Export-Led Recovery, Multipliers, and Other Fanciful Notions

BY CHRISTOPHER LINGLE

Many developing and emerging market economies are struggling to keep their economic growth rates high enough to raise local standards of living. Moreover, many governments responded to lagging economic conditions by promoting export-led growth, evident in their obsession with restraining the appreciation of their currencies. While China will immediately come to mind in this regard, it is joined by many others, including Japan, South Korea, and Taiwan, to name a few.

The simple logic behind export-led growth is that higher foreign demand for domestic goods and services will boost local economic activity and bring higher rates of long-term growth. Underlying this logic is a technical notion that economists refer to as an “expenditure multiplier.”

Multipliers are explained by tracing the effect of new spending through the economy as it supposedly passes through many hands. For example, assume that most Taiwanese consume 80 percent of each additional dollar they earn while saving the rest. Under these conditions, a rise in the earnings of exporters by $10 billion would induce them to spend $8 billion. As they buy more inputs or expand their production capacity, those who receive payments from that round of spending will consume 80 percent of the $8 billion of their increased income. Adding up this continuous series of spending rounds supposedly generates $200 billion.

And, voilà! More spending begets more spending, so the slump ends. And we all live happily ever after. Wouldst that real life were as simple as it is in such fairy tales.

As it turns out, expenditure multipliers are the stuff of fanciful fiction. Despite many empirical studies to seek them out, they remain elusive beasts and when sighted have been of small and disputable consequence. As such, multipliers are rather like Elvis.

In all events, without the supporting argument of multipliers, export-led growth becomes a hollow concept.

It turns out that the demand by foreigners is not the source of greater wealth, nor for that matter does greater wealth depend on domestic consumption. Instead, the direction of causation is the reverse. Wealth depends on production being made possible through increased investments in capital goods that depend on more funds being made available through savings.

Increased demand for exports cannot have a multiplier effect since each economic activity requires a funding source. But the competition for scarce funds means that spending more on one good or service has to come at the expense of another. This logical limit on the nature of economic activity and spending means that the multiplier effect cannot function as predicted.

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It would seem plausible that the multiplier effect might work if a country were able to divert buyers for its exports from other countries. In a static framework this would be a rearrangement of global spending that might be offset by declines in spending by foreigners on some other country’s domestic production. In reality, spending “multipliers” are a Keynesian phantom. The only way to have multiple advances in wealth is for there to be a sustainable increase in wealth to support an increase in overall production.

Another logical flaw in the notion that rising export demand can boost the production of wealth is the implicit suggestion that demand is independent of the production of goods and services. Yet it is impossible to consider demand as being independent of the production of goods and services. Demand can only be satisfied if preceded by production.

The ideology behind export-led growth is contradicted by economic theory and reality. The notion that the advantages from trade come from exporting was the basis of mercantilism, a creed discredited several centuries ago. Adam Smith pointed out that the real advantages of trade come from allowing producers and consumers to buy from least-cost providers, regardless of their national origins.

And so it is that increasing imports is a better way to boost growth since enhanced economic efficiency and increasing real purchasing power are what benefit people.

For one thing, foreign competition provides domestic producers with an incentive to become more innovative and efficient in their local operations. When such improvements lead to gains in labor productivity, higher wages will allow household incomes to rise so that there can be more consumption and savings.

Increasing productivity will also lead to higher profits due to declining per-unit production costs. This will also enhance shareholders’ wealth to allow more consumption and savings.

And then the benefits begin to extend to the international sector of the economy. Allowing export sectors to import inputs or intermediate goods will lower operating costs. Falling costs and rising productivity will enhance their ability to export. Rising profits allow domestic multinational enterprises to shop around for overseas production facilities and better sources of raw materials.

Recently Taipei announced plans to relax restrictions on inward-bound investment capital by ending the qualified foreign institutional-investor scheme. This opening of the capital market is certainly a sensible step in the right direction.

The Market That Never Sleeps

Since global capital does not sleep, it will continuously seek out those countries with the most hospitable economic structures. Those with weaknesses will experience net capital outflows and economic slowdown. Economies with healthy and open domestic sectors will perform the best.

So why were people misled into thinking that export-led growth was the best model for emerging economies? Much of the confusion comes from believing that increasing demand can bring higher economic growth. The perpetuation of the expenditure multiplier continues to interfere with the formulation of sensible economic policy.

In all events, it turns out that much of the growth associated with the years before 1997–98 in the “miracle” performance of some East Asian economies turned out to be illusory. But this fact seems to be overlooked by promoters of export-oriented growth.

Instead of muddying up the policy waters with confusion sown by a dependence on exports, political leaders in developing economies should push for more competitive and flexible domestic markets for goods, services, labor, and other resources. Then a sharp rise in imports could set the path for their economies to embark on a higher long-term growth trajectory.