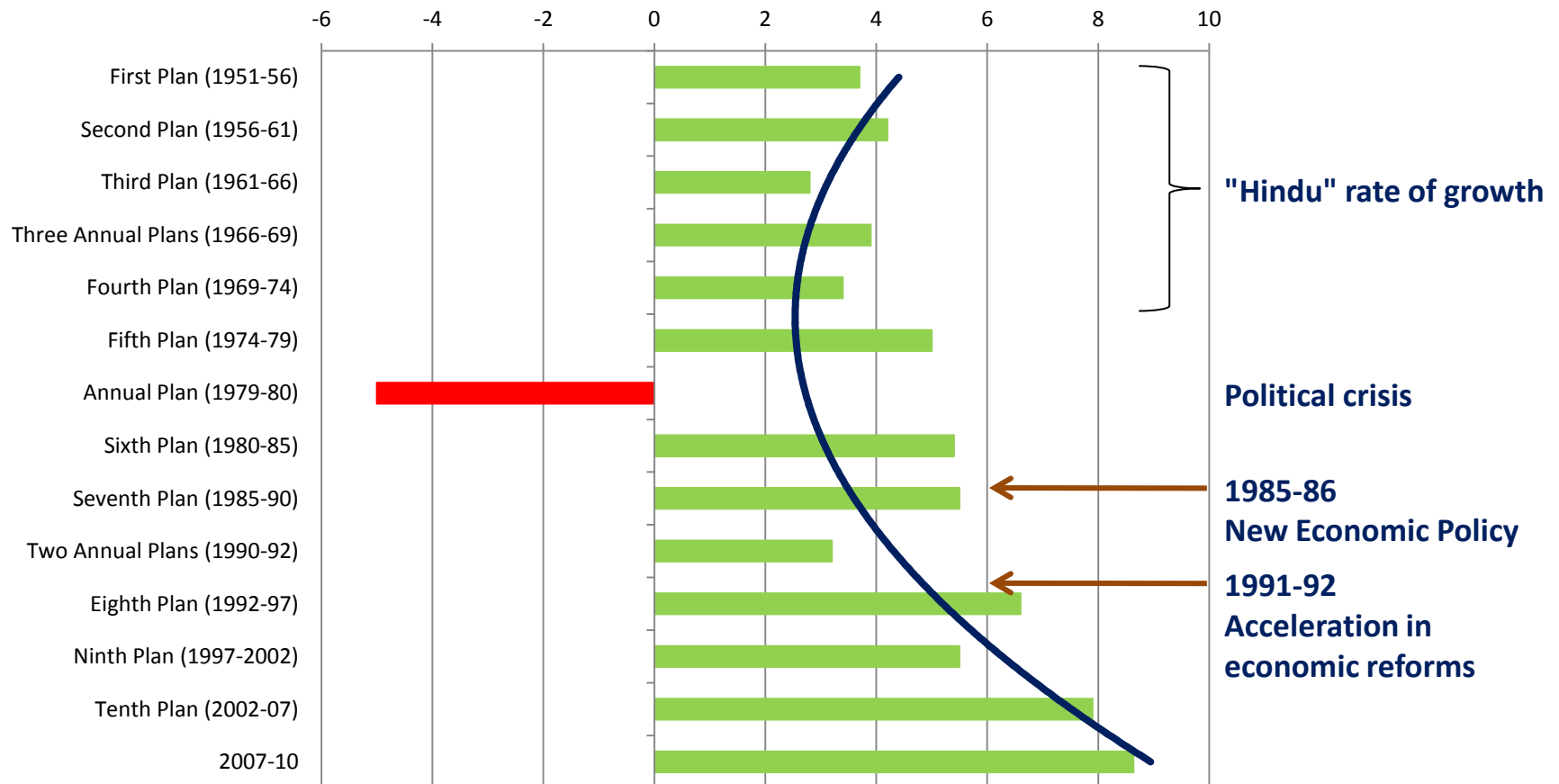
Barro, Robert J. (1991). Economic growth in a cross section of countries. Working Paper No. 3120, National Bureau of Economic Research, Cambridge, Massachusetts, <http://www.nber.org/papers/w3120>.

Mankiw, N. Gregory, Romer, David and Weil, David, N. (1992). A contribution to the empirics of economic growth. *Quarterly Journal of Economics*, Vol. 107, No. 2, pp. 407-437.

# Economic growth

## The case of India

**Growth of GDP at factor cost (in 1990-91 prices)**



# Going beyond theories about growth

## Questions

- Savings and investment:
  - Why should I save unless I have an assurance that the financial intermediary between me and the investor will return my money (and unless the real value of savings is preserved over time)?
  - Can a financial intermediary exist unless it can enter into contracts that would be honoured by borrowers (and savers)?
  - Why should I invest in an environment of uncertainty?
- Technology and human capital
  - Why should I invest in better technology if others can imitate my technology costlessly once it is developed?
  - Why should I invest in human capital if I can be forced to work as a serf?

