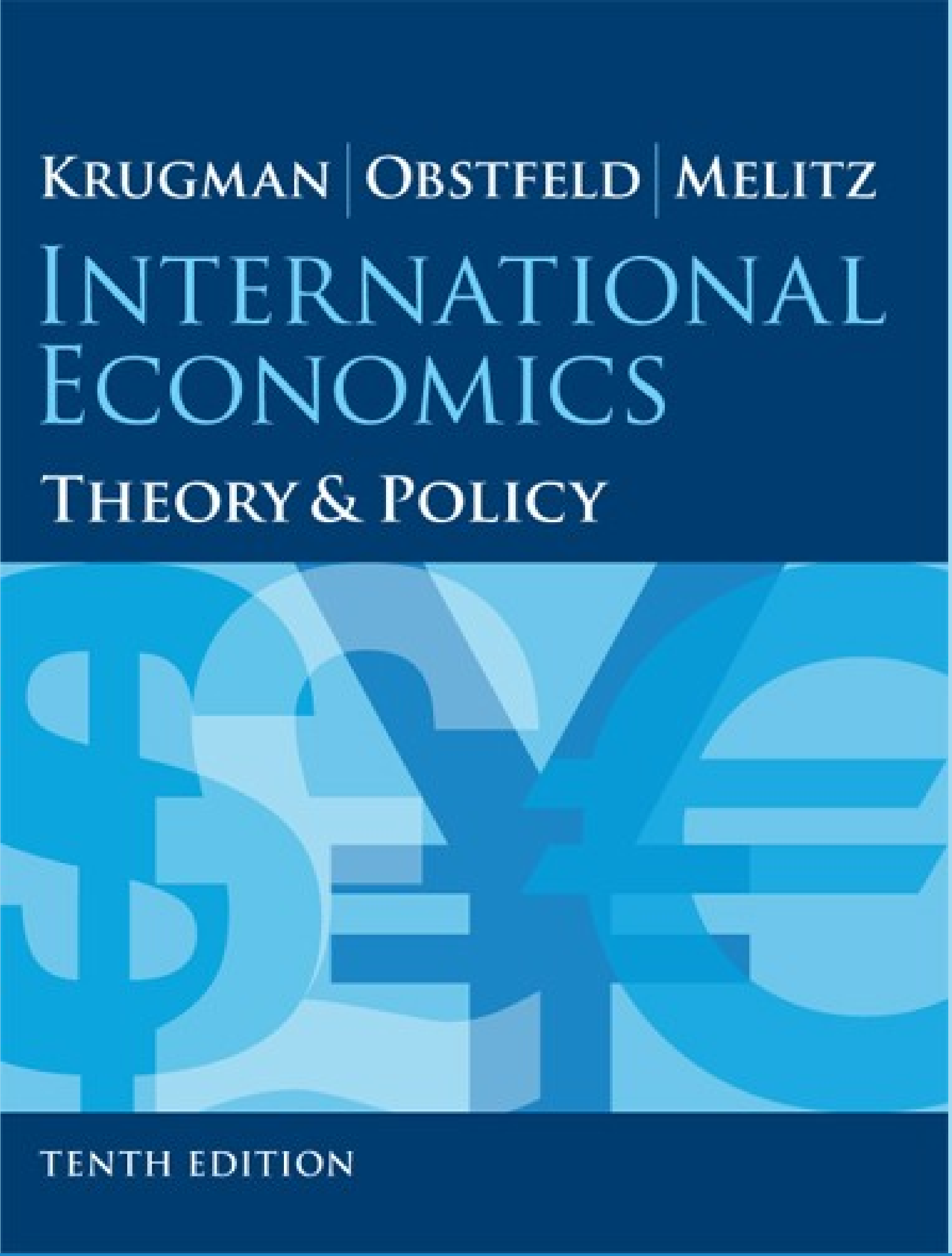


Chapter 11

Trade Policy in Developing Countries

Preview

- Import-substituting industrialization
- Trade liberalization since 1985
- Trade and growth: Takeoff in Asia

Introduction

- Which countries are "developing countries"?
- The term "developing countries" does not have a precise definition, but it is a name given to many low- and middle-income countries.

