Trade Policy in Developing Countries

International Economics

Krugman et al., Chapter 11

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Topics

- Import-Substituting Industrialization
- Results of Favoring Manufacturing
- Trade Liberalization since 1985
- Trade and Growth: Takeoff in Asia

Import-Substituting Industrialization

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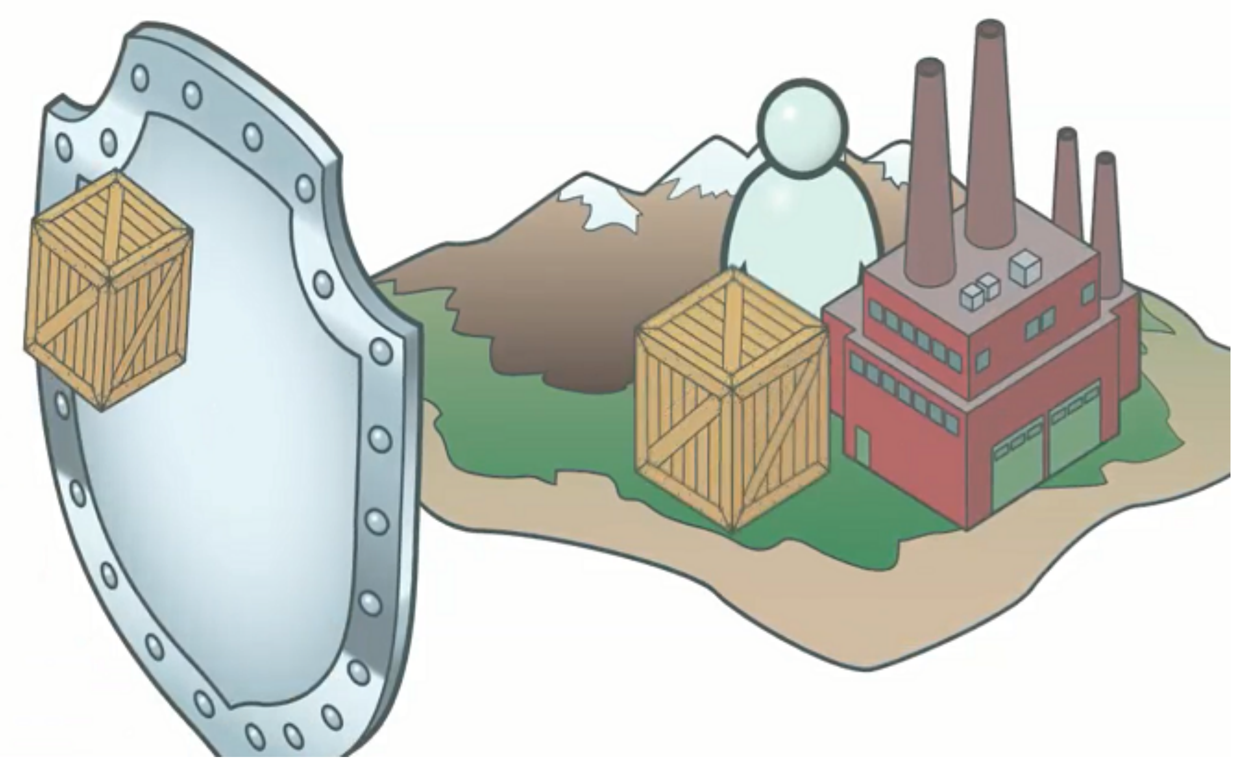
The Infant Industry Argument

- Temporal protection for potential comparative advantageous industry
- Historical Evidences:
  - World's largest market economies began their industrialization behind trade barriers
  - United States (19C), Japan (-1970s), South Korea (-1990s),..



https://www.investopedia.com/terms/p/protectionism.asp

Problems with the Infant Industry Argument

- In spite of its persuasive power, economists suggest that it must be used cautiously
  - Protection is not always a good idea
  - Protection itself should make protective industry competitive
  - Unless there is some domestic market failure, government intervention is not justified

