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Is an Export-Led Growth Sustainable for Bulgaria?

Victor Yotzov[1]

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Abstract: *The study considers the main economic growth models from the perspective of their relation to the external sector. It defines the advantages and drawbacks of the export-led model and the import-substitution model and sheds light on the growth constraints ensuing from the balance of payments and the elasticities of imports and exports. It analyses the prerequisites for selection of one or another growth model and comes to the conclusion that Bulgaria will have to implement an export-oriented growth model within a medium-term perspective. In this relation, it makes proposals aimed at improving the country's foreign trade policy.*

1. INTRODUCTION

Economic growth models have undergone a number of changes in the recent decades. Right after World War II, a prevailing part of developing countries adopted an economic development model based on the so-called import-substitution model. The rationale of this model was to encourage domestic production and development of an own economic base. Corresponding to this view, large part of the developing countries enforced (to a varying extent) protectionist policies and ardently protected their newly emerging production and industries. In spite of the timely warnings by economists of potential losses owing to the unreasonable distribution of resources, the generally accepted view was that the benefits from increasing production output and ensuring domestic employment compensated for the losses resulting from ineffective distribution. This model was widely used until mid-1970s, and later was gradually abandoned.

Approximately at the same time, the economic success started to stand out, first in Japan and later on in South Korea, Singapore, Taiwan, and Hong Kong, which all used an economic development model based on strong encouragement of exports. Soon after, the export-led growth (ELG) became the standard development practice and was widely imposed by the IMF in the Fund-supported programmes.

Empirical data, however, cannot fully confirm the assumption of the existence of any advantages of export-led growth over the import-substitution growth, as according to data of the United Nations Conference on Trade and Development (UNCTAD) it turns out that economic growth rates slowed down after 1980. The slowdown of economic growth continued as late as the end of 1990s, when the impact of the inclusion of China and India in the international division of labor started to be strongly felt, pulling up the whole group of developing economies. Even before the global financial crisis, there were signs of wearing out of the export-led growth paradigm. Japan was the first country to evidence drastically reduced growth rates in spite of the great volumes of its exports. Similar trends were also evidenced in other countries, mainly in Latin America, which renewed the interest in the limits of the ELG.

[1] University of National and World Economy and Economic Research Institute at BAS, Bulgaria

2. COMPARING EXPORT-LED GROWTH TO DOMESTIC DEMAND-LED GROWTH

The rationale of the ELG lies in the ability of foreign trade to drive economic growth, in the sense that it facilitates the more effective distribution of resources within a single country, and between different countries and regions. Besides, exports are an effective tool for introducing new technologies and acquiring new knowledge, which (from the perspective of the endogenous theories) stimulates growth. In other words, growth of exports plays an important role in the overall process of economic growth, with its positive impact on both demand and accumulation of capital. Having achieved high export growth, import capabilities of an economy increase as well and thus further enhancing economic growth. The implementation of ELG models, on the other hand, can be viewed as a step back to the mercantilists' views, particularly in the context of the laissez-faire doctrine. There are numerous studies establishing strong correlation between export growth and economic growth. The advantages of ELG are well known and hardly deserve more attention.

ELG, however, has serious opponents (Palley T. , 2011), bringing to the fore some inherent deficiencies, the most important of which are:

- Developing of dependence on external demand by developed countries and increased volatility of growth;
- Slowdown of growth rates in the domestic market;
- Ferocious competition between the developing countries leading to "export displacement" and ultimately to deterioration in the conditions of trade for all exporters;
- Exacerbation of global imbalances and negative impact on financial stability;
- The more countries implement this strategy, the lower its effectiveness due to the constraints of global demand.

Because of these drawbacks, more and more supporters gather the view that the ELG is exhausted and has to be replaced with a domestic demand-led growth. One of the major arguments is that China's entry into the international markets has significantly changed the "rules of the game". ELG models are hierarchical and assume replacement of old players with new ones that offer lower costs per unit of output. Offering cheap, unpretentious and relatively well trained labor in China is practically unlimited, which places the other developing countries (both in the region and globally) in unequal position. There are already a number of examples – primarily in the light industry and more specifically in the production of knitwear – proving the assumption of "export displacement".

In spite of the existing shortcomings of the ELG, it is clear that the developing countries (at least at the early stage in their development) cannot succeed without relying on export industries. The question is in what context export stimulation is considered. From this point of view, international trade should be governed by the idea of economic development, rather than seeking at any cost comparative advantages in various activities and industries, as this often results in negative effects in the longer-term perspective.

