Chapter 10
Trade Policy in Developing Countries

■ Chapter Organization

■ Key Themes

The final two chapters on international trade, Chapters 10 and 11, discuss trade policy considerations in the context of specific issues. Chapter 10 focuses on the use of trade policy in developing countries and Chapter 11 focuses on new controversies in trade policy.

While there is great diversity among the developing countries, they share some common policy concerns. These include the development of domestic manufacturing industries, the uneven degree of development within the country, and the desire to promote changes in the international economic system. This chapter discusses both the successful and unsuccessful trade policy strategies which have been applied by developing countries in attempts to address these concerns.

Many developing countries present the creation of a significant manufacturing sector as a key strategic step toward economic development. One commonly voiced argument for protecting manufacturing industries is the *infant industry argument*, which states that developing countries have a potential comparative advantage in manufacturing and can realize that potential after an initial period of protection. This argument assumes *market failure* in the form of imperfect capital markets or the existence of externalities in production: such a market failure makes the social return to production higher than the private return. In this case, a firm will not be able to recapture rents or profits that are in line with the contribution to welfare made by the product or industry establishment of the firm. Without some government support, the argument goes, the amount of investment which will occur in this industry will be less than socially optimal levels.

Given these arguments, many nations have attempted to nurture their manufacturing sectors. The industries supported can either substitute for imported goods (*import-substitution strategy*) or can produce for export (*export-promotion strategy*). In the 1950s and 1960s the import-substitution strategy was quite popular and led to a dramatic reduction in imports in some countries. The overall result, though, was not a success. The infant industry argument did not always hold, as protection could let young industries survive, but could not make them efficient. By the late 1980s, most countries had shifted away from this strategy, as exemplified by the chapter's case study of Mexico's change from import substitution to a more open strategy.

Since 1985, many developing countries have abandoned import substitution and pursued (sometimes aggressively) trade liberalization. The chapter notes two sides of the experience. On the one hand, trade has gone up considerably and changed in character. Developing countries export far more of their GDP than prior to liberalization and more of it is in manufacturing as opposed to agricultural or mining sectors. At the same time, the growth experience of these countries has not been universally good and it is difficult to tell if the success stories are due to trade or due to reforms that came at the same time as liberalization.

The East Asian "miracle" of the high-performing Asian economies (HPAEs) provides a striking and controversial example of export-oriented industrialization. While these countries encountered difficulties in the late 1990s, this chapter focuses on their spectacular growth from the 1960s to 1990s. It is acknowledged that the growth is extremely impressive; the controversy is over the source of the success by these countries. Some observers argue that although these countries do not practice free trade, they have lower rates of protection (and more outward orientation) than other developing countries. Other observers argue that the interventionist industrial policies pursued by the HPAEs have been the reason for success, and outward orientation is just a by-product of active rather than passive government involvement in industry. Still others argue that high rates of domestic savings and rapid improvements in education are behind the stunning growth performance.

The broad range of country experiences with growth and policy formation will continue to pose important challenges to economists: the issue of strategy for attainment of growth and international influence remains a key objective of many developing and emerging economies.

■ Key Terms

Define the following key terms:

1. Imperfect Capital Markets ____

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2. Import-Substituting Industrialization ______________________________________

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3. High Performance Asian Economies (HPAEs) ____
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4. Appropriability ____
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■ Review Questions

1. a. Discuss the shortcomings of using traditional trade theory as a guide to developing country development strategy.

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b. How would your arguments be countered by the proponents of traditional trade theory?

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2. a. Discuss why international trade may not be the "engine of growth" sought by many of today's developing countries.

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b. Discuss some of the methods used by developing countries as they attempt to overcome their international trade difficulties.

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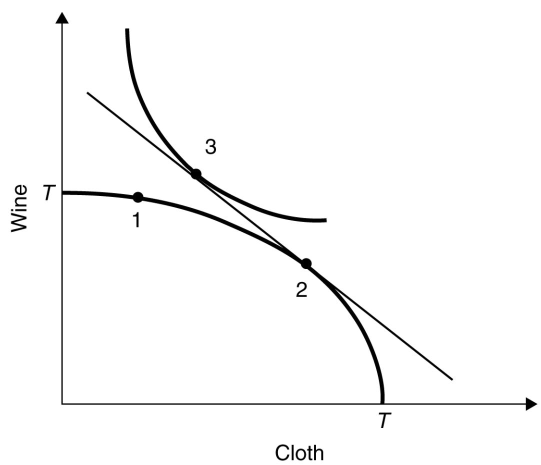
3. Assume that the developing country has a production and consumption mix as depicted in the figure below. Before trade and growth, the developing country production possibilities frontier is represented by TT, production and consumption both occur at point 1. Once trade begins, the developing country exchanges its goods (wine and cloth) at the world terms of trade, T_w. Production shifts toward cloth, and consumption of both wine and cloth rise to point 3. This represents attainment of a higher indifference level so trade has made this developing country better off.



Show how a developing country can be made worse off with growth while it remains open to trade. Discuss your result.

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4. Often, countries that are leery of the impact of trade on their societies set up special export zones that include lower taxes, special investment provisions, and other incentives for both foreign and local investment. What are some of the dangers of this approach?

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5. Which trade strategies might benefit the countries described below? Choose from: import-oriented industrialization, export-oriented industrialization, and a focus on comparative advantage which may not include manufacturing. Justify your answers and explain some of the failings of these policies that the countries must try to avoid.

   a. A large country with many natural resources used in the creation of a product which is currently made by a foreign monopolist.

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   b. A small country with excellent ports and an educated work force.

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   c. A beautiful country with an indigenous culture which values art over commerce.

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6. Which of the following countries may have been able to follow the export-oriented polices that some of the HPAE nations used? Explain why or why not.

   a. The Czech Republic. ________________________________

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   b. India. ____

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   c. Malawi. _______________________________________

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   d. Mexico. _______________________________________

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■ Answers to Odd-Numbered Textbook Problems

1. The countries that seem to most benefit from international trade include many of the countries of the Pacific Rim, South Korea, Taiwan, Singapore, Hong Kong, Malaysia, Indonesia, and others. Though the experience of each country is somewhat different, most of these countries employed some kind of infant industry protection during the beginning phases of their development, but then withdrew protection relatively quickly after industries became competitive on world markets. Concerning whether their experiences lend support to the infant industry argument or arguments against is still a matter of controversy. However, it appears that it would have been difficult for these countries to engage in export-led growth without some kind of initial government intervention.

3. a. The initial high costs of production would justify infant industry protection if the costs to the society during the period of protection were less than the future stream of benefits from a mature, low-cost industry.

   b. An individual firm does not have an incentive to bear development costs itself for an entire industry when these benefits will accrue to other firms. There is a stronger case for infant industry protection in this instance because of the existence of market failure in the form of the appropriability of technology.

5. In some countries the infant industry argument simply did not appear to work well. Such protection will not create a competitive manufacturing sector if there are basic reasons why a country does not have a competitive advantage in a particular area. This was particularly the case in manufacturing where many low-income countries lack skilled labor, entrepreneurs, and the level of managerial acumen necessary to be competitive in world markets. The argument is that trade policy alone cannot rectify these problems. Often manufacturing was also created on such a small scale, that it made the industries noncompetitive, where economies of scale are critical to being a low-cost producer. Moreover, protectionist policies in less-developed countries have had a negative impact on incentives, which has led to “rent-seeking” or corruption.