

Trade Policy in Developing Countries

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1- Introduction

Which countries are “developing countries”?

A fact

The term “developing countries” does not have a precise definition.

but it is a name given to many **low-** and **middle-**income countries.

Gross Domestic Product Per Capita, 2009 (dollars)

United States	46,008
Germany	36,163
Japan	34,167
South Korea	28,443
Mexico	15,130
China	8,383
Bangladesh	1,747

Source: Conference Board Total Economy Database.

What is the trade policy of developing countries?

A number of developing countries adopted “**import-substituting Industrialization**” before 1980s.

What is “**Import-Substituting Industrialization**”?

● **The policy aimed to:**

encourage domestic industries

by limiting competing imports.

Effective Rate of Protection

the percentage change in value added following a tariff.

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Effective Protection of Manufacturing in Some Developing Countries (percent)

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.

The justification of this policy 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

support them until they **grow strong** enough to compete internationally.

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Problems with the Infant Industry Argument

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

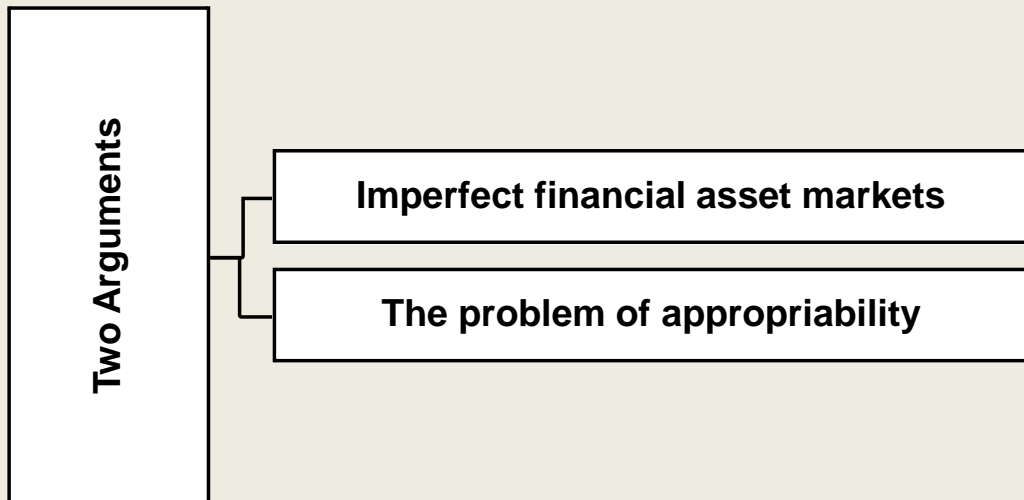
With protection, infant industries may never “**grow up**” or become competitive.

There is no justification for government intervention unless there is a **market failure** that prevents the private sector from investing in the infant industry.

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Infant Industries and Market Failures

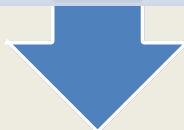
how market failures prevent infant industries from becoming competitive



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Imperfect financial asset markets

Because of ineffective financial laws and markets



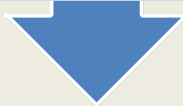
firms cannot **save** and **borrow** to invest sufficiently in their production processes.

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.

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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 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.

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Did import-substituting industrialization promote economic development?

Import-substituting industrialization in Latin American countries worked to encourage manufacturing industries in the 1950s and 1960s.

But economic development, not encouraging manufacturing, was the ultimate goal of the policy.

No, countries adopting these policies grew more slowly than others.

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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.

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Trade Liberalization

Some low- and middle-income countries that had relatively free trade

- had higher average economic growth than those that followed import substitution.

By the mid-1980s

- many governments had lost faith in import substitution and began to liberalize trade.

