

Comments on “Demand-Side Constraints in Development: The Role of Market Size, Trade, and (In)Equality,” by Pinelopi Koujianou Goldberg and Tristan Reed

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This is a bold and intriguing paper. It offers a new explanation for poverty reduction (or lack thereof) and interesting new empirical measures of global market access and the size of the middle class for developing countries. The main contribution of the paper is to point to market size as a potentially significant constraint on economic development.

Much of development theory, whether it focuses on poverty alleviation or economic growth more broadly, focuses on supply-side determinants. Development is held back by market failures, government failures, or historical and geographic disadvantages that hold back productive development and slow down structural change towards more advanced sectors. The Goldberg-Reed paper emphasizes the role of scale economies instead, which brings the demand side to the fore. If modern, productive technologies need to be deployed at scale in order to become profitable, producers in low-income countries will be at a disadvantage for lack of access to large enough markets. By implication, conventional development policies – addressing market failures, improving institutions, investing in human capital and physical infrastructure – cannot be fully effective. The most powerful remedy would be to expand market access by integrating with the global economy. This is true especially for small countries. In more populous countries, expanding the middle class and its purchasing power, can also play an important role – and possibly substitute for global markets.

The authors present evidence from a panel of developing countries that is broadly in line with this perspective. In particular, they show that sustained poverty reduction over 5-year sub-periods is positively associated with three measures of a country’s market size: the proportion of the domestic population that belongs to the global middle class; the size of the global population that is integrated with the home economy; and the average income of the rest of the world that is integrated with the home economy. The construction and presentation of these measures is among the interesting contributions of this paper. I will not discuss the procedures here. I expect they will prove popular and will be used by other researchers in subsequent work.

Note that international integration does not always have a positive effect on the market size for domestic producers. The authors emphasize demand, but neglect competitive pressures on the supply side. When China joined the world economy, it added to the global economy not only more consumers but also more producers. Many manufacturing firms in developing countries found themselves at competitive disadvantage, in advanced country markets as well as at home, and were forced to shrink or close. In the presence of scale economies, it is possible to imagine models where product differentiation ensures producers in all countries expand as a result of market integration. But it is just as easy to come up with models where asymmetries in initial conditions – for example a cost disadvantage in increasing-returns industries – lead to the contraction of industries with scale economies in certain countries. In other words, the effect of international integration on the markets size of increasing-returns industries in any particular country is theoretically ambiguous, especially in smaller developing countries with less

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competitive modern industries. The authors' approach sidesteps this difficulty by assuming such asymmetries away.

This is not just a theoretical point. There is evidence that external competition and exposure to Chinese imports have led to the contraction of modern manufacturing industries in many low- and middle-income countries. These are of course the industries that are most likely to exhibit scale effects. Mexico provides a particularly striking case. Thanks to NAFTA and geographical proximity to the U.S., the Mexican economy was particularly well-positioned to benefit from global market integration. Yet, as Fentanes and Levy (2023) have documented, the outcome was a reduction in the employment share of modern firms and an increase in informality post-NAFTA – producing an exacerbation of economy-wide misallocation and reducing overall TFP.

There is a weak and strong version of the argument in the paper. The weak version would be that market size sometimes plays an important role in promoting or constraining development, particularly in the growth of technologically more advanced sectors. The strong version would be that market size is the binding constraint on poverty reduction, period. If the strong version is correct, there are very severe implications for smaller, poorer countries. For these, the only feasible path to development is deep integration with world markets – assuming other nations will allow them to do so by signing the requisite trade agreements. The counterfactuals reported by the authors are very much in line with this strong version of the argument.

