TRADE POLICY

EE 462 Development Macroeconomics

Semester 1/2014

Topics

- Import Substitution
  - Protective Tariffs
  - Import Quotas
  - Production Subsidies
  - Exchange-Rate Management
- Export Orientation
- Trade Strategy and Industrial Policy
- Trade, Growth, and Poverty Reduction
- Key Issues on the Global Trade Agenda

Trade Strategies

- Two different trade strategies:

1. Import substitution (IS) is the production of goods and services that replace (or substitute for) imports.
   - Strategies: tariffs, quotas, subsidies, exchange rate management
   - Core idea - *Infant industries* need protection to survive.

2. Export orientation is a strategy designed to make producers internationally competitive by relying on market forces, strengthening key institutions, and in some cases using subsidies, managed exchange rates, and other instruments.
   - Core idea - Domestic producers must become internationally competitive.

Import Substitution

- Also referred to as *Import Substitution Industrialization*
  - Firms are unlikely to compete in manufactures immediately, so they need government assistance to get started.
  - Ideally, industries for *simple products with large domestic markets* (e.g. processed foods, beverage, textiles, clothing) should be the first targets.
- This argument is particularly valid for 'infant industry'.
- Government's tools:
  - ➢ Tariffs – taxes imposed on imports at the borders
  - ➢ Quotas – quantitative limits on specified categories of imports
  - ➢ Subsidies – production subsidies provided to local producer
  - ➢ Exchange rate policy – fixed exchange regime

