CONTEMPORARY MODELS OF DEVELOPMENT AND UNDERDEVELOPMENT

EE 462 Development Macroeconomics

Semester 1/2019

Topics

- Coordination failure
- Multiple equilibria
- Big push theory
- Growth diagnostic framework

Underdevelopment as a Coordination Failure

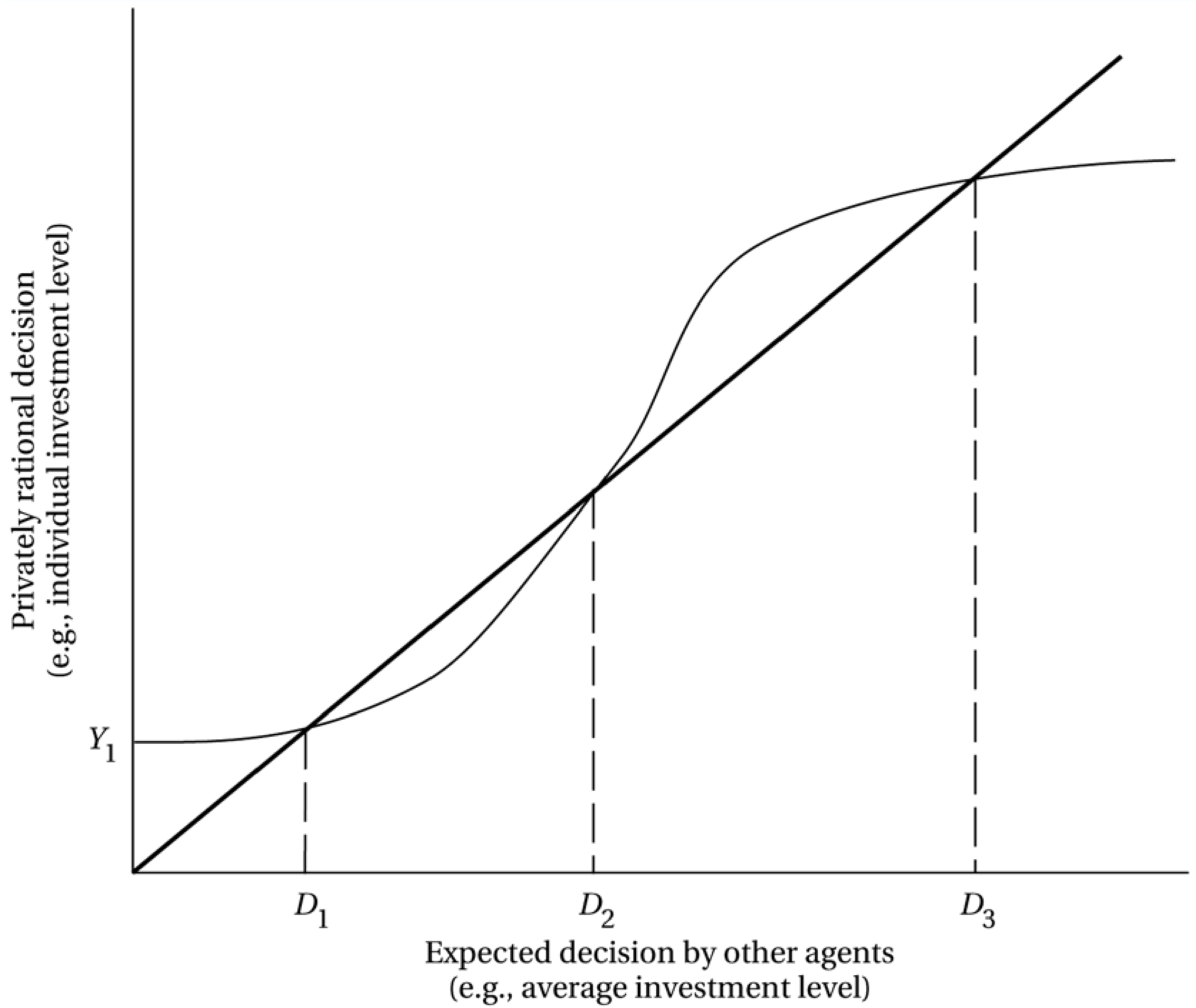
- A newer school of thought on problems of economic development emphasized *complementarities* between several conditions necessary for successful development.

- A Coordination failure is a state of affairs in which agents' inability to coordinate their behavior (choices) leads to an outcome that makes all agents worse off.
  - Could be due to some difficulties or people hold different expectations.
  - This can occur when actions are complementary.
  - i.e. actions taken by one agent reinforces incentives for others to take similar actions.