Table 11-1: Gross Domestic Product Per Capita, 2009 (dollars)

MyEconLab Real-time data

United States	49,428
Germany	40,511
Japan	37,449
South Korea	32,954
Mexico	14,943
China	10,371
Bangladesh	1,929

Source: Conference Board Total Economy Database.

Import-Substituting Industrialization

- Import-substituting industrialization was a trade policy adopted by many low- and middle-income countries before the 1980s.
  - The policy aimed to encourage domestic industries by limiting competing imports.
- The principal justification of this policy was/is the *infant industry argument:*
  - Countries may have a potential comparative advantage in some industries, but these industries cannot initially compete with well-established industries in other countries.
  - To allow these industries to establish themselves, governments should temporarily support them until they have grown strong enough to compete internationally.

Table 11-2: Effective Protection of Manufacturing in Some Developing Countries (percent)

Mexico (1960)	26
Philippines (1965)	61
Brazil (1966)	113
Chile (1961)	182
Pakistan (1963)	271

Source: Bela Balassa, *The Structure of Protection in Developing Countries* (Baltimore: Johns Hopkins Press, 1971), p. 82.

Problems with the Infant Industry Argument

1. It may be wasteful to support industries now that will have a comparative advantage in the future.

2. With protection, infant industries may never “grow up” or become competitive.

3. There is no justification for government intervention unless there is a market failure that prevents the private sector from investing in the infant industry.
   - If an industry is supposed to be profitable in the future, then there should be private investors willing to bear short-term losses in exchange for profits in the future.

Infant Industries and Market Failures

- Two arguments for how market failures prevent infant industries from becoming competitive:

1. Imperfect financial asset markets
   - Because of poorly working financial laws and markets (and more generally, a lack of property rights), firms cannot or do not save and borrow to invest sufficiently in their production processes.
   - If creating better functioning markets and enforcing laws is not feasible, then high tariffs would be a second-best policy to increase profits in new industries, leading to more rapid growth.

Infant Industries and Market Failures

2. The problem of appropriability
   – Firms may not be able to privately appropriate the benefits of their investment in new industries because those benefits are public goods.
   – The knowledge created when starting an industry may not be appropriable (may be a public good) because of a lack of property rights.
   – If establishing a system of property rights is not feasible, then high tariffs would be a second-best policy to encourage growth in new industries.

Import-Substituting Industrialization

- Import-substituting industrialization in Latin American countries worked to encourage manufacturing industries in the 1950s and 1960s.
  - But economic development, not encouraging manufacturing, is the ultimate goal of the policy.
- Did import-substituting industrialization promote economic development?
  - No, countries adopting these policies grew more slowly than others.
  - Some low- and middle-income countries that had relatively free trade had higher average economic growth than those that followed import substitution.

