

Econ 340

Lecture 19 International Policies for Economic Development: Trade

Outline: International Policies for Economic Development: Trade

- The Main Issues of Development
- The Washington Consensus
- Special Problems of Developing Countries
- Pros and Cons of Tariffs Used by Developing Countries
 - The Infant Industry Argument
 - Primary-Product Specialization
 - Growth and Exports / Import Substitution
- Pros and Cons of Subsidies Used by Developed Countries
- Policy Recommendations

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The Issues

- The Two Main Issues:
 - Should developing countries be open to international trade?
 - Should developing countries be open to international capital movements?
(both financial and FDI)
- Answers are not easy and obvious
 - Even though the standard advice of IMF, World Bank and most economists today is:
YES to both

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The Washington Consensus

- This is a list of policies and institutions that were said to be pushed upon developing countries by
 - The IMF
 - The World Bank
 - United States agencies that deal with developing countries
 - USAID (US Agency for International Development)
 - US Treasury Department
- The name "Washington Consensus" was coined by economist John Williamson in 1989
 - He intended it "to refer to the lowest common denominator of policy advice being addressed by the Washington-based institutions to Latin American countries as of 1989."

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The Washington Consensus: The Policies

1. Fiscal Discipline
Don't spend too much
2. Public Expenditure Priorities
Spend intelligently
3. Tax Reform
Lower marginal tax rates and broaden tax base
4. Financial Liberalization
Allow financial markets to function competitively
5. Exchange Rates
Have a competitive (not overvalued) exchange rate

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The Washington Consensus: The Policies

6. Trade Liberalization
Reduce tariffs and NTBs
7. Foreign Direct Investment
Let it in
8. Privatization
Turn state-owned enterprises into private firms
9. Deregulation
Remove unnecessary regulation of industries
10. Property Rights
Define and enforce clear property rights

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Special Problems of Developing Countries

- First, what to call developing countries
 - “LDCs” used to be = Less Developed Countries
 - “LDCs” now also = “Least Developed Countries”
 - Poorest of the poor
 - On a list of 47 at the United Nations (as of November 2018)
 - Developing Countries (a more optimistic name)
 - LICs = Low Income Countries (vs. MICs, HICs = Middle, High Income Countries)
 - Third World (slightly obsolete)
 - (Used to be called “backward” countries)

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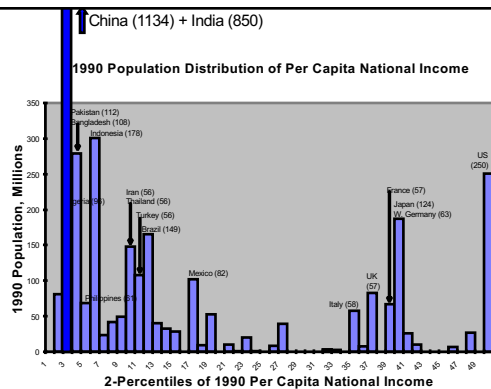
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Special Problems of Developing Countries

- The defining and most basic problem of developing countries: Low per capita income (low GDP per person)
 - Compared to US in 1990
 - (the data I happen to have)
 - real per capita incomes were only
 - 7% in China, India, Pakistan, Bangladesh
 - Even less in much of Africa
 - Less than 15% in Brazil, Turkey, Thailand, etc
 - There were hardly any countries in the “middle,” between the poorest and Europe/US

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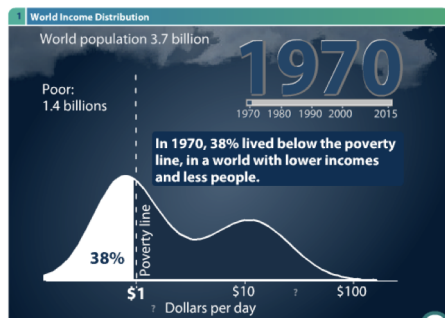
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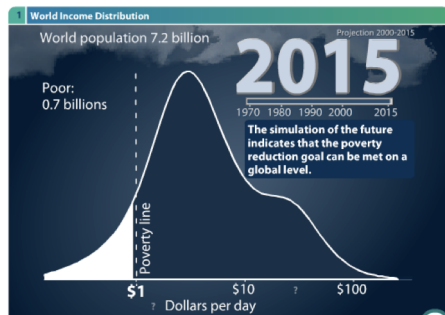
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Special Problems of Developing Countries

