STUDIORUM UNIVERSITATUM DOCENTIUM CONGRESSUS
THE GREAT JUBILEE 2000

*"North-South Relationships In The World Economy In The XXI Century: Inequalities, Well-Being, Opportunities"*

# Economic development and the reduction of poverty

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L'Aquila, 8 September 2000

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In a memorable encyclical in 1967, Pope Paul VI, observing that the social question had taken on a global character and noting that the mechanisms in being would work “rather to widen the differences in the world’s levels of life, not to diminish them”, launched an appeal to all men of good will for “the development of those peoples who are striving to escape from hunger, misery, endemic diseases, and ignorance; of those who are looking for a wider share in the benefits of civilization and a more active improvement of their human qualities.”

Thirty years since this appeal, it is high time to start examining the path taken by the world economy, investigating the aggravation or the attenuation of inequalities, the sharing of all peoples in the benefits of economic progress.

From 1700 to 1800 the world’s population grew at an average annual rate of 0.4 per cent, and it is estimated that the growth of output was only marginally faster. In the $19^{th}$ century population growth rose to 0.6 per cent and that of gross output to an estimated 1.9 per cent annually, so that there was an appreciable increment in per capita output. The acceleration came during the second half of the century.

In the first half of the $20^{th}$ century output growth was diminished by the mass destruction of two world wars. Population growth, severely affected in Europe by wartime loss of life, averaged 0.9 per cent per year.

Between 1950 and 2000 the population growth rate doubled to 1.8 per cent per year, while world GDP expanded by an average of 4 per cent annually.

As a consequence, total output increased more than sevenfold over this half-century; per capita output rose by 2.1 per cent a year to increase nearly threefold. But variance also increased; the disparities between living standards in different parts of the world widened.

The increase in world output in the last 150 years has stemmed from the improvements to technology and production methods in the agriculture and industry of the West beginning in the 19th century. The regular production of resources over and above subsistence requirements became possible. Investment increased and a steadily increasing portion of the population was able to gain an education and work for the expansion of human knowledge. During the last century inventions and discoveries have come at a pace without precedent in all previous history.

Essential to economic as well as to other advances has been the improvement in the state of health of the population. Even in the first half of the 20th century, and all the more so in the second, medical progress drastically reduced the incidence of infant illness and mortality, not just in the advanced nations by also in the developing world.

## *1. Theories of growth and increases in inequality*

According to neoclassical growth theory, which posits decreasing returns to productive factors, in the long run the rate of increase in per capita output for a given level of technique tends to zero. During the 1950s and 1960s the need to explain the empirical evidence of sustained rapid growth led Solow (1956) and other economists to incorporate technical progress into their analysis as a propulsive factor in continuous growth.

Technological innovation nevertheless remained exogenous to economic analysis.

A broader concept of capital embracing human capital was considered. Lucas (1988, 1993) hypothesized that a society's overall investment in human capital generates positive externalities on the productivity of individuals, thus superseding the hypothesis of decreasing returns to factors. The very fast growth of some economies, in this theory, is explained by their specialization in productive sectors with high rates of accumulation of knowledge.

Elaborating on Arrow's original notion (1962) of technical progress as learning by doing, Romer (1986) extended Solow's analysis by considering innovation as a product springing directly from the accumulation of physical capital. New investments improve the way in which accumulated capital is utilized, in a process that he rechristens "learning by investing".

Again Romer (1990) makes technical innovation no longer a spontaneous process but the conscious product of optimizing choices on the part of economic agents, who determine the quantity of resources to allocate to research and development activity.

The concept of knowledge as cumulative and working to the benefit of the first to appropriate and develop it has been accompanied, in economic analysis, by a complementary vision of its dissemination: the process of imitation fosters the application of new technologies also in countries that are relative latecomers to development. These matters have been treated authoritatively in Professor Baumol's opening remarks.

These processes marked the economic history of the 20th century, determining the growth of output in the various economies in absolute and in relative terms. The growth of per capita output, between the beginning and the end of the century, benefited above all the countries that were most highly developed at the outset. Inequalities were aggravated.