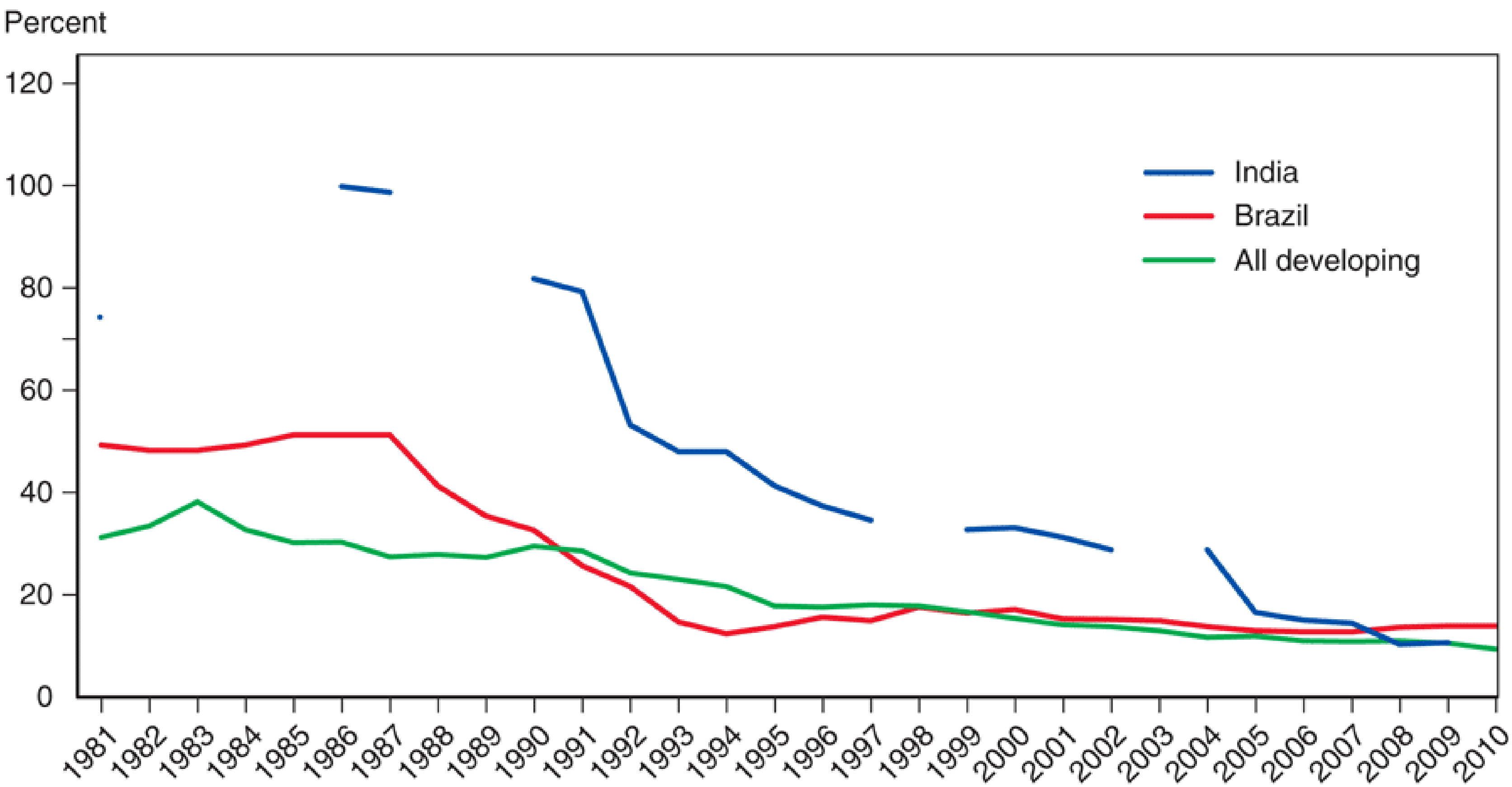
Import-Substituting Industrialization

- It appeared that the infant industry argument was not as valid as some had initially believed.
- New industries did not become competitive despite or because of trade restrictions.
- Import-substitution industrialization involved costs and promoted wasteful use of resources:
  - It involved complex, time-consuming regulations.
  - It set high tariff rates for consumers, including firms that needed to buy imported inputs for their products.
  - It promoted inefficiently small industries.

