

TRADE POLICY

Lecture 7

International competitiveness

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Last time

- Factor mobility
 - Labor
 - Capital
 - Technology
- Foreign direct investment
 - Motives
 - Effects of FDI on host economies

This time

- Development and export strategies in East Asia. How do countries manage to break out of poverty?
- What does theory say about economic development?
- The Asian Miracle
- Country cases
 - South Korea
 - Taiwan
 - China
 - Vietnam
 - (North Korea)

Theoretical explanations: Neoclassical and endogenous growth models

- Harrod-Domar model (constant rts)
 - Higher savings rates needed for investment and growth
- Solow growth model (diminishing rts)
 - Technical progress necessary for long-run growth, because marginal returns to investment are diminishing
- Endogeneous growth à la Romer and Lucas (externalities)
 - Human capital and internationalization can help sustain growth rates because of externalities and the public good character of knowledge
 - The more you know, the faster you learn new things
 - The more you know, the higher the return on other people's investment

Developmentalist theories

- Rosenstein-Rodan's Big Push
 - Coordination of investment (i.e. state planning) needed to exploit “hidden potential”, complementarities, and externalities
- Nurkse and Balanced Growth
 - Infant industry protection and forced savings needed to compensate for other weaknesses
- Hirschman and Unbalanced Growth
 - Industrialization focusing on key export sectors needed to use scarce resources more efficiently. Linkages and bottlenecks will jointly stimulate broader development

Contrasting Nurkse and Hirschman

Nurkse: Import substitution

- Development of domestic industry to substitute for imports
 - Trade barriers, subsidies, and exchange controls necessary to protect domestic producers: state intervention replaces market prices
- Benefits: short-cut, coordination, synergies
- Problems: low level of competition, “inappropriate” factor inputs, administrative costs, current account deficits, interest groups

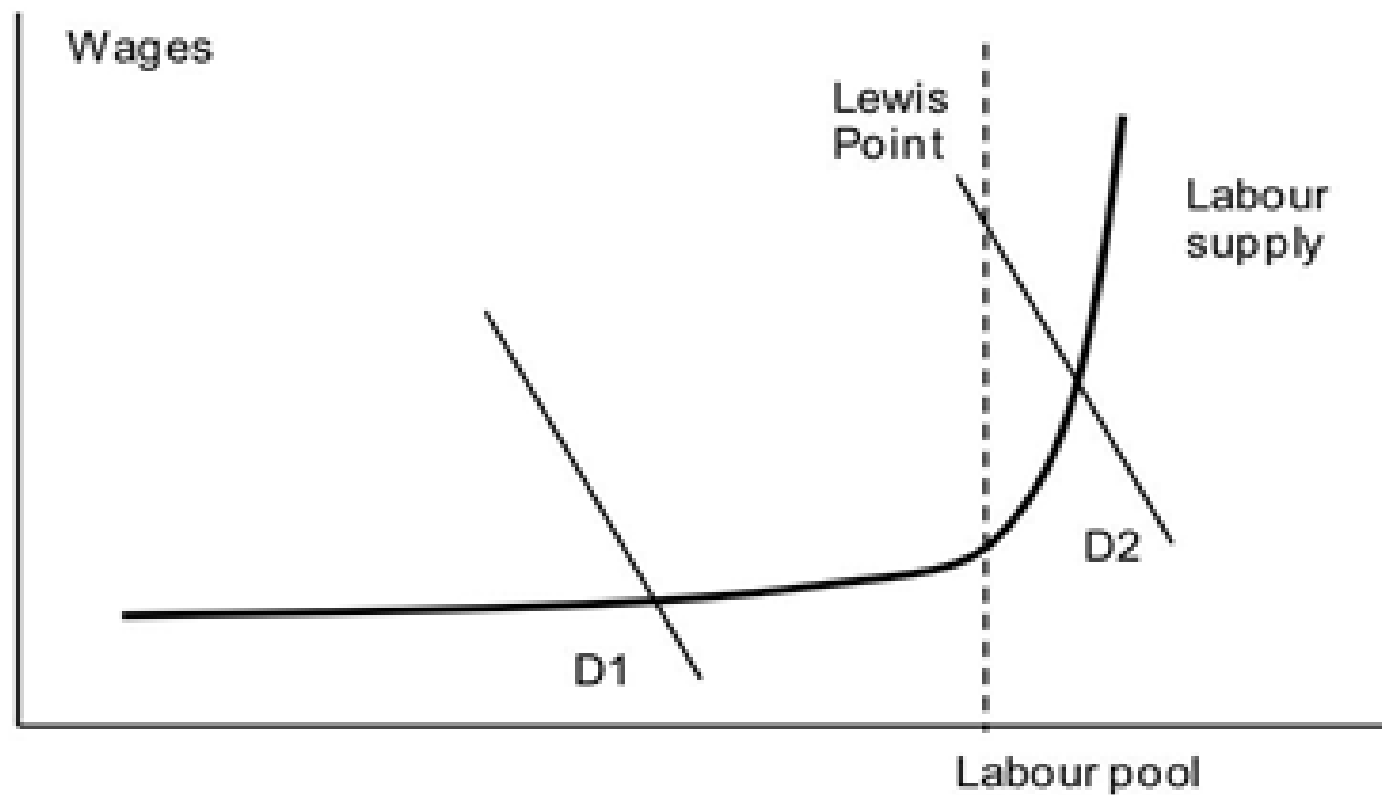
Hirschman: Export orientation

- Development based on exploitation of comparative advantages
- Gradual diffusion of wealth to other sectors expected
- Benefits: foreign exchange, competition, technology transfer
- Problems: information, incomplete markets, market access, diffusion of benefits

Developmentalist theories

- Lewis dual economy (surplus labor) model
 - Surplus labor and migration from countryside help promote (urban and industrial) growth and capital accumulation in early phases of development
- Rostow's stages-of-growth model
 - Historic pattern: Traditional => Pre-takeoff => Takeoff => Maturity => Mass consumption. Increases in productivity and investment needed to generate take-off.
- Akamatsu's Flying Geese model
 - Increasing wages push leading economies to move production to lower-wage locations (c.f. Vernon's Product Cycle model).

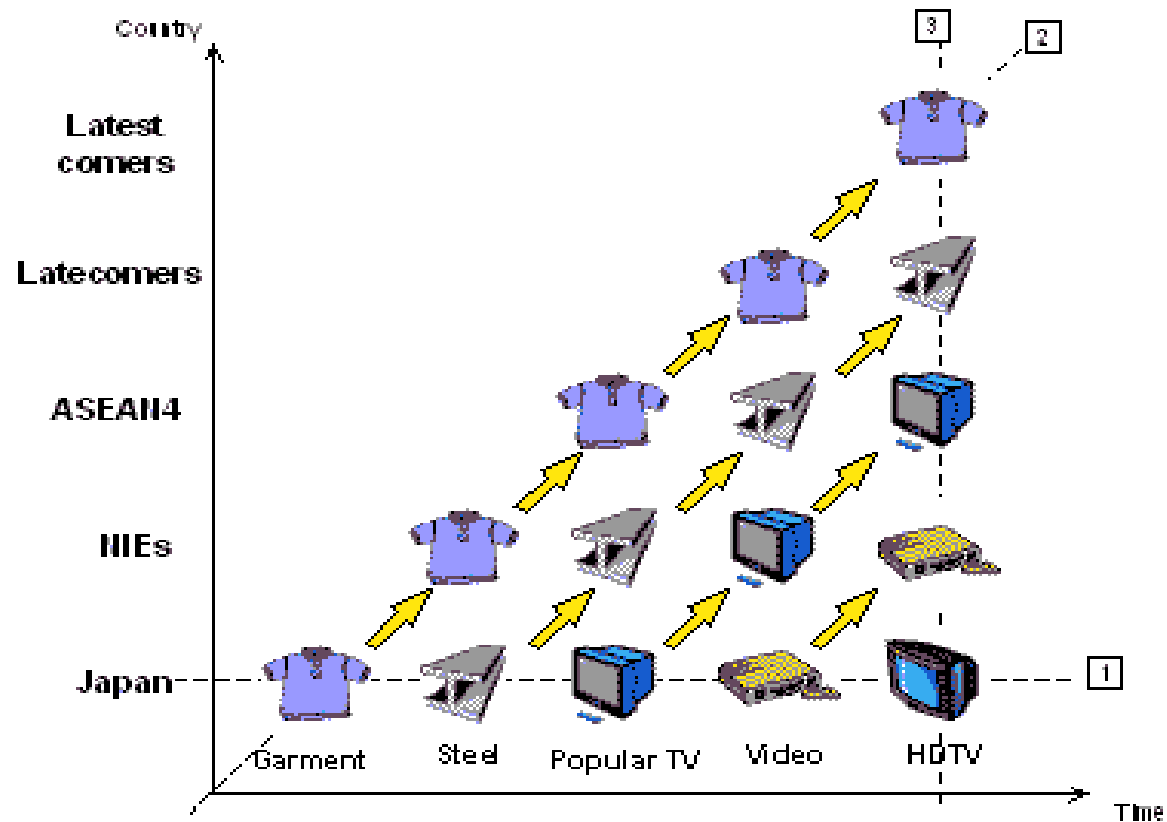
The Lewis Turning Point



Source: Nomura, Business Insider (2013)

The Flying Geese model

Structural Transformation in East Asia



Non-developmental and institutional theories

- Prebisch's structuralist model
 - Terms of trade of periphery declining over time: no scope for sustainable development with free trade
 - Prebisch-Singer Hypothesis: relations between the center and the periphery are antagonistic and detrimental rather than complementary and harmonious
- Myrdal's institutionalist model
 - Trade and industrialization not sufficient to generate development because of “backwash effects” creating dual structures. Institutional changes – land reform, political reform, legal reform – needed to address underdevelopment

Non-developmental and institutional theories

- Dependency models
 - Underdevelopment of the periphery is a consequence of the development of the center. Trade, FDI, World Bank, IMF are perpetuating the suppressed role of periphery
 - Baran's Marxist model of dependency: monopoly capitalism not interested in developing periphery, but rather extracting the economic surplus
 - Cardoso's non-Marxist model: dependency is a phase, but there is a possibility for a more equitable outcome as multinational enterprises become more dependent on the markets in the periphery

Development theory: references

- Akamatsu K. (1962), "A Historical Pattern of Economic Growth in Developing Countries, *Journal of Developing Economies*, 1 (March-August), 3–25.
- Baran, P. (1957), *The Political Economy of Growth*, Monthly Review Press: New York.
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- Prebisch, R. (1950), *The Economic Development of Latin America and Its Principal Problems*, United Nations: New York.
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- Rostow, W. (1960), *The Stages of Economic Growth: A Non-Communist Manifesto*, Cambridge University Press: Cambridge.
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- Solow, R. (1956), "A Contribution to the Theory of Economic Growth", *Quarterly Journal of Economics*, 70(February), 65-94.

Country experiences in East Asia

- Waves of export-led growth and expansion
 - Japan
 - South Korea, Taiwan, Singapore, Hong Kong
 - Malaysia, Thailand, Indonesia
 - China, Vietnam
 - *Laos, Cambodia, Myanmar*
- *The Asian Miracle*
- Three illustrations: South Korea, Taiwan, China
- What is the Vietnamese model? What will Vietnam be known for in 10 years?
 - and some words about North Korea

Is there an Asian growth model?