In the most advanced economy, that of the United States, per capita output has increased sixfold since 1900; worldwide, less than fourfold. Whereas in 1900 the world's average per capita output was 27 per cent of that of the wealthiest country (then the United Kingdom), the figure is now down to 22 per cent of US per capita GDP.

Among the regions suffering the greatest lags in growth is Africa, which was the world's poorest continent at the beginning of the 20th century; its inhabitants have at their disposal just one-twentieth the per capita output of the United States.

In Asia, differences have widened greatly between those countries which have experienced periods of rapid economic development and the more backward ones. Excluding Japan and China, per capita GDP in Asia is now 8 per cent of that of the United States.

Only China and a tiny group of other countries, mostly Asian, have succeeded in moving out of the low-income into the lower-middle group. No country classed as high-income has fallen into the upper-middle-income category.

In the last thirty years the gap between the advanced and the developing countries has widened. In East Asia, real per capita GDP has grown at an average annual rate of 5.6 per cent, while in Africa it has declined by 0.2 per cent per year. In the poorest heavily indebted countries per capita output has stagnated.

The causes impeding convergence in levels of output between countries remain uncertain. Two processes that may favour convergence are to be observed: the achievement of similar degrees of capital intensiveness and the adoption of comparable technologies.

Barro (1991) sought to explain the absence of convergence within conventional economic theory by positing that every country tends to a specific equilibrium level of per capita output.

According to Lucas (2000), the lack of any perceptible amelioration of the distribution of output depends on the slowness with which technological progress is spreading to the less advanced countries.

In this model, which invites a substantially optimistic reading, in time the spread of technical progress can prompt rapid growth in the more backward countries as well and possibly a decrease in international inequalities.

There must be no impediment to the spread of progress; on the contrary, propitious conditions for the diffusion of knowledge must be created, including institutional and social conditions. This means offsetting the adverse repercussions of the distribution of income within individual economies and societies.

## *2. Widespread poverty: economic growth can reduce it*

Excessive inequality within a community is harmful to growth, in that it can undermine the very basis of civil coexistence.

In economists' theoretical models, the sign of the relationship between economic growth and poverty is indeterminate.

In the initial stages of development, when capital is the decisive productive factor, accelerating growth can bring greater inequality in income distribution. In the more advanced stages of development, when the most important factor becomes human capital, the correlation may be inverted.

A recent World Bank study, while not ruling out undesired distributive effects due to growth, tends to confirm that even the most economically disadvantaged classes benefit in the medium run, in relative as well as absolute terms, from faster economic development. It finds a positive correlation with an elasticity of one between GDP growth rate and the rate of increase in the average income of the lower parts of the income scale.

According to this analysis, then, economic growth is essential to sustain and increase the lowest incomes.

Measures to stimulate growth in individual sectors can increase inequality in the short run. In particular, the liberalization of trade may drastically reduce the welfare of those whose incomes depended on protective barriers.

### *3. World trade as a factor in development*

The exceptional economic development of the last two centuries, and especially the last fifty years, has been accompanied and sustained by the rapid expansion of world trade. Since 1820, the volume of trade has increased at an annual rate of about 4 per cent, compared with an annual increase of about 2 per cent in world output. With the crisis of the gold standard and the outbreak of the First World War, a long period of growth and economic integration was interrupted by widespread instability that culminated in the Great Depression of 1929; a sharp regression in integration followed.

The collapse in international financial flows in 1931, the consequent rush to competitive devaluation or to strict exchange controls and import quotas, and the Second World War led to a pronounced decline in economic relations between countries.

The ratio of the volume of merchandise exports to world output, which had risen to 9 per cent in 1913, fell back to 7 per cent in 1950.

The post-war period was marked by the massive reconstruction effort in Europe and the establishment of a new international monetary order. Output and world trade expanded exceptionally swiftly. Between 1950 and 1973 world merchandise exports rose at an annual rate of 7 per cent, twice the pace recorded during the gold standard era. The beginning of the construction of a closely integrated area in Europe contributed to these positive developments.

Economic growth spread from the West to other areas of the globe, notably the Far East. In successive waves, these economies took the path of development led by exports, which grew by annual rates of over 10 per cent for two decades and more.