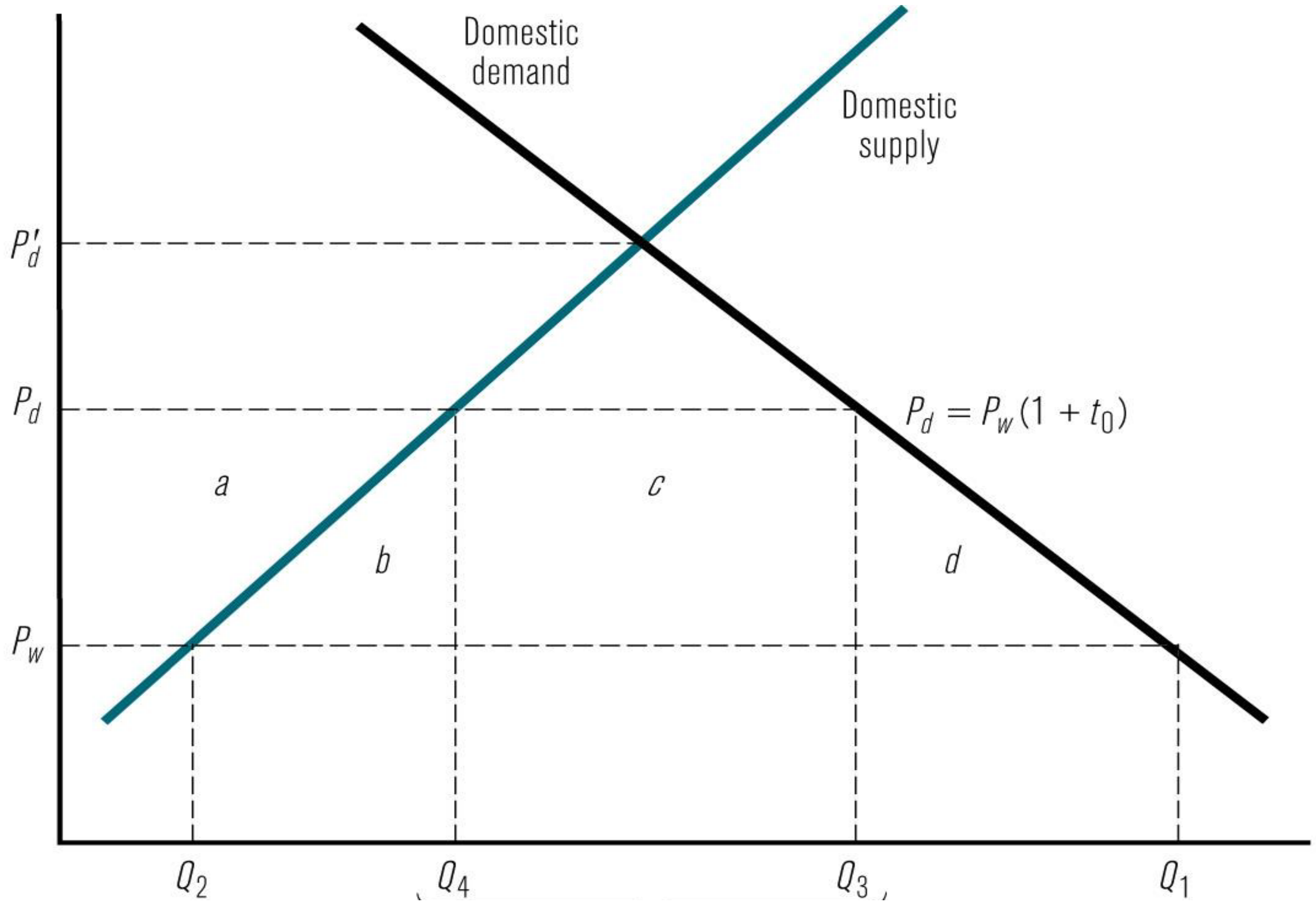
Protective Tariffs

- Protective tariff is aimed at *raising the domestic price* of the imported good *above* the world price.
- For importing country, the world price is the cost at the port of entry, called the *c.i.f. price* (including costs, insurance, and freight) or *border price*.