According to *The Asian Miracle* (World Bank 1993), successful Asian economies were characterized by

- Macroeconomic stability
 - Growth fundamentals (savings and investment)
 - Equity and income distribution
 - Appropriate government intervention (exports, industrial development)
-
- Many elements that match the Washington Consensus
 - ...but analysis did not include China

Washington consensus (Williamson 1989)

1. Fiscal policy discipline
2. Public spending on pro-growth, pro-poor services rather than subsidies
3. Tax reform: broader tax base and moderate marginal tax rates
4. Market-determined interest rates
5. Competitive exchange rates
6. Trade liberalization and transparent protection
7. Inward foreign direct investment
8. Privatization of state enterprises
9. Regulatory reform and simplification
10. Protection of property rights

See e.g. <https://piie.com/publications/papers/williamson0204.pdf>

South Korea

Emphasis on exports from early 1960s, because of sharp reduction in US aid

- Strong state with *export success* as main goal
- Highly successful neutral export promotion until early 1970s
- Targeting of heavy industries from mid-1970s to 1979, with mixed success

South Korea

Instruments of export promotion

- Credit allocation; banking system nationalized
- Subsidies, tax and tariff exemptions
- Exchange rate policy
- Explicit links between domestic protection and exports
- Institutional incentives: presidential commendations

Taiwan

Strong export orientation from early 1960s because of sharp reduction in US aid

- Successful targeting of light labor intensive industry until mid-1970s
- Focus on heavy industry from mid-1970s, with some problems
- Redirection to high-tech industries from early 1980s

Taiwan

Instruments of export promotion

- Fiscal and institutional incentives. Small role for credit allocation: little subsidized capital
- Promotion of FDI, unlike Japan and South Korea
- Export processing zones
- SOEs producing inputs for private sector exports

Differences between South Korea and Taiwan

- Model 1: South Korea

- Strong government, selective intervention
- Controlled capital markets, debt financing
- Concentrated industry (50 large *chaebols*)

- Model 2: Taiwan

- Strong government but less selective intervention
- Informal capital markets, equity capital
- 57,000 small and medium-sized firms in industrial sector (on average ~40 employees)

Rapid development and growth...

- Remarkable success in both South Korea and Taiwan
- Growth rates of 8-10% most years from early 1960s to Asian crisis
- Per capita incomes grew from less than 200 USD in the 1950s to over 10,000 USD in the mid-1990s.

... with a higher price tag in South Korea...

- The price of growth was one third higher in Korea
 - Korea invested 30-35% of GDP every year, Taiwan managed equally well with 20-25%
- Korea was forced to borrow heavily while Taiwan became a capital exporter
- Clear differences in vulnerability when the Asian crisis struck in 1997

Common elements in South Korea and Taiwan

- Gradual movement towards more liberal and transparent trade policy
 - No major role for classical import substitution
- Characteristics of successful state intervention (export promotion programs)
 - Allocation of preferences based on markets and competition: hard budget constraints
 - Policies targeted the private sector
 - Relatively little corruption and interference from interest groups as long as policies were neutral

Common elements in South Korea and Taiwan

- Areas for public sector intervention
 - Infrastructure investment
 - Institutions for technology and market research
 - Quality control and quality standards
 - Access to inputs at world prices
- Cautions
 - Preferential access to loans and forex
 - Fiscal incentives to promote new industries

China

- Main differences compared to South Korea and Taiwan

- Leading role of state-owned enterprises
- Strong intervention in all markets
- Targeting of strategic sectors

but also

- Vibrant domestic private enterprise sector, both large firms and SMEs
- Massive inflows of FDI

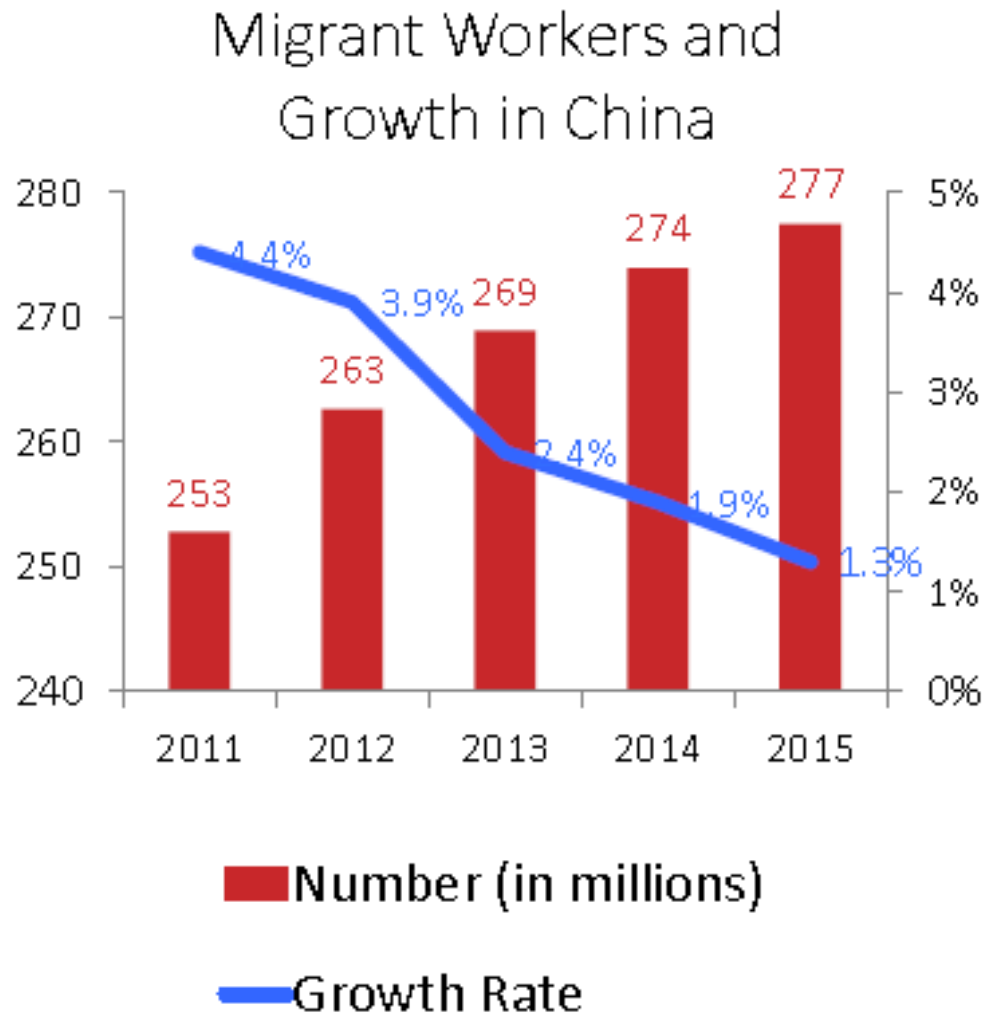
China's export miracle

- Not only undervalued currency
- Abundant labor supply...
 - Pool of rural surplus labor
 - Demographics
- ...together with restrictions on the bargaining power of labor...
 - No independent labor unions
 - No “traditional” labor parties promoting labor interests
 - National development strategy based on export competitiveness
- ...have resulted in a severely underpaid working class
 - Labor share of GDP is only a bit over one-third, and fell continuously from 1990 to 2013

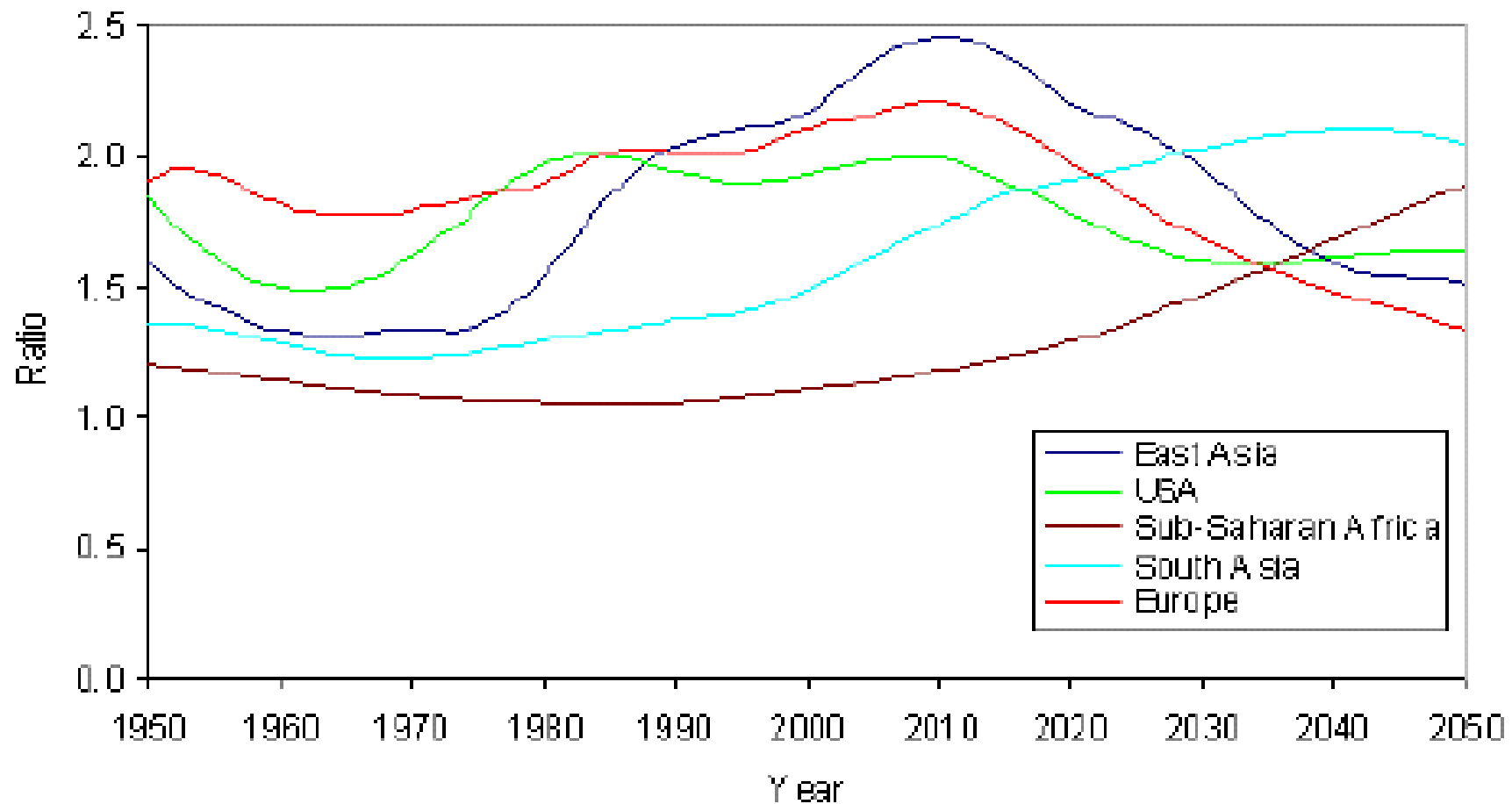
Yao Yang's model of export competitiveness

- Initial export success
 - Profits that go mainly to capital owners
 - Increased investment in capital, higher productivity
 - Stronger export competitiveness
 - More profits that go mainly to capital owners
 - Increased investment, higher productivity
 - ...and so forth...

Migrant workers 2011-2015



Working age ratios and *demographic dividends* across the world



Source: Bloom, David etc. "Demographic change, social security systems, and savings," *Journal of Monetary Economics*, 2007, 54(1), pp. 92-114.

