Date: 04.03.02
Continued from last lecture…
IV.

A. Infant Industry Argument: learn by producing, decrease costs, become competitive in world markets, remove protection. This theory needs imperfect capital markets; otherwise company could just borrow during their "lose money" period.
   Problems with IIA:
      Protection must be temporary: if permanent, there is no reason to learn and become more efficient. Often statements by governments concerning the removal or eventual removal of protection are plagued with credibility problems (workers = votes, etc.).
      Selecting which individuals to help can be difficult if not impossible.
      Second best: some other policy would be better than IIA to help an industry. A subsidy to production will provide assistance at a lower cost to the country as a whole (and would be first best).

B. Other Objections to Free Trade
   LDCs forced to specialize in primary products (timber, oil, etc.)
      Note: Canada has prospered while trading in primary products
      Argument: primary products are low tech and thus have no future
         The primary product market is very competitive, thus has low profits.
         Primary products are subject to competition from synthetics.
         They have a low demand elasticity (to sell much more they must reduce price by a lot). However, if they produce less, the price will increase, but restrictions on supply rarely work. These restrictions are often called International Commodity Agreements and they almost always fail. This low elasticity of demand makes it possible for increased production to cause immizerizing growth (produce more, made worse off).
      All of these are often said to imply:
         - Declining terms of trade for LDCs (relative price of exports compared to your imports is falling). Things they sell are decreasing over time in price. Studies concerning this result have produced ambiguous results.
         - Countries should not rest their growth entirely on primary products.

Pro:

C. Exports and Growth
   Why is trade good for growth?
   - Possibilities of economics of scale (dynamic): the bigger you are, the faster your ability to produce will improve (produce for the world as opposed to local market, this makes you bigger)

- Stimulate technological progress: increased competition from international trade provides an incentive to improve technology and raise productivity.
- Exports permit imports of high tech capital goods (because they pay for them)

FDI: inward FDI (to LDC) for EXPORT (this brings superior technology to the LDC). The argument is that if FDI is only to produce in the LDC to sell to the domestic market, the foreign firm will have no incentive to be more productive or use better technology than the domestic firms. If FDI is for export, on the other hand, firms need the highest quality and lowest cost possible, so they use their best technology.

D. Track Record of Import Substitution (Protection)
2 strategies for development:

1. Import Substitution: using tariffs to keep out imports and produce them domestically instead.
2. Export Promotion (free trade): use government to encourage exports.

In early history there was success with import substitution (I-S) strategy: US & Japan.

After WWII many followed I-S (e.g. India, Latin America) and it hasn't seemed to work as well there.
Some did not follow I-S and used Export Promotion instead (Hong Kong, South Korea, Taiwan, Singapore: 4 Tigers) and have done rather well. More recent countries to follow this example: Thailand, Indonesia, and Philippines.

V. Policy Recommendations

- Don't limit imports
- Should you subsidize exports? Hard to say. If you have overvalued currency, you may need to.
- Developed Countries (DCs) must let in LDC exports (Trade not Aid)
- Scrap "S&D", special and differential treatment for LDCs under WTO, which has allowed them to keep trade barriers high
- Curtail Anti-Dumping laws since these provisions permit nations to use protectionist policies against LDCs. LDCs often sell at lower prices and it is often quite easy to make dumping cases against them (since law is so ambiguous).

International Policies for Economic Development: Monetary

I. Issues

Two main issues for LDCs:

- How to manage their exchange rates (or dollarization)
- Whether or not to restrict capital flows

Questions for DCs:

- Bailouts (can help, can hurt)
- Aid
- Debt Forgiveness

II. Choice of Exchange Rate Regimes

-Fixed vs. Float, problems with both!

Float: temptation to inflate exists (expand money supply to finance government expenditures without going into debt). Often a pegged exchange rate can act as an "anchor" on their price level to prevent this type of inflation and this "anchor" has worked quite often.

Peg: often nations won't entirely resist the temptation to inflate, the currency can become overvalued (reserves are lost) and the nations become subject to an exchange rate crisis.