International Economics

Industrial Policies in Developing Countries

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Agenda

The myth of free markets and development

Why might it be good produce industrial products?

What explains the failure of the LA import substitution strategy?

What explains the success of Asian countries?

Neoliberal view: Free trade is the ideal to which all countries should strive to attain higher economic growth and employment

- The theory of comparative advantage holds that countries should specialize in the production and exports of those goods in which they are more productive (irrespective of the product)

- Any intervention in the market forces will distort price signals and is thus costly for the country and as well for its trading partners (global output is lower)

- Specialization will be not only beneficial for the country that specializes but also for its trading partners

- Countries are also better off if only they reduce barriers to trade while their trading partners still have barriers

- Trade liberalization might lead to some (small) adjustment costs in the short-run (jobs, firms and industries might be lost) but in the long-run the gains outweigh the costs

Neoliberal view: Example of nowadays developed countries show that free market economies are better off than those with state intervention

- A showcase for this theory are the US and the UK which growth and today´s wealth demonstrates the positive effects of free markets
- Another argument is that the failure of the import-substituting industrialization (ISI) in Latin America and Africa has shown that intervention in markets has bad consequences
- As a result, the Washington Consensus aroused in the 1980s which had as an agenda to liberalize trade under the structural adjustment programs in the 1980s and 1990s
- According to WTO regulations developing countries can only introduce tariffs,
  - Developing countries can protect some new domestic industries but these protection must be temporarily (5 – 8 years)
  - only industries should be protected in which the country has already a comparative advantage
  - max. tariff allowed is 20%

However, history has shown that some countries that implemented industrial policies were very successful

- During the free-market policies of pre-WW II era developing countries had sluggish growth
- **Economies that closed the gap to rich countries** (Japan, South Korea, Taiwan, Singapore) and economies that are growing fast nowadays (China) **used active government intervention** to increase their competitive advantage and/or develop new competitive advantages
- Historically, the same is true for the vast majority of OECD countries (e.g. the USA)
- Also nowadays rich countries imposes trade restrictions (Stiglitz & Charlton, 2006)
- The **claim that free trade and free financial flows** without any protection, barriers and/or intervention has **made now developed countries rich is a myth** (Chang and Grabel, 2004)

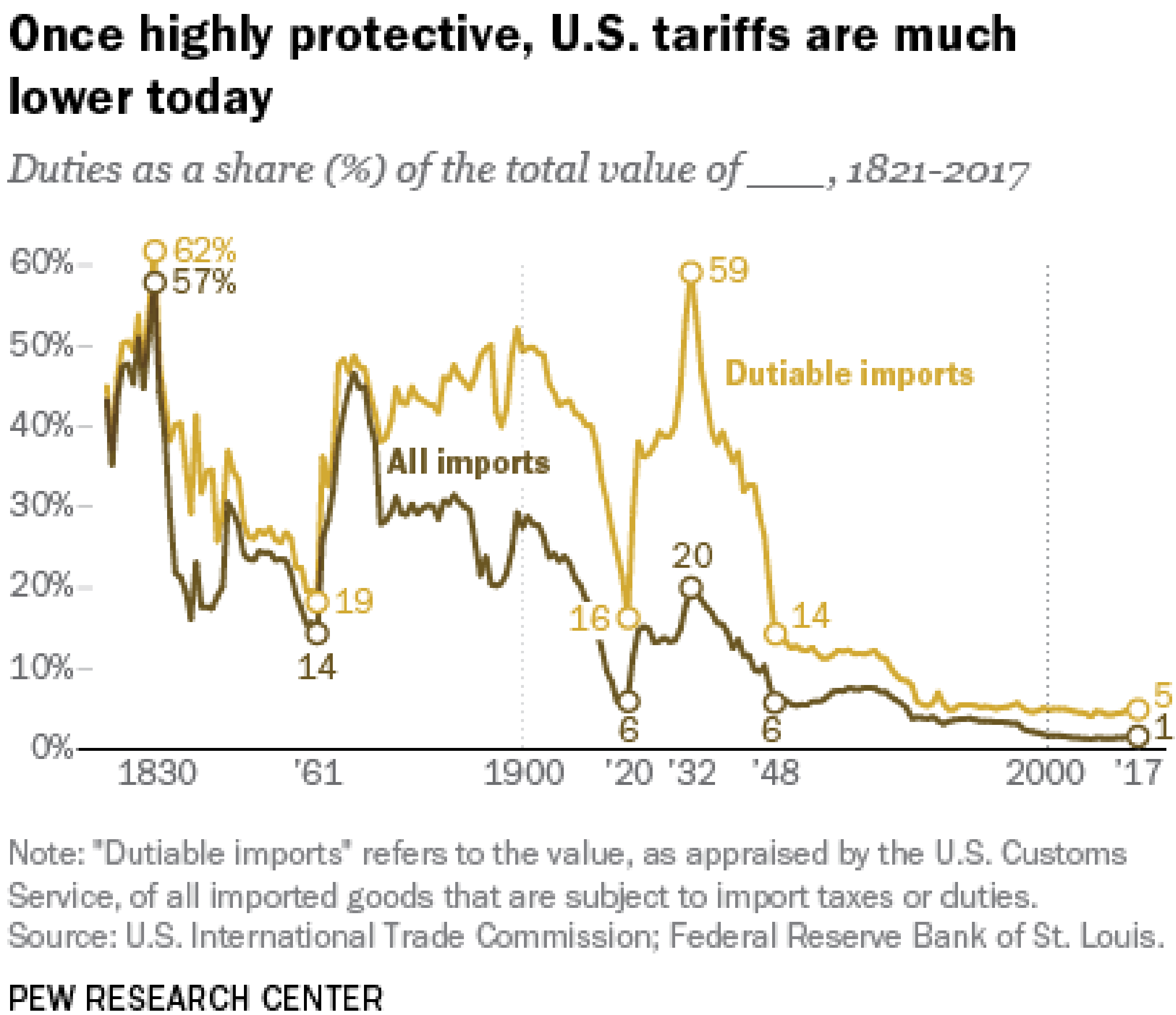
In the first stage of their development nowadays rich countries used industrial policies

- Before they became rich governments of today´s developed countries used different combinations of
  i. tariffs
  ii. subsidies
  iii. Other non-tariff barriers
  iv. government assistant in export markets / marketing / lobbying
  v. Building of domestic monopolies to achieve economies of scale
  vi. Investment in infrastructure, R&D and education
  vii. Industrial espionage / political pressure / war (e.g. East Indian Company)

- In 1841 Friedrich **List** argued that Britain had perfected the art of industrial policies:

  "Any nation which by means of protective duties and restrictions on navigation has raised her manufacturing power and her navigation to such a degree of development that no other nation can sustain free competition with her, can do nothing wiser … to preach to other nations the benefits of free trade"

Throughout the 19th century and up to the 1920s, the USA was the fastest growing economy in the world, "despite" being the most protectionist with regard to tariffs



Under “protectionism” global growth rates tended to be higher than nowadays

Average GDP per capita growth (in %)