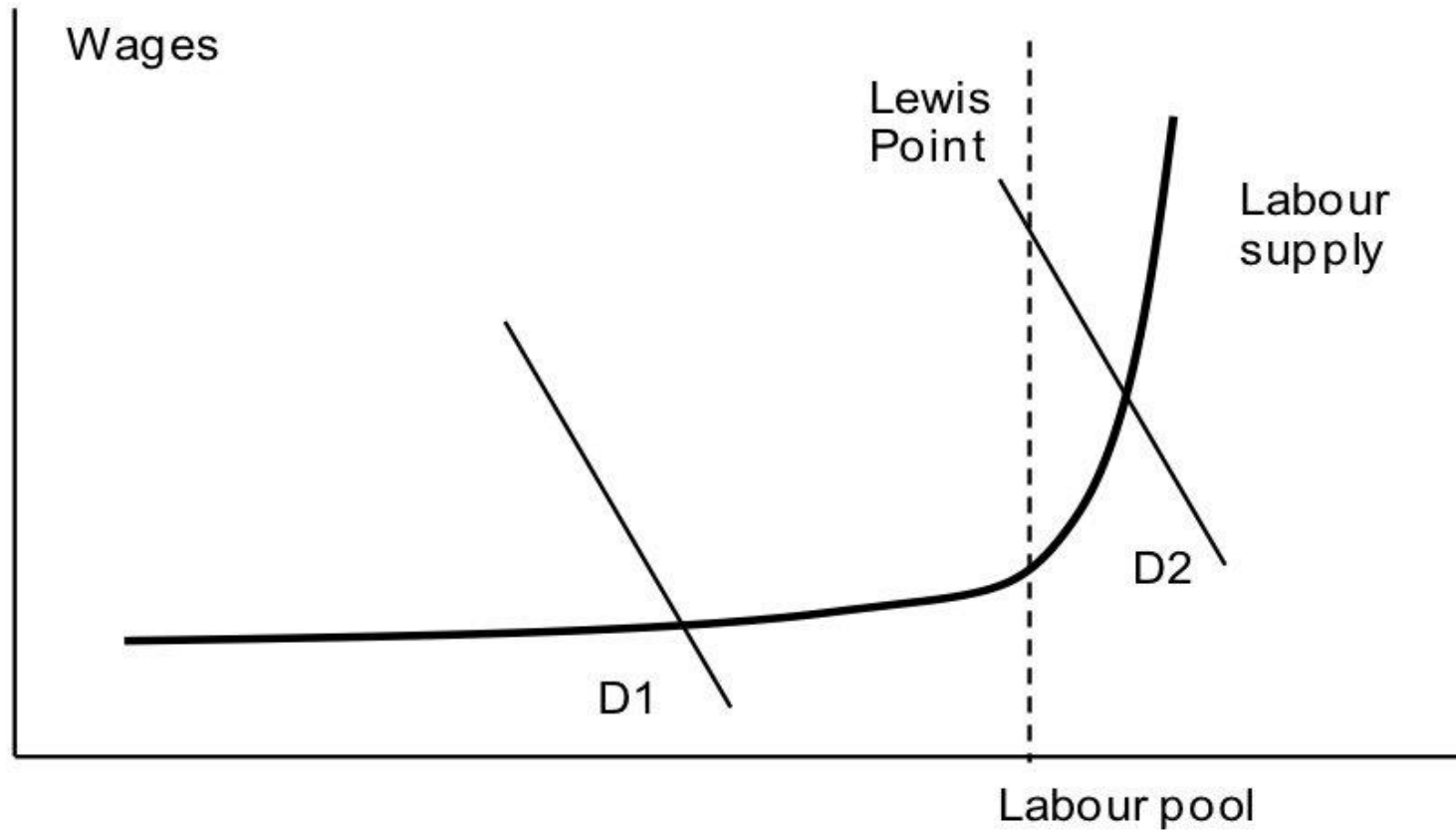
In addition

- A large share of China's exports has been shipped by foreign multinational enterprises (MNEs), but Chinese firms have managed to become important suppliers and subcontractors
- Chinese outward FDI increasingly important (often SOEs)
- Successful upgrading of skills and knowledge
 - Several world class universities

End of cheap-labor era in sight

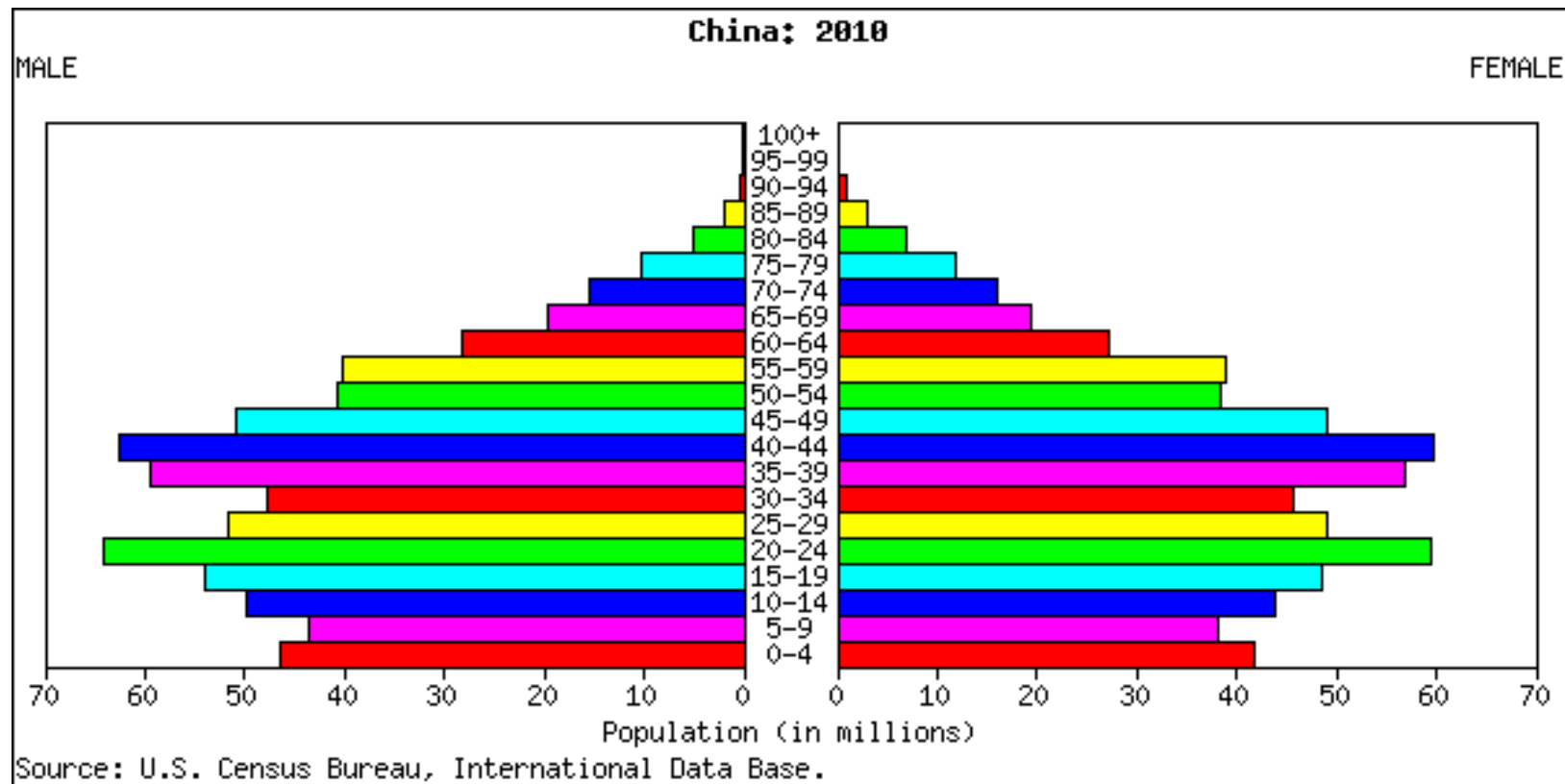
- Lewis turning point
- Demographics
- Increasing demands from working class

The Lewis Turning Point

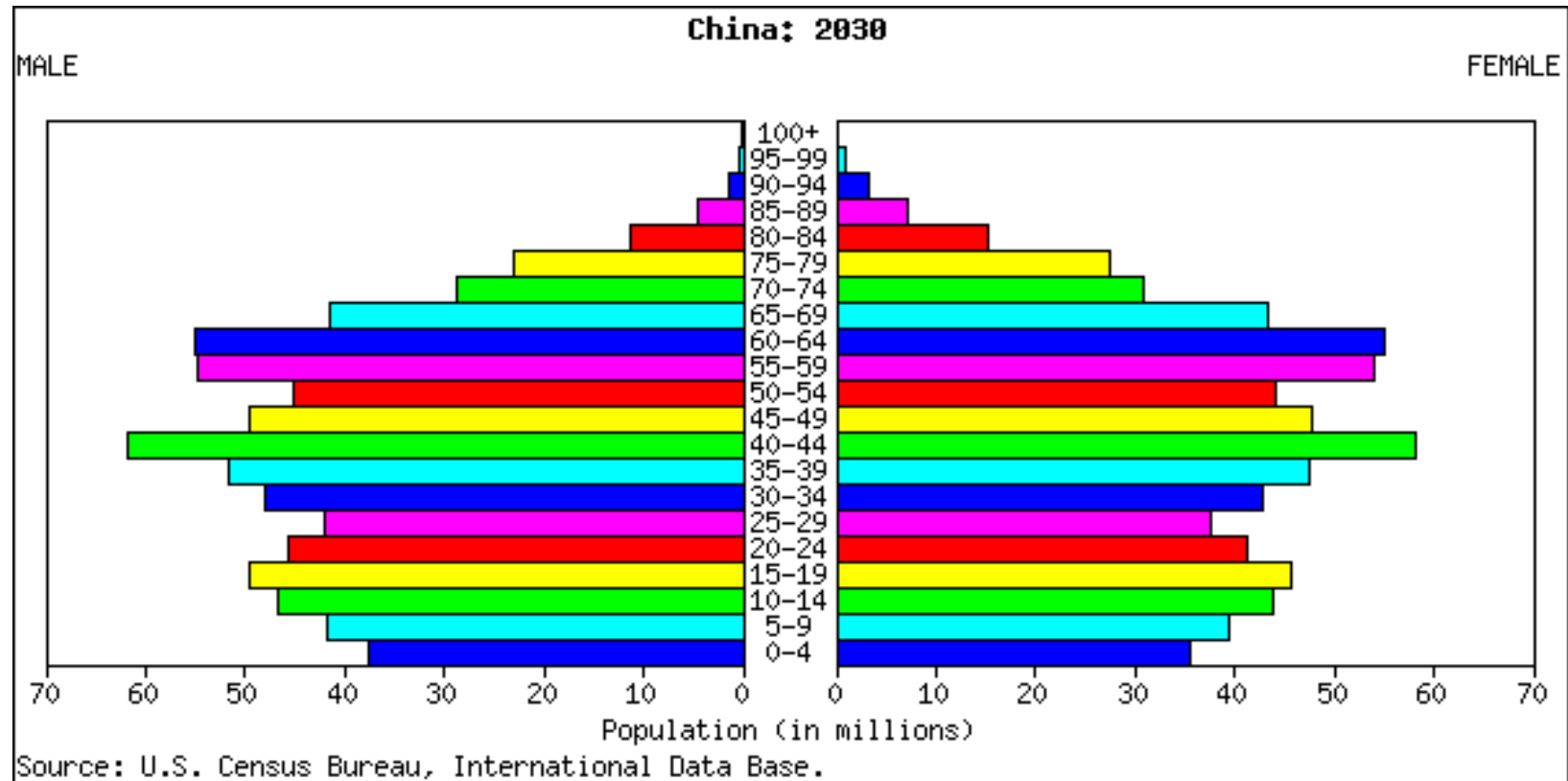


Source: Nomura, Business Insider (2013)

China's population pyramid yesterday... (average age: 33 years)