Trade Liberalization

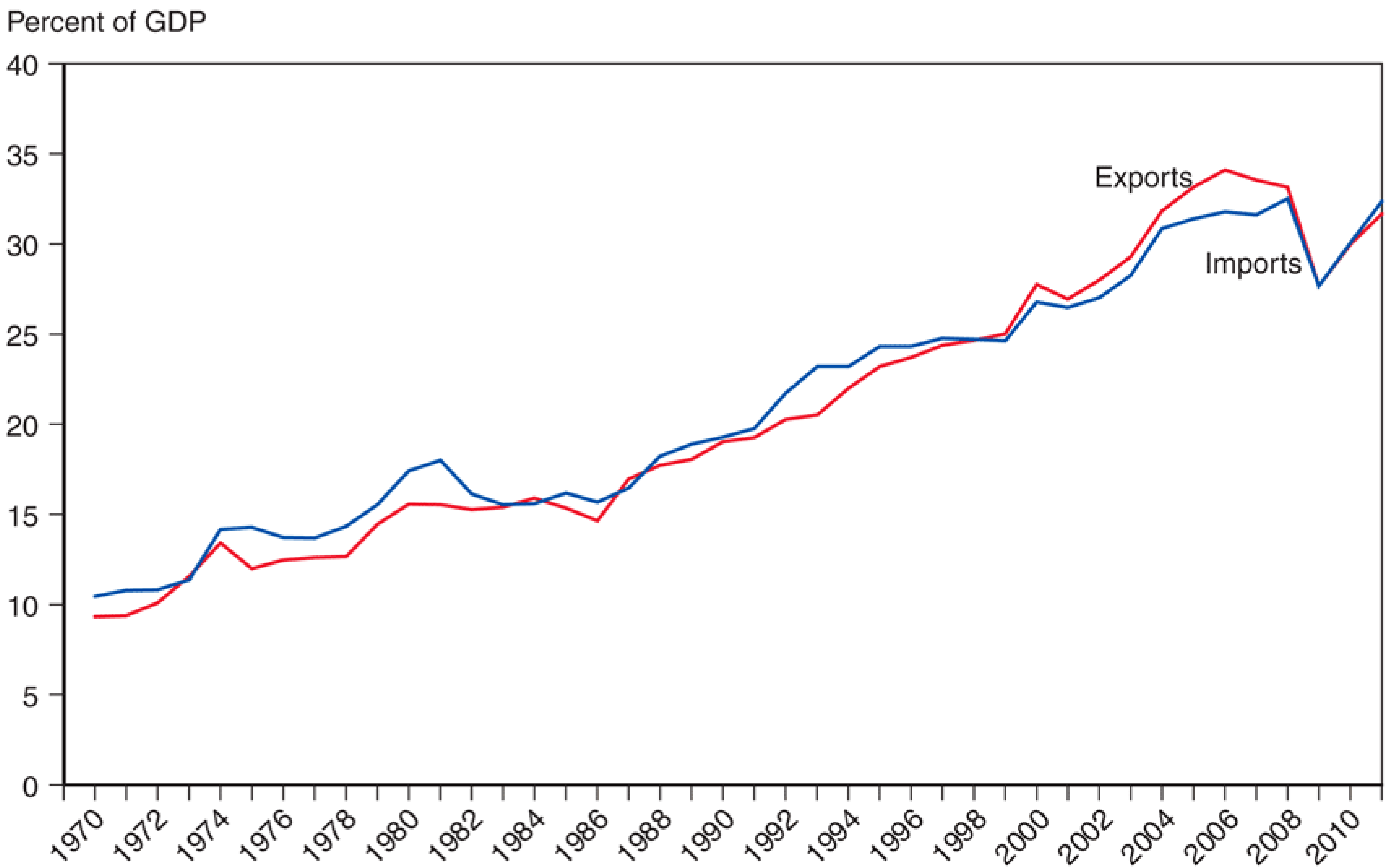
- By the mid-1980s, many governments had lost faith in import substitution and began to liberalize trade.
  - Dramatic fall in tariff rates in India and Brazil, and less drastic reductions in many other developing countries.
- Trade liberalization in developing countries occurred along with a dramatic increase in the volume of trade.
  - The share of trade in GDP has tripled over 1970–1998, with most of the growth happening after 1985.
  - Manufactured goods started to dominate the exports of the biggest developing economies.
- A number of developing countries have achieved extraordinary growth while becoming more, not less, open to trade.

