Trade Policy in Developing Countries

Chapter 10
Intermediate International Trade
International Economics, 5th ed., by Krugman and Obstfeld
Import-substituting industrialization

• the development strategy for many developing economies from World War II until the 70s was to limit imports of manufacturing goods to foster the creation of a domestic manufacturing industry

• the main theoretical argument for import substitution is the **infant industry argument**

• the infant industry argument emerges from the theory of *external economies of scale*
Infant industry and external economies of scale

• due to external economies of scale, there are increasing returns at the level of national industry: the larger the industry’s output, the lower the price at which firms are willing to sell their output (forward-falling supply curve)

• when the industry is at early stages of development, it is necessary to protect the manufacturing sector until it reaches a size to compete with developed countries
• problems with infant industry argument:
  (1) it alters comparative advantage in an “artificial way”: it pushes countries into developing today their comparative advantage in the future
  (2) protection by itself is not good, unless it helps make the industry competitive

• defending the infant industry argument: the defend is based on the existence of market failures:
  (1) imperfect capital markets: when financial institutions are underdeveloped, the ability of the manufacturing sector to grow is limited: a second-best policy is to protect the industry from foreign competition (the first-best policy is to develop a financial system)
(2) *appropriability*: pioneers in an industry generate large social benefits that they cannot appropriate: a second-best policy is to protect the industry to give incentives to new entrants (the first-best policy is to directly compensate the firms for the social benefits created)

- **notice**: import-substitution policy through tariffs, implies a reduction of both imports and exports: the reason is that resources in the economy will move towards the import-competitive sector, and away from the exporting sector.

- therefore, in practice there are two competing strategies of development: *import-substitution* and *export growth*
Some consequences of import substitution:

(1) the share of local manufacturing production in total output is almost as large in Latin American countries as it is in advanced nations

(2) the percentage of exports in GDP is extremely low in small developing countries

(3) import substitution did not foster economic growth, because trade policy is not enough to solve other problems of social organization that are important for growth

(4) import substitution was implemented with an extremely distorted policy that offered effective protection rates of around 200%
Economic dualism

- **economic dualism** refers to the division of a single economy into two sectors that are at very different levels of development.
- Many developing countries exhibit: (1) a modern, capital-intensive, high-wage *industrial sector*; (2) a very poor traditional *agricultural sector*.
- Economic dualism gives rise to the *wage differentials argument* in favor of protectionism: industrial wages are larger than agricultural wages, and so few workers are employed in industry: with a tariff to protect industry, more workers will be employed and more output will be produced in industry.
• a problem with the wage differentials argument is that by stimulating the flow of workers from agriculture to the industry sector, this sector might not be able to absorb all those workers and then unemployment increases

• trade policy has some role in creating economic dualism: import substitution in developing economies helped creating a dualism by protecting the industry and creating a bias against agriculture
Export-oriented industrialization: The East Asian miracle

• from the mid-1960s it became apparent that exporting manufactured goods to advanced nations was another strategy for industrialization
• Eastern Asian countries achieved growth rates of even more than 10% per year via export-oriented growth
• what is the role of trade policy in the East Asian miracle? ….there is disagreement among economists
• four “tigers” with rapid economic growth in the 60s: Hong Kong, Taiwan, South Korea and Singapore
• late 70s and 80s rapid growth: Malaysia, Thailand, Indonesia, and China
• common features of these countries: (1) very high growth rates; (2) more export oriented than Latin America and South Asia
• although compared to other countries, Eastern Asian economies followed trade policies closer to free trade, there were fairly substantial tariffs, quotas and export subsidies in place
• average rate of protection in 1985 was 24% for Eastern Asia, against 46% in South America, and 34% in Sub-Saharan Africa

• while there is *correlation* between rapid growth in exports and rapid economic growth, this does not necessarily mean that free trade is a *cause* of higher growth

• it is possible that other industrial policies, different from trade contributed to the Asian miracle: policies such as low-interest loans and government support for R&D were also implemented