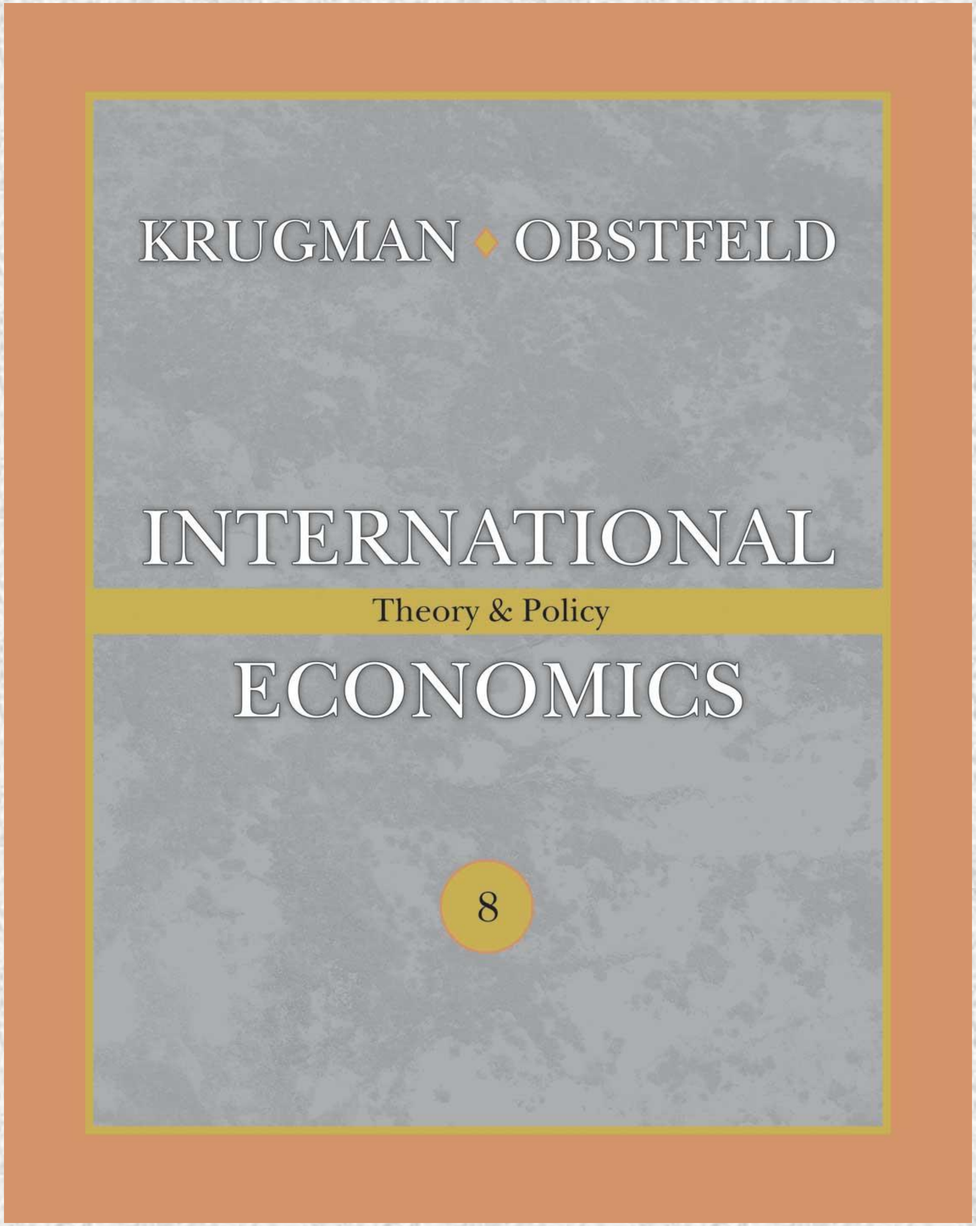

Chapter 10

Trade Policy in Developing Countries

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Preview

- Import substituting industrialization
- Trade liberalization since 1985
- Export oriented industrialization

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 10-1: Gross Domestic Product Per Capita, 2005 (dollars)

United States	41,899
Japan	35,484
Germany	33,890
Singapore	26,877
South Korea	16,387
Mexico	7,447
China	1,720
India	736

Source: World Bank.

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.
- It was often accompanied with the belief that poor countries would be exploited by rich countries through international financial markets and trade.