If we take a broad, historical view of development, the strong version encounters a problem. Deep integration, whether one measures it in the specific way done in this paper (by the number of trade agreements) or more broadly, is clearly a relatively recent development. Deep integration in the sense of the authors became feasible for independent nations only after the 1990s, with the establishment of the World Trade Organization and the spread of regional and bilateral free-trade agreements. So how did development happen ever? How did smaller countries, whether it is Mauritius, Costa Rica, South Korea, or Taiwan during the 1960s and 1970s – or for that matter smaller European nations during the 19th century – ever develop in the absence of deep integration possibilities?

Most of these cases experienced rapid export growth, so the world market did matter. But that fact alone is not enough to adjudicate whether the constraints these countries managed to relax were on the supply side or the demand side. The fact remains that the export growth was achieved without deep market integration in the way the authors think of and operationalize the term. (The conventional account would be that the export booms were the result of reforms on the supply side of the economy, though which reforms really mattered remains a source of dispute.)

Even for the time period covered by the authors, there are some interesting anomalies. Consider Ethiopia, one of the most successful post-2000 development experiences. In the counterfactual exercises, Ethiopia is one of the countries that would fall below the market size required to achieve sustained poverty reduction in the absence of deep integration. Yet Ethiopia's actual experience of rapid growth and poverty reduction took place under very limited market integration (by the author's own measures, see Annex B of pre-publication version). The country's leadership has had a very skeptical attitude towards trade agreements and is yet to bring the country into the WTO. Perhaps this is merely a counter-example that does not diminish the overall value of the argument. But it is still an awkward case, since Ethiopia is one of the key successes of the post-2000 period.

It is true that that the recent era of deep integration has witnessed widespread economic growth and poverty reduction in the developing world. Indeed, for the first time in economic history, the world economy experienced some unconditional convergence after the 1990s, until the pandemic struck (Kremer et al., 2021; Patel et al., 2021). Poverty reduction also has been globally broad based. But there are other contending explanations for what happened during this period. Perhaps it was better macro policies and more business-friendly policies that were pursued in the majority of low-income countries. Perhaps it had to do with the high level of commodity prices. Perhaps it was low interest rates and easy credit conditions globally. We would need to discriminate among these stories by looking for evidence for the specific causal channels.

Whatever the underlying cause, the post-1990s development picture does not look like the standard trade-led growth story. As the authors note, the African or Latin American success cases of this period were not driven by export-oriented industrialization. Very few countries outside East and Southeast Asia experienced significant growth in manufacturing employment. And even in those where manufacturing did expand, the bulk of the expansion took place in smaller, informal firms where scale economies are unlikely to have played a significant role (Diao et al., 2021).

To explain this experience, we provide in Diao et al. (2019) a different demand-side argument that does not rely on trade or the presence of scale economies. We start with a model of a dual economy where there exists a gap in labor productivity between the traditional and modern sectors. We then posit an increase in domestic demand that might arise from a variety of different sources. Public investment, the animal spirits of private business, external transfers, increase in farmers' incomes, and commodity booms all seem to have played a role depending on country. Rising incomes spur greater demand for services at the margin (with non-homothetic demand), labor moves out of agriculture into services, and urban services expand. Since labor productivity in services is higher than in agriculture, economy-wide productivity rises. The result is a growth boom. However, in the absence of supply-side impetus for productivity growth in services, diminishing returns have to set in. Hence, this model also suggests the growth booms would run out of steam, as they clearly did in the years preceding the pandemic.

Whatever the underlying explanation for the pre-pandemic development experience, the authors are right that we are entering a different global context where the world economy will play a lesser role for most developing nations. Technological change and the backlash against globalization are making East Asia-style export-oriented industrialization much more difficult to achieve. The waning of the power of industrialization does render growth miracles and extremely rapid poverty reduction less likely. The question is whether it also rules out other forms of sustained economic development -- perhaps less rapid and less trade-dependent, but still poverty-reducing. If there is an alternative path, it is clear that domestic demand will have to feature more prominently. Therefore, the authors' emphasis on building a domestic middle class seems entirely appropriate to me, even though we may disagree on our interpretations of recent economic history.

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