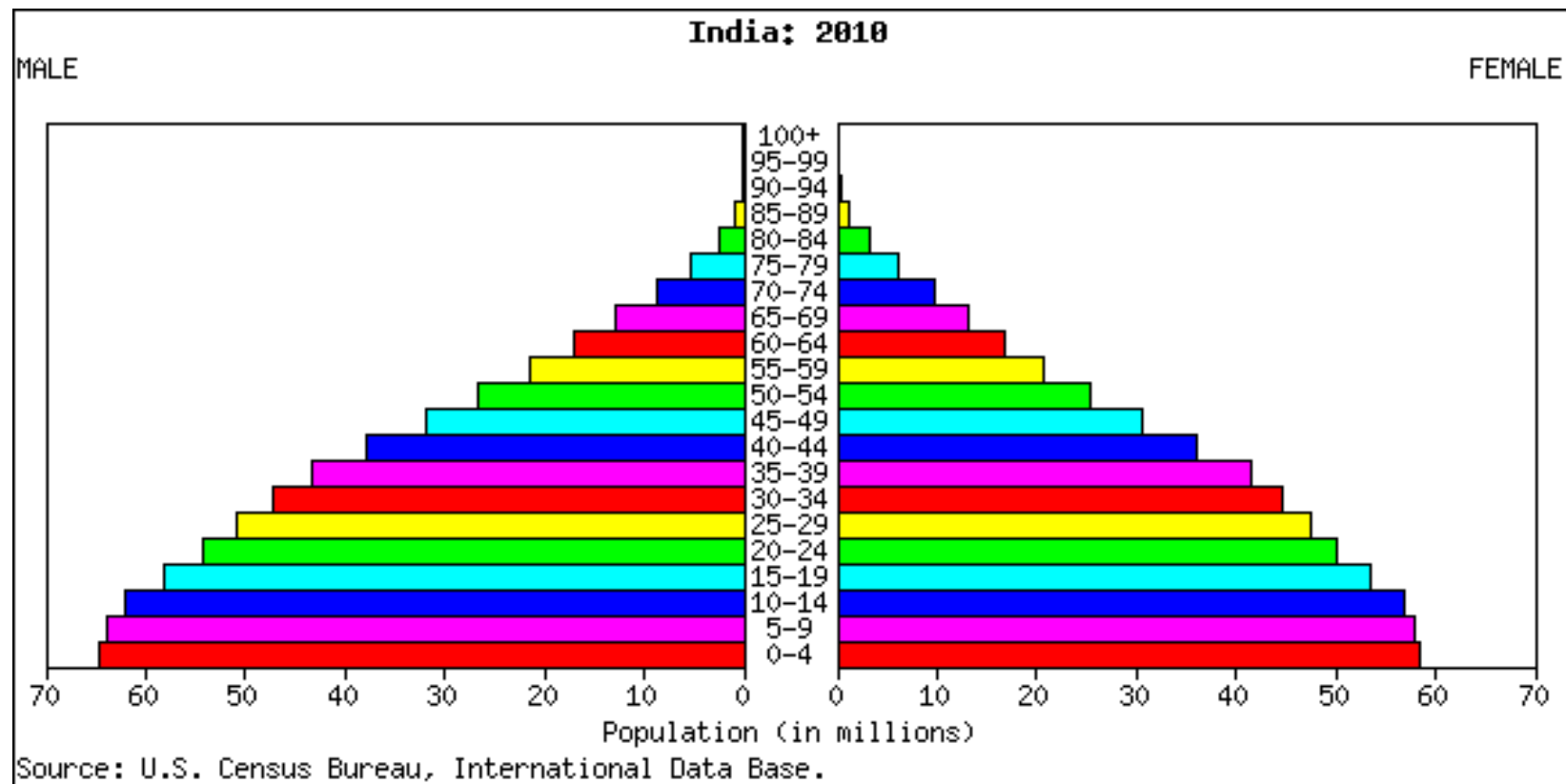


...and in a few years

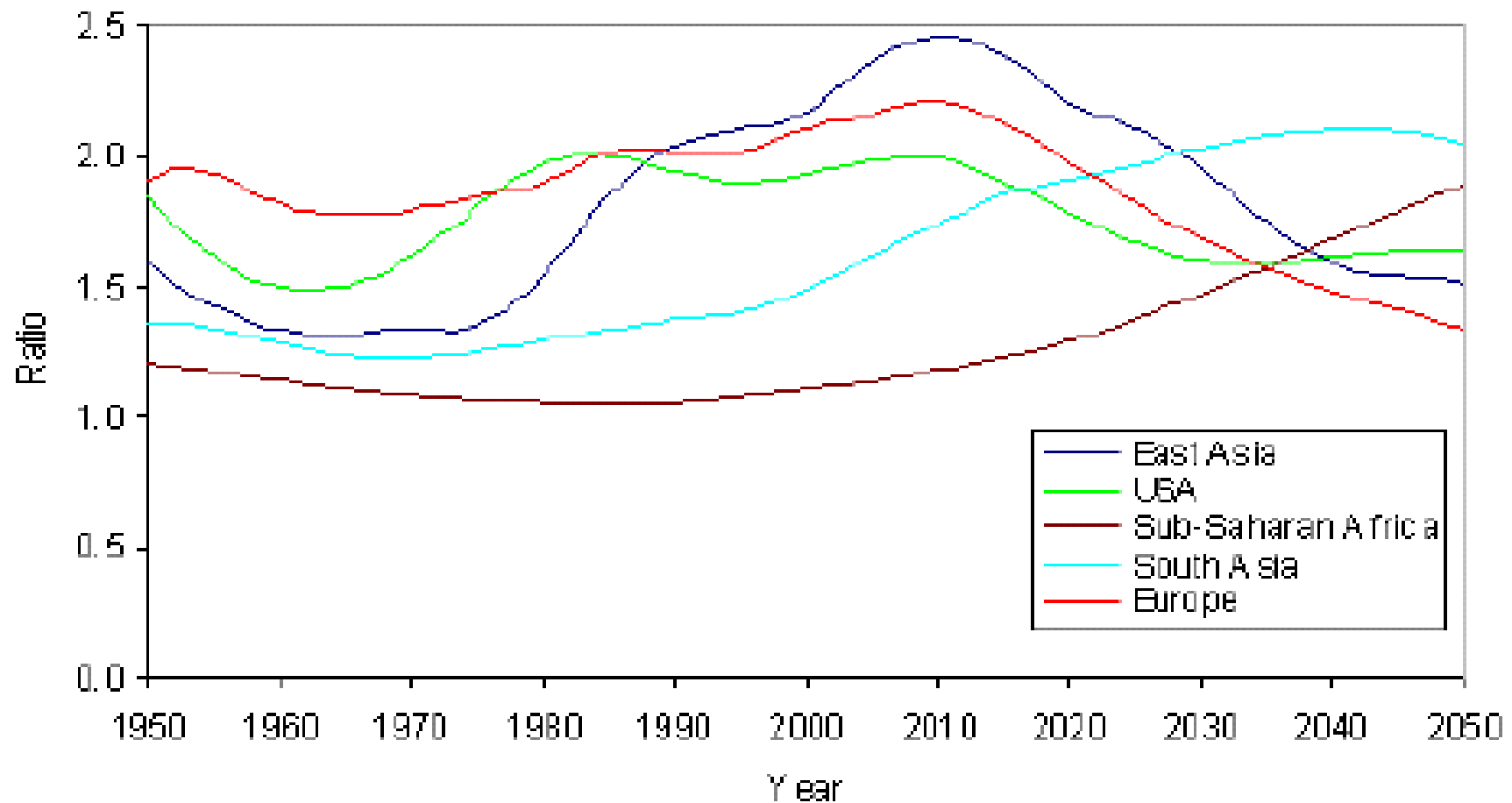


A *real* pyramid: India

(average age: 24 years)

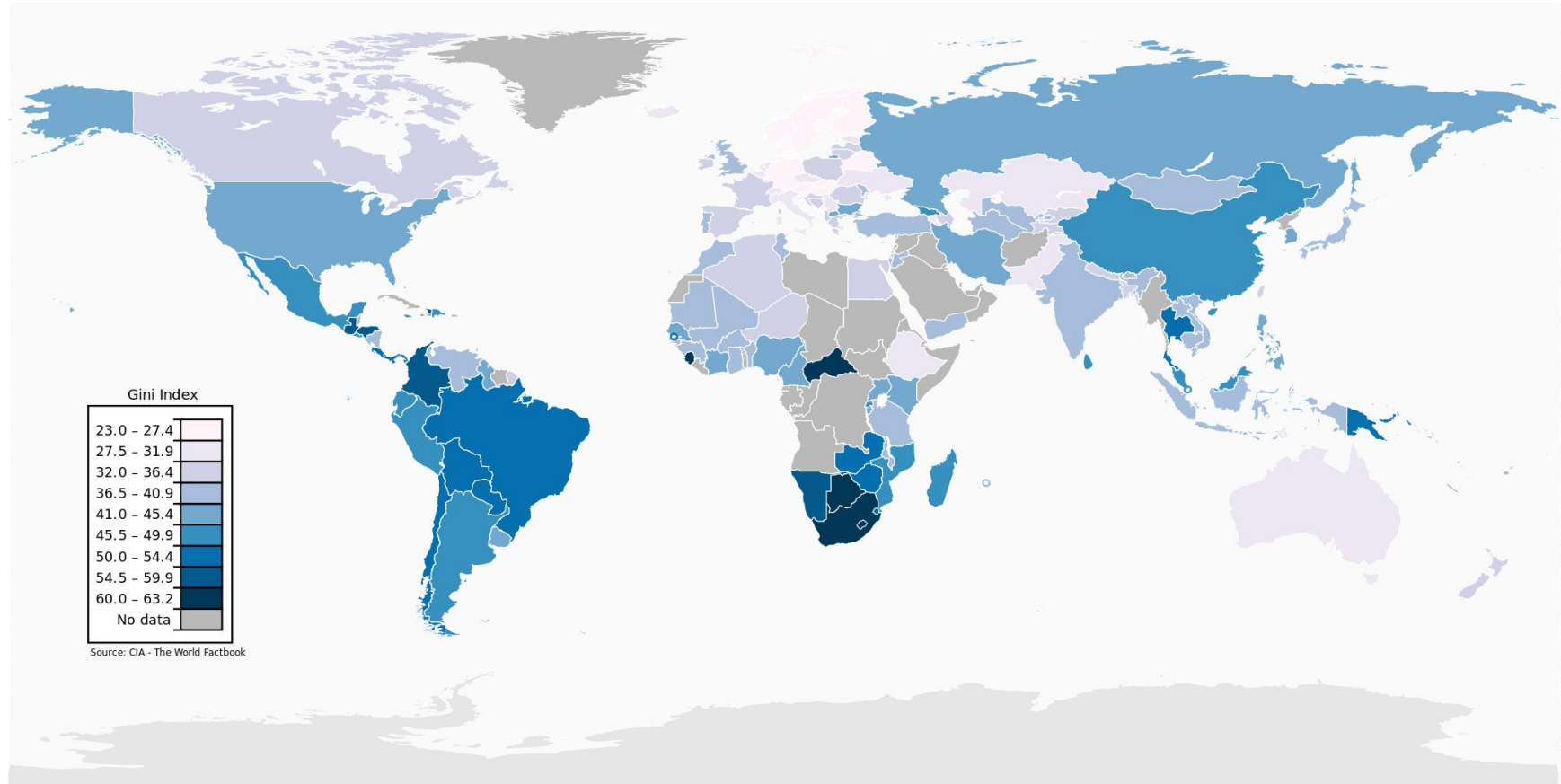


Working age ratios already on the way down



Source: Bloom, David etc. "Demographic change, social security systems, and savings," *Journal of Monetary Economics*, 2007, 54(1), pp. 92-114.