# Looking beyond aggregates

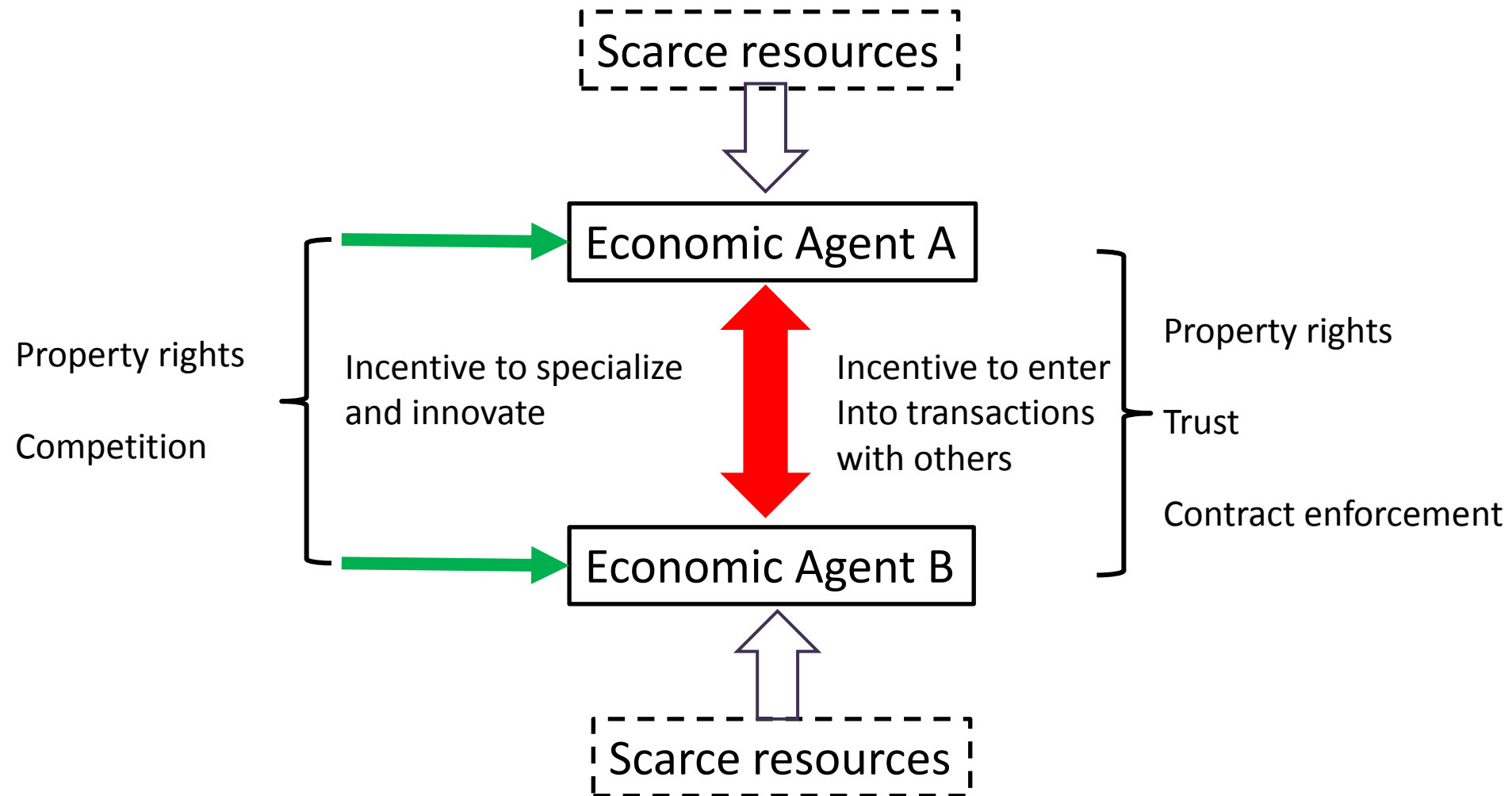
## Gains from trade

	Potential output		Actual output		Consumption	
	Person 1	Person 2	Person 1	Person 2	Person 1	Person 2
<b>Good A</b>	10	10	5	10	15	0
<b>Good B</b>	10	5	5	0	0	5

1. Given available resources, Person 1 can produce either 10 units of Good A or 10 units of Good B; she prefers to consume Good A
2. Given the same resources, Person 2 can produce either 10 units of Good A or 5 units of Good B; she prefers to consume Good B
3. At least one of them would gain if they specialise in the production of one good and trade, without reducing the consumption of the other
4. Specialisation and trade is the only way to efficiently use limited resources, as human demand expands continually

# Looking beyond aggregates

## Economic agents and the economic environment



# Economic environment – “Institutions”

## Why are not good institutions ubiquitous?

Explanation	Summary
Colonial heritage	Countries inherited poor institutions from colonial masters
	Common or civil law origins affect contemporary institutions
Colonial heritage plus	Countries had valuable resources; people and colonisers designed institutions to exploit them
	Interaction between institutions and initial conditions create persistent inequality
Political conflict	Countries had too little political competition over borders or between elites, and this allowed rulers to build institutions to serve selfish interests
Beliefs and norms	Countries had beliefs and norms inhospitable to markets or trust, and this prevented them from building institutions to encourage trade and investment

# The challenge of choosing “good” institutions

## Democracy – an example

- Institutions will be built bottom up and hence would be most appropriate for the context
- Problems
  - Growth in democracies is not necessarily higher than that in autocracies
  - What form of democracy are we taking about?
    - Presidential vs. parliamentary
    - Large or small districts (which influence extent of power of interest groups) ..... Etc.
  - Federalist structure of governance
  - Collective action on the part of the citizens to make the government accountable?
  - Trust that those who lose on account of reforms will be compensated

# Institutional change

- Competition is the key to institutional change
- As competition forces organisations to invest in new skills and knowledge, the kind of skills and knowledge the individuals and organisations acquire will shape evolving perceptions and hence choices that will incrementally change institutions
- Perceptions are derived from the mental constructs of the players
- Factors such as complementarities and network externalities make institutional change very incremental and path dependent