	1960s	1970s	1980s	1990s	2000s	2010s
Low- & middle-income countries	2.9	3.3	1.3	1.0	4.3	3.6
East Asia & Pacific	1.5	4.9	5.7	6.5	8.0	6.5
Europe & Central Asia				-3.4	5.2	2.8
Latin America & Caribbean	2.7	3.7	-0.1	0.8	1.6	0.7
Middle East & North Africa	7.5	2.4	-2.0	2.0	2.5	1.0
South Asia	1.9	0.6	3.2	3.3	4.2	5.3
Sub-Saharan Africa	1.6	1.6	-1.3	-0.8	2.5	0.9
High income	4.4	2.7	2.2	1.9	1.1	1.4

Data source: World Bank, 2020

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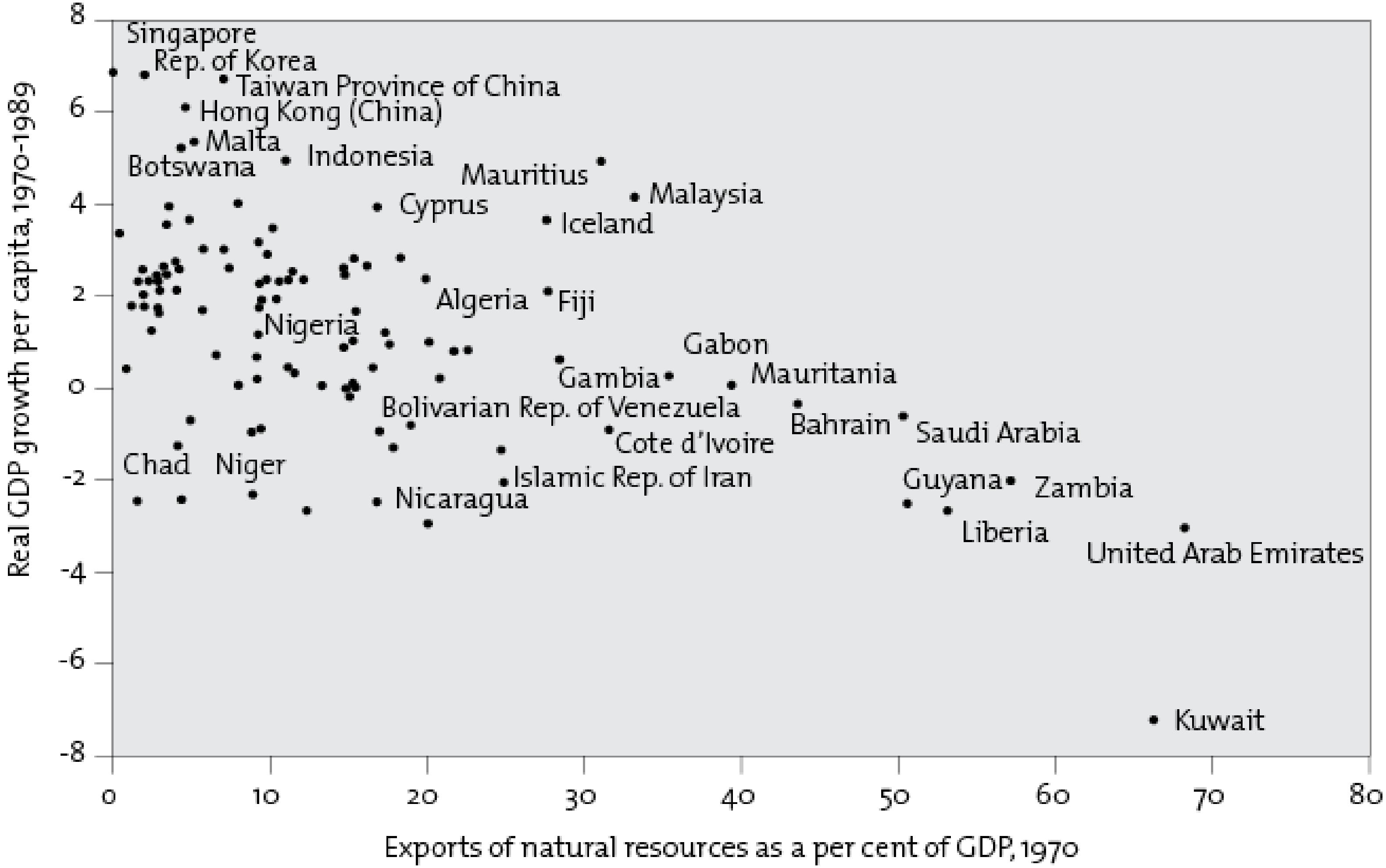
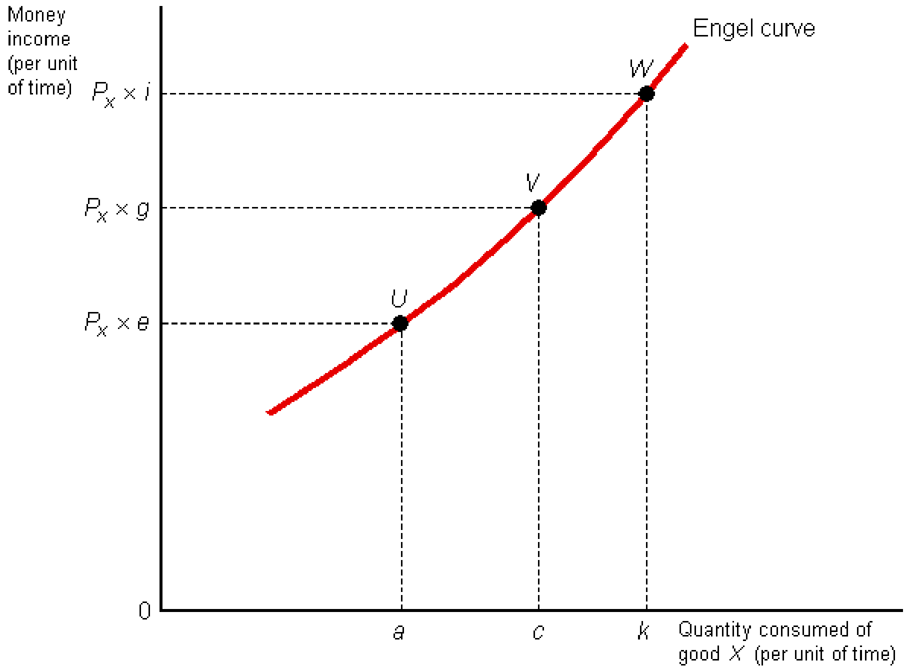
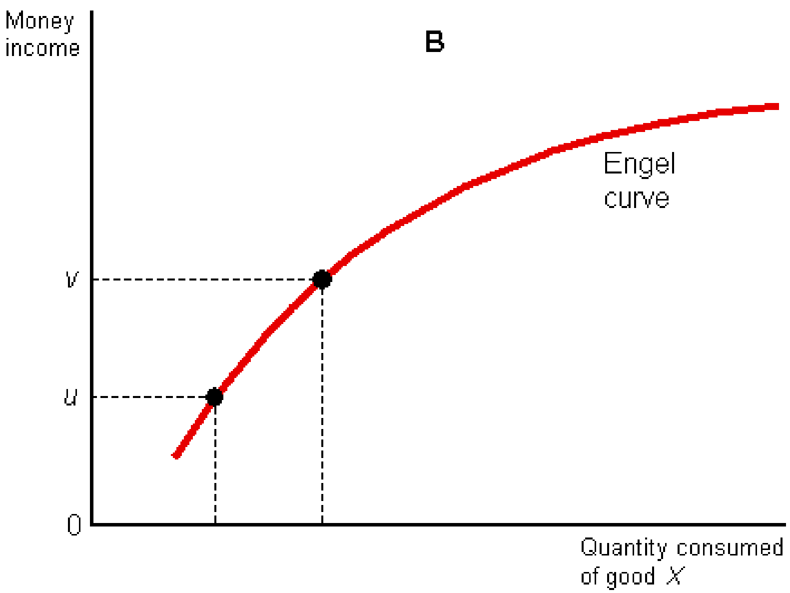
Sachs and Warner noted that over the 20-year period from 1970 to 1990, countries with a high percentage of natural resource exports tend to grow slower