Chinese inequality: almost like Latin America



Summary:

Chinese export competitiveness

- Highly successful economic growth and export strategy
 - Largely WTO consistent (but WTO was not designed for command economies / state-owned enterprises)
 - Cost: three decades of underpaid labor
- China's extreme export competitiveness gradually diminishing
 - Lewis turning point, demographics, inequality and social pressures
 - Who will be able to absorb larger Chinese deficits?
- Will China be able to overcome middle income trap?

Vietnam's export miracle

- Export restructuring
- Massive inflows of FDI
- Problem: weak integration of Vietnamese firms into global value chains
- Solutions?

Vietnam's “traditional” export commodities

RICE



COFFEE



RUBBER



FRUITS &
VEGETABLES



CASHEW NUTS



PEPPER



TEA



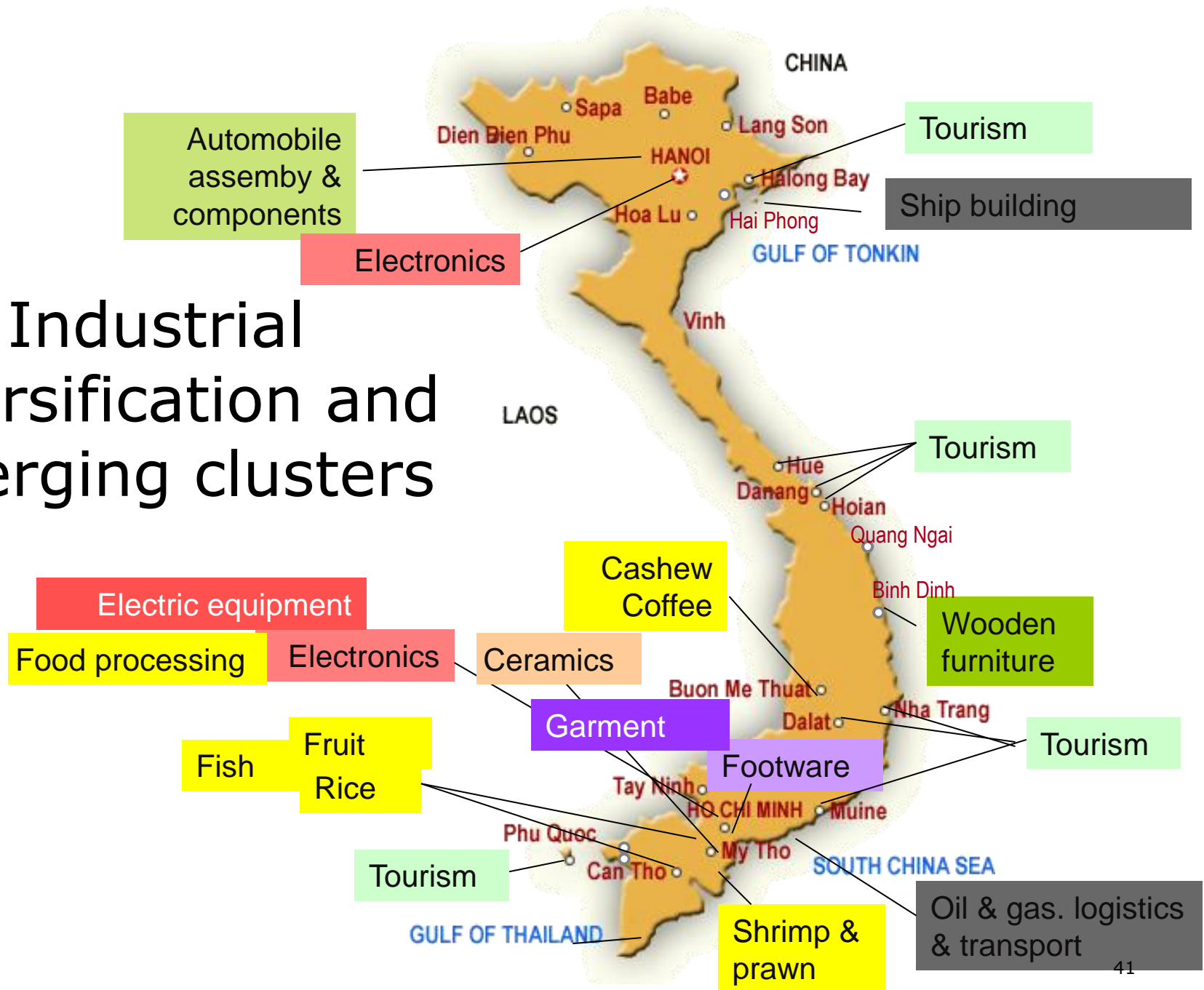
TIMBER and
wood furniture



RATTAN



Industrial diversification and emerging clusters

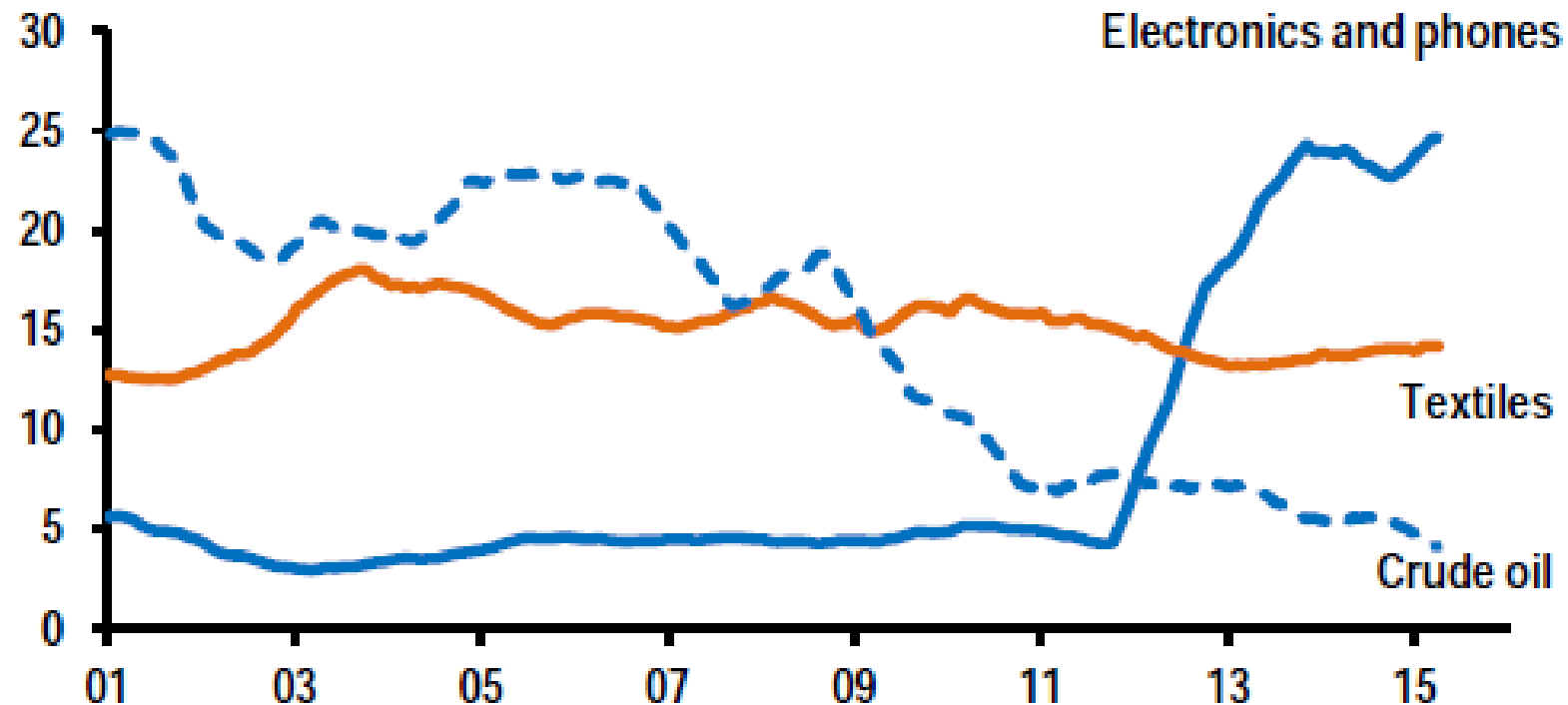


Upgrading of export basket

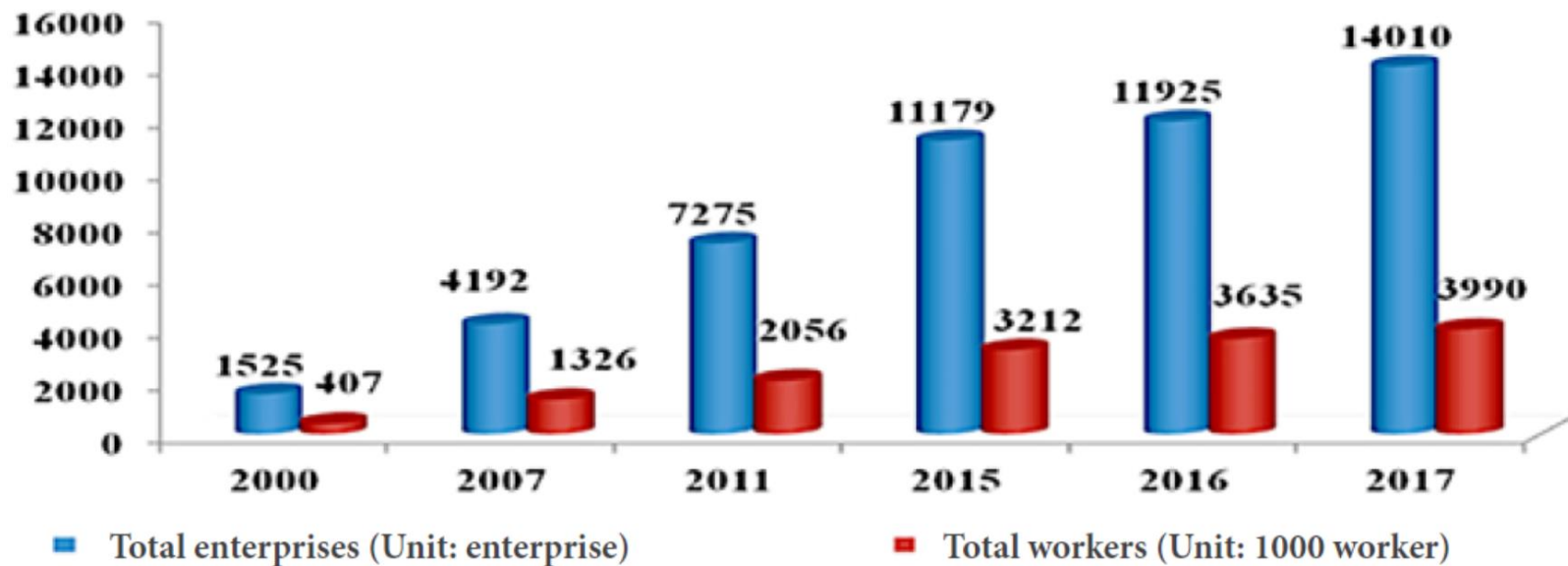
Striking shift in composition of Vietnam's exports...

