The magic of growth compounding

Wednesday, Jul 23, 2014

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In the early 1970s, Bangladesh, China, Malaysia and Korea were

all low-income countries (based on the definition used by the World Bank). Today after some 40 plus years South Korea has become a part of the global high income group that includes such elites as the United States of America, Japan and Germany among others. Malaysia and China have both crossed the threshold of upper middle income country and are now aspiring to entire the club of the high income elites. Yet, notwithstanding its solid growth performance since the 1990s, Bangladesh still is a low income country and is struggling to reach low middle income status.

What has happened to the gross domestic product (GDP) growth rate for each of these countries that have caused such a divergence between Bangladesh and these three dynamic East Asian economies? In this write-up I explore this question and illustrate the magic of growth compounding that-shows that seemingly small differences in annual GDP growth rates when compounded over a long period of time can make a huge difference in the well being of a-nation over the longer term. This also constitutes a plea to policy makers in Bangladesh to pay attention to the challenge of faster economic growth.

Per capita income outturn of Bangladesh and the three dynamic East Asian economies is shown in the Table below. As can be seen, all three East Asian countries were low-income countries like Bangladesh (per capita income below $750 during the 1970s). Although Malaysia was well ahead of the pack and South Korea also was ahead, per capita income of Bangladesh was not much different from that of China. Both were very poor with per capita income of below $200.

South Korea achieved the most radical transformation, moving from a low-income economy in 1974 to high income economy in the early 2000s. In 2012, its per capita income reached $22,670 that is 47 times higher than the level in 1974. China similarly performed well after 1990. It achieved the fastest rate of 20 year plus sustained growth in the world, exceeding 13 per cent per year. This is indeed a remarkable performance that has set the stage for China to take over the dominating role of the USA as the world's largest economy. Malaysia also performed well but less dramatically than Korea and China. As a result, it lost its huge advantage at the initial year (1974) to Korea. Indeed, if China continues to perform as well as now it will likely cross Malaysia's per capita income level. So, an initial advantage is no guarantee that this will stay put unless concerted efforts are made to grow the economy at a continued rapid pace.

The striking point that emerges from the Table is that all three East Asian countries grew substantially faster than Bangladesh over the past 40 years allowing them to move away from a low-income status to higher middle income (China, Malaysia) or high income (South Korea) status. In comparison Bangladesh is still at a low-income status. Had Bangladesh grown at the same pace as China over the past 40 years its per capita income would have been $3575. If it had grown at the same rate as South Korea, the per capita income would have crossed the present threshold of upper middle income and reached $4723. The magic of the compounding effects of higher long-term sustained growth is obvious.

What explains these differences in economic performance? What can Bangladesh learn from the experiences of these dynamic economies? While each of the three East Asian country experiences has its own unique features and political and social institutions in each country are vastly different, a number of common factors stand out. Research shows the following common aspects in each country:

- In the early stages of transformation from low-income to lower middle income, the main emphasis was placed on capital accumulation. All three countries achieved and maintained high rates of national savings and investment (exceeding 35% of GDP).
- All countries emphasized investment in human capital from the early stages, both in terms of education spending as well as skill formation through labor training. This focus grew as the economy expanded with emphasis on tertiary and scientific education. The transition from lower middle income to higher middle income saw considerable capital deepening. Capital intensity of production increased substantially that contributed to increased labour productivity. Considerable effort was put on the acquisition of new technology, especially through rapid inflows of foreign direct investment. Research and Development (R&D) spending was emphasized and it grew in strength as the capital and skill intensity of production increased.
- The development of infrastructure (electricity, energy, transport network) was given the highest priority. All three countries relied very heavily on a diversified manufactured exports base as an engine of growth.

The implications for Bangladesh policy-making is clear. Following impressive gains during the early years, Bangladesh investment rate is now stuck up at the 24-25% of GDP level. Boosting the rate of investment in both private and public sectors is amongst the foremost policy challenge. Political stability and rule of law are essential to build investor confidence. Alongside, the lowering of cost of doing business, easing land transactions, rationalizing corporate tax laws, and improving infrastructure are all essential ingredients to boost private investment.

Regarding public investment, greater domestic resource mobilization, better use of aid pipeline, improved expenditure planning, strengthening the implementation capacity of public sector and removing corruption from public procurement are critical elements of a strategy to increase the quantity and quality of public investment.

Exports have grown but are dependent upon only one product group – readymade garments

(RMG). Diversification of exports is yet another major policy challenge. The incentive policies, especially trade policy, are biased against non-RMG exports that must be removed. Appreciation of the real exchange rate has to be addressed.

Progress has been made in expanding enrollments in primary and secondary education but quality is weak and-expansion of tertiary education, especially relating to science and technology, is heavily constrained. Except in the RMG sector, on-the-job training is virtually non-existent and vocational training is limited and of low quality. A much more comprehensive effort to build human capital through substantially larger public spending and improved service delivery is essential to push the growth rate to the 8.0-10% per year range.

Research & development (R&D) spending is solid only in agriculture; its scope is very limited in other areas including manufacturing. Public spending will need to take the lead initially as a part of the broader effort to acquire better technology. Stronger public resource mobilization and better expenditure allocation are necessary to increase public R&D spending.

The role of foreign direct investment (FDI) is very limited. For example, according to the UNCTAD data on global inflow of foreign investment, in 2011 China received $124 billion of FDI, Hongkong $74 billion, India $34 billion, Malaysia $f12 billion and Bangladesh only $1.0 billion. The policy challenge for attracting FDI is a substantial endeavour. Policies that help private investment will also help FDI. Additionally, the Government’s foreign, finance and commerce ministries have to be much more proactive to push FDI.

In infrastructure the gap is huge. According to rankings prepared by the World Economic Forum, despite recent progress Bangladesh is still seriously deficient in infrastructure in regards to almost all competitors. For example in terms of the 2013-14 ranking of infrastructure Bangladesh ranks a low of 132 out of 148 countries. This compares with ranking scores of 11 for Korea, 29 for Malaysia, 48 for China, 82 for Vietnam and 85 for India.

Clearly Bangladesh has a long way to go. Substantially larger public investment, stronger public-private-partnership initiative, reliance-on turnkey projects and improved public procurement will all be essential to address the infrastructure gap.