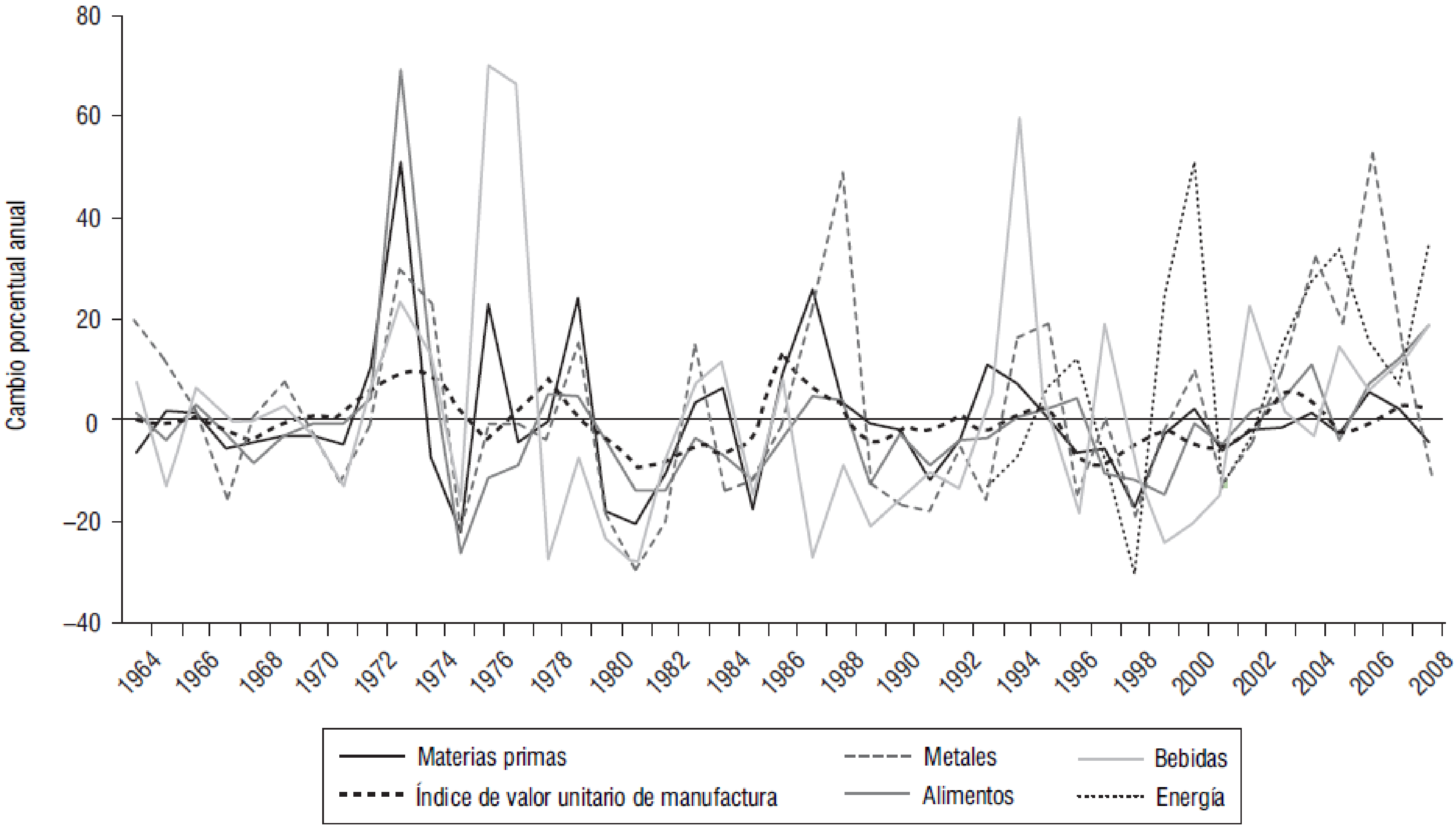
While with rising income the demand for consumption and capital goods increases, whereas especially agricultural products have a low elasticity of demand

Rising income and demand





The price volatility of commodities tend to be much higher than that of industrial products



Further negative effects of resource dependence

- A price boom can lead to Dutch Disease issues (appreciation of the exchange rate that makes other sectors less competitive)
- Countries that concentrate on natural resources tend to be less diversified and to be less economic complex
- Countries that are dependent on natural resources tend to invest less in infrastructure, R&D and human capital
- The windfall gains of commodities can lead to rent-seeking and higher levels of corruption
- Resource dependent countries tend to have a higher probability to have more (prolonged) internal conflicts and crime

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Developing countries started to use import substitution policies in the 1950s

- The idea of import substitution was advocated by economists like Raul Prebisch and Albert Hirschman
- Argument: the division of labor between the North (core) and the South (periphery) meant that poor countries stayed poor and dependent on rich countries
- The South dependent mainly on the production of agricultural goods and raw materials in which they had a comparative advantage
- However, those products can lead to “bad” terms of trade for the South as the income elasticity for those products is relatively low

➢ The protection of the domestic industry indented to reduce the dependence on imports from rich countries to allow “infant industries” in to grow

The import substitution strategy of Latin American countries failed for various reasons

- Governments were given indiscriminate protection to consumer good producers
- Governments continuing to support all industries although companies stayed inefficient
- In Latin America policies were often inconsistent and contradictory
  - The bureaucracy that should plan and implement the program was not free from the pressure of the dominant class and political pressure
    - The upper and middle level civil servants are political appointees who change with every government
  - 'Alliance for profit' between the state and local capital in the 1940s to which foreign capital was added in the 1950s
    - State's goals were reducible to private interests
    - State intervention rescued firms from bankruptcy (under political pressure)
    - interests of landowners were expressed through the Ministry of Agriculture, those of industrialists through the Ministry of Industry or of private banks through the Central Bank and the Ministry of Finance

The import substitution strategy of Latin American countries failed for various reasons