- Developing countries tend not to have
 - Physical Capital
 - Technology
 - Human Capital
 - Infrastructure
 - Markets (especially markets for capital)

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Special Problems of Developing Countries

- Developing countries also tend not to have
 - “Economic Freedoms”
 - Rule of law (property, contracts)
 - Sound money
 - Open markets
 - Transparent & accountable government regulations

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Special Problems of Developing Countries

- Developing countries do not have enough
 - “Intangible Capital ” (See Bailey)
 - Combines human capital and value of institutions
 - Components:
 - trust among people in a society
 - efficient judicial system
 - clear property rights
 - effective government
 - Contributions to explaining intangible capital:
 - Rule of law 57%
 - Education 36%

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Special Problems of Developing Countries

- Developing countries do tend to have
 - Overpopulation
 - Poor health and sanitation
 - Corruption

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Pros and Cons of Tariffs Used by Developing countries

- Con: Same advantages of free trade as for developed countries
 - Efficiency gains from exploiting comparative advantage
 - Improved competition, variety, scale economies, productivity
 - Trade may promote growth through exports
- Pro: Developing countries are “behind” and therefore “can’t compete”

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Infant Industry Argument

- The argument
 - Developing country firms
 - lack experience,
 - thus are not productive,
 - therefore cannot survive in world markets
 - So they need protection in order to
 - give them time gain experience and to learn
 - to become more productive and competitive

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Infant Industry Argument

- Is it valid?
 - Yes, when there really is “learning by doing”
 - AND if capital markets are imperfect
 - Otherwise firms could borrow to cover their losses while they become competitive (just as firms in developed countries routinely do)
 - OR if the learning accrues to workers who then
 - Leave their firms
 - And become competitors

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Infant Industry Argument

- Problems (even if these conditions are met)
 - Protection should be temporary
 - But that's very hard to do
 - Protected industries don't willingly give it up
 - Protection is second best
 - It would be more efficient (and thus better for country) to use a more direct policy instead of a tariff:
 - Subsidize production
 - Subsidize loans

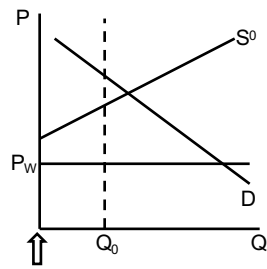
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Infant Industry Argument

- Example
 - Suppose that costs are so high that, at world price P_W , country does not produce at all.
 - So with free trade, $Q=0$.
 - But that by sustaining production at Q_0 for 3 years ...

Domestic Market in LDC



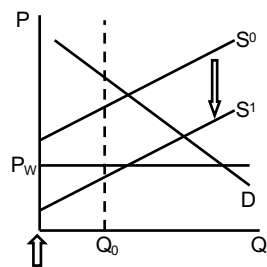
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Infant Industry Argument

- Example
 - ... by sustaining production at Q_0 for 3 years,
 - Costs will fall from S^0 to S^1 for 30 years

Domestic Market in LDC



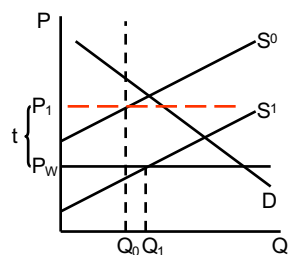
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Infant Industry Argument

- Example
 - By raising price to P_1 using a tariff t for 3 years
 - Output is Q_0 for 3 years
 - and then, because S shifts down, output is Q_1 for 30 years

Domestic Market in LDC



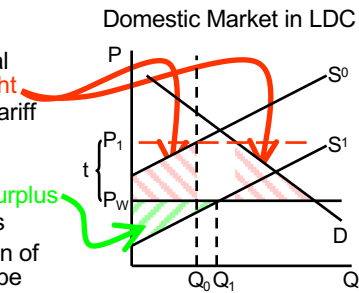
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Infant Industry Argument

- Example

- Cost: Usual **Dead Weight Loss** from tariff for 3 years
- Benefit: **Producer surplus** for 30 years
- Combination of these may be positive



