



## Book Review: Economic Growth in an Open Developing Economy: The Role of Structure and Demand

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Thirlwall, A.P. (2013). *Economic Growth in an Open Developing Economy: The Role of Structure and Demand*. Cheltenham, UK and Northampton, USA. 189 pages.

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*"Thirlwall does away with the orthodox view that trade liberalisation is generally beneficial both to developed and less-developed countries. He shows both theoretically and empirically that economic growth of less-developed countries is typically balance of payments constrained."*

This book is a sequel to *The Nature of Economic Growth: An Alternative Framework for Understanding the Performance of Nations*, published in 2002, but is broader in scope and presents a great deal more empirical evidence. This view is essentially developed vis-à-vis the orthodox neoclassical approach to the problem of development and growth in terms of macroeconomic production functions, which are often called, misleadingly, 'aggregate' production functions, although they are just postulated and no aggregation from micro units has ever been carried out. Thirlwall's view differs from the orthodox in three important respects: (i) the economies under consideration are typically demand-constrained and not supply-constrained; (ii) the major constraint of their growth performance is the balance of payments; (iii) economic structure matters or, more specifically, developing economies need to industrialise in order to be able to reap static and dynamic returns to scale, because the manufacturing sector is an 'engine of growth and development'. Thirlwall elaborates on arguments originally put forward by Adam Smith ('division of labour'), Allyn Young ('increasing returns'), John Maynard Keynes ('effective demand') and Nicholas Kaldor ('Kaldor's laws'). By combining their insights and putting them into a coherent whole in terms of a model of balance of payments constrained growth, Thirlwall throws light on the process of globalisation, its winners and losers, and suggests economic policy options for developing countries. He shows, in particular, that trade liberalisation has not been a universal blessing because it has raised import growth of developing countries more than it

has their export growth thus worsening their balance of payments. This has forced them to reduce the growth of imports by decelerating the growth of output, which results in unemployment. This has in turn widened the internal and international inequality of income and has prevented a reduction in the level of poverty (outside China).

The book has six chapters. Chapter 1 argues that economic growth is a necessary but not sufficient condition for poverty reduction. Whilst prior to the agricultural revolution, the 'Age of Enlightenment' and the Industrial Revolution the gap in living standards between countries was not that great, the situation began to change dramatically then and led to what the economic historian Kenneth Pomeranz (2000) called 'The Great Divergence'. Chapter 2 is a critical account of growth theories, old and 'new'. Thirlwall points out that Smith's approach to the problem of economic growth was 'cumulative' in the sense that growth breeds growth. Smith also understood 'that the structure of production matters for economic performance because different goods have different production characteristics'. He was convinced that the manufacturing sector allowed for a much deeper division of labour than agriculture, commerce or trade. But he totally missed the importance of the manufacturing sector as an engine of growth by assuming that the sector produced only 'amenities and luxuries', but not tools and machines to be employed in all sectors of the economy increasing labour productivity everywhere. Smith stood at the threshold of the 'Age of Coal and Iron', but he remained very much a man of the 'Age of Corn'.

Thirlwall calls Malthus, but also Ricardo an 'economic pessimist'. This is a widespread view, which however, cannot be sustained. When Ricardo discussed the tendency of the general rate of profits to fall he did so explicitly on the assumption that there were no 'improvements' in the methods of production, that is technical progress, which would counteract the 'niggardliness of nature' reflected in extensive and intensive diminishing returns in agriculture. Yet there is technical progress and therefore growth would continue (Kurz, 2010; Sraffa. 1951–1973). Next Thirlwall expounds why the Harrodian growth model contains useful insights concerning developing economies, namely unemployment and inflation, the coexistence of which 'is not a paradox in developing countries. His assessment of Solow's growth model is much less favourable: not only are assumptions unrealistic, but its main predictions are wrong, as is elaborated later in the book. The so-called 'new' growth theories

do not fare much better, because most of their advocates are said to be 'old neoclassical economists in disguise'. In a sense Thirlwall maintains that what is good in these models (increasing returns, externalities) is not new, and what is new (the representative agent that maximises utility over an infinite time horizon) is no good.

Chapter 3 provides a critique of orthodox growth theory. Thirlwall puts forward three major objections: (i) There is no independent investment function, as if there was no problem of the coordination of savings and investment and thus effective demand – the model is entirely supply driven ('Say's law'). (ii) The emphasis is on models of closed economies, which sets aside the overwhelming importance of a country's foreign trade performance for its growth and the role of the balance of payments in it. (iii) The inverse relation between the growth of output per capita and the initial level of income per capita cannot be interpreted as rehabilitating the neoclassical growth model, because the negative sign may be explained in terms of 'catch-up' processes or structural change, which cannot be captured by one-good models. Thirlwall then discusses in some depth Kaldor's famous growth laws (pp. 43-50), which are largely ignored in the new growth literature. First, there is a strong positive causal relation between the growth of manufacturing output and GDP growth. Secondly, there is a strong positive causal relation between the growth of manufacturing output and labour productivity growth in manufacturing, reflecting static and dynamic increasing returns, also known as 'Verdoorn's law'. Third, there is a strong positive causal relation between the growth of manufacturing output and the growth of labour productivity outside of the manufacturing sector. Thirlwall then tests these laws empirically, sees them largely confirmed, and concludes that 'a fast growth of exports and industrial growth will tend to set up a virtuous circle of growth working through Verdoorn's law and other reinforcing feedback mechanisms'. Developing countries are therefore well advised to lay the foundations for manufacturing industry to prosper. This was, of course, the main message of the German economist Friedrich List, who in his *National System of Political Economy* (1856) advocated tariffs designed to protect the nascent domestic industry from foreign competitors. List, as is perhaps known, is held in high esteem in China; his ideas can be said to have exerted some influence on Chinese economic and industrial policy.