- A large number of government ministries and agencies were involved in formulating economic policy
- In none of the Latin American countries was there an agency with overall responsibility for economic development
- Major part of the banking system was in private hands and financial institutions belong to the economic groups which dominate industry
- State had not much power to allocate resources for development programs
- An absence of performance criteria and widespread protection of the whole manufacturing sector
- Exports were neglected (no export promotion meant no incentives to increase productivity) - overvaluation of their exchange rates
- Competition was deemphasized as all companies were protected against outside competition. This lead to an environment that discouraged learning

The import substitution strategy of Latin American countries failed for various reasons

- Outcomes:
  - Consumption goods producing industries were not competitive (expensive products which had a low quality)
  - Ongoing dependence on the imports of capital goods and exports of commodies
  - Ongoing trade deficits
  - High debt levels were unsustainable when the US increased its interest rates (1981-1983)
  - When protection was (too quickly) removed in the 1980s and 1990s many domestic industries vanished quickly

Manufactures exports (% of merchandise exports)

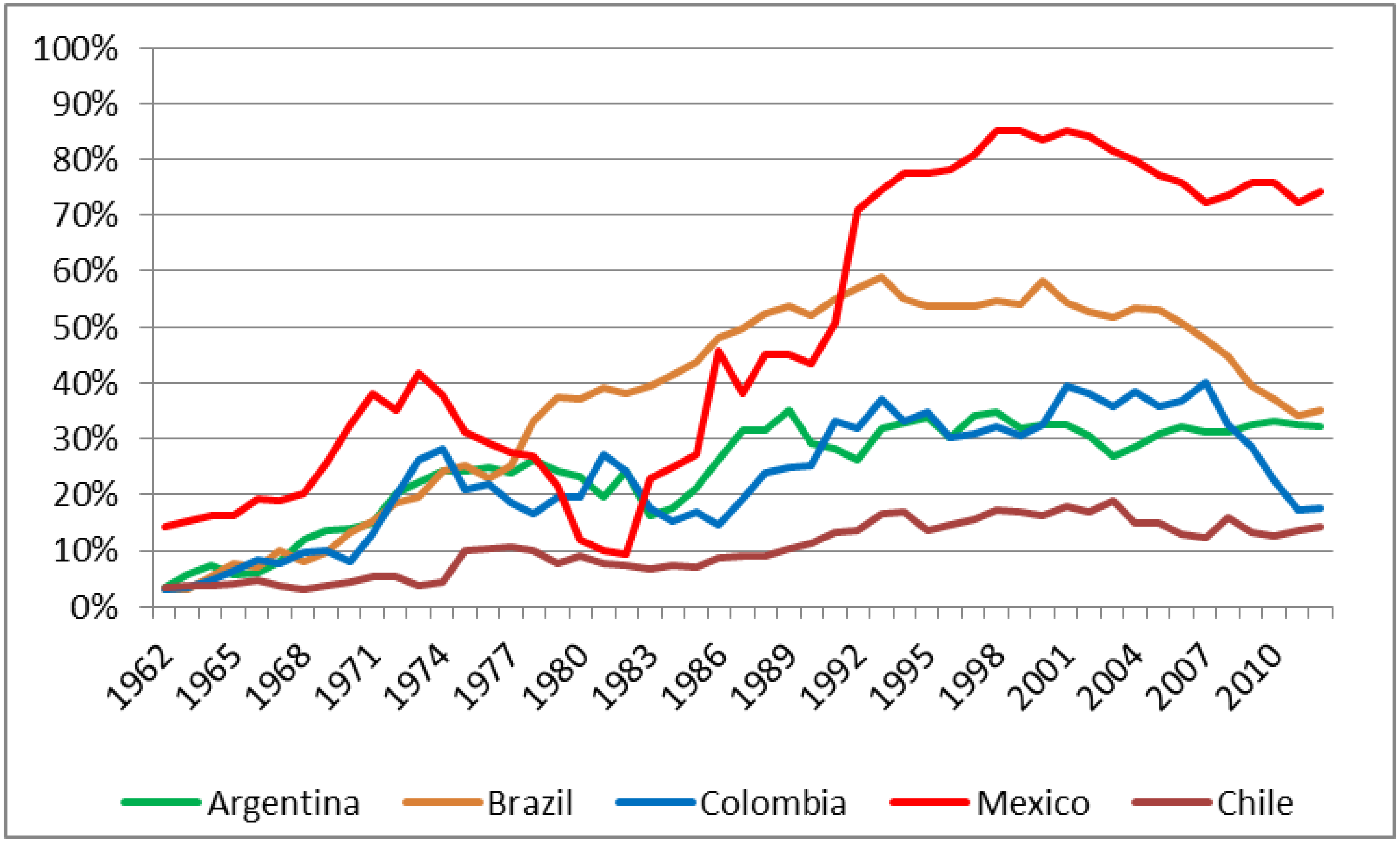
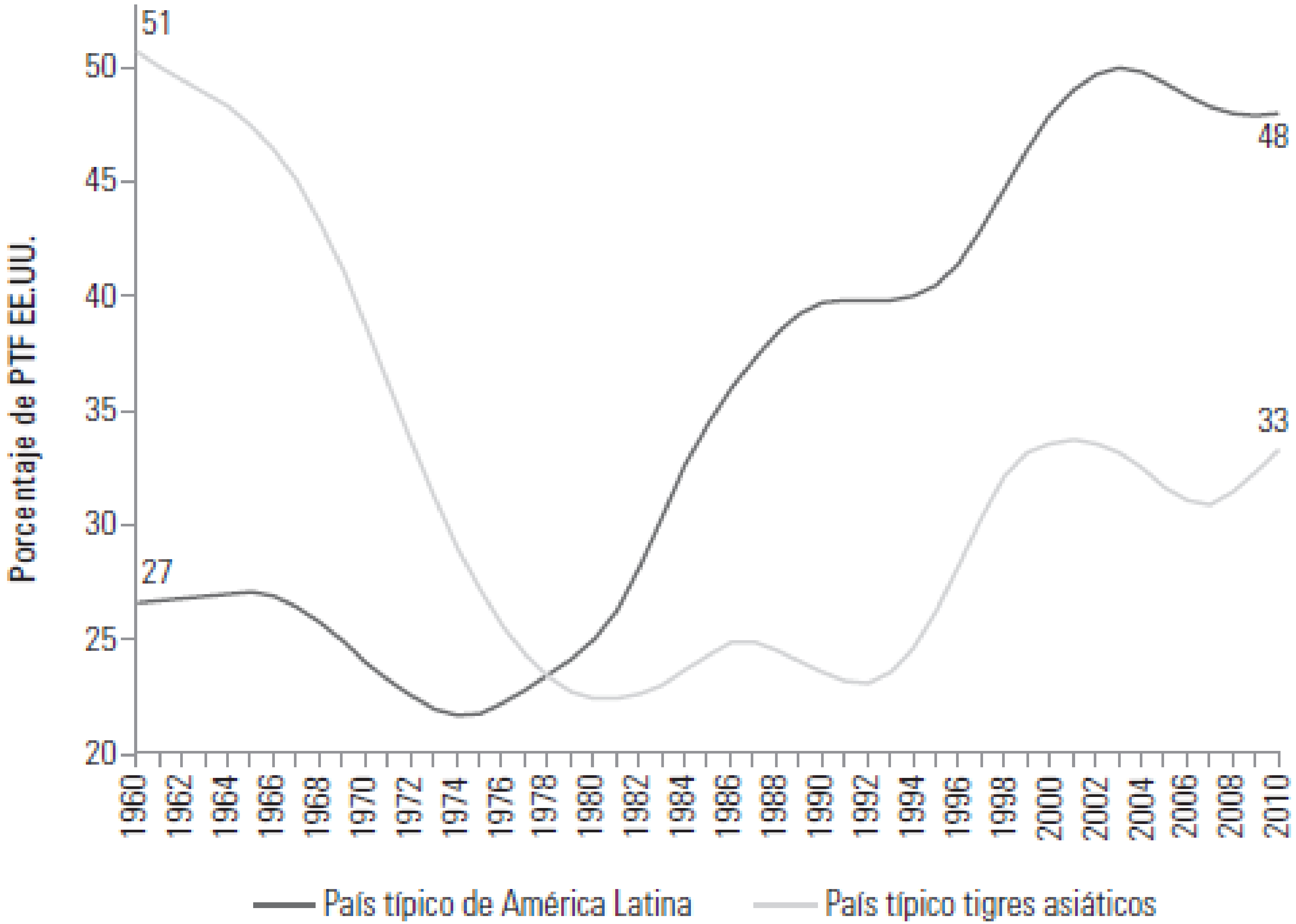