- Suppose P_w is the world price with free trade, and

  an ad varolem tariff, t_0, is imposed on the good.
  - Domestic price becomes: $P_d = P_w(1+t_0)$
  - The nominal rate of protection is:

$$t_0 = (P_d - P_w)/P_w$$

Nominal Tariff Protection



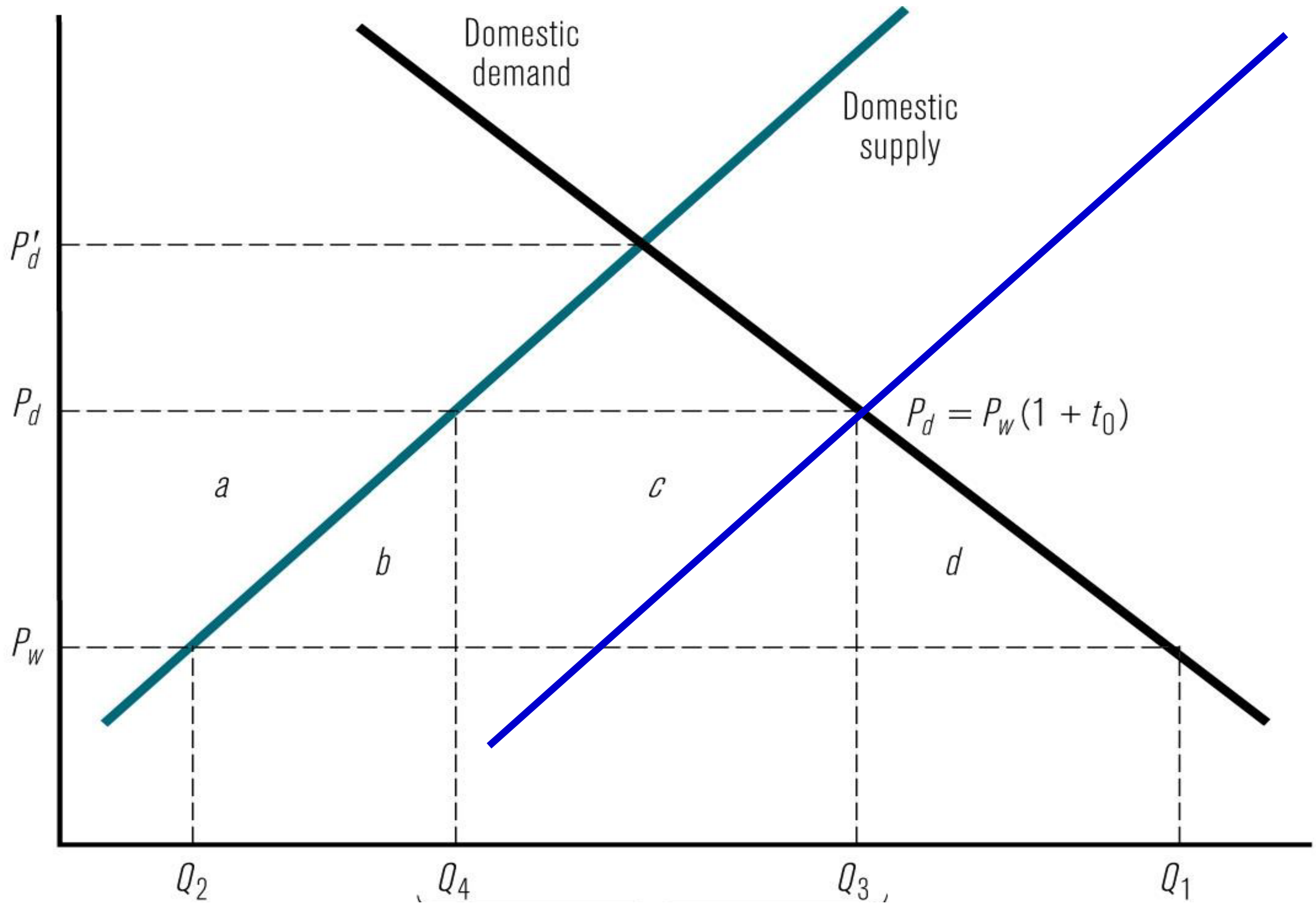
Impact of Tariff Protection (from diagram)

