

Sessions 17-19. Government intervention and economic development and growth strategies

7. Government intervention: policy and strategy

7.1 Revisiting the case for free trade

- 7.1.1 Based on cost-benefit analysis: gains from trade, increased social welfare, no dead-weight loss
- 7.1.2 Based on efficiency grounds: cost of trade protection, economic integration, economies of scale; long-term dynamics resulting from liberalization
- 7.1.3 Political economic argument: policy making process captured by special interests results in use of trade policy rather than domestic policy

7.2 Case against free trade (or for government intervention)

- 7.2.1 Theoretical conditions under which H-O-S model applies do not hold in practice: theory of 1st best: $P_w = MC = MB$ and private $MC =$ social MC and private $MB =$ social MB is violated (through cases of imperfect competition, externalities, market failure)
- 7.2.2 Theory of 2nd best: government intervention can improve domestic welfare through policy intervention (but which policy response is most appropriate: e.g. trade policy or domestic policy in cases of externalities or market failure in goods or factor markets)

8. Strategic [trade] policy intervention, by country type

8.1 Developing strategies in some developed countries: 3 interrelated arguments for intervention

- 8.1.1 Factor market failures: presence and consequences of a dual economy
- 8.1.2 Import substitution industrialization (ISI): risk and uncertainty in agriculture (Prebisch-Singer hypothesis revisited)
- 8.1.3 Infant industry argument: externality from too little manufacturing
- 8.1.4 Consequences: Does ISI with trade restrictions worsen market failures and a dual economy?
- 8.1.5 ISI toolkit of the strategy of developing countries during 1950s-1980s
 - [1] Industrial policy, state-owned enterprises (SOEs), government intervention
 - [2] Restrictive trade policy
 - [3] Accommodating monetary and fiscal policy

8.2 East Asian export-led development (Japan, S. Korea, dragon economies, China)

- 8.2.1 Fast GDP growth using strategy pioneered by Japan: market-based, state supported not planned
- 8.2.2 Compare/contrast of Asian trade and industrial policy with ISI in Latin America
- 8.2.3 Asian economic miracle: trade openness; industrial policy, macroeconomic policy
- 8.2.4 Asian financial crisis – downside of the strategy
 - [1] Macroeconomic distortion: TOT implications, over-investment, diminishing returns on capital
 - [2] Political argument: cronyism, SOEs close to government; non-enforcement of competition
- 8.2.5 Long-term consequences: slower growth; middle-income trap hypothesis; de-industrialization
 - [1] Declining total factor productivity slows growth
 - [2] Middle-income trap hypothesis
 - [3] Premature deindustrialization
- 8.2.6 Evidence of the end of miracles? Cases of South Korea, Japan, and China
- 8.2.7 Evidence of neo-developmentalism and statism (state intervention)

8.3 Policy intervention in developed economies: use of subsidies and/or trade policies

- 8.3.1 Policy space constrained by WTO rules
 - [1] Low tariff ceilings
 - [2] Industrial subsidies or export subsidies prohibited
- 8.3.2 Wakening of multilateral rules: national emergencies, tariff wars, investment controls
- 8.3.3 Infant industry argument for high value-added sectors: R&D, patent protection
- 8.3.4 Externality argument applied to de-industrialization from North-South trade
- 8.3.5 Imperfectly competitive international markets

Key concepts: Trade policy as an instrument of government; Lerner symmetry condition; case for and against free trade; theory of the 1st best and 2nd best; private and social marginal cost/benefit; externality, market failure, dual economy, infant industry argument, import substitution industrialization; export-led growth; middle income trap hypothesis, de-industrialization

Review questions: What are various reasons given by opponents of free trade for government intervention and use of trade policy? What are the objectives of a government for the trade policies that it uses? When is trade policy an appropriate policy response? How is policy captured by special interests? Why might trade policy be considered a politically easier policy response than enacting a domestic policy equivalent? How has trade policy been used as growth and development strategies in different countries? administration of a quota important? Why should countries be concerned with an exporting country that restricts exports?