Gráfico 1.3 Brecha de productividad en relación con Estados Unidos

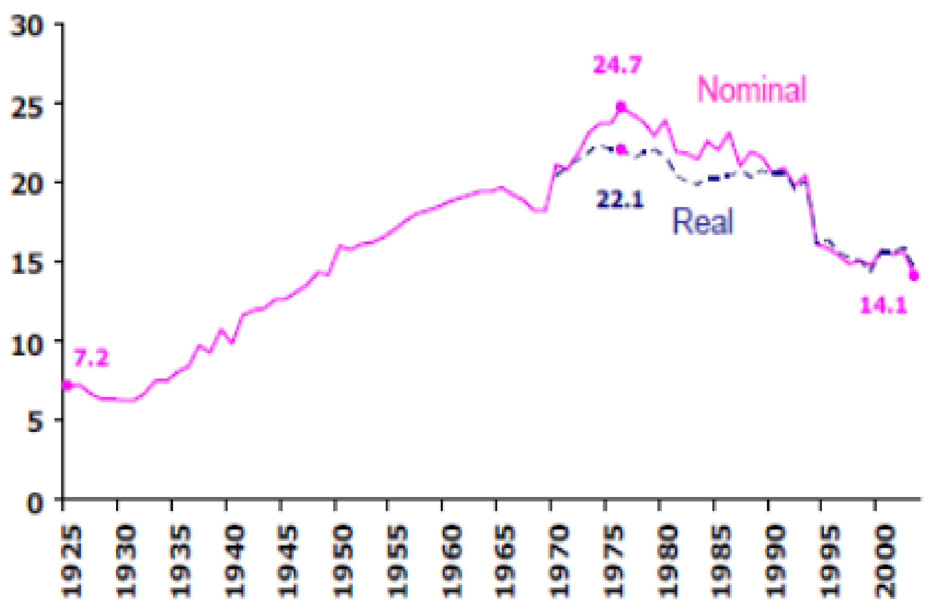


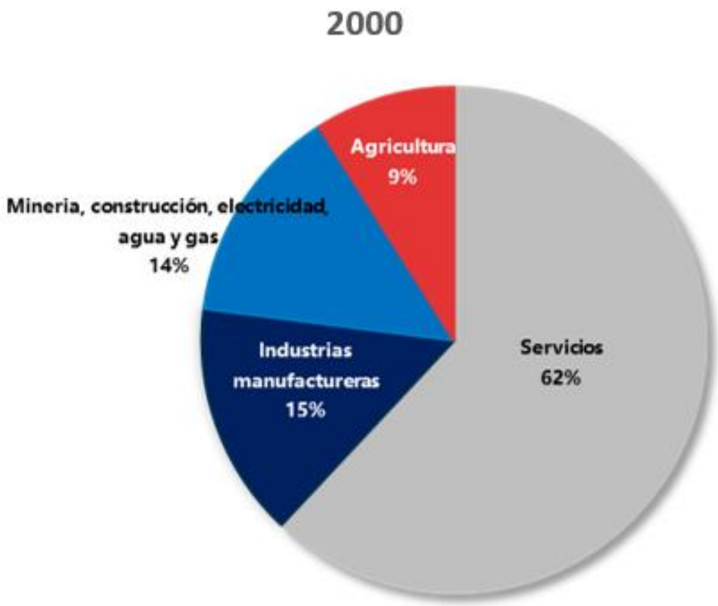
Source: BID (2015)

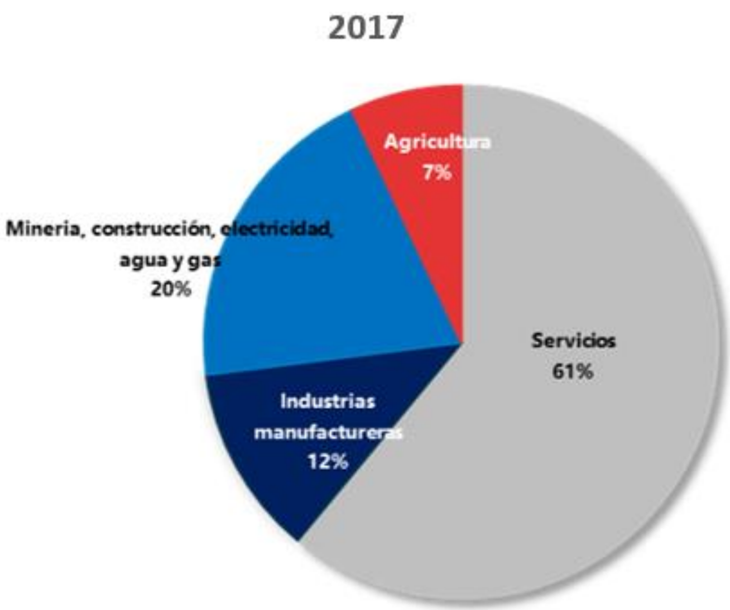
Latin America and the Caribbean: structure of exports to selected destinations by technology intensity, 2000, 2005 and 2014

(Percentages)

Participation of the manufacturing sector in Colombia's GDP







What does Colombia export?

