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# DOES ECONOMIC GROWTH ALWAYS REDUCE POVERTY?
## Reflections on the Mozambican experience

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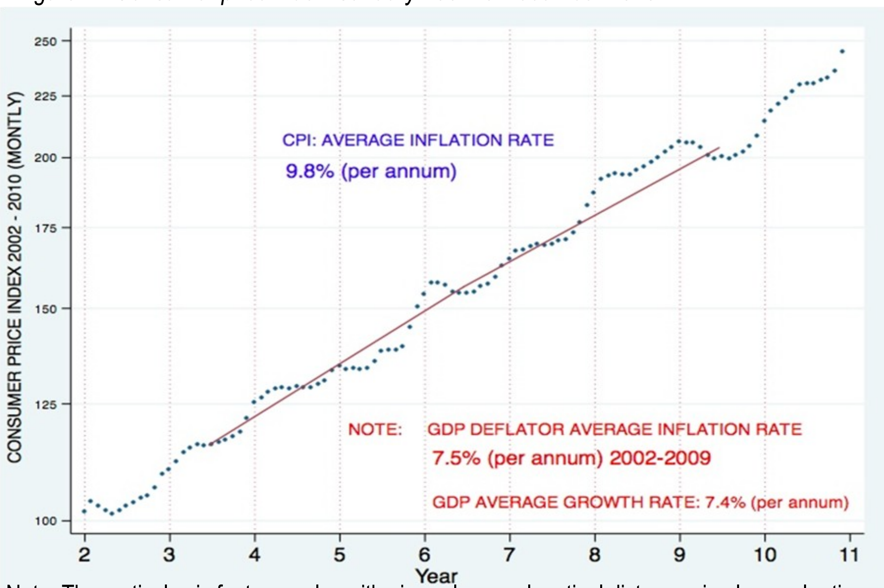
Undoubtedly, economic growth matters for poverty reduction. It is indeed hard to envisage that sustained reductions in poverty could take place in a context of economic stagnation or decline. Growth matters, therefore, but the question is whether growth always reduces poverty. The usual argument is that the adoption of certain core macroeconomic policies — the so-called 'fundamentals' of low inflation, trade openness, market liberalization, sound financial policies and good governance — will induce economic growth, which will in turn lead to poverty reduction. More specifically, the argument states that, if GDP *per capita* grows significantly and inequality (usually measured by the GINI coefficient derived from successive household budget surveys) does not worsen, then the incidence of (absolute) poverty must fall. if this does not happen, a paradox is said to exist or, as is most commonly asserted, something is wrong with the data. In this note, however, I argue that this argument ignores the importance of relative price movements within an economy between broad categories of commodities. More specifically, it ignores the importance of the impact of changes in the relative price of food on poverty. I shall argue, therefore, that it is possible for *per capita* economic growth to go hand in hand with stagnating or even rising incidence of income poverty, even if inequality does not worsen.

Why do relative prices matter? The reason is that the growth in *per capita* GDP cannot always be equated with the growth in the average standard of living. Indeed, the GDP of a country measures the aggregate value added of its domestic production, which comprises the production of consumer goods, investment goods and exports (after netting out imports). To measure its growth over time, GDP is calculated as constant prices. The appropriate deflator, therefore, is the *implicit GDP deflator*, which depicts the general rate of inflation of aggregate domestic output. To measure real changes in standards of living, however, it is the prices of consumer goods that matter. In this case, therefore, the appropriate deflator is the consumer price index (CPI). These two price indices, however, do not necessarily go hand in hand. It is possible for consumer prices to rise faster (or slower) than the general rise in prices of domestic output. If this is the case, the growth in the average standard of living will be less (or more) than the growth in GDP per capita.

*Figure 1: Consumer price index: January 2002 to December 2010*




Note: The vertical axis features a logarithmic scale: equal vertical distances imply equal ratios.

During this period, GDP grew at 7.4% *per annum* and population growth was ± 2.4% *per annum,* which means that GDP per capita grew approximately at 5% *per annum.* As shown in figure 1, the inflation rate for the implicit GDP deflator was 7.5% *per annum* as against 9.8% for the consumer price index, a difference of 2%. The potential growth in the average standard of living, therefore, should be corrected for this differential between inflation rates: hence, the average standard of living grew at most with 3% (= 5% - 2%) *per annum*

A caveat is necessary here. This quick calculation only represents a very crude measure of the rise in the average standard of living because (1) it assumes that the share of consumption in aggregate expenditures remained constant and, importantly, (2) that the growth in GDP also reflects the growth in gross national income. However, if, as is the case in Mozambique, profits constitute a significant share of value added (particularly, in mega projects) and are repatriated abroad, the growth in national income will fall short of the growth in GDP.