- Gain in producer surplus =
- Loss of consumer surplus =
- Tariff revenue =
- Resource cost (i.e. cost of using resources inefficiently) =
- Deadweight loss =

Import Quotas

- These involve the quantitative restrictions on imports by import licensing – government determines in advance *the quantity of imports it wants to allow*.
- The loss in consumer surplus, deadweight loss, and gain in producer surplus are the same as in the case of equivalent tariff.
- 2 distinctions from tariffs:
  1. Government does not necessarily collect revenue, so the area c becomes license holder's bonus a.k.a. "quota rent"
     - Room for rent seeking activities including bribes.
  2. When the world price decreases, imports cannot rise unless the quota increased. → .

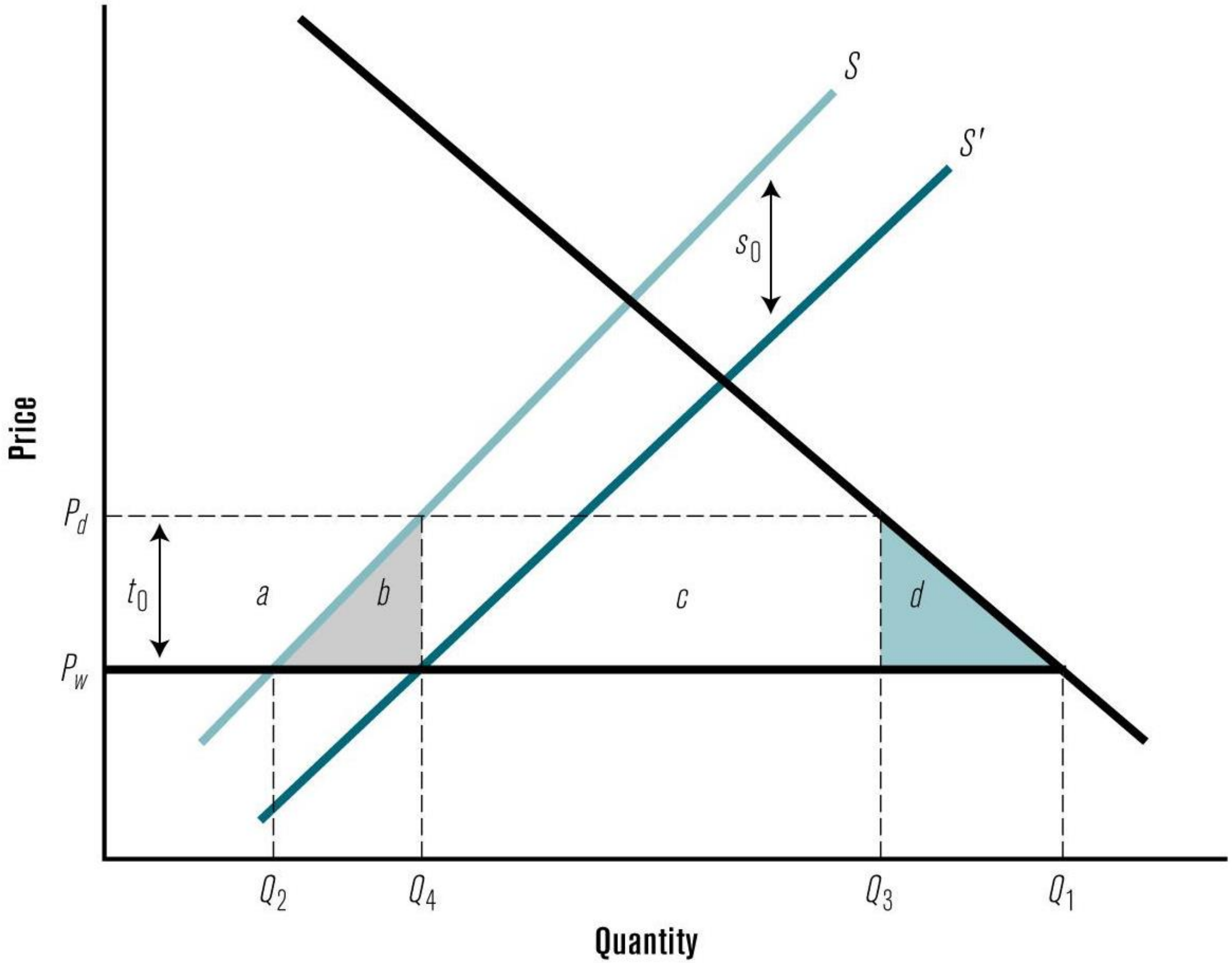
Import Quotas



Production Subsidies

- Government provides direct subsidies as a means of protecting domestic manufacturers (just like how high-income economies subsidize their agricultural production).
- Producers are equally happy with a subsidy or equivalent tariff.
- But consumers are better off because *there is no loss in consumer surplus*.
  - Lower deadweight loss
- Economists generally prefer subsidies over tariffs, and tariffs over quotas.
- But government officials tend to prefer quotas or tariffs over subsidies. Why?

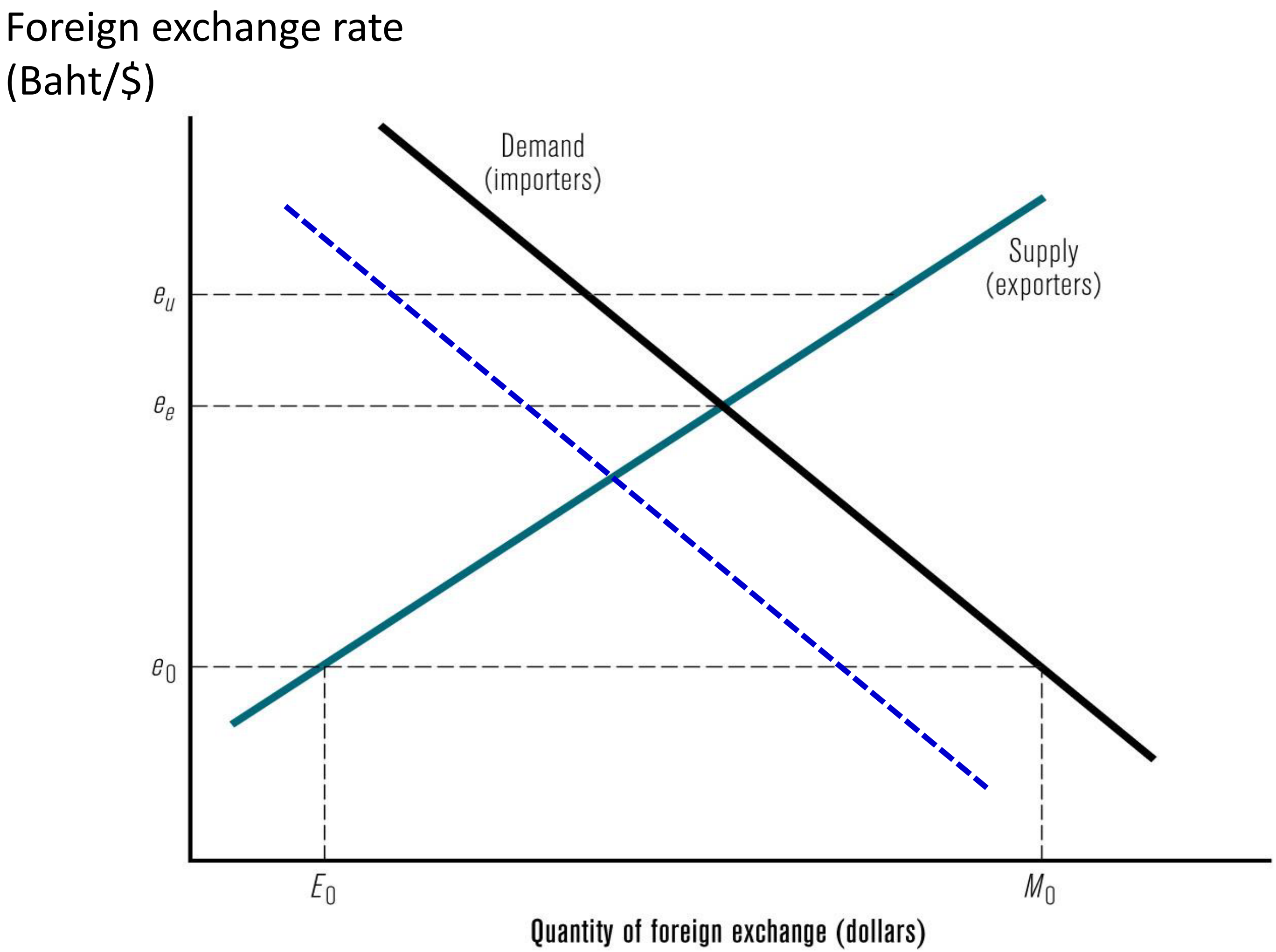
Impacts of Subsidies on Firms Competing with Imports