Protection is not always a Good Idea

- Example: Automobile industry of South Korea
- It began to take comparative advantage from 1980s
- It will not be successful if South Korea start to try develop auto industry in the 1960s because capital and skilled labor were very scarce

Protection itself should make Protective Industry Competitive

- Example: Manufacturing sectors of Pakistan and India
- They have protected heavy manufactures for decades but what they start to export was light manufactures.
- Pseudoinfant industry: Became competitive industry which has been protected but not actually by the protection

Government Intervention cannot always be Justified

- Development of an industry is costly and time-consuming
- But the fact is not an argument for government intervention unless there is some domestic market failure
- There is an argument that private investors take into account only the close future and fail to take account of the long run, but it is not consistent

Example: China's electric vehicle (EV) industry

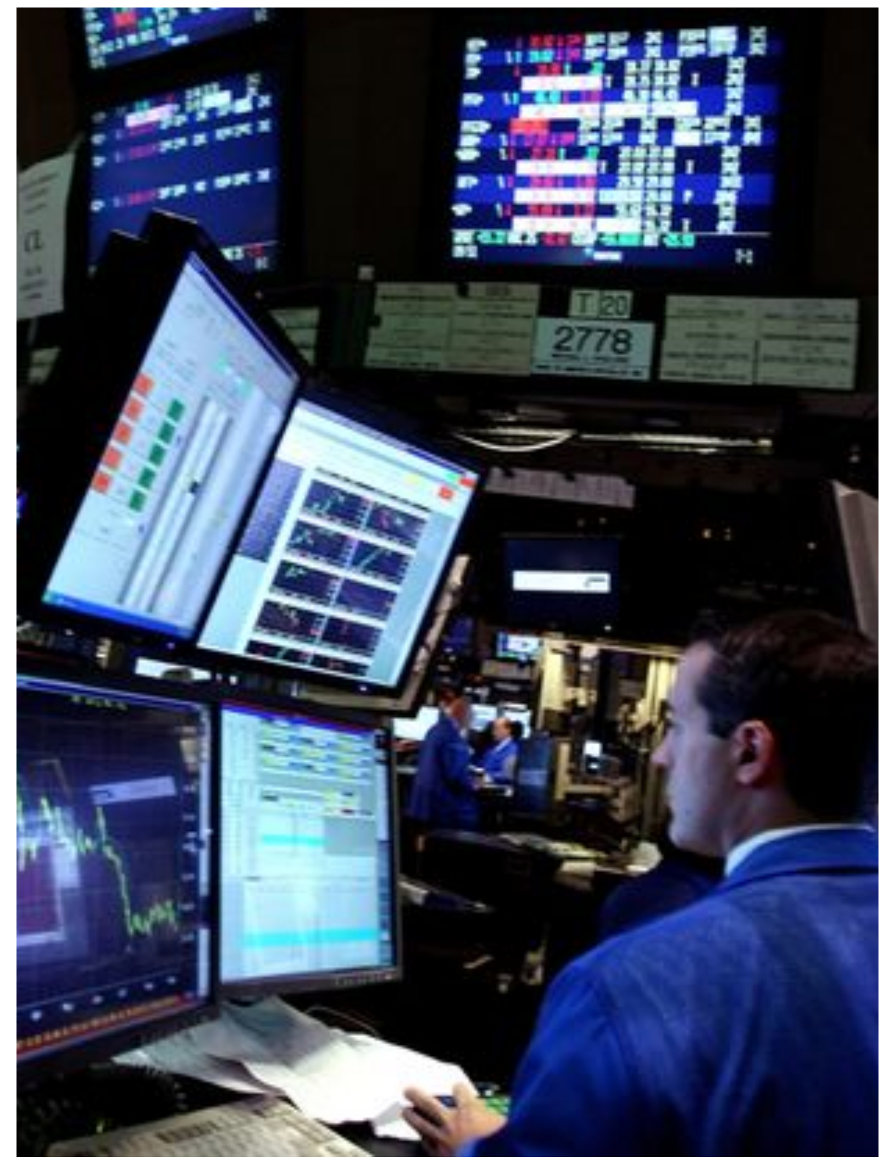
- Attracted private investments early 2000s
- China's EV sales skyrocketed in the end of 2014