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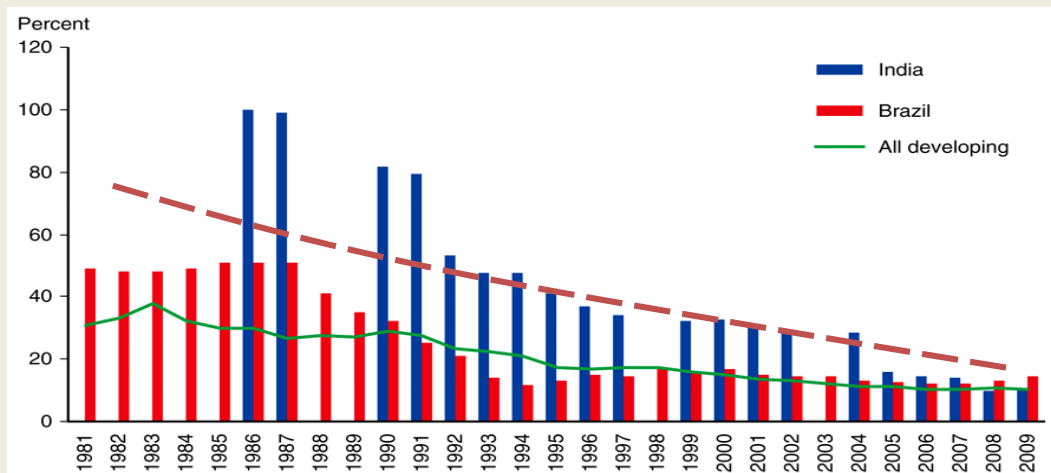
Trade liberalization in developing countries occurred along with a dramatic increase in the volume of trade.

- The share of trade in GDP has **tripled** over 1970–1998, with most of the growth happening after 1985.
- The share of **manufactured goods** in developing-country exports surged.

A number of developing countries have achieved extraordinary growth while becoming more, not less, open to trade.

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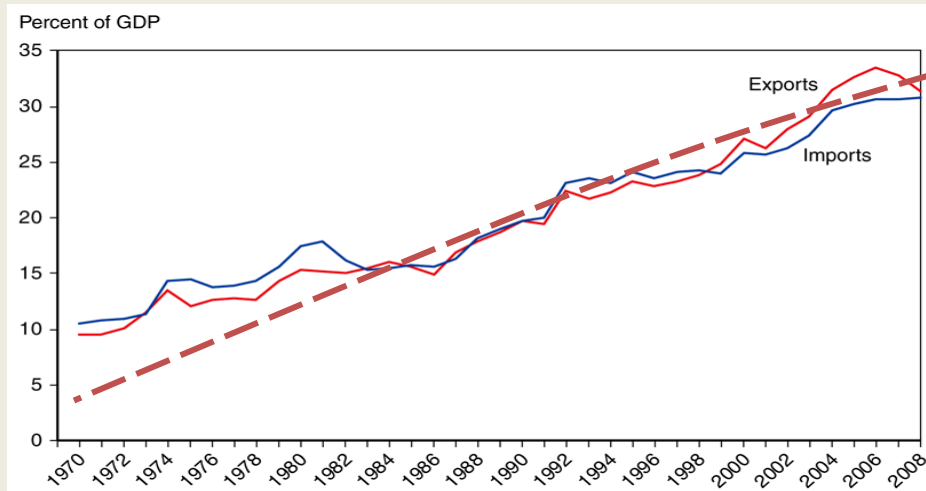
Tariff Rates in Developing Countries



Source: World Bank.

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The Growth of Developing-Country Trade



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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.

But unstable macroeconomic policies and financial crises contributed to slower growth since the 1980s.

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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.



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Instead of import substitution, several countries in East Asia adopted trade policies that **promoted exports** in targeted industries.

- export-oriented growth

Japan, Hong Kong, Taiwan, South Korea, Singapore, Malaysia, Thailand, Indonesia, and China

All the above mentioned countries have experienced **rapid growth** in various export sectors and rapid **economic growth** in general.

These high-performance Asian economies generated a **high volume of exports and imports** relative to total production.

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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.

This suggests that other factors must have played a crucial role in the Asian miracle.

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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 rates important for a productive labor force.

These nations also undertook other **economic reforms**.

Summary

Import-substituting industrialization aimed to promote economic growth

By

restricting imports that competed with domestic products in low- and middle-income countries.

The infant industry argument says that new industries need temporary **trade protection** due to market failures:

1

- **Imperfect asset markets** that restrict saving, borrowing, and investment in production processes

2

- **Problems of appropriating** gains from private investment in production processes

Import-substituting industrialization was tried in the 1950s and 1960s

But

by the mid-1980s it was abandoned for **trade liberalization**.

