Trade Policy in Developing Countries

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Abstract

Each country has its own distinctive history and issues, but in discussing economic policy one obvious difference between countries is in their income levels. In most developing countries the basic strategy for industrialization to promote the domestic market, using trade restrictions such as, tariffs and quotas. Most trade restrictions are inappropriate for developing countries. But, in sometimes those restrictions are disadvantage for developing countries. It isexpected to discuss how trade policies effect for the developing countries through this article.

Key words: Trade Policy, Developing Countries

Introduction

There is a great diversity among the developing countries in terms of their income per capita. Why are some countries so much poorer than others? Why have some countries that were poor a generation ago succeeded in making dramatic progress, while others have not? These are deeply disputed questions. What can be said, however, is that changing views about economic development have had a major role in determining trade policy.

Table 1.1 Gross Domestic Product Per Capita 1999 (dollars)

Country	GDP
United States	33,900
Japan	23,400
Germany	22,700
Singapore	27,800
South Korea	13,300

Mexico	8,500
China	3,800
India	1,800

Source: CIA, 2000

As table 1.1 suggests nations differ greatly in their per capita incomes. At the end of the spectrum are the developed or advanced nations , a club whose members include Western Europe, several countries largely settled by Europeans (including the United States), and Japan; these countries have per capita incomes that in many cases exceed $20,000 per year (Krugman, 2008). Most of the world's population, however, live in nations that are substantially poorer. The income range among these developing countries is itself very wide. For virtually all developing countries the attempt to close the income gap with more advanced nations has been a central concern of economic policy.

For about 30 years after World War II trade policies in many developing countries were strongly influenced by the belief that the key to economic development was creation of a strong manufacturing sector, and that the best way to create that manufacturing sector was by protecting domestic manufactures from international competition.

While the main concern of economic policy in developing countries has been the low overall level of income, it is also the case that many developing countries are characterized by large differences in income between regions and sectors. Finally while economists have debated the reasons for persistent large income gaps between nations, since the mid 1960s a widening group of East Asian nations has astonished the world by achieving spectacular rates of economic growth.

Import Substituting Industrialization

From World War II until the 1970s many developing countries attempted to accelerate their development by limiting imports of manufactured goods to foster a manufacturing sector serving the domestic market. The most important economic argument for protecting manufacturing industries is the infant industry argument.

The Infant Industry Argument

According to infant industry argument, developing countries have a potential comparative advantage in manufacturing and they can realize that potential through an initial period of protection. It implies that it is a good idea to use tariffs or import quotas as temporary measures to get industrialization started.

Example: - The U.S and Germany had high tariff rates on manufacturing in the 19th century while Japan had extensive import controls until the 1970s.

Problems with the Infant Industry Argument

- It is not always good to try to move today into the industries that will have a comparative advantage in the future.

  Example: - In the 1980s South Korea became an exporter of automobiles, whereas in the 1960s its capital and skilled labor were still very scarce.

- Protecting manufacturing does no good unless the protection itself helps make industry competitive.

Example: - Pakistan and India have protected their heavy manufacturing sectors for decades and have recently began to develop significant exports of light manufactures like textiles.

Market Failure Justifications for Infant Industry Protection

Two market failures are identified as reasons why infant industry protection may be a good idea. Such as,

1. Imperfect Capital Markets Justification

If a developing country doesn't have a set of financial institutions that would allow savings from traditional sectors (such as agriculture) to be used to finance investment in new sectors (such as manufacturing), then growth of new industries will be restricted.

2. Appropriability Argument

Firms in new industry generate social benefits for which they aren't compensated (e.g. start-up costs of adapting technology).

Promoting Manufacturing Through Protection

Although there are doubts about the infant industry argument, many developing countries have seen this argument as a compelling reason to provide special support for the development of manufacturing industries, the strategy of encouraging domestic industry by limiting imports of manufactured goods is known as the strategy of import-substituting industrialization. By protecting import-substituting industries, countries draw resources away from actual or potential export sectors. So a country's choice to seek to substitute for imports is also a choice to discourage export growth.

The reasons why import substitution rather than export growth has usually been chosen as an industrialization strategy are a mixture of economics and politics. It is worth pointing out that some advocates of a policy of import substitution believed that the world economy was rigged against new entrants, that the advantages of established industrial nations were simply too great to be overcome by newly industrializing economies.

The 1950s and 1960s saw the high tide of imports-substituting industrialization. Developing countries typically began by protecting final stages of industry, such as food processing and automobile assembly. In the larger developing countries, domestic products almost completely replaced imported consumer goods (although the manufacturing was often carried out by foreign multinational firms.) In most developing economies, the import substitution drive stopped short of its logical limit: Sophisticated manufactured goods such as computers, precision machine tools, and so on continued to be imported. Nonetheless, the larger countries pursuing import- substituting industrialization reduced their imports to remarkably low levels.