Market Failure Justifications for Infant Industry Protection

- The justifications for infant sector protection depends on the existence of market failure
- Two market failures as reasons why infant industry protection may be a good idea:
  - Imperfect capital markets
  - The problem of appropriability

The Imperfect Capital Markets Justification

- If a developing country does not have sufficient set of financial institutions such as:
  - Stock markets
  - Banks
- Then, growth of new industries will be restricted



The Imperfect Capital Markets Justification

- Low initial profits will be an obstacle to investment even if long-term returns on the investment will be high
- The first-best policy: Creating a better financial markets ⇒ sufficient investment ⇒ rapid growth
- The second-best policy: Infant sector protection by raising profits ⇒ rapid growth

The Appropriability Argument

- Main idea: firms in a new industry generate social benefits without compensation
  - Positive externality
  - intangible benefits
  - start-up costs of adapting technology, opening new market and so on
- Follower will not pay for the prevention of these start-up costs

The Appropriability Argument

- The first-best policy:
  - To compensate firms directly for their intangible contributions
- The second-best policy:
  - To compensate firms indirectly by the protection

Limitations of the Market Failure Approach

- "Special" cases of market failure justification for interfering with free trade
  - For "NEW" industry (i.e., not any industry)
- Hard to identify market failure
- Risk of being captured by special interests
  - There are many stories of protected infant industries that have never grown up

Promoting Manufacturing through Protection

- Most of developing countries' basic strategy is limiting imports rather than promoting exports
- Import-substituting industrialization:
  - The strategy of encouraging domestic industry by limiting imports of manufactured goods
- Tariff reduce exports as well as imports ⇒ Why they do the import-substituting industrialization?

The Reason

- A Mixture of economics and politics
- Economic perspective:
    - Until the 1970s, many developing countries believed that industrialization should be based on a substitution of domestic industry of imports
- Politic perspective:
    - In many cases, import-substituting industrialization policies fit existing political biases: directly benefited existing powerful interest groups

Import-Substituting Industrialization: Short History

- 1950-60s: The high tide of import-substituting industrialization ⇒ domestic products replaced imported products
  - Target industry: Consumer goods ⇒ Intermediate goods
- Manufacturing grew
- However, growth in manufacturing does not promote economic development in many countries ⇒ Increasingly harsh criticism

Results of Favoring Manufacturing: Problems of Import-Substituting Industrialization

Poor Result of Import Substitution Strategy

- Many countries pursuing import substitution were not catching up with advanced countries
  - Some developing countries lagged further behind advanced countries even as they developed a domestic manufacturing base
    - Example: Growth rate of India < Growth rate of United State (Since 1950)
- Why?

The Reasons for Failure to Develop

- Existence of problems which cannot be resolved by trade policy
  - Protection can allow inefficient sector to survive, but it cannot directly make that sector more efficient
- Lack of other kinds of factors for develop:
  - Skilled labor, Entrepreneurs, and Managerial competence
- Problems of social organization:
  - Spare parts, electricity, etc

The Costs of the Import Substituting Policies

- Many less-developed countries used complex methods to promote their infant industries
    - Tariffs, import quotas, exchange controls, and domestic content rules
    - Many research indicates that the degree of protection is often higher and more variable across industries than the government intended

Case of Infant Industry Protection: Latin America and South Asia

- For example, Pakistani industry can exist even when their prices are over 2.7 times than world prices

TABLE 11-3 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.

