# Topic 8: Trade Policy and Development

By

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# Objectives

- International trade of goods and services is conducive to faster economic development and growth as we have seen in the previous chapter. Yet many developed and developing countries try to create barriers to free trade. Are there good reasons for such barriers? Whose interests these barriers serve?
- WTO is an international forum that try to facilitate free trade among countries
- Some countries give subsidies to private companies to encourage them to export more. Is it good or bad for the country? Is this an unfair trade practice, and what rules WTO has regarding this?
- WTO includes a large number of countries as members. On top of WTO, in many regions trade blocs are formed among many neighboring countries which further facilitate free trade among member countries. Examples of such trade blocs are NAFTA, EU. Why are there trade blocs? Isn't WTO enough?

# Topics

- Trade policies:
  - Import restrictions: Tariff, quota, non-tariff barriers, e.g., product safety requirements, local content requirements for imports.
  - Export Promotion policies: export subsidy
- Export promotion (EP) vs Import Substitution (IS)
  - Pros and Cons of each approach
  - Examples of countries following each strategies and their development experiences
- Economic Integration and Globalization of Trade: Theory and Practice

# Export Promotion (EP)

- The main policy is export subsidy to private companies.
- Example: India allows a private firms to import capital goods and raw materials if it exports as compared to firms which do not export. Korea give subsidy to firms if they export steel.
- Other ways to promote export: devaluation of currency, the banks can give credits to exporting firms at a lower rate than the other ones.
- Yet another set of policies include govt. provides information about foreign markets, technology updates, even act on behalf of small firms to negotiate price of an exportable good in the world market.

# Pros and Cons of EP

- Pros and Cons
  - will be discussed after categorizing primary outward looking, I.e., EP in non-oil primary goods such as agricultural products (e.g., Coffee, jute) versus secondary outward looking policies, I.e., promoting export of manufacturing goods such as textile, electronics etc.
- Pros:
  - It provides foreign earnings for an LDCs to import the most needed capital goods and raw materials for development, and also to import food, medicines during drought, flood, and with epidemics.
  - Export can lead to positive externality or learning effect for non-exporting firms. Example, an exporting firm may learn about better technology and management practices abroad and adopt them in the firm. The non-exporting firms can learn by watching the exporting firms and adopt better management and technology themselves.

# ….continued

  - Export allows a firm to have market beyond its limited domestic market. If there is positive economy of scale in production, so that producing at a larger scale can reduce the cost of production, export can lead to efficiency gain.
- The above arguments are part of what is also known as trade is an engine of growth.

Cons:

- If not done right can make a country vulnerable to upheavals to international events, such as war, etc. Here are some of the other reasons factors that export promotion policies are to take into account.

## Export Promotion: Pros and Cons

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## Obstacles to Primary EP (demand and supply factors, in developed countries)

- <u>Demand side obstacles:</u>
- Low income elasticity to LDC primary products such as coffee (what about cocaine)
- Population growth is low, so market is not expanding.
- Low price elasticity
- Synthetic substitutes (example, plastic bags for jute bags)
- Tariffs in DCs in agricultural products, example rice in Japan.
- <u>On supply of export constraints</u>:
- low infra-structure (roads, electricity), poor climate, bad soils, corruption and poor legal institutions.

## Obstacles of Primary EP (demand and supply factors, in developed countries)

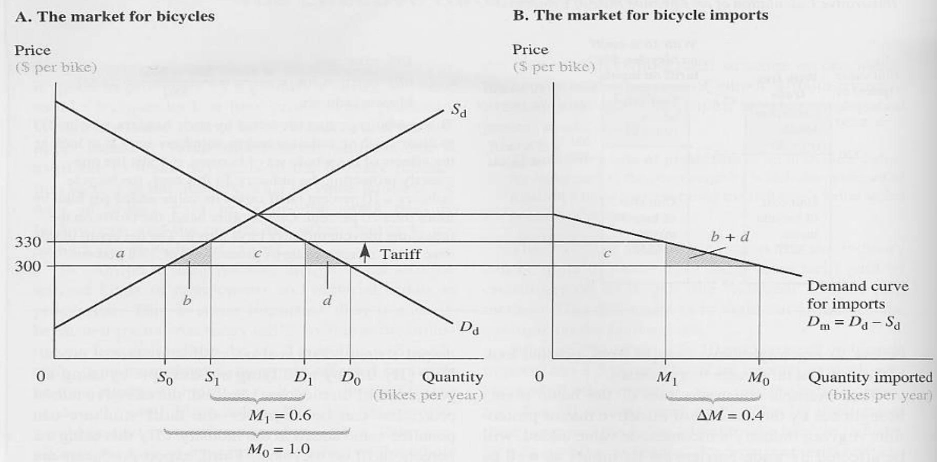
- Similar to primary products. Manufacturing or Secondary exports, however, create less problems than Primary exports.
- Noteworthy is MFA (Multi-Fiber Arrangements) that restrict import of LDC cotton, wool, and synthetic fiber products. (The estimated cost is $24billion dollars per year for LDCs).

## Import Substitution (IS)

- Broadly, it means a country will impose import tariff and quota, VER to restrict and more importantly substitute with domestic production.
- Justified on infant industry ground, what is it?
- First let us look at the theoretical arguments against tariff. → loss to small country, and the world as a whole from tariff. (next slide).
- Effective Rate of Protection (ERP) is a measure of protection against import.

# What happens when a small country imposes a tariff

FIGURE 7.4 *The Net National Loss from a Tariff in Two Equivalent Diagrams*




| | | |
|---|---|---|
| Consumers lose | Area $a + b + c + d$ | = $45 million (loss) |
| Producers gain | Area $a$ | = $21 million |
| Government collects | Area $c$ in tariff revenue | = $18 million |
| Net national loss from the tariff = | Area $b + d$ | = $ 6 million |

# Countries that followed EP and IS

- No country followed one or the other of EP and IS, most countries followed a mixture of the two. Depending on the degree of the mixture, we can categorize countries into two.
- IS strategy: -- India, Chile, Peru Argentina, Pakistan, Ghana, Zambia
- EP strategy: South Korea, Taiwan, Singapore, Hong Kong, more recently Brazil, Chile, Thailand and Turkey.