The effect of liberalized trade on national welfare is still being **debated**.

1

- Trade helped growth in some sectors, but the **influence of trade on the overall economic growth** has been unclear.

2

Some argue that trade has caused increased **income inequality**.

Several East Asian economies adopted **export-oriented policy** instead of import-substituting 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.

Thank you

Resources and Trade: The Heckscher-Ohlin Model

Introduction

- The Ricardian theory showed how trade can arise because of differences in **labor productivity**.
- The Heckscher-Ohlin theory argues that, in addition, trade also occurs due to:

differences in the availability of labor, labor skills, physical capital, or other **factors of production across countries**

Choosing the Mix of Inputs

Assumptions:

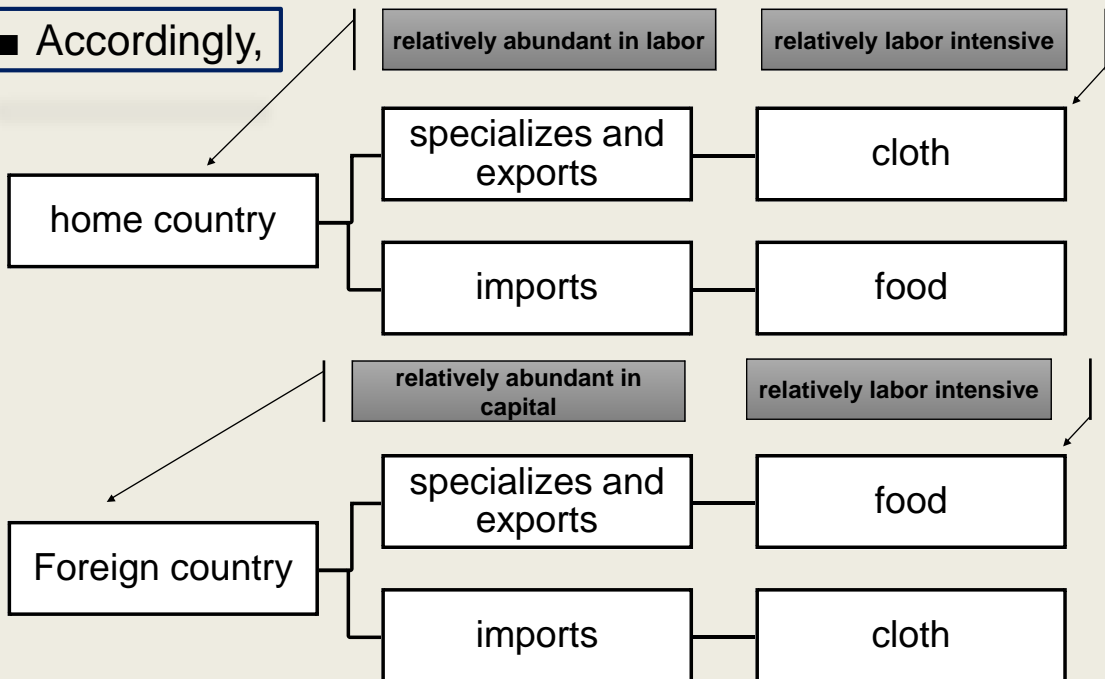
1. Two countries: home and foreign.
2. Two goods: cloth and food.
3. Two factors of production: labor and capital.
4. Home is relatively abundant in labor and Foreign is relatively abundant in capital

■ To produce a given amount of cloth (or food), a country may choose different amounts of labor and capital depending on the wage, w , paid to labor and the rental rate, r , paid when renting capital.

■ When the wage w increases relative to the rental rate r , producers use less labor and more capital in the production of both food and cloth.

- For any given values of w and r , if cloth production uses more labor relative to capital than food production uses, we can say that:
 - production of cloth is relatively labor intensive,
 - while production of food is relatively capital intensive.

■ Accordingly,



■ If the **relative price of a good** increases, then the real wage or rental rate of the factor used intensively in the production of that good increases, while the real wage or rental rate of the other factor decreases.

■ Any change in the relative price of goods alters the distribution of income.