Promoting Inefficiently Small Scale by Import Restrictions

- Domestic market sizes of less-developed countries are not large enough to allow an efficient-scale production facility
- When this small market is protected ⇒ Relatively many firms enter ⇒ Production at a highly inefficient scale
- Solution is to specialize (see Chapter 8)
  - But import-substituting industrialization eliminate this option

Trade Liberalization since 1985

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Trade Liberalization since 1985

- Many developing countries reduced tariffs and removed import quotas
- Consequences:
  - Dramatic increase in the volume of trade
  - Change in the nature of trade
    - Exports: agricultural and mining products → manufactured goods

Tariff Rates

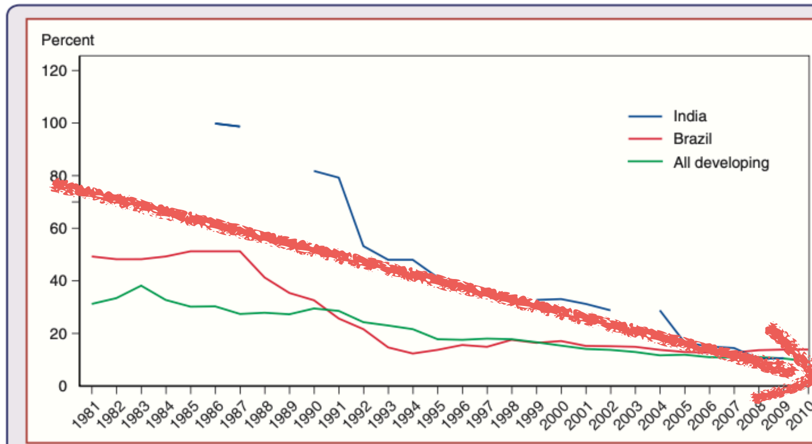

FIGURE 11-1

Tariff Rates in Developing Countries

One measure of the shift away from import-substituting industrialization is the sharp drop in tariff rates in developing countries, which have fallen from an average of more than 30 percent in the early 1980s to only about 10 percent today. Countries that once had especially strong import-substitution policies, like India and Brazil, have also seen the steepest declines in tariff rates.

Source: World Bank.

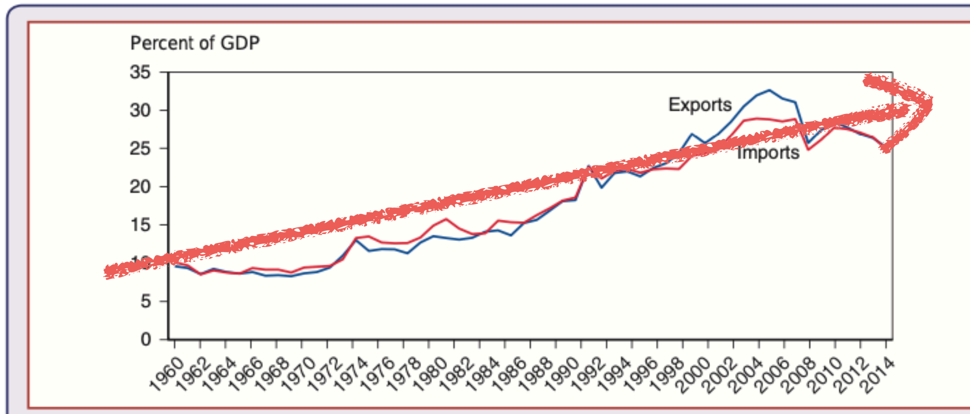

FIGURE 11-2

The Growth of Developing-Country Trade

Beginning in the 1980s, many developing countries began shifting away from import-substitution policies. One result has been a large rise in both exports and imports as a percentage of GDP.

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

Trade Volume

Was the Trade Liberalization Good?

