Lecture 19: Development Strategies

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Today’s Plan

• Housekeeping
• Your papers
• Reading Quiz

• Natural Resources and Long Run Growth
• Dutch Disease (How does that work, anyway?)

• Today’s topic:
  • Development Strategies
    • Why circle back to this?
    • Tying things back together
Housekeeping

- Curve on your papers
  - You get back 25% of the points you missed
  - Don’t expect a curve on paper 2
Reading Quiz (1)

• Import substitution has the following advantages in developing nations:
• a. Trade restrictions give domestic industries incentive to increase efficiency
• b. A small domestic market allows manufacturers to have low per-unit costs
• c. Removes corruption and lowers the gains from smuggling
• d. In order to avoid tariff walls, FDI increases, which creates local jobs
• e. only c & d
Reading Quiz (2)

• All are true of export-led growth except:

• A. It helps industries in developing nations that have a comparative advantage in producing a specific good.

• B. Trade openness allows domestic manufacturers a larger market to exploit economies of scale.

• C. During the 1990s, developing nations that remained closed to the international economy grew faster.

• D. It entails low restrictions on imported goods

• E. all of the above are true
Are Natural Resources Always a Blessing?

• The US got so rich in part because it has so many natural resources
• Japan entered WWII because it needed access to more resources
• It’s hard to get rich if you live in a dessert with no oil

• But there are two (potential) problems associated with natural resource wealth
  • Dutch Disease
  • Resource Curse
To understand the following video:

- The Canadian currency is the dollar, sometimes also called the Looney
- The Canadian oil sands are mostly in Alberta
Dutch Disease (1)

• Step 1: Natural resource exports go up (a lot)
• Step 2: Foreign money flows in
  • Foreign investment in resource extraction
  • Purchases of natural resources
  • Current account surplus
• Step 3: This drives up the value of the currency
• Step 4: Is having a highly-valued currency good or bad?
  • Yes
Dutch Disease(2)

• The Bad:
  • Labor & land get more expensive
  • Manufactured goods get more expensive to produce
  • Manufacturing exports decline, jobs are lost

• The Good:
  • Increased employment in natural resource extraction
  • Increased ability for manufacturing firms to invest
    • This raises productivity per worker
    • Offsets the increase in wages, allows (high end) manufacturing to remain competitive.

• Manufacturing is more labor-intensive than natural resource extraction, so net loss of jobs
Dutch Disease (3)

• Takeaway:
  • Dutch disease may not be a problem if natural resource profits end up invested
    • Education (human capital) and high-end manufacturing technology
Dutch Disease: Connecting Back

• When foreign exchange flows in to purchase natural resource exports, is there anything the government can do to stop their currency from appreciating?
  
  • A. No  
  • B. Yes, print local currency and use it to buy foreign currency  
  • C. Yes, enact capital controls
The Resource Curse

- Oil, natural gas, diamonds, high-value tropical hardwoods
  - “Lootable Resources”
  - Tend to cause bad governance and civil war
- First, a step back
Roving vs. Stationary Bandits

• “Roving” bandit takes everything and moves on
• The stationary bandit can only take just so much
  • Needs to leave citizens enough to survive & stay productive
  • Protects them from other bandits
• Also leaves citizens enough to avoid revolt
  • Two tools: repression and public goods provisions
  • Repression reduces future revenue, public goods increase it
• Social contract: taxes for government protection/services
• Takeaway: The better the economy, the higher government revenue
The Resource Curse (2)

- If a government has revenue from natural resources, it doesn’t need to tax the population.
- So it doesn’t care if the population earns enough to tax.
- It just needs to prevent rebellion.
  - And repression becomes cost effective.
- Empirical evidence on the resource curse is mixed.
The Resource Curse (3)

• Why did Norway work out?
• Because they had strong institutions BEFORE oil was discovered
  • But they still have Dutch Disease
  • Wages are high, and they can only export very high-end manufactured goods
ISI vs EOI: A review

- Both involve taxing farmers and subsidizing particular industries
  - Both involve the government picking winners
- Key difference:
  - EOI focuses on production for exports (free trade)
  - ISI focuses on replacing imports with domestic production, and reducing trade as much as possible (near autarky)
- Only EOI allows countries to capture the gains from trade
Openness and Economic Growth in Developing Countries

Average Annual Growth in Real Income per Capita (Percent)

- Globalizers:
  - 1960s: 1.4%
  - 1970s: 2.9%
  - 1980s: 3.3%
  - 1990s: 1.4%

- Nonglobalizers:
  - 1960s: 2.4%
  - 1970s: 3.3%
  - 1980s: 3.5%
  - 1990s: 5.0%
“Flying Geese” pattern of economic growth

• Step 1: Japan is the world leader manufacturing textiles (1950s & 60s)
• Step 2: Japan invests in more education and infrastructure, wages rise
• Step 3: Japan loses competitive advantage in textiles
  • gains a competitive advantage in cars and electronics
• Taiwan and Malaysia take over in apparel and textiles
• Taiwan and Malaysia invest more in education and infrastructure, wages rise
• Taiwan and Malaysia move from apparel to electronics etc
  • Thailand, Vietnam, and Indonesia rise as major textile manufacturers
• All of these countries are following Export-Oriented Industrialization
Trade Openness and Financial Openness

- Very similar tradeoffs
- Openness increases wealth, but increases volatility
  - May also increase inequality
- Winners and losers from trade, winners and losers from FDI
  - Import-competing industries lose out from free trade
  - Domestic firms that have to compete with new foreign entrants may also lose out
- How do you sustain economic openness in a democracy?
  - Redistribution is larger where openness is larger
$y = 0.3447x$
$R^2 = 0.3401$
Circling Back: The Big Picture

• Is growth good for the poor?

• Economic growth is not always evenly distributed across the economic spectrum
  • In the short run, growth generally increases inequality

• Growth is better for the poor than not growth
  • But the distribution of gains depends on domestic political decisions
The Gains From Openness: Core Decisions

- How much of the gains from openness are collected by the government?
  - Taxes too high -> low growth
  - Taxes too low -> low investment (education, infrastructure), low redistribution
- Does the government spend (i.e. invest/redistribute) that wisely?
  - Investment/redistribution vs. vanity projects/corruption
- What level of regulation?
  - Too much regulation -> low growth
  - Too little regulation -> workers exploited, environment destroyed, communities displaced
You’re the Peruvian Finance Minister, what do you recommend?

- Chinese foreign direct investment in Peru is rapidly expanding
  - Almost all in mining
- Civil society groups have raised concerns about the environmental and social impacts of these investments
  - Water quality
  - Displacement of native/traditional communities
- Many projects are currently on hold pending government review
- What policies could help Peru achieve economic growth that benefits the greatest proportion of its population?