Trade Policy in Developing Countries

"Economically, what is the difference between restricting imports of iron to benefit iron producers and restricting sanitary improvements to benefit undertakers?" Henry George (1886)

Fall 2010

Import Substitution

- Basic idea

$\hookrightarrow$ erect barriers to foreign imports

$\hookrightarrow$ satisfy demand with domestic (less efficiently–produced) substitutes

$\hookrightarrow$ allow domestic producers to become more efficient

$\hookrightarrow$ eventually remove the trade barriers

- Main policy tools:

$\hookrightarrow$ Tariffs

$\hookrightarrow$ Quotas (often combined with tariff beyond quota)

$\hookrightarrow$ Non–tariff barriers

The Impact of Import Barriers (Small Open Economy)

- Implicit assumptions:

$\hookrightarrow$ competitive markets

$\hookrightarrow$ all the parties get equal weight in the welfare analysis

$\hookrightarrow$ world price, P^*, is **independent** of domestic policy

- **Static Welfare Consequences**

$\hookrightarrow$ Domestic consumers' loss $= P^*BDP^t$

$\hookrightarrow$ Domestic producers' loss $= P^*ACP^t$

$\hookrightarrow$ Government revenue gain $= CDEF$

$\hookrightarrow$ Net deadweight loss $= ACE + BDF$

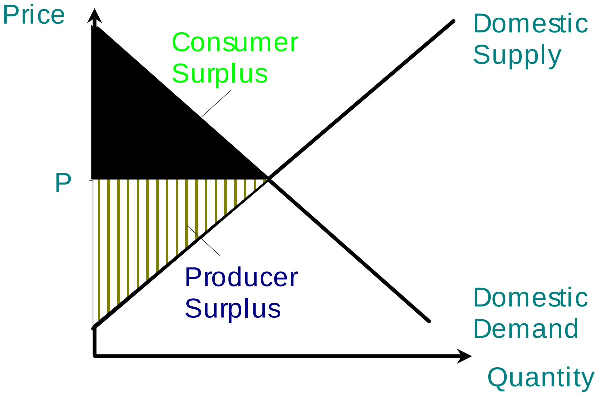

Figure: Measuring Economic Welfare

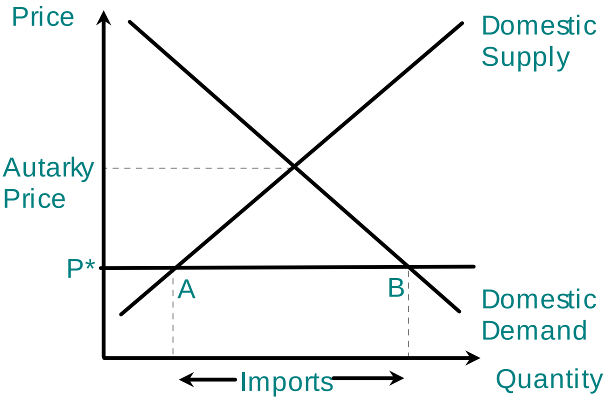

Figure: Import Sector with no Policy Intervention

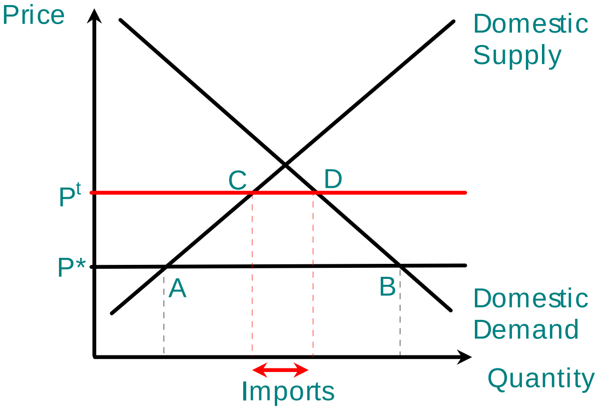

Figure: Impact of Tariff

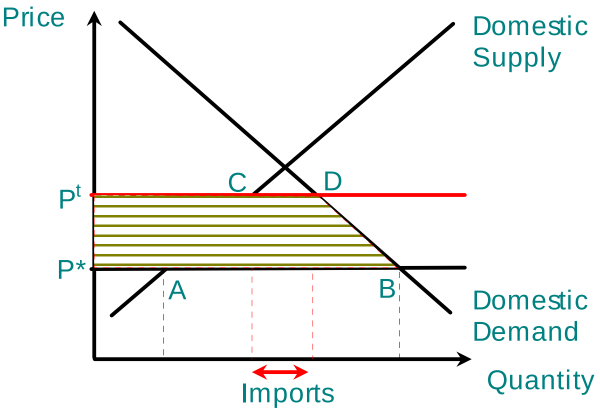

Figure: Loss in Consumer Surplus

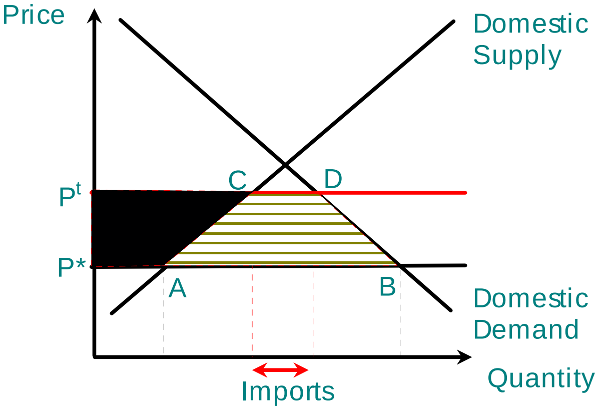

Figure: Gain in Producer Surplus

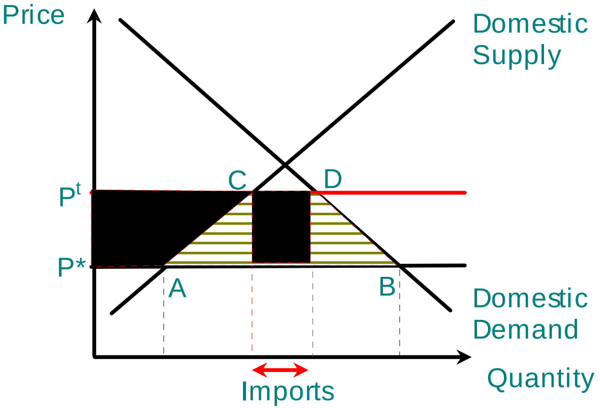

Figure: Deadweight Loss due to Tariff

Potential Dynamic Benefits

- From protecting domestic “infant” industry

- “Learning–by–doing” effects

$\hookrightarrow$ cost reductions that can only be achieved through on–going production

