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Giving Domestic Demand a Greater Role in Development Strategies

Many developing countries have pursued export-oriented growth strategies over the past three decades. The success of such strategies depends on rapidly growing global demand and the ability of a country to enter market segments with high demand growth and potential for productivity growth. The onset of the global crisis in 2008 disrupted the favourable external economic environment that had made export-oriented growth strategies viable. Developing countries are likely to face sluggish import demand for their goods as a result of a protracted period of slow growth in developed countries. To avoid an ensuing slowdown of their economic growth, developing countries need to consider moving towards a more balanced growth path and give domestic demand a greater role in their development strategies.

It is well-known that export-oriented growth strategies must sooner or later reach their limits when many countries pursue them simultaneously: competition among economies on the basis of low unit labour costs and light taxation means a race to the bottom, mostly with little gains for economic development but always with potentially severe social consequences. What is new at the present juncture, where growth of demand from the developed countries must be expected to remain weak for years to come, is that these limits are reached much earlier. Therefore, a rebalancing of the forces of growth towards a greater weight of domestic demand is indispensable. This will be a formidable task for all developing countries, though more difficult for some than for others. Considered from a demand-side [1] perspective, there are three main challenges in switching from a growth strategy based on exports to one based more on domestic demand:

- The size of the domestic market – the increase in the sum of household consumption, investment and government expenditure must be sufficiently large to compensate for the decline in the trade surplus caused by a fall in exports.

- The risk that a switch in growth strategy will rapidly become unsustainable by triggering a surge in imports[2] – this risk is determined by the degree to which the sectoral structure of domestic production is delinked from that of domestic demand. This gap is particularly large for countries that export a high proportion of primary commodities. But it is also substantial for countries heavily involved in global value chains that produce goods for developed-country markets (such as advanced consumer electronics) which few domestic consumers can afford.

- Policies regarding the creation of domestic purchasing power – unlike exports, the bulk of the other components of aggregate demand (i.e. household consumption, investment and government expenditure) is not autonomous, but induced by income. Hence, for a shift in growth strategy to be sustainable, an initial increase in expenditure in the, usually small, autonomous segments of the three domestic demand components must trigger an increase in expenditure in those of their segments that are induced by income, and income itself must be generated in the process. How to achieve this is largely a question of economic policy.

The remainder of this policy brief discusses these challenges in more detail, drawing on Mayer (2013). [3] While underlining the importance of both government spending and, especially, investment for boosting demand growth, it emphasizes household consumption expenditure, which is by far the largest component of domestic demand, generally accounting for between half and three quarters of aggregate demand.[4]

Suggestions for a greater role of consumer demand in developing countries' growth strategies have often been frowned upon because of these countries' alleged insufficient market size. However, rapid growth in many of these countries over the past two decades may well have changed the situation. The size of a country's domestic market for consumer goods is determined by the size of its population, its average level of per capita income and its pattern of income distribution.[5] Assuming satiability and a hierarchy of needs in consumer preferences, the relationship between per capita income growth and product-specific consumption expenditure can be described by an S-shaped structure that is subject to two thresholds: a lower threshold where consumer demand accelerates rapidly because households' disposable income starts exceeding a critical size that makes large-scale consumption affordable, and an upper threshold where their demand approaches saturation. Econometric estimations indicate that the lower thresholds which trigger an acceleration of demand for specific consumption items cluster at certain levels of per capita income, and that these levels closely correspond to what characterizes an individual as being "middle class".

The term "middle class" is generally used to describe the social status of individuals who have a certain amount of discretionary income at their disposal which allows them to engage in consumption patterns beyond just the satisfaction of their basic needs, though not – or only occasionally – their desire for luxury items. Kharas (2010)[6] uses an absolute approach to defining the two boundaries that separate the middle class from the poor, on the one hand, and from the rich on the other, and defines the middle class as comprising individuals whose annual expenditures are between $4,000 and $35,000 in purchasing power parity terms. These two boundaries happen to correspond to the levels of per capita income where the income elasticity of demand for durable consumer goods crosses unity (figure 1). This implies that for a one per cent rise in the income of individuals belonging to the middle class, the ensuing increase in their expenditure on durable consumer goods will exceed one per cent, involving the purchase of a car, household appliances, consumer electronics, etc.

Evidence on income distribution indicates that the size of the middle class varies widely across countries (figure 2).[7] In 2005, which is the most recent year for which comprehensive data are available, the middle class constituted 60 per cent of the population in the United States, compared with only 30 per cent in China, and roughly 5 per cent in India, but about 80 per cent in the Russian Federation. More important for the future evolution of consumption expenditure is the number of people that are at around the entry level of the middle class, where consumer spending starts accelerating. Such income brackets are virtually absent in the developed economies, but comprise more than half of the Chinese and about three quarters of the Indian and Indonesian populations respectively. Combined with these countries' large absolute population sizes, the above indicates that a range of developing countries have a large number of people that already are, or will soon be, at the entry level of the middle class. This implies that the sales potential for consumer goods is likely to be sufficiently large for these countries to give a greater role to household consumption in their growth strategy.