Multiple Equilibria: A Diagrammatic Approach

- These models can be diagrammed by graphing an S-shaped function and the 45º line.
- Equilibria are
  - Stable: function crosses the 45º line from above
  - Unstable: function crosses the 45º line from below
- Example about private decision to invest.

Multiple Equilibria



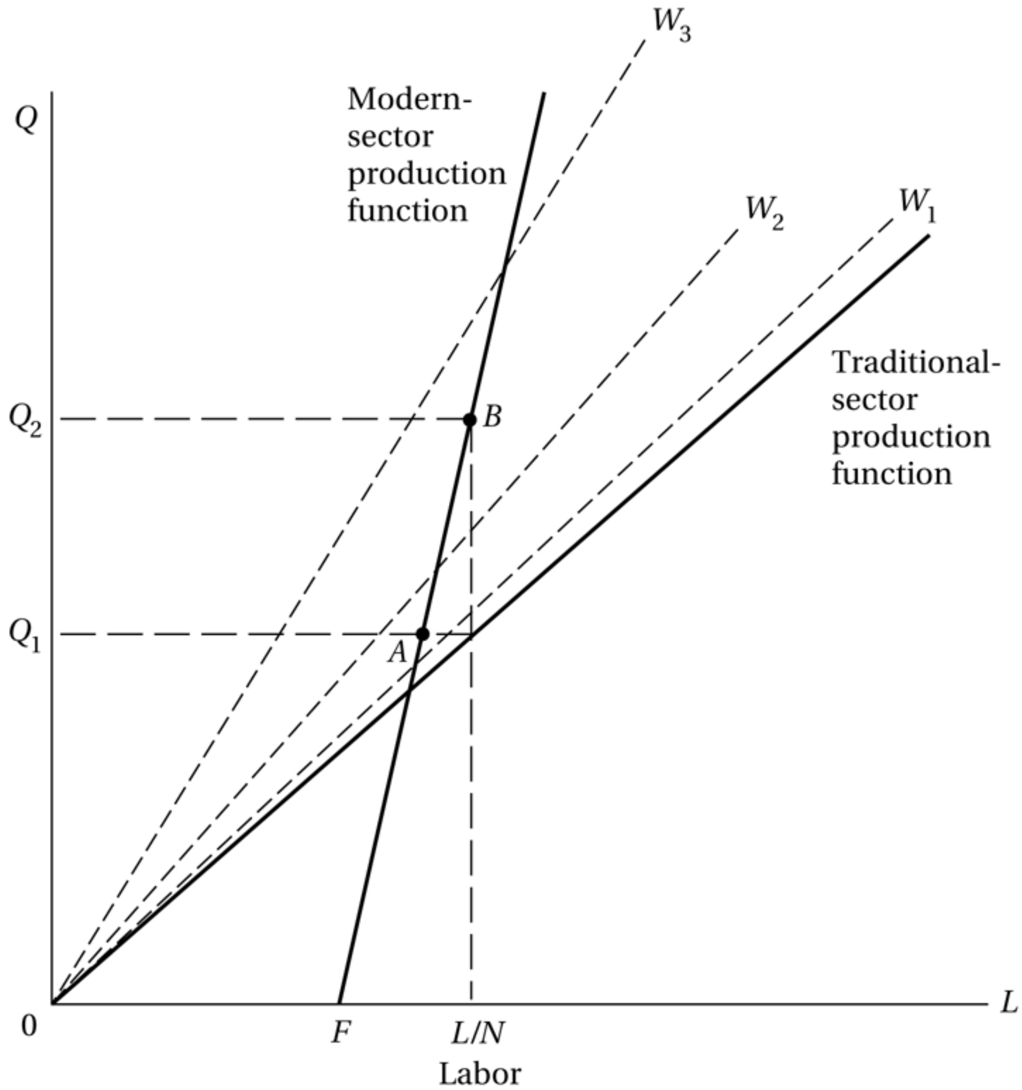
The Big Push Model: General Idea

- Originally proposed by Paul Rosenstein-Rodan in 1943.
- Basic idea:
  - A 'bit by bit' investment programme will not impact the process of growth as much as is required for developing countries. In fact, injections of small quantities of investments will merely lead to a resource waste.
  - Hence, we need a BIG injection to boost the country to achieve rapid growth.
- Example: shoe industry

The Big Push: A Graphical Model

- 6 assumptions
  - One factor of production
  - Two sectors
  - Same production function for each sector
  - Consumers spend an equal amount on each good
  - Closed economy
  - Perfect competition with traditional firms operating, limit pricing monopolist with a modern firm operating

The Big Push



W_3
Q
Modern-sector production function
W_2
W_1
Traditional-sector production function
Q_2
B
Q_1
A
0
F
L/N
L
Labor