Fig. 11-1: Tariff Rates in Developing Countries



Source: World Bank.

Fig. 11-2: The Growth of Developing-Country Trade



Source: http://data.worldbank.org/indicator/NE.EXP.GNFS.ZS, http://data.worldbank.org/indicator/NE.IMP.GNFS.ZS

Trade Liberalization

- Has trade liberalization promoted development? The evidence is mixed.
  - Growth rates in Brazil and other Latin American countries have been lower since trade liberalization than they were during import-substituting industrialization.
    - But unstable macroeconomic policies and financial crises contributed to slower growth since the 1980s.
  - Other countries like India have grown rapidly since liberalizing trade in the 1980s, but it is unclear to what degree liberalized trade contributed to growth.
  - Some economists also argue that trade liberalization has contributed to income inequality, as the Heckscher-Ohlin model predicts.

India’s Boom

- India: second-most-populous country in the world and a growing force in world trade (information technologies)
- Until about 1980 they had very slow growth, just only about one percentage point higher than population growth.
  - Mocked as “Hindu rate of growth”.
  - Mostly because of bureaucratic restrictions – virtually any kind of business required hard-to-get government permits: “licence Raj”
- After the country achieved independence in 1948, its leaders adopted an extreme form of import-substituting industrialization.
  - In the 1970s exports averaged about 5 percent of GDP.