- The answer is not so simple
- Brazil and other Latin American countries
  - Growth rates have actually been slower since trade liberalization
- India
  - Growth rates actually increased
  - However, there is an intense dispute about the degree of contribution from trade liberalization

Problems from Trade Liberalization

- Rising inequality in developing countries
  - In Latin America, real wage gap between blue-collar workers and highly skilled workers increased
- However, there are a number of developing countries which have achieved extraordinary growth by opening to trade

Trade and Growth: Takeoff in Asia

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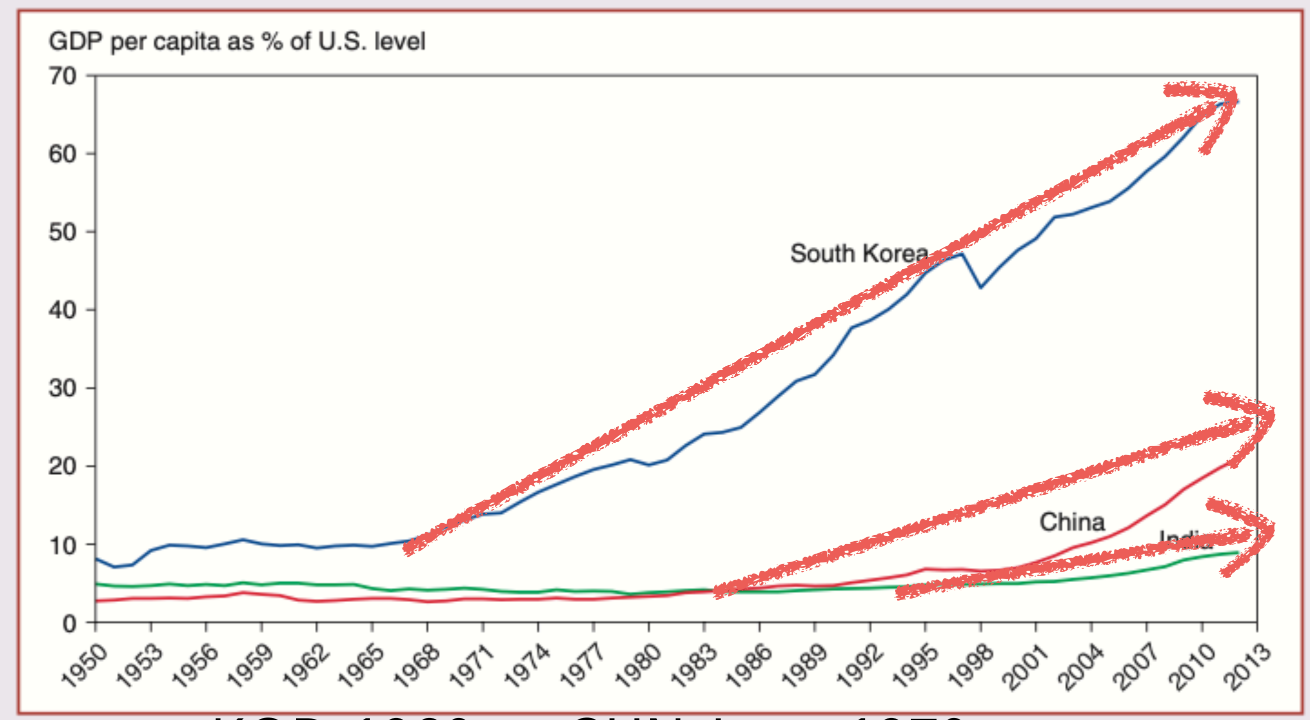
The Asian Takeoff

- There is some surprising success stories in the developing world
- Initially, these stories involved South Korea, Taiwan, Hong Kong, and Singapore
  - Called as "Asian four tigers"
- Currently, these successes began to spread including China and India

The starting point of "catchup"