Exchange Rate Management (1)

- Exchange-rate policy has a uniform effect on the prices of all tradable goods, but alters the price between tradables and nontradables.
- IS strategies tend to cause the domestic currency to appreciate.
  - Tariffs and quotas reduce the demand for foreign exchange at every exchange rate.
  - The new exchange rate acts likes a tax on exports.
- Many IS strategies were designed to foster industrial development, but at the same time often hurt traditional exports (e.g. agricultural goods).

IS Strategy and Exchange Rates

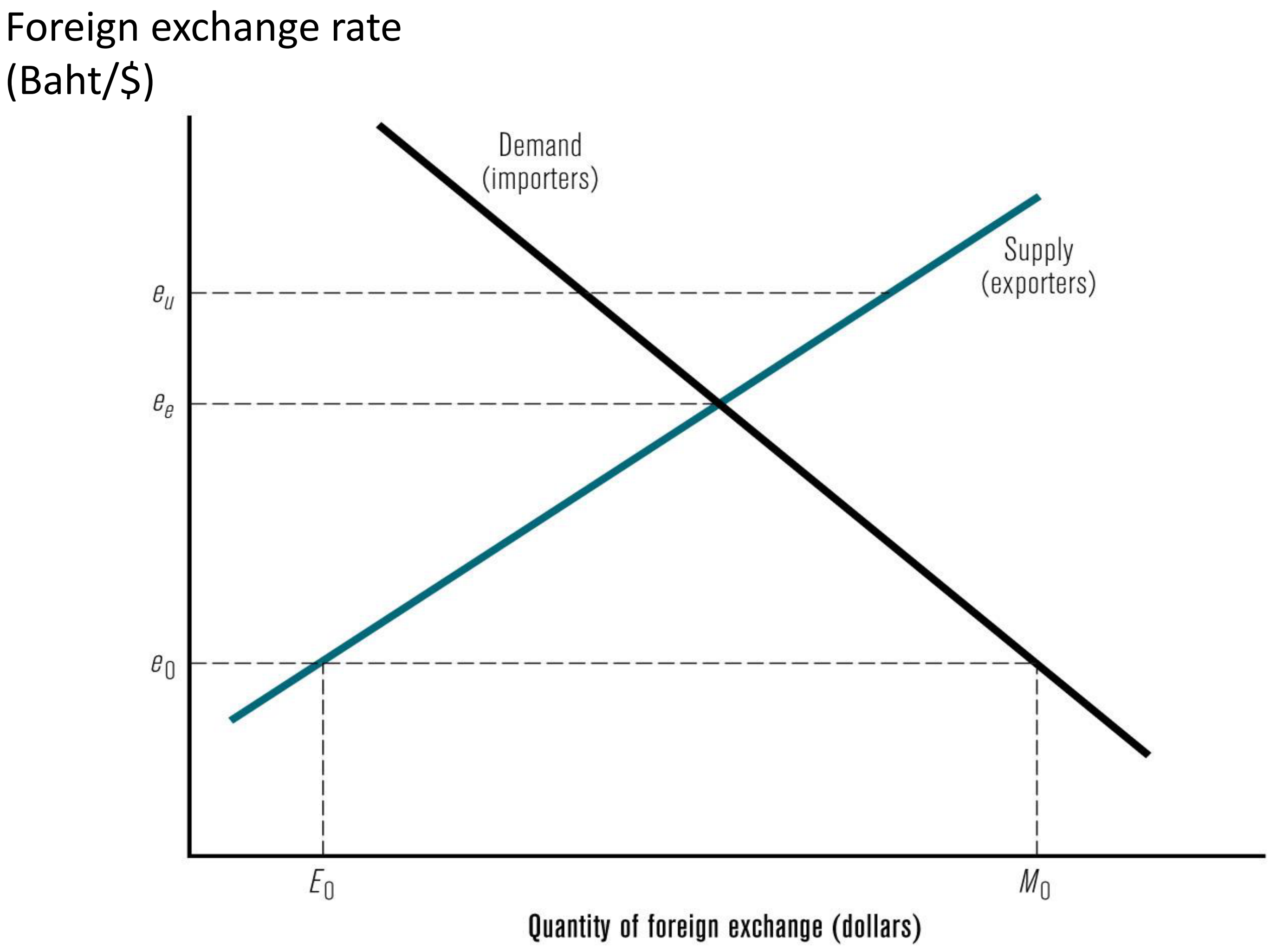


Exchange Rate Management (2)

1. Overvalued Exchange rate: fix official exchange rate *below* equilibrium rate
   - Exports less profitable and imports less expensive
   - Can harm domestic producers of goods that compete with imports, but consumers are happy.
   - Often used as IS strategy to make capital goods cheaper
   - Can also give rise to black markets for foreign exchange

2. Undervalued Exchange rate: fix official exchange rate *above* equilibrium rate
   - Exports more profitable and imports more expensive
   - Used to stimulate exports and provide protection to firms competing with imports
   - Example is China's exchange rate policy (read box 9.2)

Overvalued and Undervalued Exchange Rates



Outcomes of Import Substitution

- Countries that introduce import substitution may experience initial spurt in growth, but eventually leads to weak technology, low efficiency, growing trade deficits, and slower growth. Why?
  - IS protected too many industries and remained in place for too long
  - IS induced excessively capital-intensive investments
  - Trade protection resulted in lower productivity → unable to compete internationally
- IS also creates incentives for rent seeking, corruption, lobbying and reduced competitiveness.