Vietnam: composition of exports

% share of total, 12mma

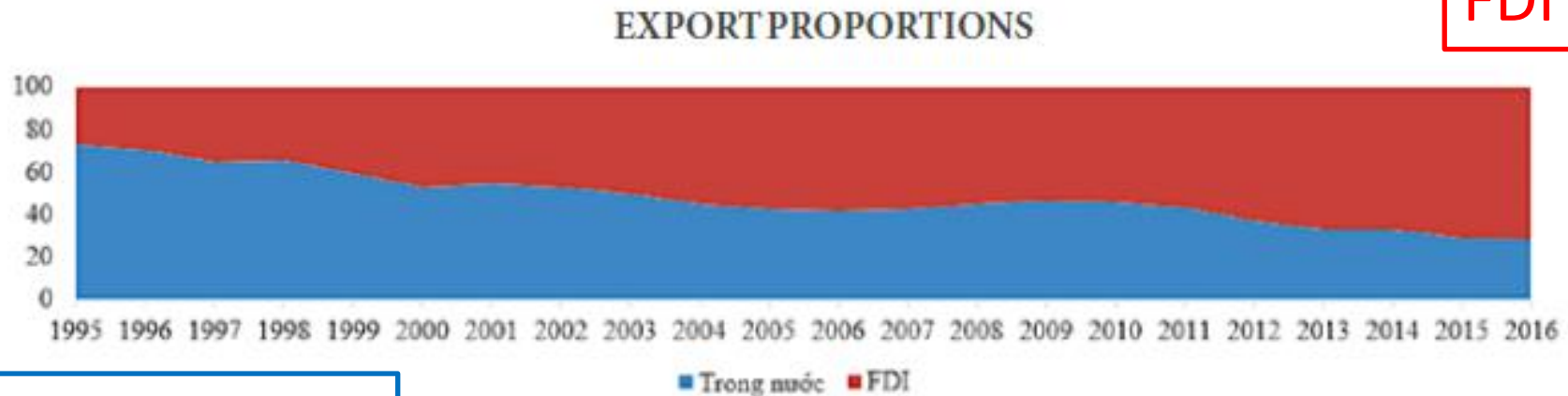


The reason: FDI



FDI accounts for most of Vietnam's exports (and its trade surplus)

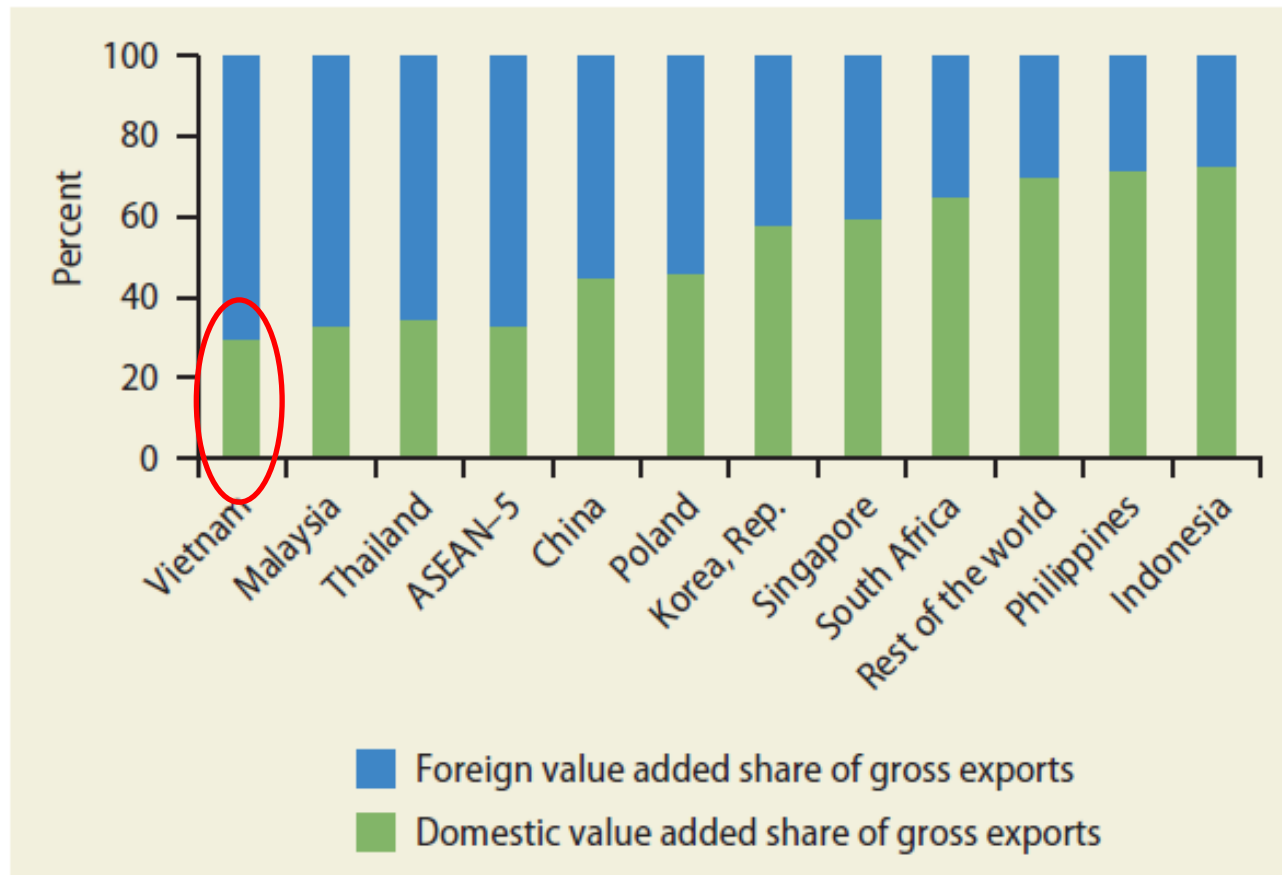
FDI



Domestic firms



Good. But domestic value added is low –
weak supporting industry sector



Source: Calculations based on OECD/WTO Trade in Value-Added database.

Example: Samsung



- Samsung is the largest enterprise in Vietnam and accounts on its own for over 20% of the country's exports
- It has more than 130,000 employees in the country, with more than 60,000 of them in its Thai Nguyen factory outside Hanoi
- Samsung says that more than half of value added in production and exports comes from Vietnam

Samsung



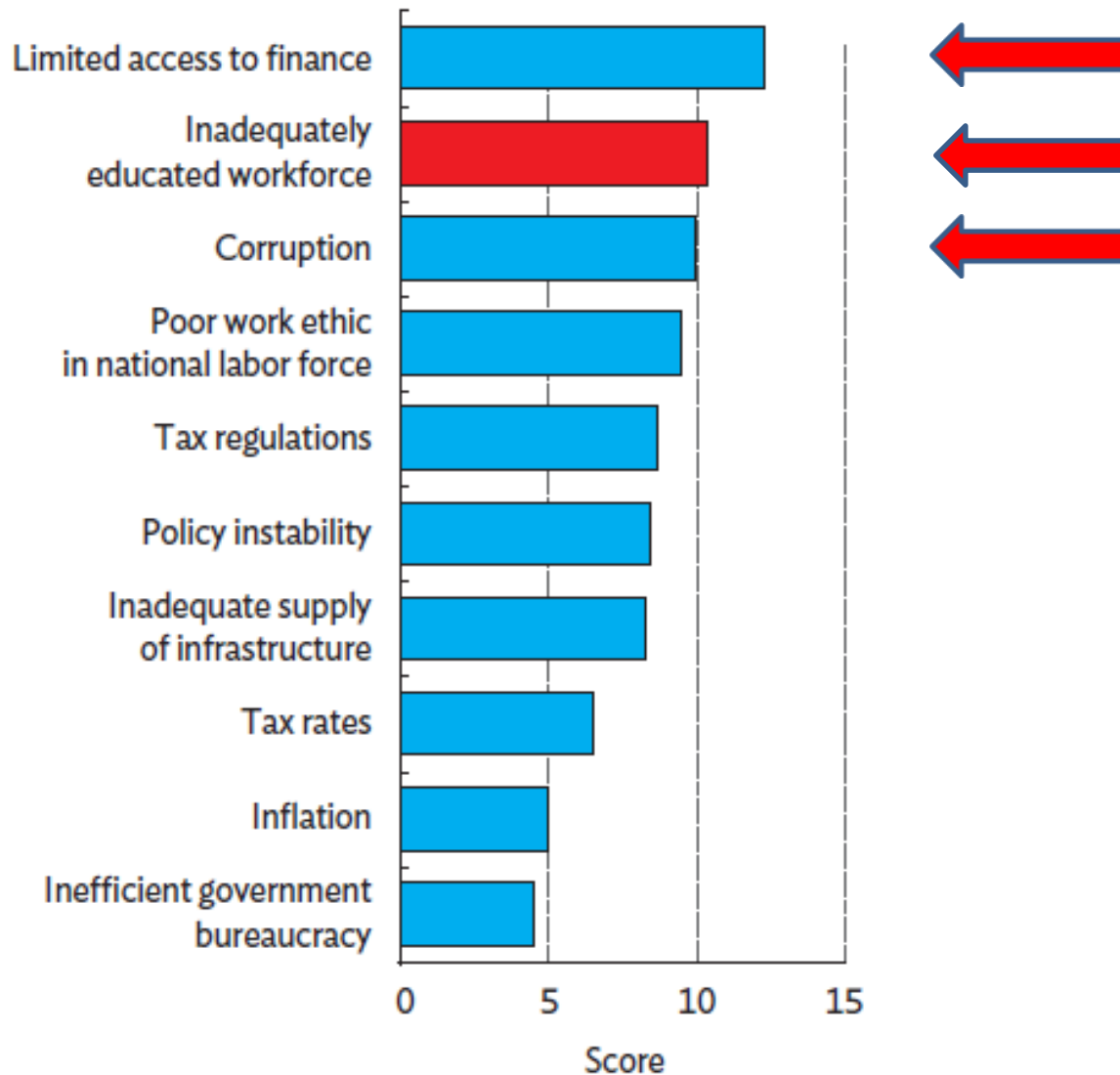
- But only four of Samsung's 60 "first-tier" suppliers in Vietnam in 2018 were local firms (in charge of security, catering, and the production of the cardboard boxes in which mobile phones are sold)
- The rest of Samsung's first-tier suppliers were foreign multinational firms that followed Samsung to Vietnam

Why so few local suppliers?

- Foreign-owned suppliers are often more attractive than local suppliers because of
 - Tax benefits that do not accrue to local firms
 - Access to land and other resources
 - Investment guarantees / BITs
- FIEs are have privileges and are protected by international regulations – local (private) firms are more exposed to political risk
- Hard to find competent local suppliers
 - Vietnamese firms were known for “*not being able to produce screws*”

Why are local suppliers weak?