KOR:1960s CHN:Late 1970s
IND:1990s

FIGURE 11-3

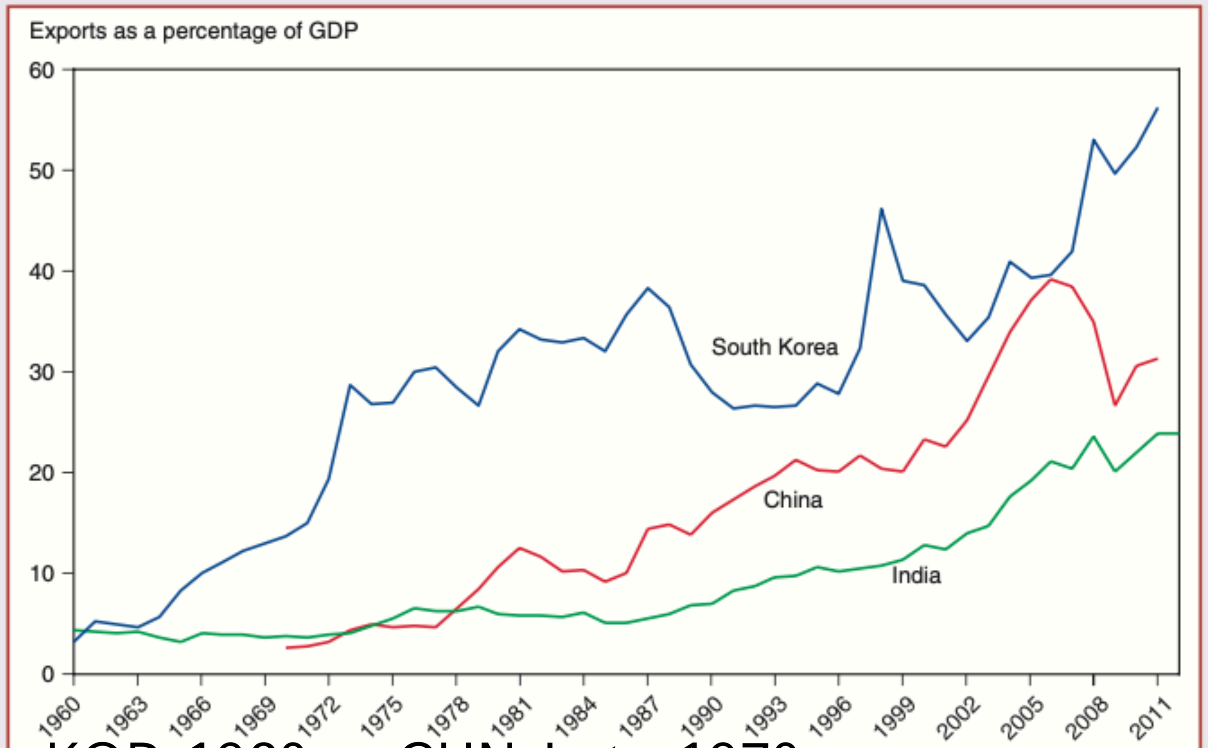
The Asian Takeoff

Beginning in the 1960s, a series of economies began converging on advanced-country levels of income. Here we show GDP per capita as a percentage of its level in the United States, using a proportional scale to highlight the changes. South Korea began its ascent in the 1960s, China at the end of the 1970s, and India about a decade later.

Source: Total Economy Database.

The Cause of Economic Takeoffs

- Reduced government regulation in a variety of areas
  - including freer trade
- Consequence: A large increase in the economy's openness (right figure)
- Development through export-oriented growth, not import-substituting industrialization



KOR:1960s CHN:Late 1970s

IND:1990s

FIGURE 11-4

Asia's Surging Trade

Source: World Bank.

Trade Liberalization and Asian Success

- The Causation is less clear:
  - Trade liberalization policies were only part of the economic reforms in Asian successful countries $\Rightarrow$ difficult to assess the importance of trade liberalization per se
- Unsuccessful cases
  - Mexico and Brazil
  - They liberalized trade and shifted toward exports, but there was no comparable economic takeoffs

The Implications of Asian Miracle

- It is still somewhat controversial
- There might be other factors played a crucial role in the Asian miracle
- One clear implication:
  - *"The once widely held view that the world economy is rigged against new entrants and that poor countries cannot become rich have been proved wrong"*

Next Topics

- Controversies in Trade Policy
- Krugman et al., Chapter 12

Thank you!

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