The Big Push Model (Cont'd)

- A big push may also be necessary when there are:
  - Intertemporal effects
  - Urbanization effects
  - Infrastructure effects
  - Training effects

Why the Problem Cannot be Solved by a Super-Entrepreneur

- Super Entrepreneur?
  - Capital market failures
  - Cost of monitoring managers- Asymmetric Information
  - Communication failures
  - Limits to knowledge
  - Lack of any empirical evidence that would suggest this is possible

In a Nutshell: Big Push Mechanisms

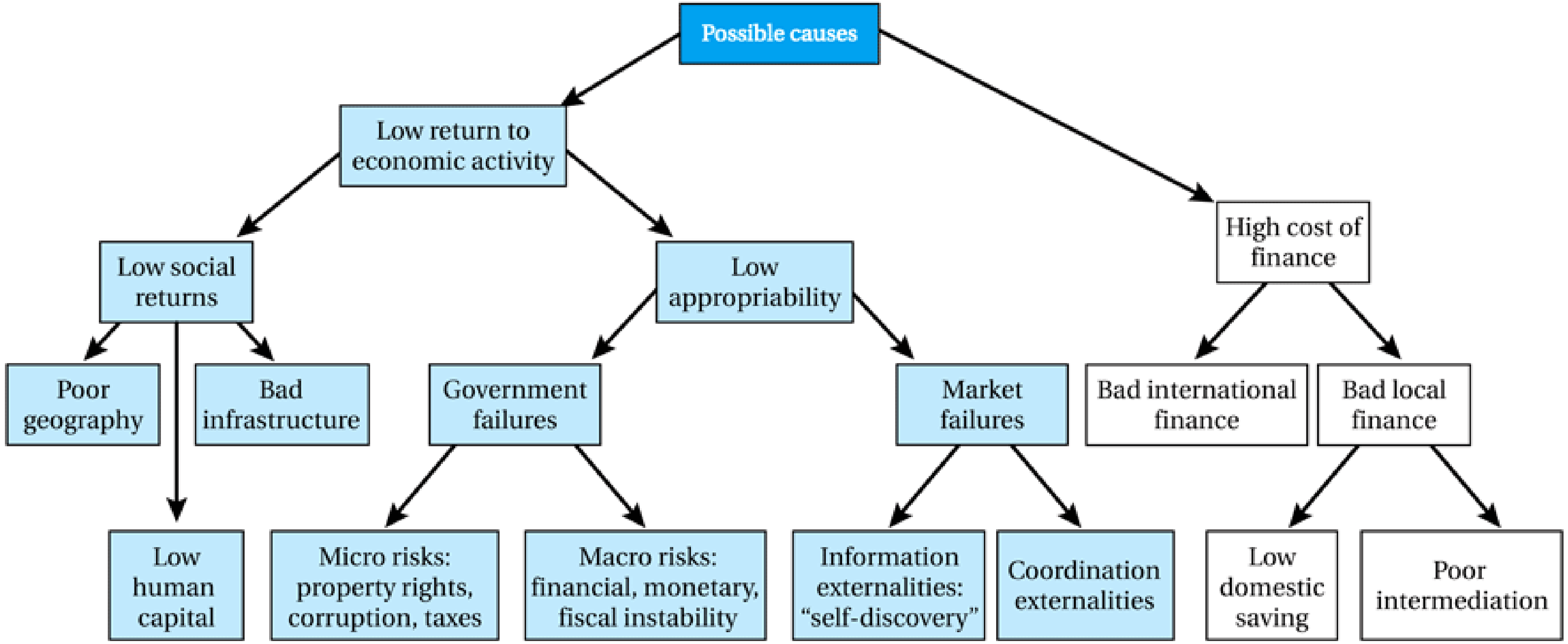
- Raising total demand
- Reducing fixed costs of later entrants
- Redistributing demand to later periods when other industrializing firms sell
- Shifting demand toward manufacturing goods (usually produced in urban areas)
- Help defray costs of essential infrastructure (a similar mechanism can hold when there are costs of training, and other shared intermediate inputs)

The Hausmann-Rodrik-Velasco (HRV) Growth Diagnostics Framework

- Focus on a country’s most binding constraints on economic growth
- No “one size fits all” in development policy
- Requires careful research to determine the most likely binding constraint

Hausmann-Rodrik-Velasco Growth Diagnostics Decision Tree

Problem: Low levels of private investment and entrepreneurship



Source: Ricardo Hausmann, Dani Rodrik, and Andrés Velasco, "Getting the diagnosis right," *Finance and Development* 43 (2006), available at http://www.inf.org/external/pubs/ft/fandd/2006/03/hausmann.htm. Used with permission.