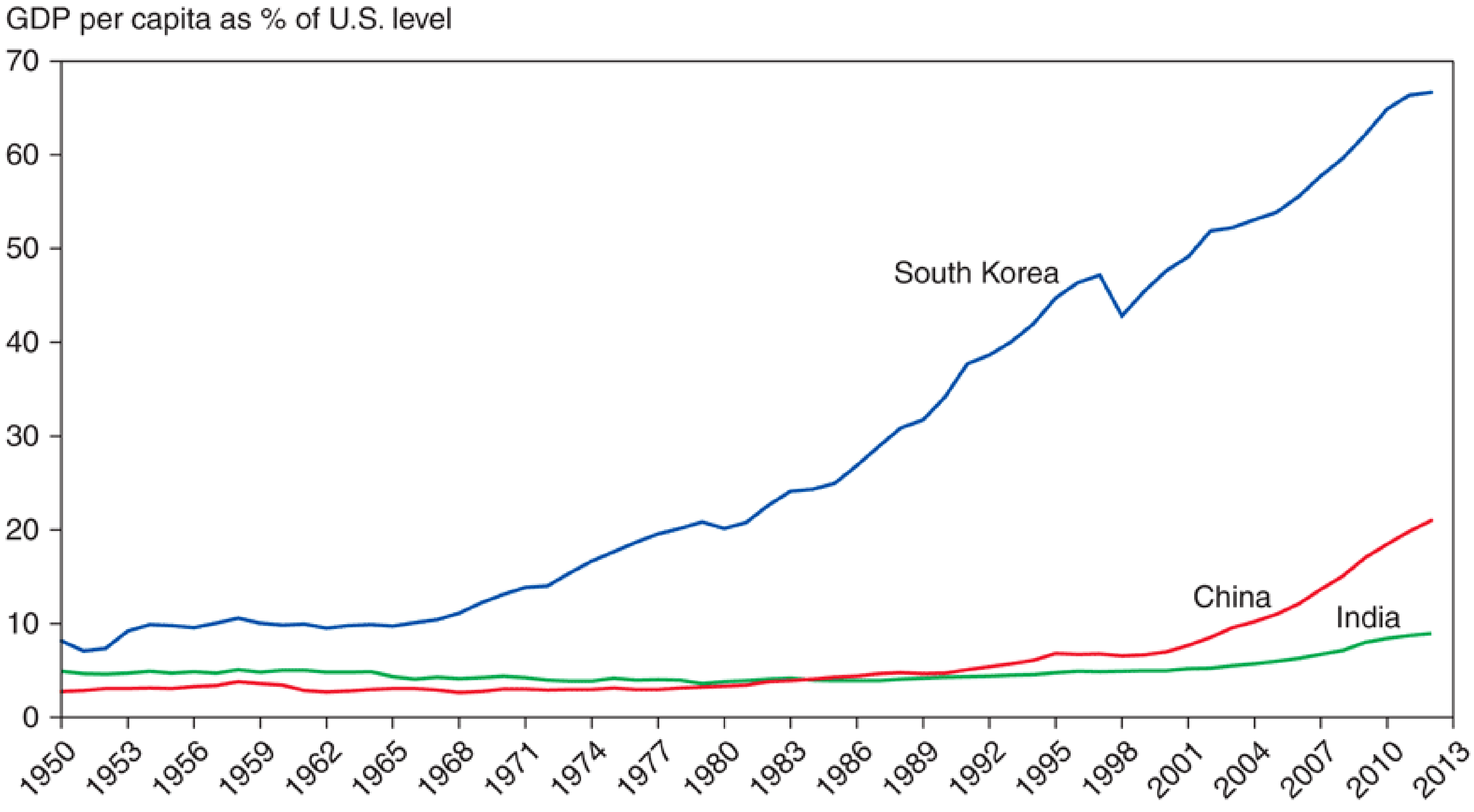
India’s Boom

- Since 1980s India significantly reduced tariffs and removed import quotas, see Fig. 11-1.
  - India’s participation in world trade surged, see Fig. 11-4.
  - Now, the share of export on GDP is higher than 20%.
  - The average annual growth rate of GDP has risen to 4%.
- Some have argued that trade liberalization, which allowed India to participate in the global economy, was crucial.
- Others point out that India’s growth began accelerating around 1980, whereas the big changes in trade policy did not occur until the beginning of the 1990s, see. Fig. 11-1.