Chapter 4 tries to dispel the myth that developing economies are constrained by a fixed labour supply. As Smith and Ricardo already stressed, the 'natural rate of growth' is not exogenous, but endogenous. The adjustment of the size of the workforce to the needs of capital accumulation is brought about in various ways: by a reduction in unemployment and underemployment; by changes in the participation rates by gender and age; by the migration of labour; by labour saving technical progress; and in the very long run by changes in the rate of population growth. The neoclassical labour supply constrained view is contradicted by the facts. Thirlwall concludes that 'if demand creates its own supply, within limits, then growth rate differences between countries can only be properly understood in terms of differences in the strength of demand, and constraints on demand. For most countries, particularly developing countries with a lot of surplus capacity, demand constraints operate long before capacity is reached' (p. 70).

This idea is developed in some detail in Chapter 5 on balance of payments constrained growth. Thirlwall rejects the orthodox neoclassical view that the balance of payments is self-adjusting and therefore does not matter for long-run economic growth both on empirical and theoretical grounds. Thirlwall elaborates his own dynamic analysis and puts forward 'Thirlwall's law'. The law states, among other things, that a country's growth rate consistent with balance of payment equilibrium is inversely related to its appetite for imports, which in turn depends on the structure of domestic production and the structure of imports (p. 91). The model performs remarkably well in empirical tests. Taking into account capital inflows financing current account deficits does not improve the predictions based on the model by much. Thirlwall concludes: 'Export growth, not capital flows, is by far the most important variable governing growth performance' (p. 107). The chapter concludes with a brief discussion of policy implications. The main message is: if a less-developed country wishes to grow faster, it must first raise the balance of payments constraint on demand. Since neither currency depreciation nor import controls can effectively accomplish the task, what remains is some sort of protection of 'infant industries', export promotion and import substitution – measures that Friedrich List and later Nicholas Kaldor have advocated and countries like Japan, South Korea and China have successfully implemented in the more recent past. (Interestingly, Thirlwall notes, once countries had become rich under a protective belt, they tended to change sides and opt for free trade.)

The concluding Chapter 6 deals with the effects of trade liberalisation across the world after the Second World War up until the so-called Washington Consensus as an expression of the 'ideology of free markets and free trade'. Thirlwall strongly contests the mainstream mantra that free trade is universally beneficial and has even Jagdish Baghwati, 'the high priest of free trade', on his side. There is no compelling evidence that trade liberalisation has launched all countries onto higher levels of economic growth. Trade liberalisation has not markedly reduced world poverty, setting aside the case of China and a few other countries. But contrary to the predictions of orthodox theory it has worsened the distribution of income between rich and poor countries and between skilled and unskilled wage earners within countries. Thirlwall concludes: 'Overall, trade liberalisation has not delivered the promises expected. There is a divorce between the rhetoric of trade liberalisation and the reality' (p. 125). Orthodox theory is a victim of especially three premises on which it is based: (i) Say's law and thus the assumption of a natural tendency of the economic system towards the full utilisation of its productive resources; (ii) the idea that the structure of production does not matter and that everything that can be said can be done so in terms of a model with a macroeconomic production function; and (iii) the idea that the balance of payments is self-equilibrating. However, trade liberalisation had an unfavourable impact on the trade balance and current account balance of many less-developed countries. Frequently this triggered currency crises or led to severe deflations of domestic income and demand in order to control imports. The positive effect of trade liberalisation on exports was more than annihilated by its effect on imports. Thirlwall quotes economists from Joseph Stiglitz to Dani Rodrik in support of a view he has long advocated. Alas, 'the orthodoxy prevails despite the evidence'.

The book concludes with a sort of manifesto of a trade strategy for development: 'A new world trade order is required which acts on behalf of poor countries; and poor developing countries need a louder voice in any reformed structure. In the final analysis, structural change which adds to the demand for domestically produced tradable goods is the only way that poor developing countries can grow faster on a sustainable basis. The market mechanism by itself is unlikely to bring about the required structural change without help from the state'.

The book is very well written and offers a host of theoretical and empirical insights into the problems at hand. It contains the fruits of the lifelong studies of a major development economist and is a must for everyone working in the field under consideration. Tony Thirlwall is to be congratulated for opening the reader's eyes and freeing him from the fetters of ideology and prejudice.

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