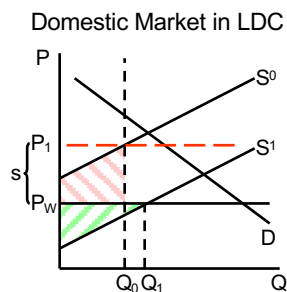
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Infant Industry Argument

- Example

- But subsidy $s=t$ achieves same result without raising price to demanders
- Thus cost is smaller but benefit is the same



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Other Objections to Free Trade in Developing Countries

- Countries are forced by trade (comparative advantage) to specialize in Primary Products
 - These are (it is argued)
 - Low-tech (thus no future)
 - Competitive (thus no profit)
 - Subject to competition from synthetic substitutes
 - Of low "demand elasticity"
 - Unclear what this means, but presumably income elasticity
 - » So that demand rises little as world income rises
 - Claimed implication: demand rises less rapidly than demand for manufactures

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Other Objections to Free Trade in Developing Countries

- Countries are forced by trade to specialize in Primary Products
 - Supposed conclusion: Declining Terms of Trade
 - This has sometimes been true, but not always
 - Primary product prices rose in middle 2008
 - Prices have fallen since then
 - Overall, it does look like primary product prices do tend to fall over time

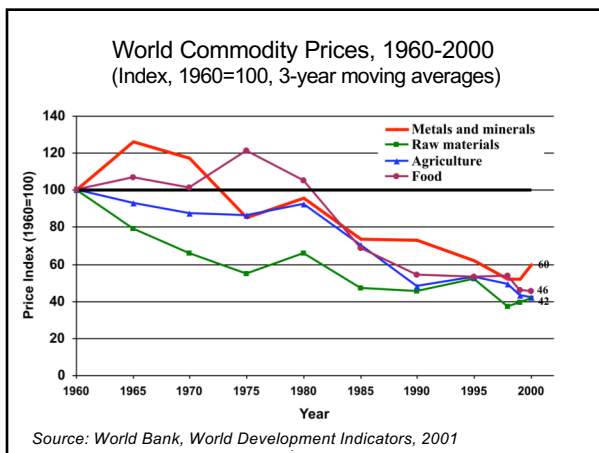
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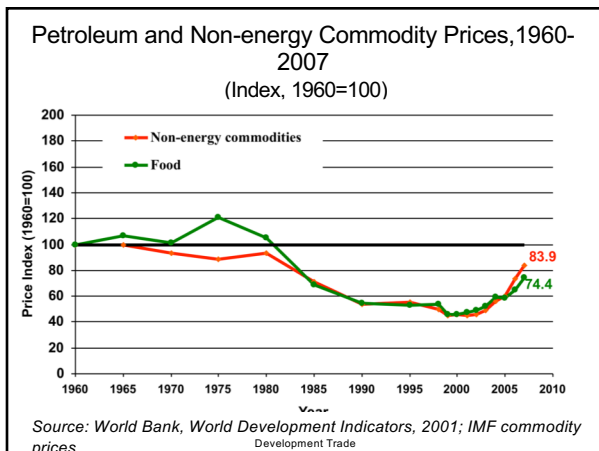
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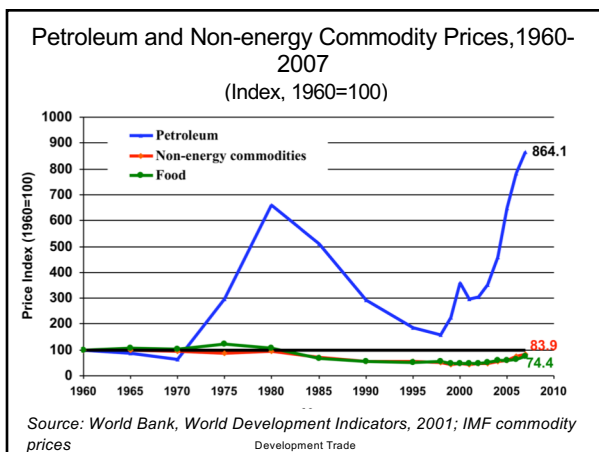


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Exports and Growth

- How exports may help growth
 - Economies of scale: Produce for world market to achieve higher scale
 - Stimulate adoption of international best-practice technologies
 - Not necessary for firms protected by tariff
 - Finance imports of higher-tech capital goods
 - Encourage inward FDI to produce for export – bringing capital and technology