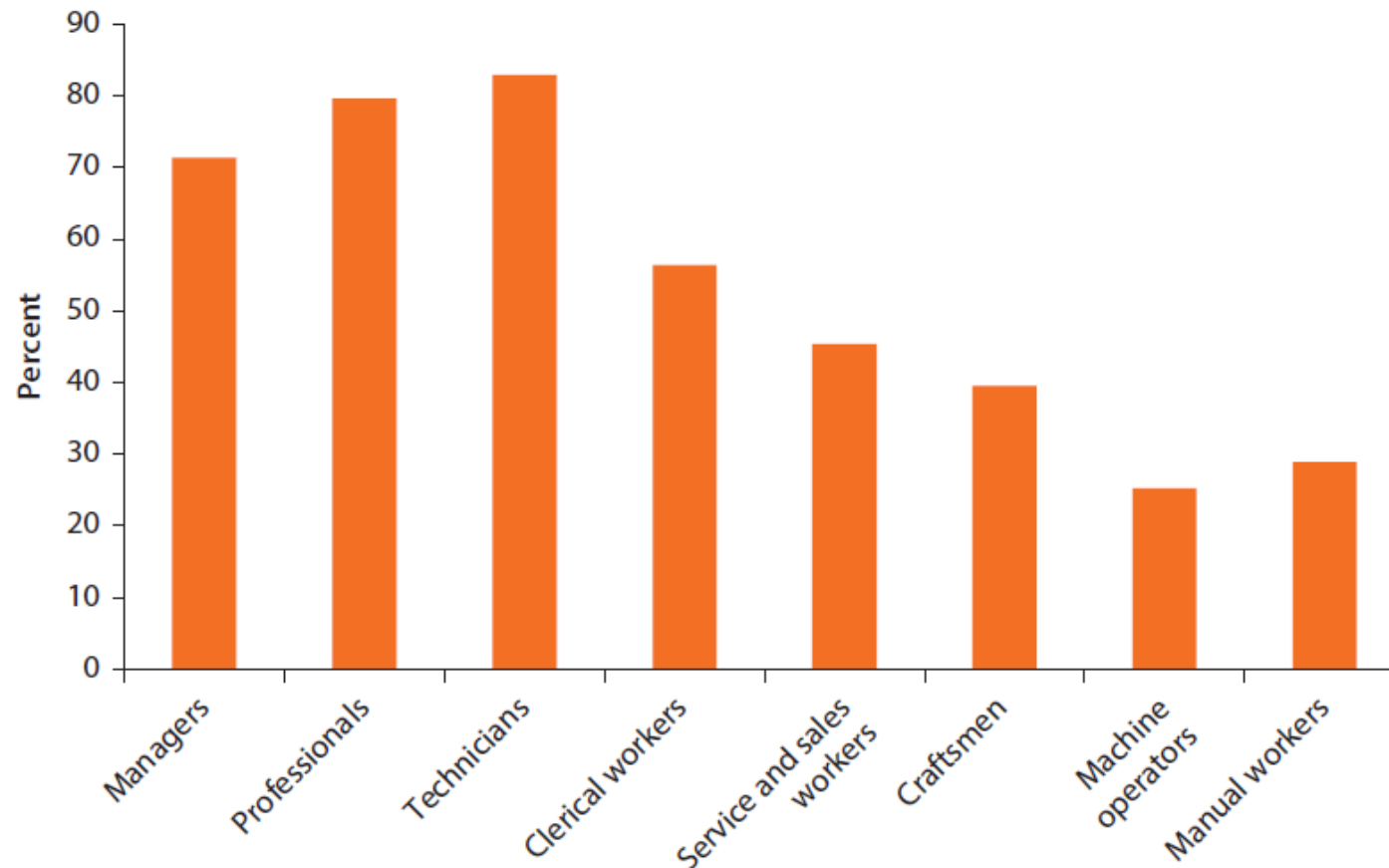
What are their main challenges?



Why are local suppliers weak?

Lack of skilled workers

Figure 2.3 Percentage of Employers Claiming that Job Applicants Lacked Skills Required for the Job



Source: World Bank staff estimates using STEP employer survey data.

Solutions?

- How can Vietnam overcome "low income trap"?
- Key policy areas?

The North Korean Case

- Background
- Economic reform in DPRK
- Where are we now?

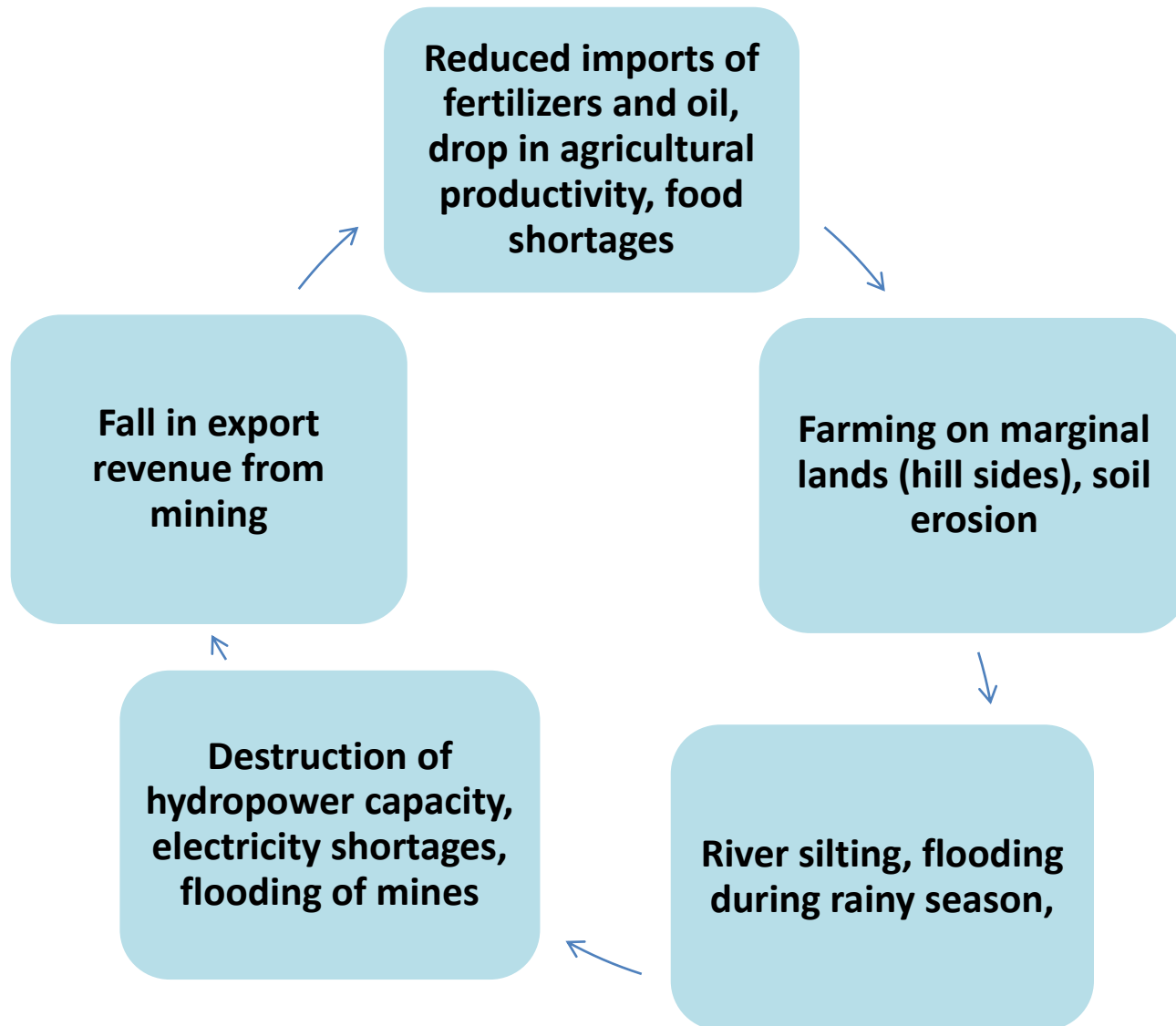
Background

- North Korea before the 1990s: attempt to create “extreme welfare state”
 - State to care for citizens from cradle to grave
 - Public Distribution System (PDS): minimal role for markets
 - One of the most urbanized and industrialized states in Asia until 1980s
- Collapse of European communist states undermined North Korean economy
 - Both agriculture and industry were dependent on subsidies from the SU: fuel, fertilizers, other raw materials
 - North Korean central planning collapsed already in early 1990s; widespread starvation during second half of 1990s
- Reforms initiated in early 2000s, but very incomplete, fragmented, and inconsistent reform path
 - What is going on?

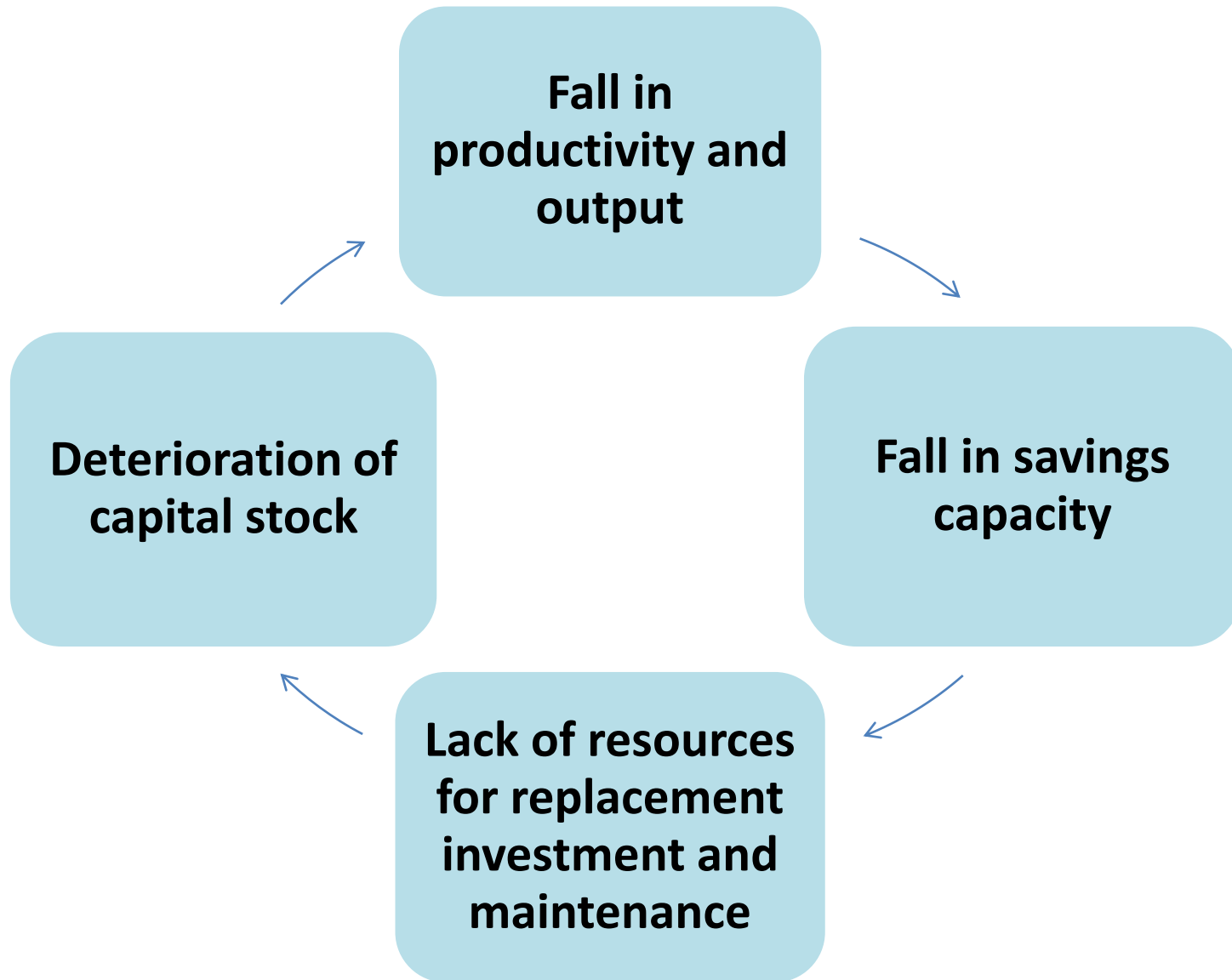
North Korean collapse: textbook example of vicious cycles

- DPRK decline triggered by Soviet block collapse and end to inflow of cheap resources
- Attempts to compensate lost inputs with more intensive agriculture created new problems
 - Vicious cycle 1: farming on marginal land (slopes) => soil depletion => soil erosion => river silting => severe flooding in 1994 => collapse of hydropower production => collapse of mining => lack of import capacity
 - Famine 1995-1998
 - Vicious cycle 2: Poverty trap. Insufficient output to feed population and maintain capital stock at the same time => lack of maintenance and replacement investment leads to even lower output