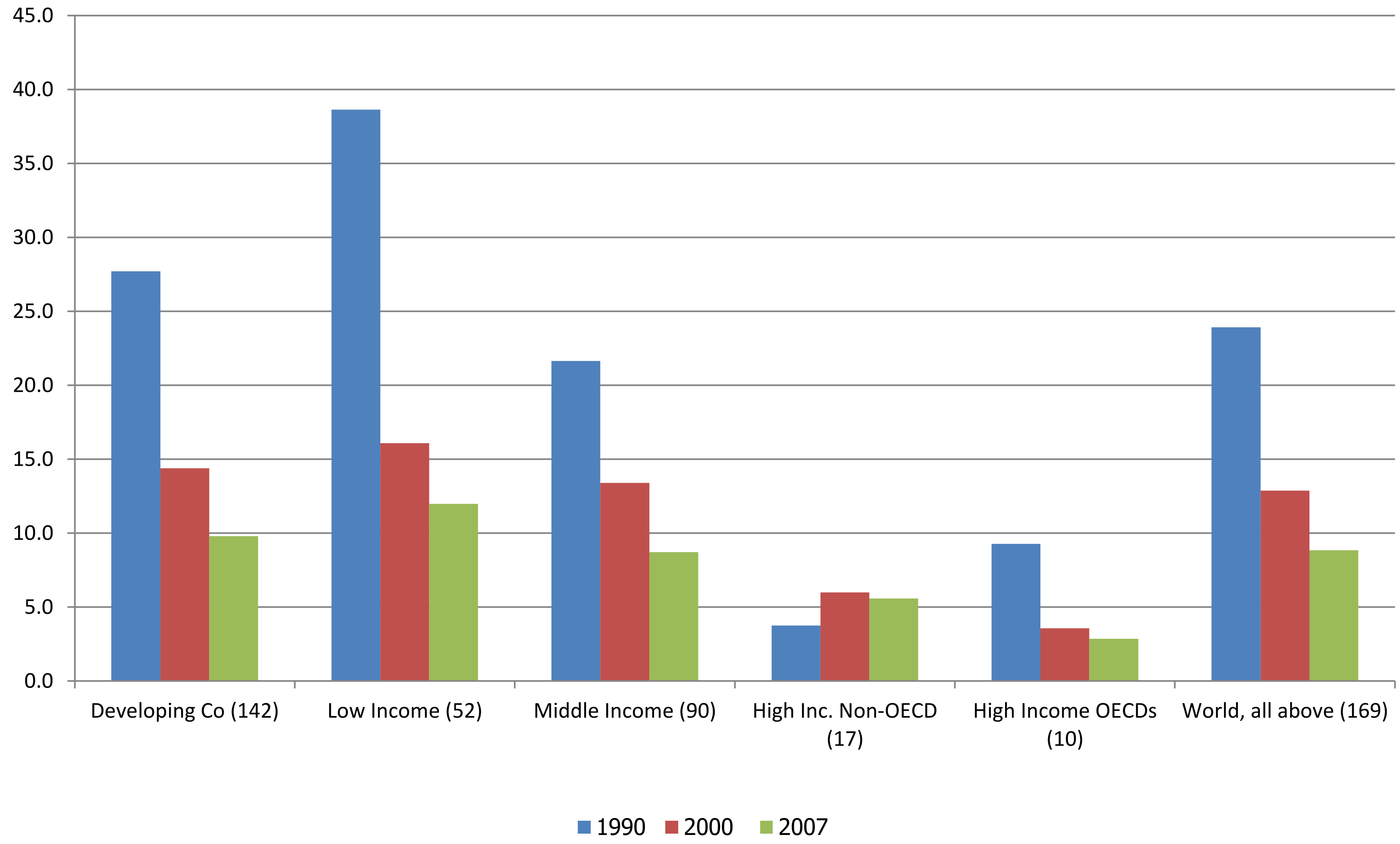
Export Orientation

- A.k.a. *outward orientation, openness, export promotion*, and *export orientation*.
- Core idea is to introduce policies that encourage firms to produce products that are competitive on world markets.
  - Encourage investment, productivity gain, learning, and new technology to support growth
  - Usually start with simple labor-intensive products, and move to more advanced manufactures
- The export-led strategy of East Asia's "tigers" has been outstandingly successful.
- There are some unsuccessful cases, e.g. Zambia.

Removing the Bias Against Exports

- Policies that favor imports (e.g. tariffs and overvalued exchange rates) are implicitly biased against exports.
- Policies to remove these biases:
  - Remove tariffs and quotas and other forms of protection, especially on capital and intermediate goods
  - Allow currency to float with market-determined rate & maintain macroeconomic stability
  - Reduce unnecessary regulatory burdens and business costs
  - Keep markets flexible for labor and credit with market determined wages and interest rates

Trends in Average Applied Tariff Rates (Unweighted in %)



Favoring Exports

- Same idea as "openness" of the economy
- Korea and China were much more interventionists.
- Korea uses an *outward-looking approach* – intervened to induce, and sometimes force, firms to meet ambitious export targets
  - A Korean firm could not take advantage of protection or other preferential treatment unless it met stringent export targets.
- China has been using exchange rate policy to favor exporters by undervaluing its currency.
  - Rapid export growth and large trade surplus
    - Large accumulation of foreign exchange reserves

Building Export Platform

- Export platform institutions are established to enable exporters to import and sell at close to world market prices.
- Forms of export platforms: *export processing zones (EPZs), bonded warehouses, duty exemption programs*, and *science and technology parks*.
- The idea is to provide an *enclave* for new or potential export industries, so they can be *insulated from price distortions of the protected domestic markets* and more able to compete on world market.
- Advantage – allow one part of the economy to be competitive, while steps are taken over time to introduce economy-wide changes.

The Benefits of Outward Orientation

- The Asian tigers (Hong Kong, Korea, Singapore, and Taiwan) has proven success of export-oriented policies.
- Their rapid growth in trade was accompanied by accelerating economic growth, reductions in poverty, and other advancements.
- These countries shared four key characteristics:
    1. a disciplined focus on policies to promote rapid economic development
    2. prudent management of macroeconomic policy and exchange-rate policy
    3. flexible factor markets
    4. insulation of exports from domestic price distortions.