TRADE POLICIES IN LESS-DEVELOPED COUNTRIES (LDCs)

QUESTIONS AND ISSUES

[1] Which countries have developed to middle or high levels of income per capita, and which ones have not?

[2] Which policies (especially in international trade) have been conducive to development success and which ones have not?

[3] Is there systematic or general evidence for or against superiority of markets or of central planning?

[4] Is there evidence or hope for “convergence” of LDC incomes per capita to levels currently enjoyed by the rich Northern or Western countries?

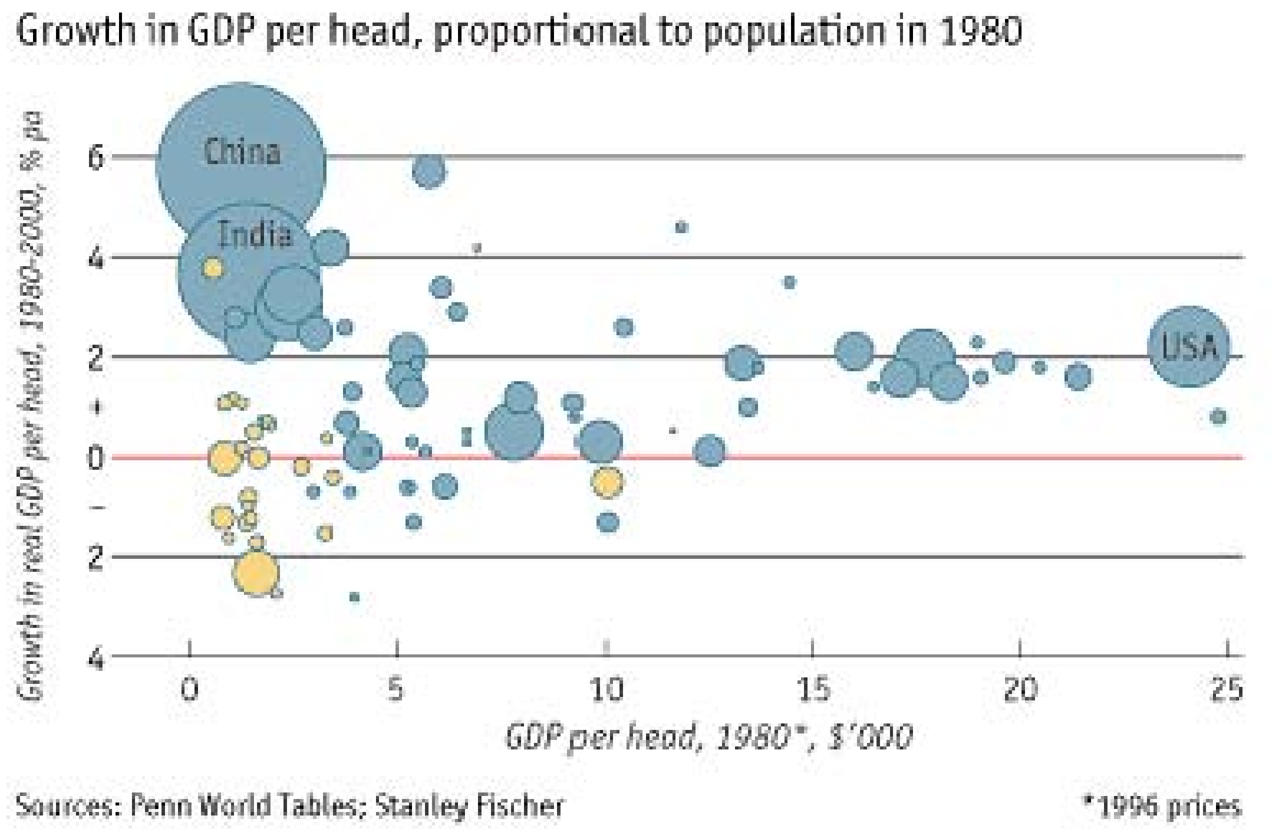
Will attempt a very brief look at these questions in the time available.