Trade and Growth: Takeoff in Asia

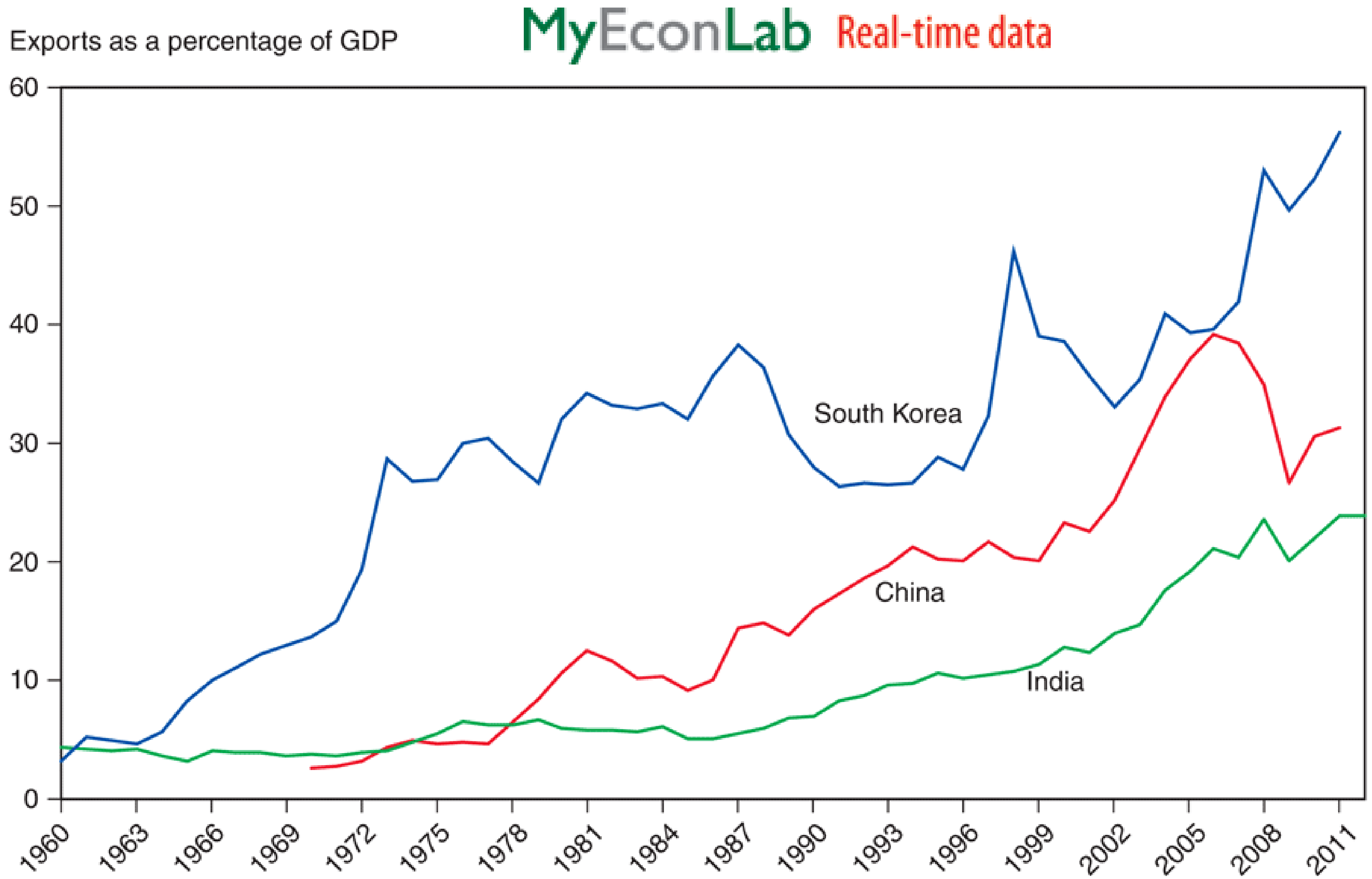
- Instead of import substitution, several countries in East Asia adopted trade policies that promoted exports in targeted industries.
  - Japan, Hong Kong, Taiwan, South Korea, Singapore, Malaysia, Thailand, Indonesia, and China have experienced rapid growth in various export sectors and rapid economic growth in general.
  - Openness of these Asian economies to international trade has increased, as measured by their share of exports in GDP.
  - So it is possible to develop through export-oriented growth.
  - However, Latin American nations such as Mexico and Brazil, which also sharply liberalized trade and shifted toward exports, did not see comparable economic takeoffs.
  - These Latin American results suggest that other factors must have played a crucial role in the Asian miracle.

Fig. 11-3: The Asian Takeoff



Source: Total Economy Database.

Fig. 11-4: Asia's Surging Trade



Source: World Bank

Trade and Growth: Takeoff in Asia

- It's unclear if the high volume of exports and imports *caused* rapid economic growth or was merely *correlated* with rapid economic growth.
  - High saving and investment rates could have led to both rapid economic growth in general and rapid economic growth in export sectors.
  - Rapid growth in education led to high literacy and numeracy rates important for a productive labor force.
  - These nations also undertook other economic reforms.

Summary

1. Import-substituting industrialization aimed to promote economic growth by restricting imports that competed with domestic products in low- and middle-income countries.
2. The infant industry argument says that new industries need temporary trade protection due to market failures:
   - imperfect asset markets that restrict saving, borrowing, and investment in production processes
   - problems of appropriating gains from private investment in production processes
3. Import-substituting industrialization was tried in the 1950s and 1960s but by the mid-1980s it was abandoned for trade liberalization.

Summary

4. The effect of liberalized trade on national welfare is still being debated.
   - Trade helped growth in some sectors, but saying that trade *caused* higher overall economic growth has attracted some scepticism.
   - Some argue that trade has caused increased income inequality
5. Several East Asian economies adopted export-oriented industrialization.
   - High export and import volumes and relatively low trade restrictions were characteristics of this policy.
   - It's unclear to what degree this policy contributed to overall economic growth, especially since other countries have not had similar successes.