Source: OEC (2020)

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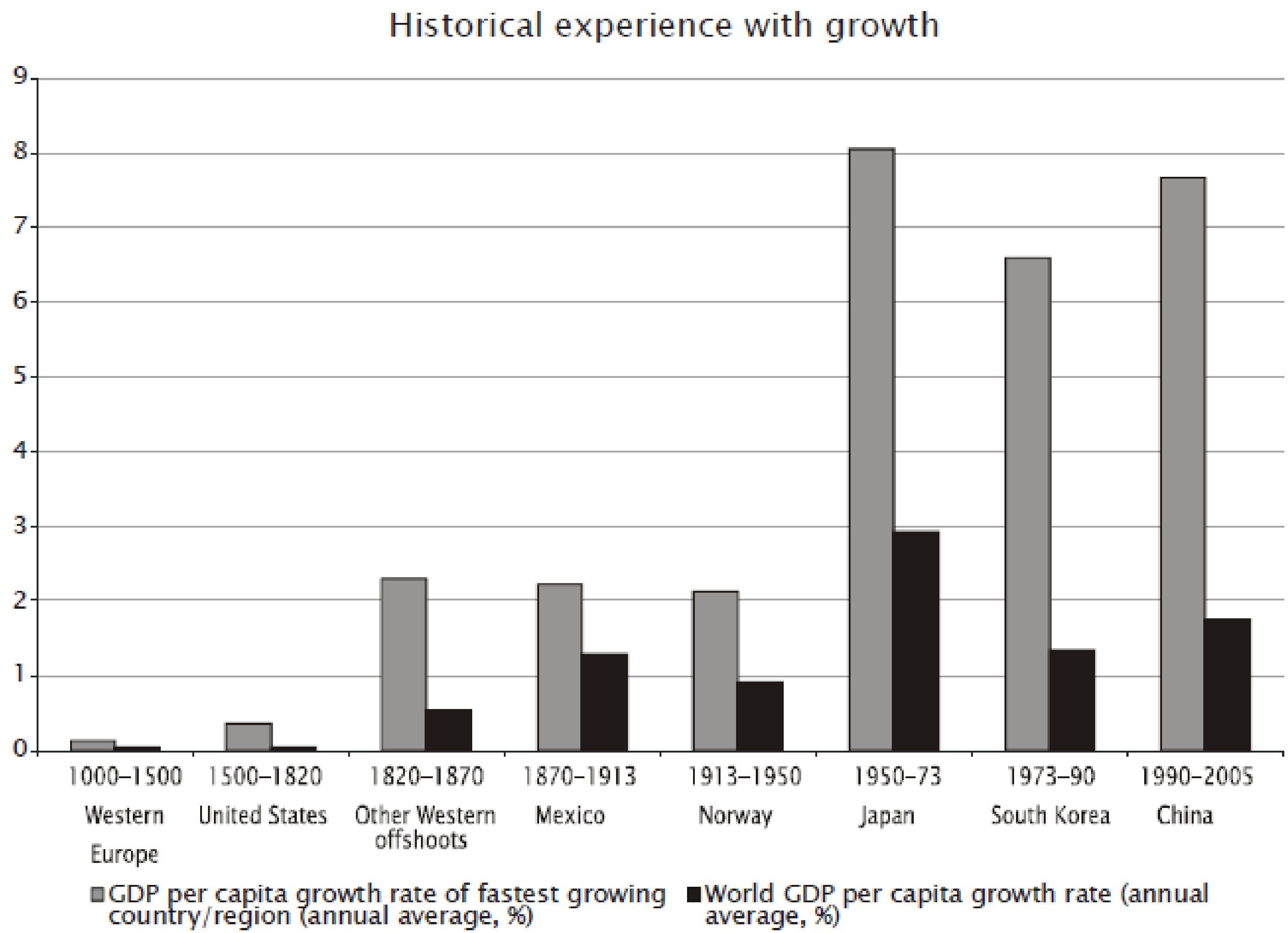
The fastest growing countries after WWII were Asian countries and all had industrial policy



Source: Rodrik (2007)

East Asian countries used a mix of import substitution and export promotion

- View is held that the East Asian NICs - Japan, South Korea, Taiwan and China - have adopted ‘outward-oriented’ policies (based on sound neoclassical principles) to **promote exports**

- But, they also have used **import substitution policies** and the state played a very huge role in their industrialization process

- Singapore, South Korea, Taiwan and China all experienced periods of import substitution before experiencing their export “miracle”

- During all the time, these countries not only promoted exports but also provided considerable protection to producers for the domestic market (forming of large conglomerates)

The government as a senior partner with a clear strategic plan

- East Asian system was based on flexibility, selectivity, coherence and an emphasis on efficiency promotion

- High degree of coherence of the policies pursued
  - Long-term plans were established before the policies were implemented
  - One main agency that coordinated industrial policies
  - The colonial bureaucracies inherited from the Japanese provided both South Korea and Taiwan with effective state organizations
  - the bureaucracy enjoyed a degree of autonomy
  - government was senior partner in the public-private relationship

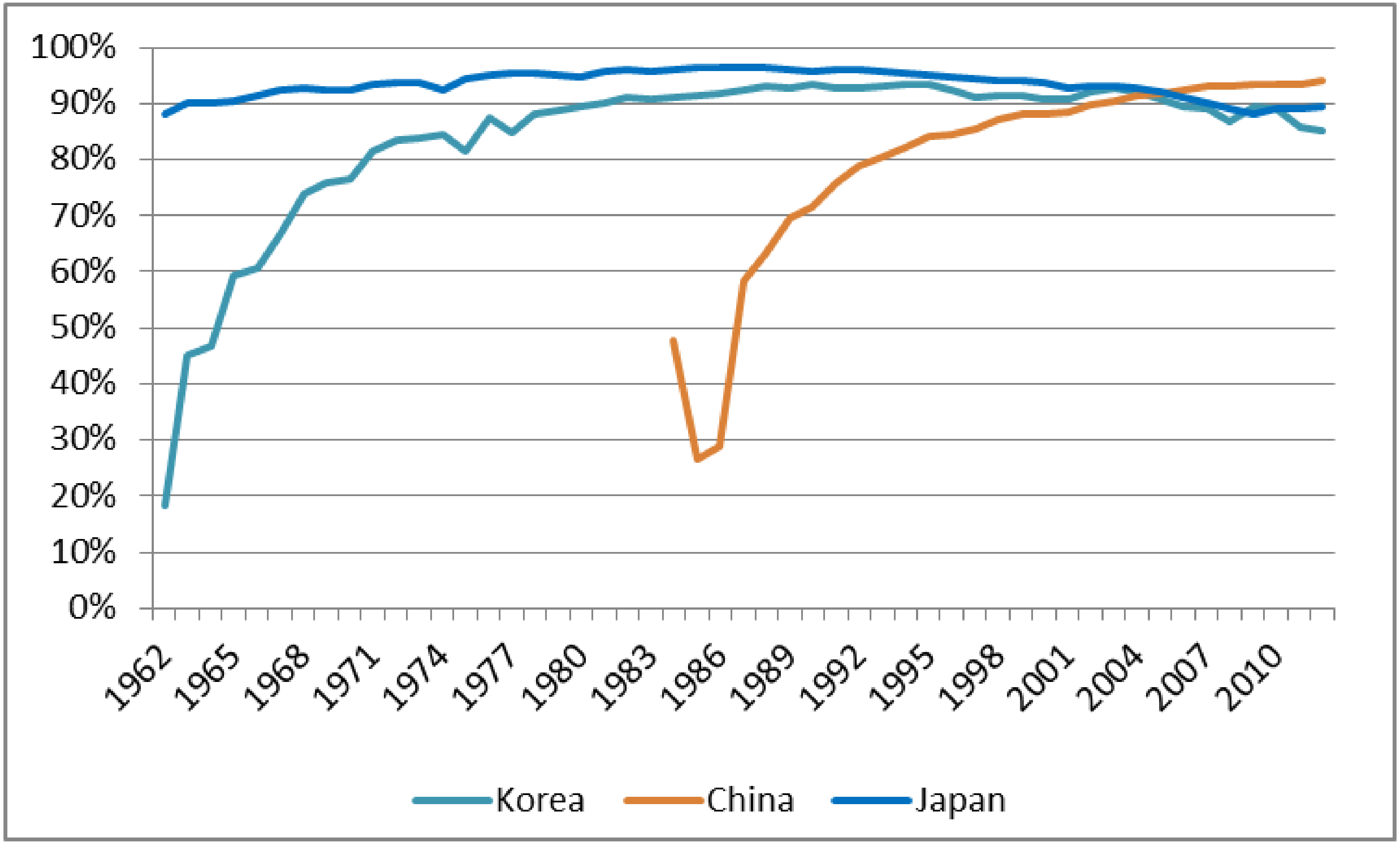
- Government dictating which sectors received support (what they should produce) and withdrew support for industries that did not perform as expected