Latin American economies now generate almost as large a share of their output from manufacturing as advanced nations. (India generates less, but only because it's poorer population continues to spend a high proportion of its income on food.) For these countries, however, the encouragement of manufacturing was not a goal in itself; it was a means to the end goal of economic development.

Table 1.2 Exports as a Percentage of National Income, 1999

Brazil	8
India	11
United States	12
Japan	11
Germany	27
South Korea	42
Hong Kong	132
Singapore	202

Source: World Bank, 2001.

Results of Favoring Manufacturing: Problems of Import-substituting industrialization

In some cases, the development of a domestic manufacturing base seems to have led to stagnation of per capita income instead of economic takeoff. This is true of India. It is also true of Argentina

Poor countries lack skilled labor, entrepreneurs and managerial competence and have problems of social organization that make it difficult to maintain reliable supplies of everything of spare parts to electricity. They can be solved by trade policy. The infant industry argument is that, given the temporary shelter of tariffs or quotas.

The problem is that many countries have used excessively complex methods to promote their infant industries. That is they have used elaborate and often overlapping import quotas, exchange controls, and domestic content rules instead of simple tariffs.

The domestic markets of even the largest developing countries are only a small typically leads several firms to enter a market that does not really even have room enough for one, and production is carried out at highly inefficient scale. The answer for small countries to the problem of scale is, specialize in the production and export of a limited range of products and to import other goods. Import-substituting industrialization eliminates this option by focusing industrial production on the domestic market.

Those who criticize import-substituting industrialization also argue that it has aggravated other problems, such as income inequality and unemployment.

Problems of the Dual Economy

Often a relatively modern, capital-intensive, high-wage industrial sector exists in the same country as a very poor traditional agricultural sector. The division of a single economy into two sectors that appear to be at very different levels of development is referred to as **economic dualism,** and an economy that looks like this is referred to as a **dual economy**.

Dualism is associated with trade policy for two reasons:

- Dualism is probably a sign of markets working poorly (market failure case for deviating from free trade).
- The creation of the dual economy (an economy that is characterized by economic dualism) has been helped by import-substitution policies

The Symptoms of Dualism:

- Development often proceeds unevenly and results in a dual economy consisting of a modern sector and a traditional sector.

The modern sector typically differs from the traditional sector in that it has:

- Higher value of output per worker
- Higher wages
- Lower returns to capital
- Higher capital intensity
- Persistent unemployment (especially in urban areas)

Trade Policy as a Cause of Economic Dualism

Trade policy has been accused both of widening the wage differential between manufacturing and agriculture and also fostering excessive capital intensity.The reasons for huge wage differentials between agriculture and industry are not well understood.Some economists believe these differentials are natural market response.Other economists argue,however,that the wage differentials also reflect the monopoly power of unions whose industries are sheltered by import quotas from foreign competition.With free trade,they argue,industrial wages would be lower and agricultural wages higher.If so,dualism and unemployment may be worsend by import restrictions,especially those undertaken in the name of import substitution.

Export-Oriented Industrialization: the East Asian Miracle

From the mid-1960s onward, exports of manufactured goods, primarily to advanced nations, was another possible path to industrialization for the developing countries. The High performance Asian economies (HPAEs) means, a group of countries that achieved spectacular economic growth.

In some cases, they achieved economic growth of more than 10% per year (Krugman, 2008).

What is the trade Policy in the HPAEs?

That means some economists argue that the "East Asian miracle" is the payoff to the relatively open trade regime. The data in table below suggests that the HPAEs have been less protectionist than other, less developing countries, but they have by no means followed a policy of complete free trade.

Low rates of protection in the HPAEs helped them to grow, but they are only a partial explanation of the "miracle."

Table 1.3 Average Rates of Protection, 1985 (percent)

High performance Asian Economies	24
Other Asia	42
South America	46
Sub_Saharan Africa	34

Source; World Bank, 1993

Industrial Policy in the HPAEs

Several of the highly successful economies have pursued industrial policies (from tariffs to government support for research and development) that favor particular industries over others.

Most economists have been skeptical about the importance of such policies because: HPAEs have followed a wide variety of policies, but achieved similarly high growth rates. The actual impact on industrial structure may not have been large. There have been some notable failures of industrial policy.

Other Factors in Growth

Two factors can explain the rapid growth in East Asia: They are,

1. High saving rates

2. Rapid improvement in public education

The East Asian experience refutes that, Industrialization and development must be based on an inward-looking strategy of import substitution.And the world market is rigged against new entrants, preventing poor countries from becoming rich.

Summary

Trade policy in less-developed countries is concerned with two objectives they are, promoting industrialization and coping with the uneven development of the domestic economy. The government policy to promote industrialization has often been justified by the infant industry argument. Many less-developed countries have pursued policies of import-substituting industrialization.These policies have fostered high-cost, inefficient production.

Most developing countries are characterized by economic dualism. Dual economies have a serious problem of urban unemployment. The difference in wages between the modern and traditional sectors have sometimes been used as a case for tariff protection of the industrial sector.The HPAEs have industrialized not via import substitution but via exports of manufactured goods.

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