BRIEF REVIEW OF ECONOMIC DEVELOPMENT

Many poor countries, especially ones with large populations, have grown fast

Those in sub-Saharan Africa (buff circles) have not

Only limited (if any) “convergence” – in samples of selected subsets of countries



Differences by region:

Area	GDP growth rate %/yr	Income relative to world		Income relative to rich	
		1960	1990	1960	1990
World	1.95	1.00	1.00	0.43	0.40
Sub-Saharan Africa	0.76	0.36	0.25	0.16	0.10
S Asia and China	2.01	0.34	0.29	0.15	0.12
SE Asia	4.22	0.55	1.14	0.24	0.64
Latin America	1.11	0.98	0.63	0.42	0.25
Industrial countries	2.92	2.32	2.50	1.00	1.00

Source: Azariadis in *Poverty Traps,* eds. Bowles, Durlauf and Hoff, Princeon U Press 2006.

Of 50 Least-Developed Countries (LLDCs), 34 in Africa
(14 in Asia-Pacific, mostly small islands)
Only 1.6% of world's FDI flows went to LLDCs
and of this, more than 2/3 was to only 6 oil-producing countries
LLDCs exports were only 0.6% of world merchandise exports
Almost 50% of LLDC population lives on less than $1/day
But a little good news: Since 2001, LLDCs have grown faster than other LDCs
In 2004, their growth rate averaged 6%, fastest in 4 decades
Data from http://www.un.org/ohrlls (UN Office of the High Representative for the Least Developed Countries, Landlocked Developing Countries, and Small Island Developing States!)

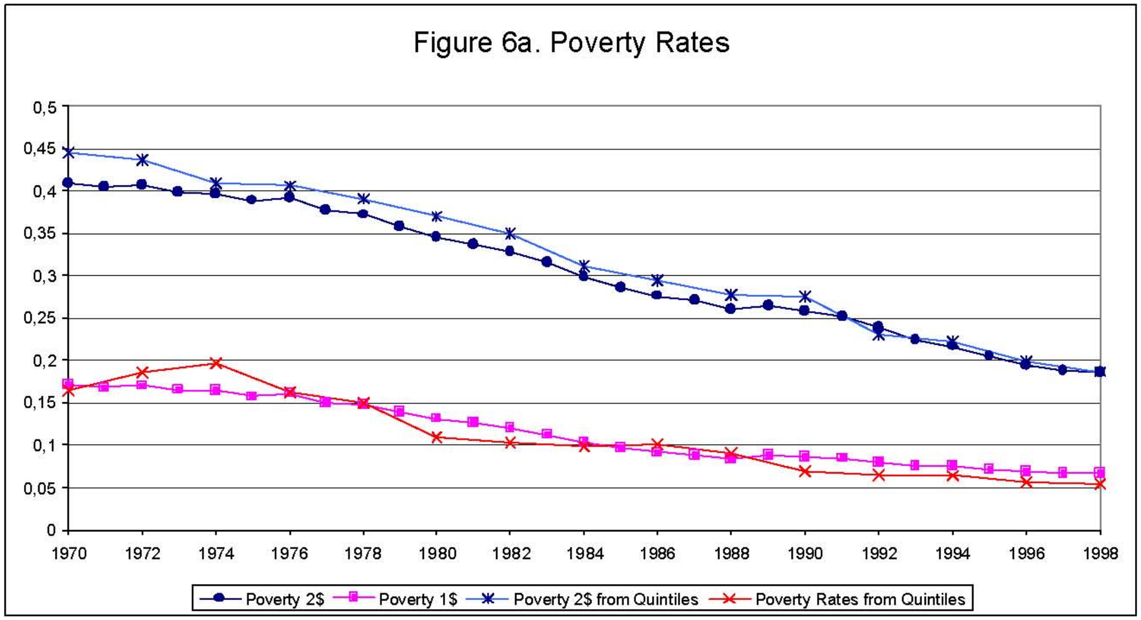
Poverty reduction:

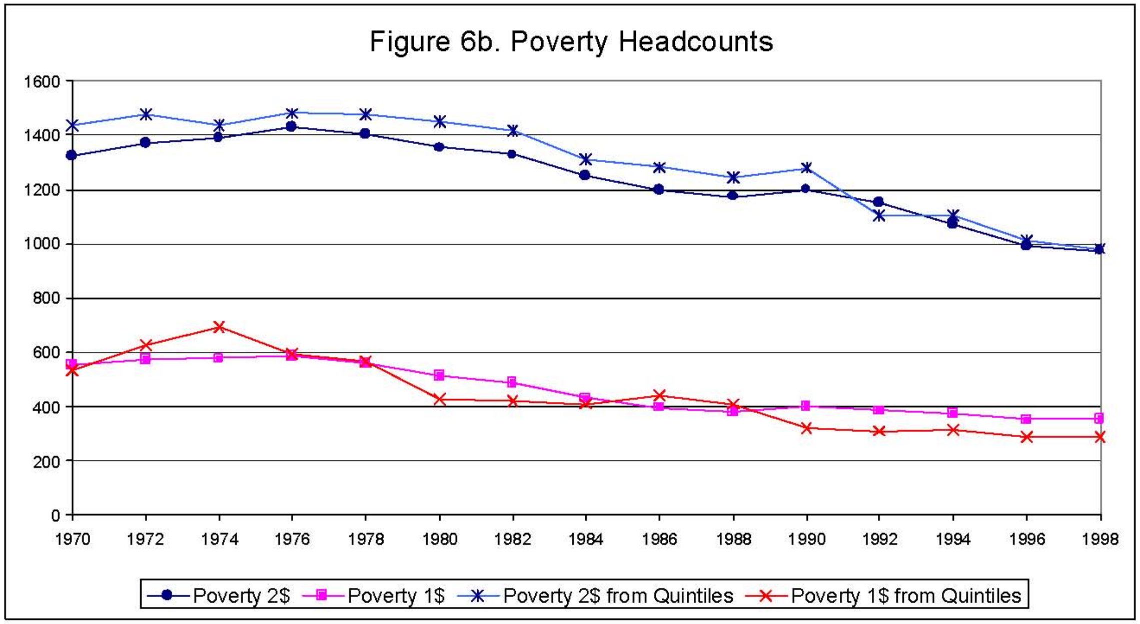
Not only as fraction of world population, but also actual numbers

Many problems with concepts and data – measuring and comparing across very different countries

But broad facts are robust

Our focus on trade and trade policies





SOME FACTS ABOUT POLICIES AND OUTCOMES IN RECENT YEARS

Many LDCs have reduced their trade barriers unilaterally:

actually applied tariff rates often < "bound" max rates agreed at GATT/WTO

But most rates are still higher than those in advanced economies

And the table does not include non-tariff barriers, some of which are still high

Country	Average bound rate	Average applied rate	Trade-weighted av
Brazil	31.4	12.2	8.7
China	10.0	9.9	5.0
Egypt	36.8	16.7	0.0
India	50.2	14.5	8.0
Kenya	95.7	12.7	6.4
Mexico	36.1	12.6	11.1
Tunisia	57.9	26.8	19.8
Bangladesh	169.2	14.6	NA
DR Congo	96.2	12.0	NA
EU	5.4	5.2	3.0
US	3.4	3.5	2.1
Hong Kong	0.0	0.0	0.0

Data for 2007, from http://www.wto.org/english/res_e/booksp_e/tariff_profiles08_e.pdf

IMPORT-SUBSTITUTING INDUSTRIALIZATION (ISI)

Policy followed in 1950s through 70s by India, many countries in Latin America etc.
Idea – develop domestic industry behind protective barriers
usually with substantial state planning, control, or guidance

Arguments for it:

[1] Terms of trade for primary products would decline – income elasticity < 1
More generally, export pessimism, inward focus from depression experience

[2] Suspicion/fear of western domination among former colonies and others

[3] Intellectual Zeitgeist of socialism, planning

[4] Infant-industry argument: LDCs had long-run comparative advantage here,
but needed temporary protection to achieve learning, scale economies

[5] State intervention was needed to overcome capital market failures
and coordination to internalize external economies

[6] Practical political economy – urban industrial workers were powerful

Problems in practice:

[1] Many infants never grew to achieve scale economies and low costs
  Didn't export; instead served home market at inefficiently small scales
  Enjoyed monopoly / oligopoly; domestic consumers paid high prices

[2] Promotion of these import-competing sectors created disincentives
  for other exporting sectors – wages rose, their inputs cost more, ...