The economic slowdown and monetary instability that struck the industrial countries in the seventies and the debt crisis of the emerging economies at the start of the eighties caused a slowdown in the growth of international trade; between 1973 and 1992 the volume of world exports increased at an average rate of 3.7 per cent.

The isolation of many emerging countries in Africa and Latin America intensifed in the eighties, a situation that was aggravated by the widespread failure of the import-substitution policies on which governments had based their strategies for industrial development in the seventies.

The system of trade relations founded on the GATT agreements of 1947 gradually began to weaken. This was manifested in the industrial countries' increasingly frequent use of discriminatory non-tariff barriers, such as farm subsidies and quotas on textile and clothing imports from the developing courntries, restrictions that were codified in the Multifibre Agreement of 1974.

Over the eighties and into the early nineties the number of regional preferential trade agreements increased rapidly and the division of the trade system into the blocs of Asia, America and Europe deepened.

In the nineties world exports picked up to an annual rate of 6.3 per cent, compared with 4.2 per cent in the eighties. The recovery of trade in the developing countries was linked to the economic and trade liberalization measures implemented in many emerging economies, especially in Latin America and Asia.

A truce in the highly conflictual trade relations between the United States, Japan and Europe was achieved with the conclusion of the Uruguay Round of multilateral trade talks in 1994 and the founding of the World Trade Organization in 1995.

The empirical evidence, especially for the industrial countries in the post-war period, points to a positive correlation between growth and trade.

A recent IMF study of a sample of low and medium-income countries finds that the fastest-growing countries opened their economies to international trade much more than those that recorded slow or negative growth. It also finds that the poorest countries have seen their terms of trade deteriorate by about 1 per cent annually.

Heavy dependence on exports of raw materials, especially non-oil products, makes the development of these economies highly vulnerable.

Increasing economies' openness to trade, albeit with appropriate gradualness and in conjunction with consistent reforms of domestic markets, should lead in the medium term to faster growth through the efficiency gains deriving from the exploitation of comparative advantage and access to more advanced technology.

The multilateral negotiations over trade liberalization conducted under the aegis of GATT in the post-war period paved the way for a considerable reduction in tariffs and the elimination of most import quotas for industrial goods in the advanced countries.

The Uruguay Round between 1986 and 1993 marked the first time that a large number of developing countries took an active part in negotiations. Issues regarding agriculture and trade in textiles and clothing, which had previously been excluded from GATT, were finally addressed. Nevertheless, the resistance of the industrial countries to dismantling the Multifibre Agreement and the reluctance of Japan and the European Union to abandon their high level of protection of domestic agriculture meant that the liberalization efforts were only partly successful.

The level of trade protection for agricultural markets in the OECD countries remains high and has not decreased significantly since the end of the eighties. Talks on agriculture, which resumed with difficulty in early 2000 at the WTO, have rightly been influenced by issues surrounding transgenic products and more generally the role of agriculture in safeguarding consumer health. The developing countries were also disappointed by the achievements of the Uruguay Round in the area of textiles and clothing. So far their exports have apparently benefited very little from the planned dismantling of import quotas in the advanced countries.

The proposal advanced at the 1998 ministerial meeting of the WTO in Geneva to launch a new global round appears likely to move forward with difficulty, following the failure of the Seattle summit in an atmosphere of protest against globalization.

The exclusion of products manufactured by the most backward countries from multilateral trade agreements is one of the factors increasing disparities in the global distribution of wealth. We must take urgent action to tackle the vital issues of greatest importance to the developing countries.

### *4. Absolute poverty*

According to World Bank figures, 1.2 billion people in the world live on less than one dollar a day, most of them in Asia.

Almost 3 billion people, or 56 per cent of the world's population, live on less than two dollars a day.

The incidence of poverty is very high in low-income regions: in sub-Saharan Africa and Southern Asia, more than 46 and 40 per cent respectively of the population live on less than one dollar a day. Excluding the Far East, where the percentage of poor fell from 27 to 15 per cent between 1987 and 1998, the developing regions saw no appreciable reduction in the poverty rate over the same period. In Latin America the situation has degenerated, with almost 16 per cent of the population subsisting on less than one dollar a day.

However, per capita income is not the only yardstick by which to judge standards of living. A population's well-being is more comprehensively gauged when other variables are factored in, such as health and education. In the long term, demographic factors and improvements in living conditions also foster economic growth.