- Land reforms to extract surplus value from the agricultural sector and to increase domestic market

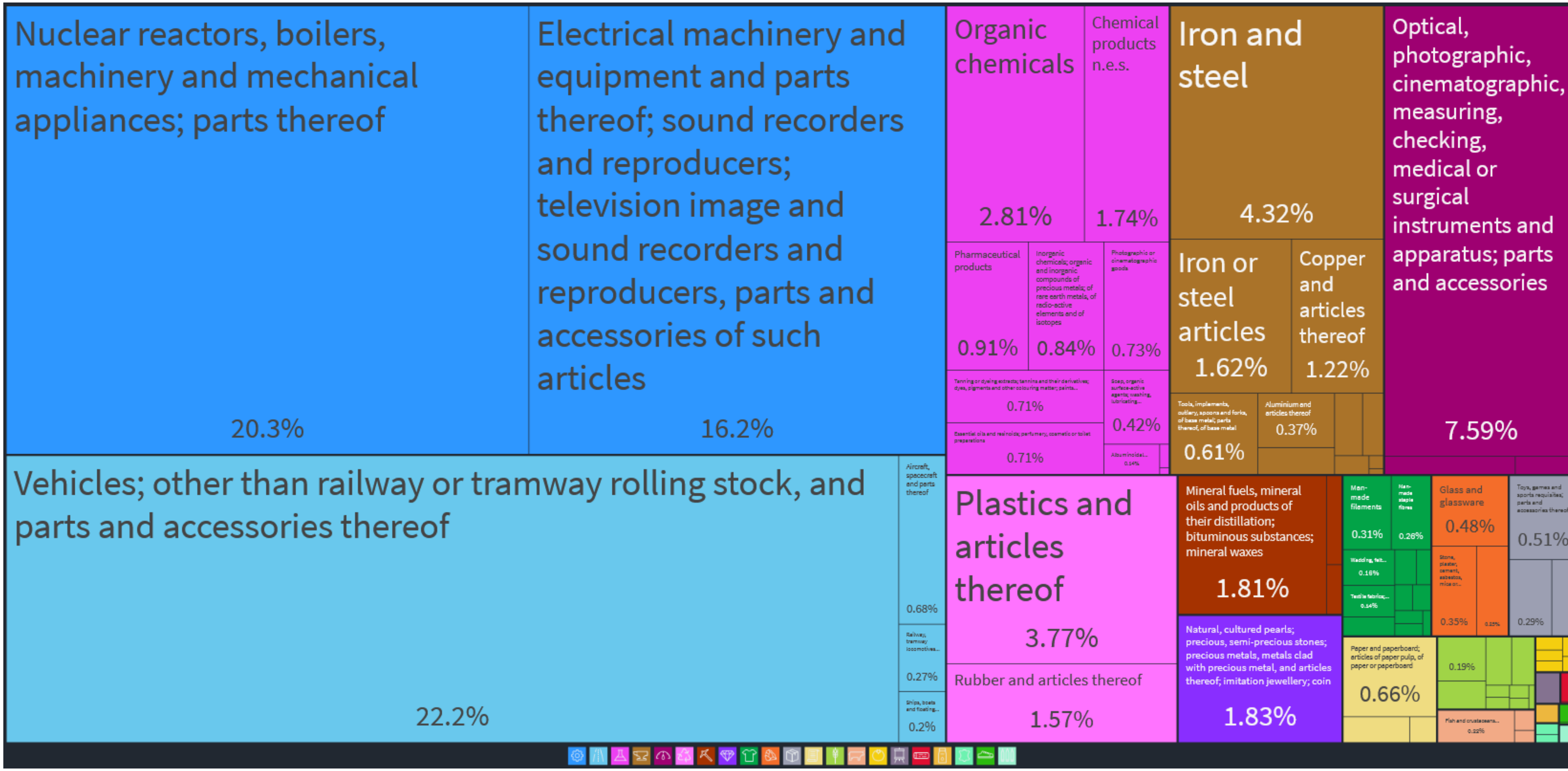
East Asian countries used a mix of state intervention and free markets

- **Main policies**:
  - Use of tariff and non-tariff barriers (subsidies) to protect selected industries
  - Protection with the aim to develop high value added products (ships, cars, electro domestic products; IT products)
  - Huge conglomerates were build to be able to achieve internal economies of scale
  - Certain regions received most support to build clusters and achieve external economies of scale (coastal regions)
  - Public investment in education and infrastructure (roads, ports, airports, internet)
  - Use of state banks to support selected sectors with cheap credit
  - Selective FDI strategy (domestic-foreign partnerships; domestic content requirements)
  - Use of exchange rate policies to gain competitiveness

Manufactures exports (% of merchandise exports)

