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

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

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

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 March 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
• Developing countries tend \textit{not} to have
  – Physical Capital
  – Technology
  – Human Capital
  – Infrastructure
  – Markets (especially markets for capital)

Special Problems of Developing Countries
• Developing countries also tend \textit{not} to have
  – “Economic Freedoms”
    • Rule of law (property, contracts)
    • Sound money
    • Open markets
    • Transparent & accountable government regulations

Special Problems of Developing Countries
• Developing countries do \textit{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%

Special Problems of Developing Countries
• Developing countries do \textit{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
  - 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
- 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 by sustaining production at $Q_0$ for 3 years,
  - Costs will fall from $S_0$ to $S_1$ for 30 years
  - But world price is $P_W$
  - So with free trade, $Q=0$

- 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

- 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
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

World Commodity Prices, 1960-2000
(Index, 1960=100, 3-year moving averages)

Petroleum and Non-energy Commodity Prices, 1960-2007
(Index, 1960=100)

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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
    - …
    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
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)

- 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?