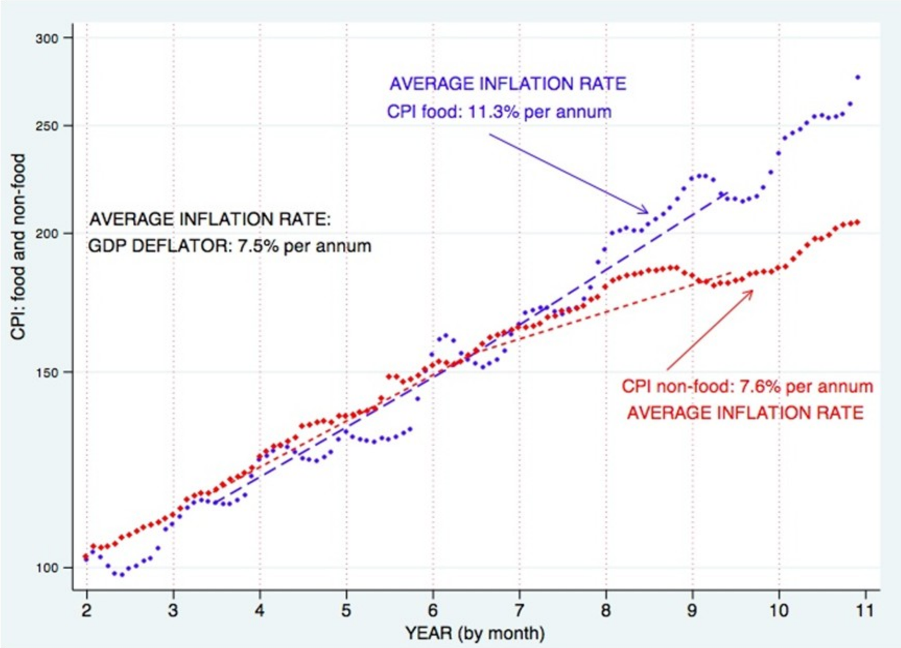
Looking at the general rate of inflation in consumer prices is unsatisfactory, however, because of the following reasons:

- consumption patterns differ among households depending on whether they are poorer or richer;
- more specifically, the proportion of income spent on food declines as income increases (which is known as "Engel's law");
- The consumer price index is calculated assuming that, on average, 55.46% of household expenses are spent on food;
- but this proportion is too high for the rich and much too low for the poor (who often spend up to 70 or 80% of their income on food).

It is important, therefore, to decompose the consumer price index into at least two components: the price indices for food and non-food items, respectively. Price inflation of food hits the poor much more than the rich and, hence, has important consequences for the incidence of poverty.

Figure 2 reveals a worrying state of affairs. Throughout the period 2002 to 2010 food price have been increasing at 11.3% *per annum* on average. At this rate of inflation, food prices double every 6½ years! Yet, if we are concerned about food poverty (which is extraordinary high in Mozambique), it is the inflation rate of food prices that matters most.

*Figure 2: Food versus non-food consumer price indices: January 2002 to December 2010*




Food inflation of 11.3% *per annum,* on average, as against 7.5%, on average, for the GDP deflator implies a discrepancy of 3.8%, which depicts the annual rate at which food prices rise faster than the general rate of inflation. Economic growth, therefore, went hand in hand with rapid inflation in the relative price of food (and, more generally, of basic consumer goods), which implies that it is possible for the incidence of poverty to remain the same or even worsen, even if the monetary distribution of expenditures (or incomes) remains unchanged. Indeed, given that the poor spend a much higher proportion of their income on food than the rich, this differential rate of inflation hits the poor far worse than the rich, thus leading to a worsening of the distribution of income to worsen *in real terms.*

This argument has important implications for economic strategy. In recent years, world prices of foodstuff have been rising rapidly, which brought increased import prices of food in its wake. The domestic production of food, however, has been highly variable with low levels of overall growth in output, thus rendering the country more dependent on imports. From 2002 to 2008, food production expanded by 2.2% *per annum* (which is less than population growth) and productivity (measured by yield) fell by -2.7% *per annum* (source: Poverty and Well-being in Mozambique: Third National Poverty Assessment, October 2010). At the same time, Mozambique has witnessed impressive rates of growth. What matters for poverty reduction, however, is not just the rate of growth, but also the type of economy it constructs in the process, which – in the case of Mozambique – appears to be quite unbalanced in favour of export production propelled by mega projects. The lesson appears to be that, while export production undoubtedly matters, so does the expansion of production for the home market – in particular, the growth in the production of essential consumer goods at affordable prices, especially food.