Table 10-2: 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*, 82. (Baltimore: Johns Hopkins Press, 1971).

Import Substituting Industrialization (cont.)

- 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 can not 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.

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.

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 can not 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 (cont.)

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 be not 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

- As a strategy to encourage manufacturing industries, import substituting industrialization in Latin American countries worked in the 1950s and 1960s.

Import Substituting Industrialization (cont.)

- But economic development, not encouraging manufacturing per se, was the ultimate goal of the policy.
- Did import substituting industrialization promote economic development?
  - No, countries adopting these policies grew more slowly than rich countries and other countries not adopting them.

Import Substituting Industrialization (cont.)

- 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

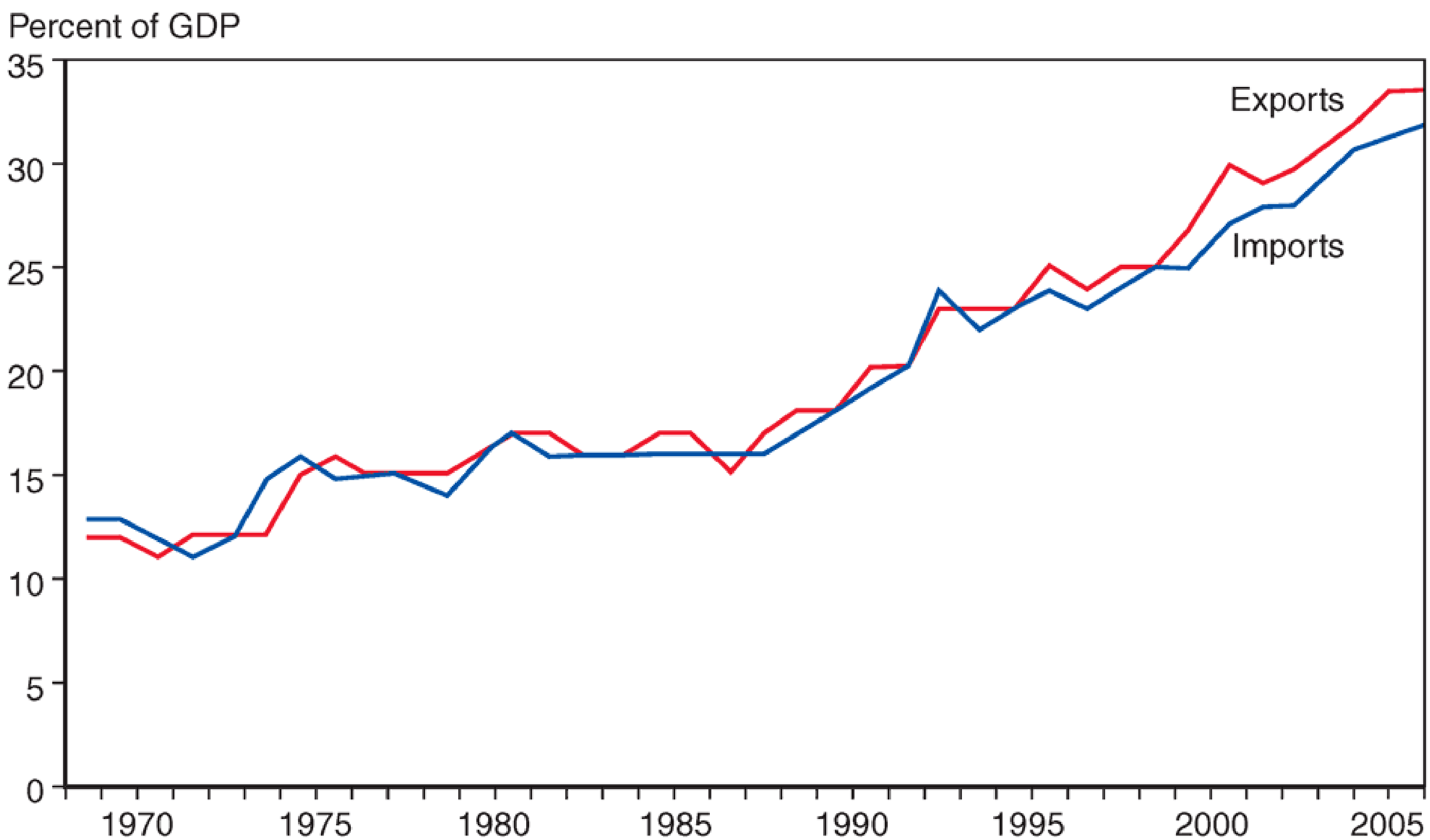
- There is some evidence that low and middle income countries which had relatively free trade had higher average economic growth than those that followed import substituting industrialization.
  - But this claim is a matter of debate.
- Regardless, by the mid-1980s many governments had lost faith in import substituting industrialization and began to liberalize trade.

