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
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."
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

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)

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

Chart 4: 1990 Population Distribution of Per Capita National Income

Excluding China and India

- 1990 Population, Millions
  - Nigeria (96)
  - Indonesia (178)
  - Pakistan (112)
  - Bangladesh (108)
  - Brazil (149)
  - Turkey (56)
  - Iran (56)
  - Thailand (56)
  - Philippines (61)
  - Mexico (82)
  - Italy (58)
  - UK (57)
  - Japan (124)
  - W. Germany (63)
  - France (57)
  - US (250)
  - China (1134) + India (850)
Special Problems of Developing Countries

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

- 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%

- 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”
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

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

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
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 ...

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

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
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

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

• 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

Fig. 1. Relative price of primary commodities 1900-91 (in logs)
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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

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
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

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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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

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

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)
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

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

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)

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
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

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

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?