3. SELECTING A GROWTH MODEL FOR BULGARIA

Political factors influencing the selection of a development model are of a great importance, if not even more important than the economic ones. Government authorities, with no exception, always want to see surpluses on the current account of the balance of payments (BOP), and are concerned with having deficits, irrespective of their economic nature. This argument, no matter how trifling it may seem from economic point of view, very often turns to be decisive in making specific governance decisions. The reason lies in the believe that by pursuing an export-oriented policy (instead of stimulating domestic demand) can more easily ensure high employment without causing any inflationary pressure in terms of payment of labor. This, however, presupposes (since trade globally is balanced by definition), that for each country implementing such a mercantilist approach to the trade balance, there should be a country(s) that is/are ready to carry the burden of a trade deficit and to import inflation (deflation).

The issue actually boils down to the question why many countries consider trade balance surpluses as a stronger instrument for increasing revenues, than domestic investments? The explanations that are usually offered are along two lines: first, trade surpluses to a great extent solve the problems with effective (unlimited by other markets) demand, and second, from the perspective of national accounting, the external account surpluses can be presented as external investments, which subsequently have a multiplication effect both on production and on employment. The logic here is: any increase of domestic economic activity leads to an increase in imports, thus any income and employment increase as a result of internal factors should be at least partially compensated by a decrease of external investments. On its part, any increase in trade surpluses due to increased exports does not lead to a decrease in domestic investments, but rather creates conditions for their increase, provided external demand remains stable.

Comparing and analyzing the two alternative models is useful as it outlines the differences and offers possibilities to choose depending on specific conditions. There is another approach, however, to analyzing export-led models, which is based on a more in-depth analysis of the BOP. The underlying idea here is that the condition of the BOP (in the context of an open economy) is a natural constraint of growth. Traditional theories of economic growth usually ignore the BOP and exclude monetary impacts. These models are demand-led and assign an auxiliary role to the BOP, assuming that it is self-equilibrating through the mechanism of domestic and/or external price adjustments. Thus, the relation is lost between the condition of the BOP and the accumulation of resources in support of economic growth.

The Keynesian approach puts the emphasis on demand, proceeding from the assumption that supply adapts to demand and not the other way round. From this perspective, economic growth should not simply be considered as constrained by supply. This, of course, does not mean that there are no such constraints, but that they are not the determining ones. This approach is based on the understanding that normally the supply of labor in developing countries is more than sufficient, but there is no capital (or it's insufficient), which can be provided by imports, for which foreign currency is needed. The economically most advantageous and sustainable manner of providing the required financial resources is by stimulating exports, which ensure import of capital in the conditions of maximum employment. This is what ensures stable economic growth in the long-term. If exports cannot provide the necessary funds for imports, incomes will start decreasing, which will cause a decline in the rate of imports and equilibration with the volume of exports. In other words, the equilibration of the external sector would come as a result of adjustment of incomes. The trivial conclusion regarding the economic policy is that if the economy develops below the levels of productive potential (i.e. when the constraints placed by supply are not of determining nature), then the economic growth rates will be determined by demand. From this point of view, the differing rates of economic growth between different countries are explained with the differences of aggregate demand. Therefore, the question boils down to: what constrains the implementation of an active economic policy (both fiscal and monetary) in an open economy, and could/should Bulgaria use this approach?

Until recently, the understanding that demand cannot be uncontrollably stimulated due to the constraints imposed by the budget deficit and interest rate level was accepted as self-evident. Theoretical and empirical research, however, in the recent years increasingly drew the attention to the BOP as the main growth curbing factor. The main idea of this approach is that the international financial markets' assessment of the external position of a country limits its economic growth to levels below the constraints set by employment and production capacity utilization. The arguments are as follows:

- BOP problems are relatively quickly passed over to the real sector;
- Sustainable economic growth cannot be maintained without sustainable BOP, as financing the increasing deficits leads to increase in interest rates, which is acceptable only within a short-term horizon;
- High interest rates shift investors' interest to financial assets, which results in a reduction of investments in real assets, thus lowering growth rates.

The mechanism of implementing BOP constraints is relatively simple. If an economy starts facing BOP problems as a result of increased domestic demand (i.e. before reaching the short-term production capacity), aggregate demand shrinks, and aggregate supply is not used to its full extent. When this happens, investments decrease, thus directly impacting factor productivity, respectively growth. On the other hand, if an economy can increase its aggregate domestic demand to the level of the existing production capacity (i.e. without accumulating external sector imbalances), the pressure exerted by the demand will have a positive impact on production capacity, and from there on economic growth. Practice has proven this is possible under certain conditions, the most important being:

- Investments should be channeled into the tradable sector;
- Production factors are distributed with priority to the sectors with higher productivity;