- Spillovers to other industries

$\hookrightarrow$ e.g. through effects on public education system

- Increasing returns to scale

$\hookrightarrow$ DC producers often have a **first–mover advantage**

$\hookrightarrow$ LDC producers must achieve an **efficient scale** to compete

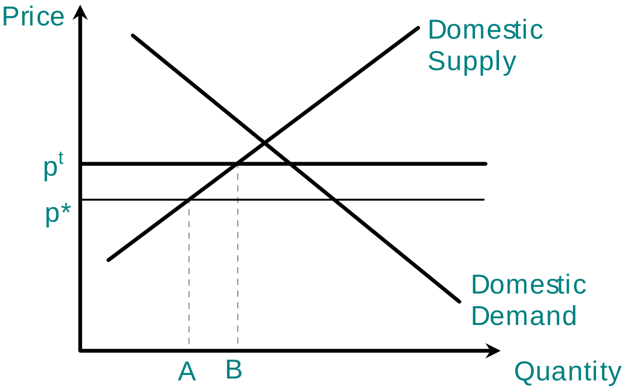

Figure: Short Term Increase in Domestic Production due to Tariff

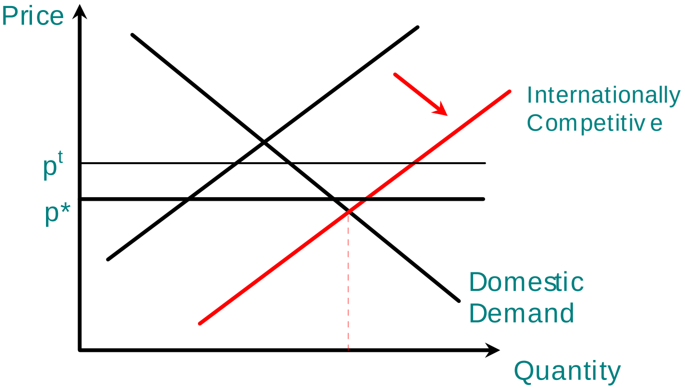

Figure: Long Term – after cost reductions due to learning

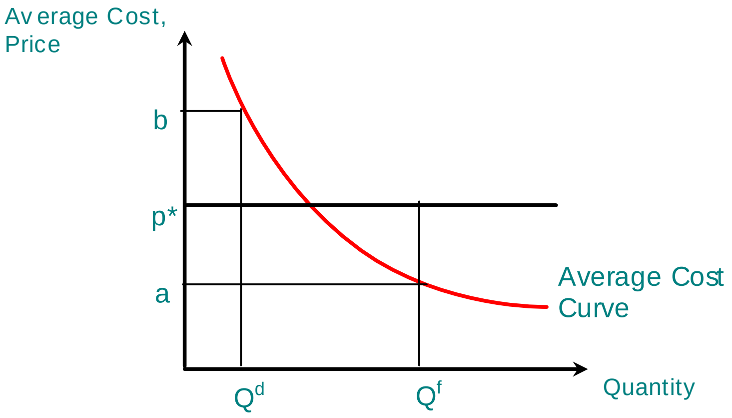

Figure: Increasing Returns and Protection

Problems with the Import Substitution Strategy

- **Protection may induce continued inefficiency**

$\hookrightarrow$ becoming competitive requires costly effort and investment

$\hookrightarrow$ incentives to incur costs depend on ultimate removal of trade barriers

$\hookrightarrow$ BUT once protected, removal of barriers becomes difficult — why ?

$\hookrightarrow$ domestic producers may have little incentive to invest

$\Rightarrow$ ultimately depends on **credibility** of the government's strategy

- **Detrimental impact on primary exports due to exchange rate distortions**

$\hookrightarrow$ widespread IS reduces demand for foreign currency

$\hookrightarrow$ domestic currency becomes **overvalued**

$\hookrightarrow$ foreign prices of domestic exports rise and demand for them contracts

$\hookrightarrow$ tends to hurt primary goods producing sectors (e.g. agriculture),

The Move away from Import Substitution

- Many LDCs ran into severe **debt crises** in the 1980s

- crises were not caused by IS policies, but it made it difficult to react

$\hookrightarrow$ overvalued currencies — difficult to obtain foreign currency via exports

$\hookrightarrow$ mis–allocation of resources due to distorted internal prices

- Strongly influenced **structural adjustment programs** imposed by creditors (e.g. IMF)

$\hookrightarrow$ required the removal of trade barriers as a condition for new lending.

Export Promotion

- Basic idea

$\hookrightarrow$ provide preferential treatment to exporters of manufactured goods

$\hookrightarrow$ once they are established, remove this aid

- Main policy tools used in export promotion are:

$\hookrightarrow$ export subsidies

$\hookrightarrow$ reduced import duties on material inputs

$\hookrightarrow$ preferential credit access and terms of that credit.

The Impact of Export Subsidies

- Effective world price for producers increased to

$$P^s = (1+s)P^*$$

- **Static Welfare Consequences**

$\hookrightarrow$ Domestic producers' gain $= P^* BDP^s$.

$\hookrightarrow$ Domestic consumers' loss $= P^* ACP^s$

$\hookrightarrow$ Cost of government subsidy $= CDFE$

$\hookrightarrow$ Net deadweight loss $= ACE + BDF$.