Table 10-3: Effective Rates of Protection for Manufacturing in India and Brazil

	India	Brazil
Late 1980s	126	77
Late 1990s	40	19

Sources: Marcelo de Paiva Abreu, "Trade Liberalization and the Political Economy of Brazil Since 1987," Working Paper, Inter-American Development Bank, 2004; Dani Rodrik and Arvind Subramian, "From 'Hindu Growth' to Productivity Surge: The Mystery of the Indian Growth Transition," International Monetary Fund Working Paper, 2002.

Fig. 10-1: The Growth of Developing-Country Trade



Source: World Bank

Trade Liberalization (cont.)

- As with import substituting industrialization, economic development was the ultimate goal of trade liberalization.
- Has trade liberalization promoted development?
  - The evidence is mixed.
  - Growth rates in Brazil and other Latin American countries have been slower since trade liberalization than they were during import substituting industrialization,

Trade Liberalization (cont.)

- 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 Hechscher-Ohlin model predicts.

Export Oriented Industrialization

- Instead of import substituting industrialization, 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 are countries that have experienced rapid growth in various export sectors and rapid economic growth in general.
  - These economies or a subset of them are sometimes called “high performance Asian economies.”

Export Oriented Industrialization (cont.)

- These high performance Asian economies have generated a high volume of exports and imports relative to total production.
  - By this standard, these economies are “open economies.”
- But it is debatable to what degree these economies established “free trade.”
  - Although evidence suggests that these economies did have less restricted trade than other low and middle income countries, some trade restrictions were sometimes still in effect.

Table 10-4: Average Rates of Protection, 1985 (percent)

High performance Asian economies	24
Other Asia	42
South America	46
Sub-Saharan Africa	34

Source: World Bank. *The East Asian Miracle: Economic Growth and Public Policy* (Oxford: Oxford University Press, 1993), p. 300.

Export Oriented Industrialization (cont.)

- It is also unclear if the high volume of exports and imports *caused* rapid economic growth or was merely *correlated* with rapid economic growth.
  - Some economists argue that the cause of rapid economic growth was high saving and investment rates, leading to both rapid economic growth in general and rapid economic growth in export sectors.
  - In addition, almost all of the high performance Asian economies have experienced rapid growth in education, leading to high literacy and numeracy rates important for a productive labor force.

Industrial Policies in East Asia

- Some East Asian economies have implemented **industrial policies**: policies intended to promote certain industries.
  - Examples of industrial policies include not only tariffs, import restrictions, and export subsidies for import-competing industries and export industries,
  - but also policies like subsidized loans for industries and subsidized research and development.
- But not all high performance Asian economies implemented these policies, and the ones that did had a wide variety of policies.

Industrial Policies in East Asia (cont.)

- There is little evidence that countries with industrial policies had more rapid growth in the targeted industries than those that did not.
- There is some evidence that industrial policies failed: chemicals, steel, automobiles were promoted by the South Korean government in the 1970s,
    - but the polices were later abandoned because they were too expensive and did not produce desired growth.

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 (ex., in poor countries) need temporary trade protection because of market failures:
   - imperfect asset markets that restrict saving, borrowing and investment in production processes
   - problems of appropriating gains from private investment in production processes

Summary (cont.)

3. Import substituting industrialization was tried in the 1950s and 1960s but by the mid-1980s it was abandoned for trade liberalization.
4. The precise 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 skepticism.
   - Some argue that trade has caused increased income inequality.

Summary (cont.)

5. Several East Asian economies adopted export oriented industrialization instead of import substituting industrialization.
   - High export and import volumes and relatively low trade restrictions were characteristics of this policy.
   - But it is unclear to what degree this policy contributed to overall economic growth.
6. Some East Asian economies used more general industrial policies as well.
   - But it is unclear to what degree this policy contributed to or hindered overall economic growth.