Actually, the above conditions are the essence of the export-oriented growth model, in which growth of exports results in increased economic growth rates without any deterioration of the international investment position of the economy. However, it should be immediately underscored that one and the same rate of exports growth will not have similar consequences in different countries. This is so due to the fact that different countries have different sensitivity of growth rates to imports – equilibrium growth from a BOP point of view will be reached on different levels in the growth rates of aggregate demand. The pioneering research in this area was made by (McCombie & Thirlwall, 1994), who proved that from the BOP perspective equilibrium growth Yb is set according to the simple rule: $Y_b = z{\cdot}\varepsilon/\mu$, also known as the Thirlwall law, where z is the growth rate of global production (income), and ε/μ is the ratio between the income elasticities, respectively of exports (ε) and imports (μ). If we assume that global production (income) increases at regular rates, then the equilibrium (sustainable) growth of an economy is determined by the ratio of elasticities of exports and imports.

It is important to note that the effect of any changes in the exchange rate is eliminated in deriving this rule (law), as it is assumed that these changes do not impact volumes significantly. Empirical data unequivocally prove that the devaluation of the national currency can bring a short-lived improvement in the BOP, but this does not always impact growth rates positively, because the nominal devaluation rarely grows into real devaluation due to the strong inflationary effects it generates. This is also confirmed by the recent years' observations, showing that changes in the real effective exchange rate have a negligibly low relation to volumes of trade flows.

Having said all this, a conclusion can be made that different economies grow at different rates because domestic demand grows at different rates, which, on its part, is constrained by the requirements of balance of payments equilibrium, in the sense of the Thirlwall law. Hence, the issue comes down to explaining why the constraints imposed by the BOP are different in different countries, i.e. why elasticities of exports and imports differ. It is not easy to answer this question as it requires an additional analysis, which goes beyond the scope of this study. It can be mentioned, however, that the elasticity of exports (imports) reflects to a very great extent the differences in the so-called "non-price competition". The significance of this conclusion can hardly be overestimated. It turns out that supply is important only as much as the supply of production factors (investments in new technologies, R&D, education, etc.) can influence the elasticity of demand for exports which, on its part, is of crucial importance for the growth rate of exports, and from there for economic growth. This approach differs considerably from the classical interpretation of supply, where the very growth of factors (labor, capital and technologies) explains economic growth by itself.

Clarifying the theoretical concepts as regards the possible types of economic growth and the constraints they impose are important from the perspective of formulating of a specific economic policy for Bulgaria. The issue that is most important is whether the economy can generate sufficiently high growth based on internal factors, so that it won't need to rely on the vicissitudes of external markets? Furthermore, a possible positive answer to this question requires an answer to another one – what the role of the government in pursuing such a policy?

No matter how convincing the arguments of the adversaries of export-led growth might sound, the truth is that incomes in Bulgaria are low and will remain at low levels in the medium-term, which does not allow making full use of the domestic demand-led growth mechanism. The constraints set by the currency board arrangement and the impossibility (at least in the medium-term) to pursue an expansionist fiscal policy are additional factors in support of the conclusion that in the foreseeable future Bulgaria will have to rely primarily on its exports for ensuring economic growth, based on economy of scale. From the point of view of the constraints imposed by the balance of payments, the message is clear – increasing the pace of economic growth is possible only if Bulgarian exports are made more attractive and/or the elasticity of imports is reduced (in the best-case scenario a combination of both). Otherwise, i.e. if production capacity is growing at a quicker rate than domestic demand (due to the constraints imposed by the balance of payments) unemployment will increase, which will further reduce consumption. In other words – it is not just a question of ensuring economic growth by more exports, but by the export of the right goods and services, those for which there is elastic demand.

4. CONCLUSION

Drawing on all said so far, one can convincingly affirm that export-led growth means not just high rates of exports but is related first and foremost to providing all necessary conditions for improving the effectiveness of exports in a manner that makes them a driver of economic growth. Implementing this seemingly simple idea requires providing a number of prerequisites. Economic growth rates will be related to the growth of export volumes only after the strategic export industries for the economy have been determined. This is the only way to get rid of sporadic and campaign-driven measures for stimulating individual productions and for achieving short-term effects on the BOP current account, and to develop a purposeful policy of long-term effects on the overall economic development. From this perspective, the policy of export-led growth should not be based on an individual successful trade breakthrough, but rather on a comprehensive strategy for identifying, developing and establishing market positions. One of the main difficulties to be overcome in case of an export-oriented trade policy is related to the restructuring of import and export nomenclatures, but this is an issue that goes beyond the scope of this study. And last but not least, the various forms that an export-oriented policy can take are determined by both the nature and specifics of the economy and by the existing connections and relations between the government and the business – an issue that has not yet found any acceptable solution.

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