Vicious Circle No. 1



Vicious Circle No. 2



First signs of change: mid-1990s

- Inflows of humanitarian aid after 1995-1998 famine
- Other resource inflows as well: substantial trade deficit every year since mid-1990s
- How was current account deficit funded?
 - Food aid from the EU, the US, South Korea, and other countries
 - US heavy fuel oil during certain periods
 - Chinese trade credits
 - Limited exports (but rumors of various illicit income sources)

(See The Mole)

Crises motivate change in economic structure

- Serious impact of crisis on official economy
 - Collapse of PDS in large parts of the country
 - No five-year plan since 1992
- “Military first” policy protecting the military economy
 - Increasingly powerful interest group
- Gradually larger share for “informal” economy
 - Garden plots, black markets, budding private sector

First official economic reform package in 2002

- 7.1 Reforms (July 1, 2002):
 - Decentralization, formal end to central planning and PDS, some price liberalization
 - Farmers markets => general markets
 - Agriculture: smaller work units, larger household plots, lower state claims on harvests
 - Private enterprise: retail, other services (manufacturing)
- Justification / objectives
 - “Normalization” and recognition of *de facto* development
 - Need to re-establish role of state after chaotic decade, rein in uncontrolled markets
- Consequences
 - Eventually positive supply response (but it took two years), inflation, emergence of new interest groups (with resources)

Weak initial supply response, but gradual improvement

- Badly timed reforms
- Weak initial conditions
 - Much of infrastructure and capital stock worthless
 - Only 20 percent of population active in agriculture
 - No incentive goods to motivate stronger effort by farmers
- No market related skills
- Uncertainty: no clear vision for economic development
- Nuclear conflict
- Still, clear progress
 - Entrepreneurship, increased food production, "fence breaking"

Gradual reform reversal after 2004

- Stepwise increase in conservative policies from 2004
 - Extension of PDS for privileged groups in 2004
 - Price controls, crackdowns on markets, prohibition for workers to take part in commercial market activities
 - Currency reform 2009
 - Bank accounts frozen, foreign exchange confiscated
 - Price controls
- Justification / objectives
 - Need to regain State/Party control from competing interest groups: military, private traders
 - Inflation, corruption
- Consequences
 - Severe failure. Return to shortage economy. Currency reform reversed after only a couple of months

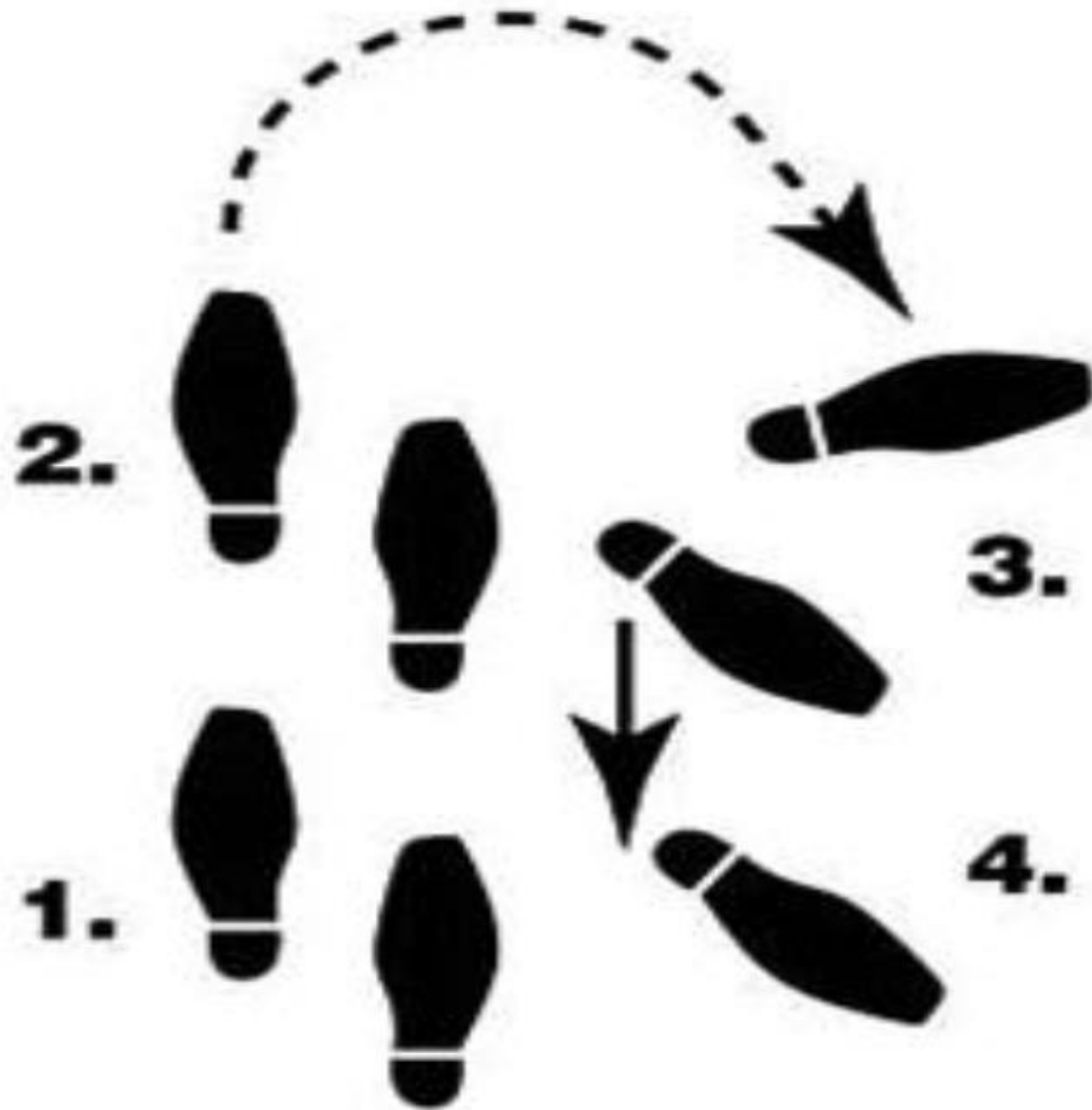
Return to reforms from 2010

- Return to more liberal policies after collapse of currency reform
 - Markets formally reopened in February 2010
 - Increase in both domestic and international trade (China)
 - USD back in circulation
- Temporary freeze after death of Kim Jong-Il in December 2011
- Further piecemeal reform after 2013
 - First television commercials (beer)
 - Management reforms and price reforms
 - 24 new Special Economic Zones introduced 2014-2015
 - ...but PDS remains important in Pyongyang
- Justification / objectives
 - Regime survival: system must deliver
 - Mixed signals: markets needed for incentives and supply, but PDS kept in place because it gives political control
- Tougher sanctions since 2017 in response to nuclear tests

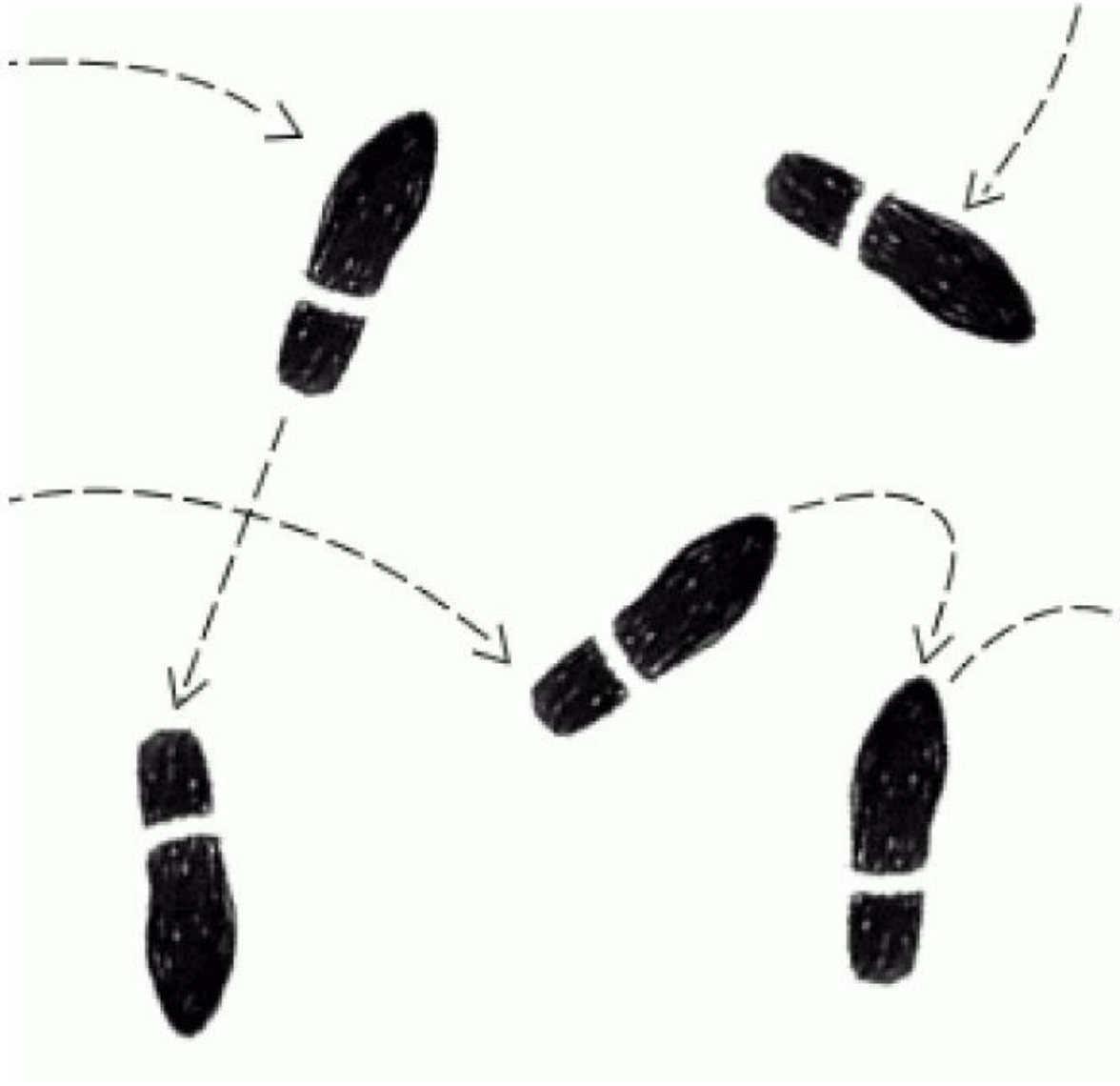
General insights

- Reforms are crisis driven
 - Ideology can be important when there is food on the table. When there is not, it is necessary to be pragmatic
- Reform success can lead to reform reversal
 - When the acute crisis fades away, conservatives regain power
- North Korean situation complicated by politics
 - Extreme nationalism, priority for regime survival, and fear of a "New Iraq" driving DPRK politics
- One-party states are not always so united
 - Competition between interest groups / ideologies drives political decision-making and reform agenda

Illustration: Economic Reform in DPRK



...or even worse...



Summary

- Little flexibility in trade policy area
 - Most countries apply WTO-consistent policies
 - Liberal and transparent trade policies make up a necessary but not sufficient condition for economic success
- Important role for general development policy
 - Credit markets, private sector development, FDI, education, infrastructure, institutions (*the usual suspects*)
 - China seems to be a special case: an authoritarian one-party state is obviously able to create great export success, but at a high cost