[3] Labor and capital moved into these industries
  became specific factors who would lose from policy reform
  constituted powerful political lobbies for continued protection

[4] Regulation and licensing regime led to corruption, misallocation
  Bias toward prestigious, highly capital-intensive industries and projects

In the meantime, E and SE Asia with outward-oriented policies grew fast
  Socialist economies collapsed; western market economies fared better

So ISI gradually reduced or abandoned around 1980
But may come back as disillusion with financial markets revives old fears, ideologies

EMPIRICAL EVALUATION OF LDC TRADE POLICIES

Evidence on trade openness and growth:

Correlation between trade volumes/shares and economic performance:
 but direction of causation unclear; must look at trade policies

Sachs and Warner (1995) Brookings Papers on Economic Activity
 Use binary classification open/closed for period 1970-89
 Find open economies on average had growth rates 2 percentage points higher

Rodriguez and Rodrik (2000) NBER Macroeconomics Annual
 Criticize methodology; show finding not robust into the 1990s

Wacziarg and Welch (2008) World Bank Economic Review 22
 Construct finer measures: liberalization dates that separate policy episodes
 Finding: For the period 1950-98, controlling for other things, liberalization
  raised trade/GDP ratios by 5 percentage points
  raised investment rates by 1.5-2 percentage points
  raised average annual growth rates by 1.5 percentage points

Topic is sure to remain controversial; how should we think about it?

Economic underdevelopment has multiple and interacting causes

Some of them are unalterable by policy.
E.g. geography : Sachs-Warner, Diamond *Guns, Germs and Steel*
S&W claim that being landlocked is bad (But what about Switzerland?)

Some are deeply rooted and slow or difficult to alter:
History: institutions developed hundreds of years ago continue
as obstacles or facilitators of growth in modern context

Other kinds of policies that matter
[1] Macroeconomic stability – low and stable inflation, low gov't debt
[2] Health – better health raises productivity, promotes long-term thinking
[3] Education – important for developing modern economy

If the other institutions and policies are bad, a good trade policy won't help
But bad trade policy can hurt even when the other dimensions are good

Least-Developed Countries' trade policies are often particularly bad
(but data imprecise since barriers are non-tariff, administrative etc.)
Recommended reading: Paul Collier, *The Bottom Billion,* Ch. 10.

Related serious problem:
Advanced countries' high barriers against agricultural exports of LDCs

REAL EXCHANGE RATE (see K-O pp. 401-403)

Exchange rate = price of foreign currency; so home currency stronger when E ↓
Exchange rate of Rupee relative to Dollar = Number of Rupees per Dollar

Real exchange rate (RER) of Rupee E^R

= Nominal exchange rate E^N × US price level P^{US} / Indian price level P^{IND}

In each country, price level is an index combining tradeables and non-tradeables:

Cobb-Douglas case $P = (PN)^a \, (PT)^{1-a}$

Law of one price for tradeables: $E^N \times PT^{US} = PT^{IND}$

RER of Rupee: $E^R = (PN^{US} / PT^{US})^a \; / \; (PN^{IND} / PT^{IND})^a$

Purchasing Power Parity (PPP) theory: eventually resources will shift and law of one price will also apply to non-tradeables, $E^R = 1$
But deviations can persist for long periods, and have important consequences

LDC government may deliberately keep $E^R > 1$ (undervaluation) or $E^R < 1$ (over...)

Real overvaluation of rupee =

price of non-tradeables relative to tradeables higher in India than in US

E Asian countries were generally outward-oriented but not pure free trade:
combined some import protection and export promotion
Prices of both import-competing and export sectors at home > those abroad
Keeping real exchange rate undervalued (keeping E^R high)

Possible rationale for such policy – External economies stronger in tradeable sectors
(RER-undervaluation policy generally not first-best, but may be second-best)
Rodrik 2008, http://ksghome.harvard.edu/~drodrik/RER%20and%20growth.pdf
Result of this policy: trade surplus, accumulation of foreign assets
Counterpart: in the future, consume and run trade deficit; overvalued real exch rate

Opposite policy was used in Africa, Latin America, S Asia for many decades
indirectly: inflation at home leads to overvalued RER, trade deficits
Results suggest that the E Asian model was closer to being correct

Undervalued RER is a *general* policy; then market picks specific sectors
Selective promotion of sectors or industries (industrial policy) has mixed record:
Possible successes: machine tools in Japan, shipbuilding in Korea
But many failures: RAM chips, HDTV in Japan
Success despite industrial policy: MITI discouraged Sony, Honda!