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Track Record of Import Substitution

- In 1950s, two opposing strategies were perceived:
 - “Import Substitution”: Use tariffs and NTBs to protect industries, substituting for imports
 - “Export Promotion”: Free trade and other policies to encourage exports
- Most developing countries, and their economist advisors, favored Import Substitution

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Track Record of Import Substitution

- Early examples of Import Substitution
 - That did well
 - United States in 19th century
 - Japan after World War II
 - That did poorly
 - India
 - South America

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Track Record of Import Substitution

- Examples of Export Promotion
 - The “Four Tigers” all did well
 - Hong Kong
 - South Korea
 - Taiwan
 - Singapore
 - Later examples did well until crisis of 1997:
 - Thailand
 - Indonesia
 - Philippines
 - ...

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} And most
recovered rapidly
after 1997.

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Pros and Cons of Subsidies Used by Developed Countries

- Many developed countries subsidize agriculture
 - Economists agree that this usually hurts them more than it benefits their own farmers
 - But the issue here: How does it affect developing countries?
 - Examples
 - US and EU
 - Cotton, Sugar

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Pros and Cons of Subsidies Used by Developed Countries

- Foreign Effects of Subsidies: Recall from Lecture 6 on Nontariff Barriers
 - Export subsidies
 - Push down world prices, and thus
 - Help foreign consumers
 - Hurt foreign competing producers
 - Help other countries that are net importers
 - Hurt other countries that are net exporters
 - Production subsidies have the same effects abroad as export subsidies

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Pros and Cons of Subsidies Used by Developed Countries

- Cotton Subsidies
 - Countries whose exports were more than 50% cotton in 2001 (& GDP/capita 2005):
 - Benin (\$1100)
 - Burkina Faso (\$1200)
 - Chad (\$1400)
 - Mali (\$1200)
 - Togo (\$1600)

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Pros and Cons of Subsidies Used by Developed Countries

- Cotton Subsidies (See FAO)
 - Costs of production in West Africa are among the lowest in the world
 - Costs in US are 3 times higher than Africa
 - US cotton farmers get about \$4 billion a year in subsidies
 - From 1998 to 2001,
 - US cotton production grew 40%
 - US cotton exports doubled
 - World cotton prices fell to record lows

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Pros and Cons of Subsidies Used by Developed Countries

- Africa opposes US and EU farm subsidies
 - Cotton is just one example
 - Rich-country subsidies in many products hurt poor farmers throughout Africa
 - It was African countries, especially cotton exporters, who derailed the Doha Round negotiations in Cancun

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Pros and Cons of Subsidies Used by Developed Countries

- But it's not that simple: Consumers benefit from subsidies
 - Many developing countries are primarily consumers, not producers, of many subsidized agricultural products
 - The poor in these countries will be hurt if subsidies are removed (See Baker)

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Policy Recommendations to Assist Developing Countries

- Developed countries:
 - Remove tariffs on developing country exports
 - See Copenhagen Consensus
 - Completing the Doha Round would have done this and more
 - High on their list of policies because costs are political, not economic
 - But some say gain is small (See Baker)

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Policy Recommendations to Assist Developing Countries

- Developed countries:
 - Remove subsidies?
 - Most developing countries want this
 - But need to watch out for developing country consumers of subsidized products

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Policy Recommendations to Assist Developing Countries

- Developing countries:
 - Reduce tariffs?
 - Yes, in most cases
 - Possible exceptions: infant industries, if conditions are met and subsidy not available
 - Subsidize exports?
 - Not clear
 - Countries that did this successfully were usually just offsetting overvalued exchange rate

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Policy Recommendations to Assist Developing Countries

- Other trade-related policy recommendations:
 - Curtail Anti-Dumping
 - See Prusa on spread of AD to developing countries
 - Relax intellectual property protection
 - WTO TRIPs Agreement hurts developing countries (See Baker)
 - Need more flexibility to assist them

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Next Time

- International Policies for Economic Development: Financial
 - Choice of Exchange Rate Regime
 - Pros and Cons of Free Capital Movements and Capital Controls
 - (How) Should Others Help?

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