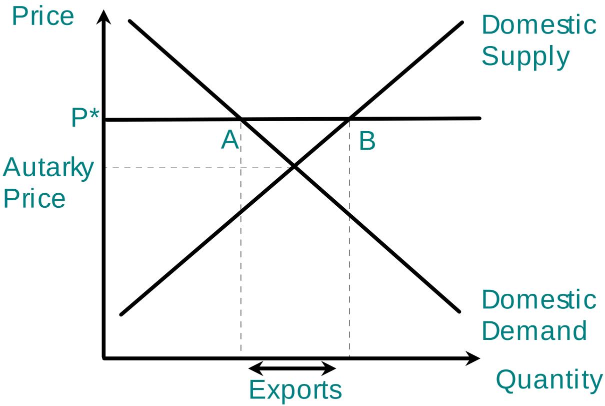

Figure: Export Sector with no Policy Intervention

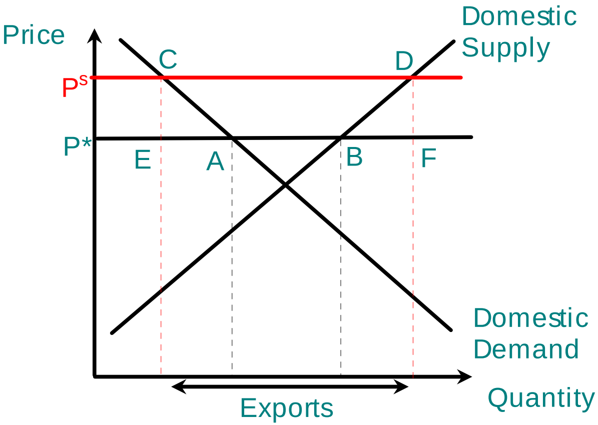

Figure: Impact of Export Subsidy

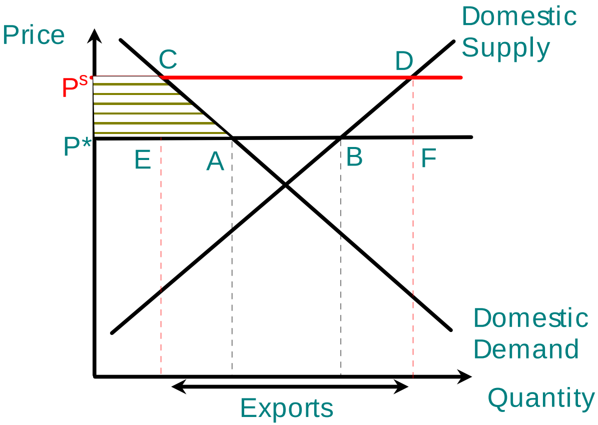

Figure: Loss in Consumer Surplus

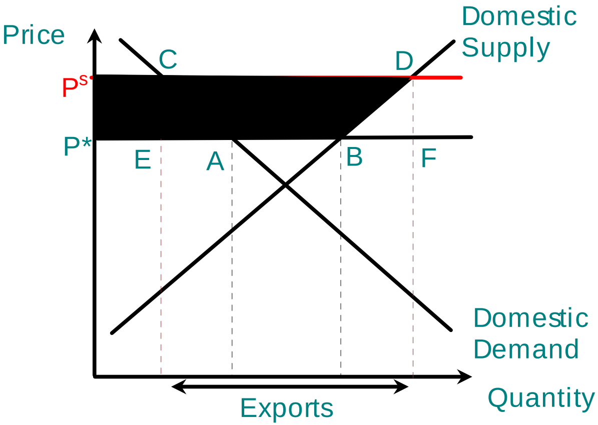

Figure: Gain in Producer Surplus

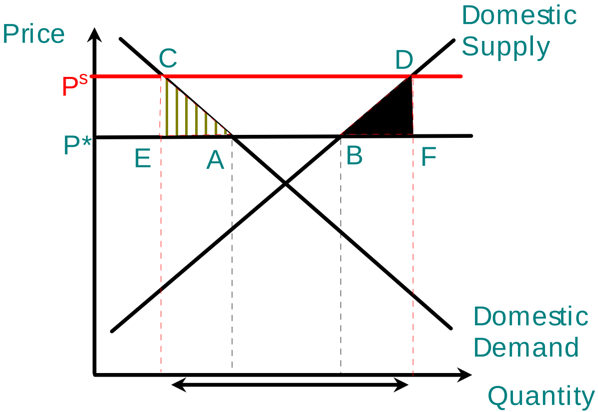

Figure: Deadweight Loss due to Subsidy

- **Dynamic Benefits**

$\hookrightarrow$ Allows producers to overcome credit market failures

$\hookrightarrow$ Learning–by–doing / positive externalities

$\hookrightarrow$ Allows producers to overcome first mover advantage

- **Exchange Rate Effects**

$\hookrightarrow$ increase in demand for domestic currency (from foreign consumers)

$\hookrightarrow$ domestic currency becomes overvalued

$\hookrightarrow$ real export prices rise

$\hookrightarrow$ hurts other exporters (primary and manufacturing)