Fundamental medical achievements have brought progress in the availability and quality of water resources and, more generally, in hygiene and health, which over the last hundred years has enormously lengthened life expectancies in the developed countries and even more so in the developing world.

Since the mid-twentieth century life expectancy in the poorest countries has risen far faster than in the industrial economies during the nineteenth century. In 1900 life expectancy in the seven most industrialized countries ranged from 46 to 51 years, compared with 77-80 today. The life expectancy in India, now 62, stood at less than 25 years at the start of the twentieth century. The poor nations achieved this improvement despite average income levels that were lower than those that had characterized the industrial countries in 1900.

A recent study by the IMF confirms the positive link between a protracted increase in domestic output and the reduction of poverty. Developing countries whose per capita income growth in recent decades has been low or negative, and which sadly are the large majority, have not in general achieved appreciable results in reducing the incidence of poverty.

## *5. Promoting growth in the poor countries*

The problem is how to consolidate, through plans and instruments, the process that will set growth in motion.

Empirically, the growth rate correlates positively with the fraction of income invested, with the school attendance rate, with such indicators of health as average life expectancy at birth, and with openness to trade. It correlates negatively with weak public sector institutions, with political instability and corruption, with social tensions and war, and with serious distortions in the working of the markets.

Inefficiency and corruption are obstacles to growth; they hold back the proper working of the entire economic system and weigh heavily on the pace of development.

Barriers to the spread of new technologies are another obstacle to development. Shortcomings in school systems and in the proper working of markets can be due to opposition by economic and social groups to the spread of new ideas.

A key factor for achieving “take-off” is openness to trade. It is through the exchange of consumer and capital goods that progress takes root and development spreads.

The protectionist policies of industrial countries in sectors such as agriculture and textiles, in which the developing countries have a comparative advantage, constitute an impediment to free trade.

Countries in the early stages of development, with low rates of saving and high investment needs, inevitably accumulate debt to the more advanced nations. Wherever an economy is growing steadily, even not inconsiderable levels of debt are natural.

However, if the resources borrowed are not used efficiently and do not produce high returns, an unsustainable situation may arise in which debt servicing alone absorbs much of a country’s output. In these cases debt relief can break the vicious circle; they must be conditional on the achievement of structural reforms to promote the fruitful use of resources.

The problem of the poor countries’ foreign debt first emerged on a systemic scale at the start of the eighties. By the end of that decade it had become clear that there was little chance of recovering the loans granted and that the traditional approach of rescheduling and refinancing loans would have to be rethought.

In 1996 the IMF and the World Bank jointly initiated measures to help the most heavily indebted poor countries.

Since then the issue has figured constantly on the agenda of the Group of Seven, most prominently in last year’s Cologne Summit. In addition to debt rescheduling and new financing packages, the strategy adopted there calls for the partial or total cancellation of debts, conditional on the submission of structural reform programmes supported by the IMF.

## *6. Conclusions*

Financial investment, of all kinds and with considerable and at times predominant use of liquid instruments, has acquired ever greater qualitative and quantitative importance over the last ten years; thanks in part to the revolution in information technology, it has become a distinguishing feature of the process of globalization in recent years.

By permitting a better global allocation of resources, this process in turn has brought remarkable benefits in developing investments and productive activities, but recently it has also led to crises that have destabilized the banking and financial systems of developing countries, with repercussions on output and employment and in some cases the standard of living of large sections of those countries' populations.

The benefits have been concentrated in a few economic systems and in the sectors best able to exploit the opportunities offered by the globalization of trade and finance.

The exacerbation of distributive inequalities between and within countries, the social fall-out and not infrequent political consequences have heightened the awareness of international institutions of the related issues, which has been reinforced by the recent crises.

Wide-ranging measures have been put in place to forestall systemic financial crises and mitigate their consequences.

Thorough studies of ways to reduce the debt of the poorest countries have been completed and proposals mooted.

The Italian Parliament recently appropriated 12 trillion lire for the total or partial cancellation of Italy’s credit claims on the most heavily indebted poor nations.

Measures to ensure the stability of the financial system are aimed at eliminating the obstacles that in recent years have hindered the development of the weakest economies.