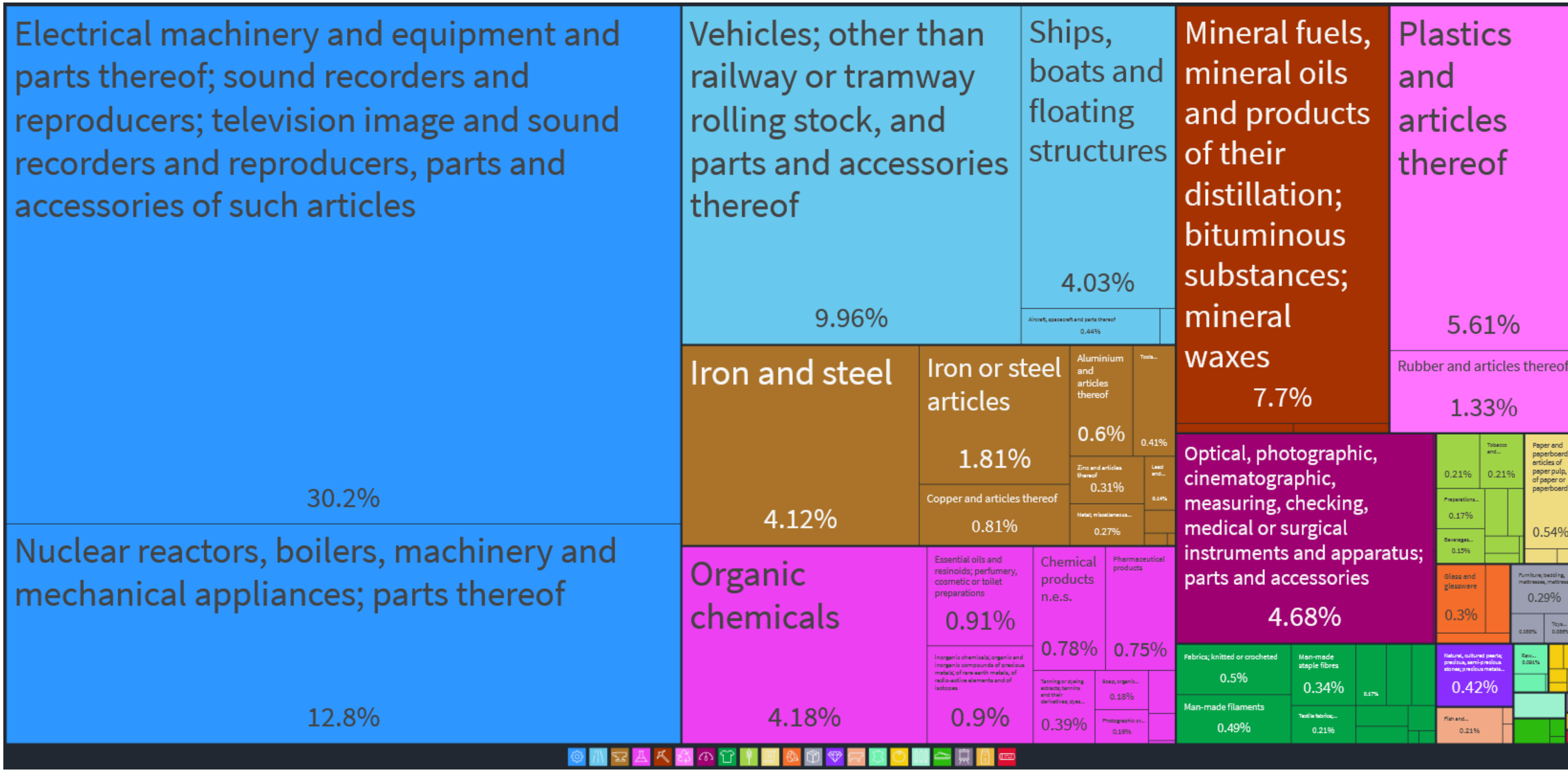


What does Japan export?



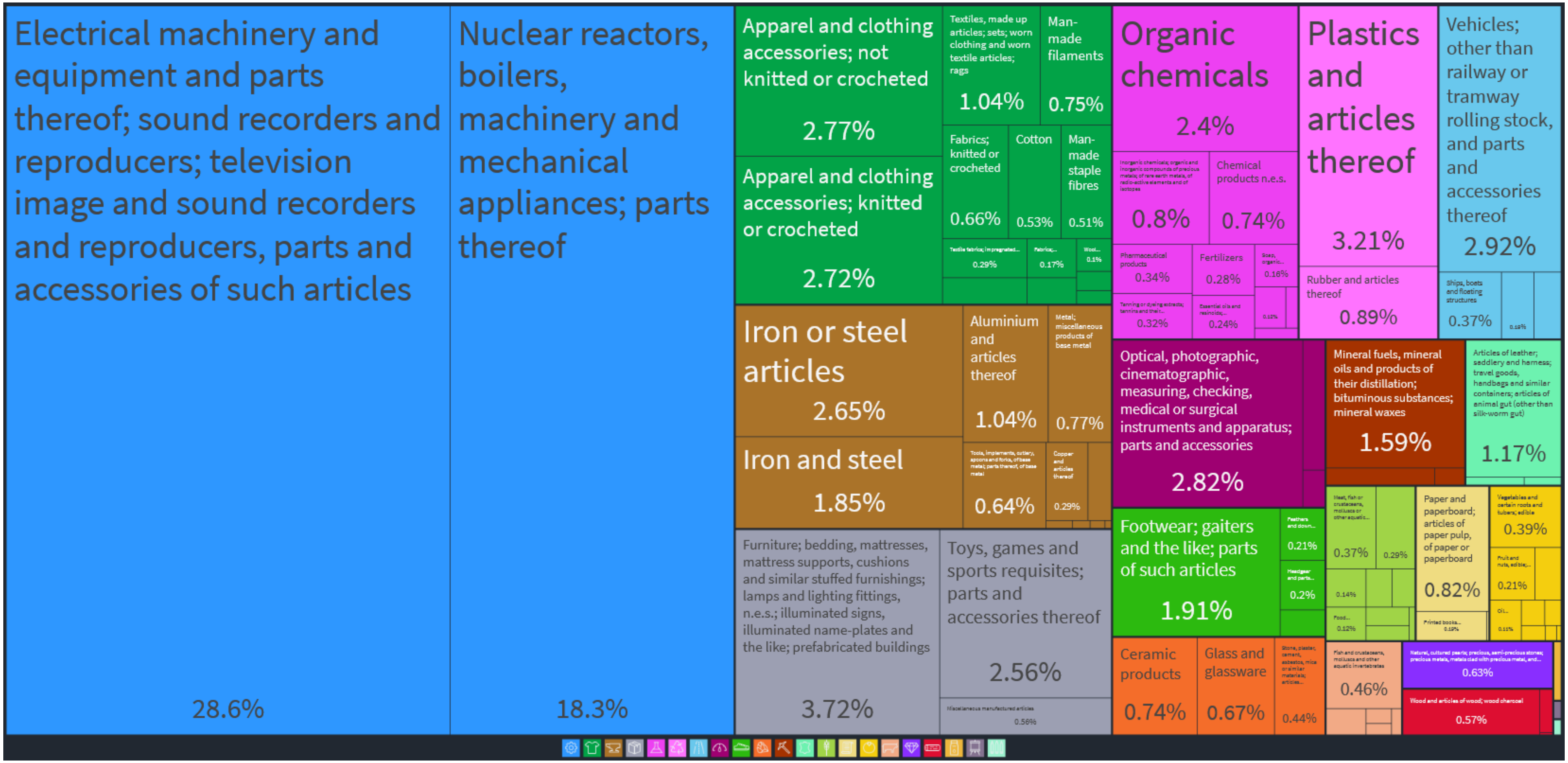
Source: OEC (2020)

What does Korea export?



Source: OEC (2020)

What does China export?



Source: OEC (2020)