But even with sufficiently large domestic markets, switching to a more balanced growth path will rapidly become unsustainable if accelerating consumer expenditure triggers a surge in imports. The implications for international trade of changes in spending patterns when these are part of a shift in the composition of aggregate demand in developing countries away from exports towards more domestic consumption may be assessed through simulations with the well-established global model of the Global Trade Analysis Project (GTAP). Such simulations indicate that, in the absence of corrective policies, most of the benefits of expanding consumer goods markets in developing countries may accrue to developed country enterprises.

In order for their domestic firms to be able to meet the demands of emerging middle-class consumers, developing countries will need to narrow the gap between the composition of domestic supply and that of domestic demand. Policymakers can use industrial policy to encourage this process in which developing-country firms may well have an advantage over developed country firms, mainly for two reasons. First, the tastes and preferences of middle-class consumers in developing countries differ from the existing high-end products much sought after by consumers in developed countries and by the most affluent groups of consumers in the largest cities of developing countries, who are the standard targets of developed country firms. Domestic producers may have an advantage over foreign enterprises in developing and distributing goods whose characteristics match the preferences of local middle-class consumers. Second, emphasizing that trade is not costless, and that geographical distance to markets still matters, the literature on international trade and economic geography has shown how market size and relative geographic position affect specialization patterns. In particular, greater domestic demand for manufactured consumer goods results in higher wages which move local production towards the manufacturing sector. To take advantage of the associated production and innovation opportunities, developing-country firms will need to transform their production structure, thereby reducing the import content of rising domestic consumption expenditure. This latter point illustrates that even a growth strategy based on an increase in domestic demand needs to take account of an economy's supply structure.

Small economies will face considerably greater difficulties than large ones in moving their sectoral sector of production closer to that of domestic demand. This means that only economies with large domestic markets will be able to emphasize domestic demand in their growth strategy, while trade, especially South-South trade, will need to remain an important growth engine for smaller economies. [8] But even the larger developing countries will need to maintain some export growth in order to finance the imports of primary commodities and capital goods required for ongoing urbanization and for an expansion of their domestic productive capacity.

What could be the source of consumers' increased purchasing power required to boost domestic consumption? Facilitating access to consumer credit would be an easy way of spurring domestic demand. But such a strategy tends to be risky, as amply demonstrated by experiences in a number of developed countries, as well as by growing difficulties in a number of developing countries, especially in Asia, that have experienced rapidly growing household debt. Boosting domestic purchasing power through the creation of jobs and income is an essential condition for a shift towards a more domestic-consumption-oriented growth strategy to be sustainable, as it will boost the non-autonomous component of household consumption. Related policy instruments include incomes policy, a legal minimum wage, targeted social transfers and public sector employment schemes. Governments can further influence the size and distribution of domestic purchasing power through changes in the tax structure and the composition of public expenditure that favour middle-class households. [9]

To sum up, developing countries should not underestimate the challenges associated with the need to adapt their policy stance to a less favourable external economic environment. The relative weight that such a policy stance confers to the three components of domestic demand (i.e. household consumption, investment and government expenditure) will depend on country-specific circumstances. Yet, any policy measure will need to recognize the strong interdependence between these three components. Changes in public revenue and spending patterns can boost both household consumption and investment. However, nurturing the interrelationship between household consumption and private investment will be at the centre of a shift towards a more balanced growth strategy.