World equilibrium requires the credibility, first of all, and the stability of the main currencies, which depends on the structural strength of the respective economies. Money is a precious public good, a tool of orderly growth. Monetary stability is the condition for financial stability. The conduct of monetary policy, in turn, can affect the real economy and the distribution of wealth at the international level.

This is an issue that demands the attention of institutional policy makers, governments, the social partners and market participants. The ultimate purpose is to safeguard saving against the risks of a resurgence of inflation; in a word, the well-being of our citizens.

The fundamental issue of forging policies capable of promoting the more harmonious growth of the world economy remains.

Any solution of the poverty problem must first address the question of the protection afforded by the richer nations to agricultural and textile products. Measures must be taken to promote greater openness of the industrial countries’ markets to the traditional exports of the developing countries. These countries can achieve their growth potential also through the expansion of trade.

On this point we noted in the Annual Report of the Bank of Italy last May: “An essential condition for growth in the world economy is an open trading system that eliminates tariff barriers and quantitative restrictions,” and, again: “Consensus must be restored between the industrial and the developing countries in order to resume talks on agriculture and services with a view to a more equitable division of the benefits.”

In the interests of the poorest countries, debt reduction must be accompanied by a strengthening of international support, aimed at the introduction of economic reforms facilitating their integration into world trade. These countries must pursue stabler and institutionally sounder arrangements in a context of democracy.

The conditions must be created for them to import new technologies that will enable them to increase their production of industrially more advanced goods, starting from their often abundant raw materials and natural resources.

The crucial importance of human capital calls first of all for the reduction of the direst forms of poverty, and access for all peoples to the essential goods of health care, food and shelter.

To this end the solidarity and aid of the richest countries — for which the costs are comparatively modest — are indispensable.

International organizations must have greater capacity to intervene; this calls for closer cooperation and greater determination on the part of the more advanced economies to supply the means and direct them to relieving the more critical situations.

Bringing the poorest countries back into world trade circuits will contribute to faster world economic growth and constitute an investment in political stability at the global level.

The cause of poverty is to be found less in a lack of economic means than in conflict and political factors. The endemic conflicts in the more backward regions of the world are both a cause and an effect of poverty.

Economic growth translates into mass prosperity only when it is coupled with the development of the fundamental rights that ensure the dignity of the individual.

Returning to Pope Paul’s encyclical, individuals and families aspire to “freedom from misery ... an increased share of responsibility without oppression of any kind ...

better education – in brief, to seek to do more, know more and have more in order to be more".

The increasing importance of international migration by men and women seeking a better standard of living, or simply wishing to escape severe privation or oppression, faces us daily with a new reality to be aware of.

Globalization has made our perception of the solidarity that marks the human condition more vivid than in the past.

This is the viewpoint that we must adopt, though without ever forgetting those closest to us, in reflecting on issues of growth and poverty.

New forms of poverty and social exclusion have emerged in the advanced countries as well. The problem of inclusion is thus diversified in dimension and in character.

In the South of Italy the sharp slowdown in growth in the 1990s generated social problems and an increase in unemployment and poverty. More than one fourth of the households in that part of Italy are now below the poverty line, conventionally defined as a situation in which expenditure for a two-person household is equal to or less than average per capita domestic consumption.

The high road to the elimination of these problems goes by way of stronger, more sustained growth and higher employment. Productive work is the fundamental means to reduce poverty and to achieve orderly political and social life.

Development will have to involve peoples and places that just yesterday were considered alien and far-removed. They are much closer than we have been accustomed to think.

Development is the new name of peace.

In the vastness, depth and gravity of the problems, signs of hope are not absent. The recent presence in Rome of two million young people, who congregated to listen to the words of the loftiest of moral pulpits, cannot but instill in us faith in the future.

In the decades to come those young people will remember their participation at an event where they absorbed and shared a set of values that will guide them in their personal and social engagement, in countries and economic systems all around the globe.

It is with these values that we must begin if we wish this dawn of the third millennium to be a turning point, a commencement in the reduction of those areas of severe want and indigence that we are now more fully aware of, and if we aspire to more harmonious growth for the entire world economy and the promotion of a new humanism.

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