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

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

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

- China (1134) + India (850)

2-Percentiles of 1990 Per Capita National Income
Data from Gapminder.org

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

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%

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”

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

- 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
  - 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

- 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 looks like primary product prices do tend to fall over time
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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

- 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

- 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)

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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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

- 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?