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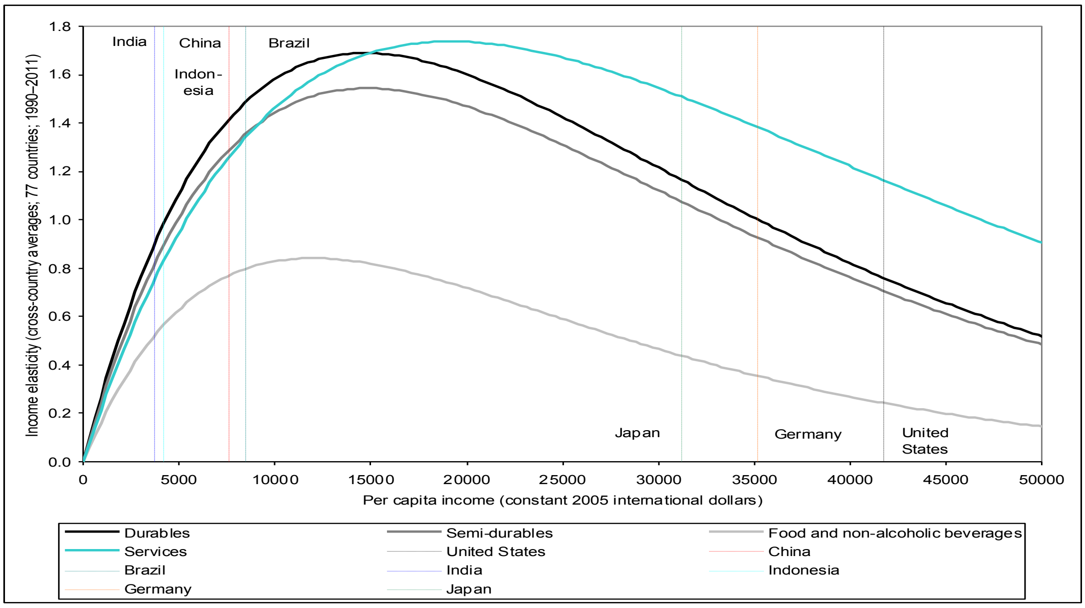
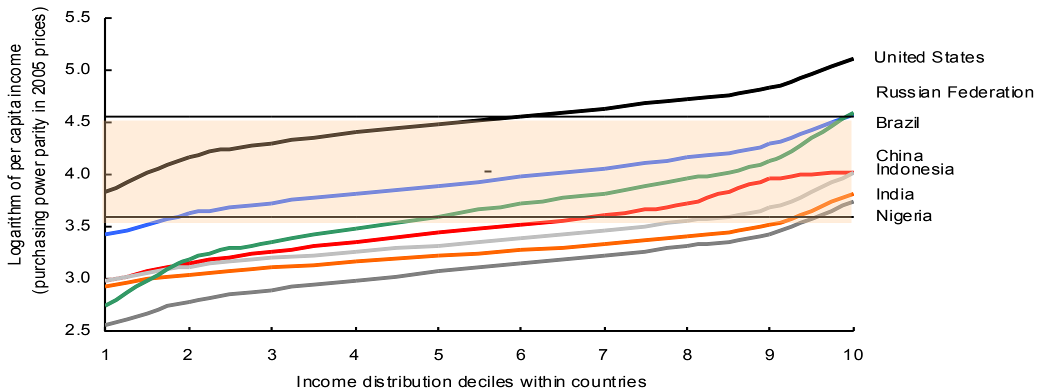
Figure 1
The relationship between per capita income and the income elasticity of demand, selected consumer good categories



Source: Author's calculations based on data from Penn World Tables, UNCTADstat and Euromonitor.

Figure 2
Size of the middle class in selected countries, 2005



Source: Author's calculations, based on Milanovic (2012).
Note: The two horizontal lines are the lower and upper income limits of the middle class. The size of the middle class in each country is measured by the width of the part of the country line that is within the shaded section.

[1] A supply-side perspective to the issue of how developing countries should adjust growth strategies to a post-crisis external economic environment is adopted by OECD (2013) *Perspectives on Global Development 2013. Industrial Policies in a Changing World*, Paris: OECD. It emphasizes investment in education and innovation, combined with closing the gaps in infrastructure, overall with a view to improving developing countries' international competiveness.

[2] A surge in imports can be balanced by accumulating external debt, absorbing a rising amount of net capital inflows or letting the real exchange rate depreciate, but none of these strategies is sustainable.

[3] Mayer J (2013) Towards a greater role of domestic demand in development strategies. UNCTAD Discussion Paper, forthcoming.

[4] Adopting a demand-side perspective and focusing on household consumption also allows establishing a link between the orientation of growth strategies and the current debate on global rebalancing, much of which relates to the share of household consumption in aggregate demand. The G20 Leaders' Statement at the Pittsburgh Summit (http://www.g20.utoronto.ca/2009/2009communique0925.html) called for a rotation of global demand from countries with a current account deficit (especially the United States) towards countries with a current account surplus (such as China and Germany), where domestic expenditure in deficit countries would no longer exceed their income but rapid global growth would be maintained. This is because surplus countries would, at least for a period of time, record accelerated domestic demand growth in excess of their income.

[5] Demography, e.g. the age structure of country's population, also plays a role but is neglected here.

[6] Kharas H (2010) The Emerging Middle Class in Developing Countries. Working Paper No. 285, Paris: OECD Development Centre, January.

[7] Milanovic B (2012) Global income inequality data, 1988–2005; available at: http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTRESEARCH/0,,contentMDK:22261771~pagePK:64214825~piPK:64214943~theSitePK:469382,00.html.

[8] Canuto O, Haddad M and Hanson G (2010) *Export-Led Growth v2.0*, Economic Premise No. 3, Washington DC, World Bank, see South-South trade as the main avenue forward for developing countries' growth strategy but acknowledge that the viability of this strategy depends on the extent to which domestically generated productivity advances are responsible for developing countries' income gains, so that their growth path becomes "decoupled" from that of developed countries. However, there is little evidence for growth decoupling.

[9] For further discussion of these policies, see UNCTAD (2013) *Trade and Development Report 2013. Adjusting to the Changing Dynamics of the World Economy*, New York and Geneva: United Nations.