

Economics 404W

lecture 26

Professor Tybout
April 20, 2006

Announcements: Final writing assignment posted; due May 1
Exams back on Tuesday

Final writing assignment

- Objectives of the report
 - Give the reader a clear overview of economic conditions in your country;
 - Explain why these conditions prevail by drawing on course material; and
 - Critically assess the country's recent economic policies, drawing again on the course material.

Final writing assignment

- 6 to 9 pages long, typewritten, double-spaced, with sensible fonts and margins. (Please do not exceed the 9 page limit.)
- Incorporate edited material from your earlier writing assignments, but it will also include some new sections.

Final writing assignment

- A good report:
 - logically structured
 - tightly reasoned
 - clearly written
 - properly documented
- A poor report:
 - lacks economic reasoning
 - includes extraneous information
 - exhibits undisciplined writing
 - doesn't cite its sources properly

Final writing assignment: Outline

1. General background

- size (population, total GDP)
- level of development (GDP per capita, life expectancies, caloric intake levels)
- Inequality and poverty (standard inequality measures, percent in poverty)
- growth performance over past twenty years (growth in GDP per capita, savings rates, extent of industrialization, productivity growth)
- factor endowments (skill level of labor force, major natural resources, capital stock per worker if available)

Final writing assignment

2. Business conditions:

- governance (rule of law, degree of corruption, crime)
- Taxation
- macro volatility (volatility in major macro variables)
- infrastructure (provision of roads, utilities, ports)

Final writing assignment

3. Population, demographic transition and labor markets

- rates of population growth, birth rates, death rates, life expectancy
- population control policies, if any.
- Unemployment rates, migration patterns.

Final writing assignment

4. Trade and foreign direct investment

- commercial policy (tariff rates, non-tariff barriers, export promotion programs)
- posture toward foreign investors
- trading patterns and their relation to factor endowments
- growth in trade flows
- foreign capital inflows (as a percent of GDP, sectors of destination)

Final writing assignment

5. Overall assessment of the country's performance

- Has the country made good progress in the past 30 years?
- What in your opinion, is the country doing right?
- What, in your opinion, needs changing?
- General comments

Openness and Growth: Possible Linkages

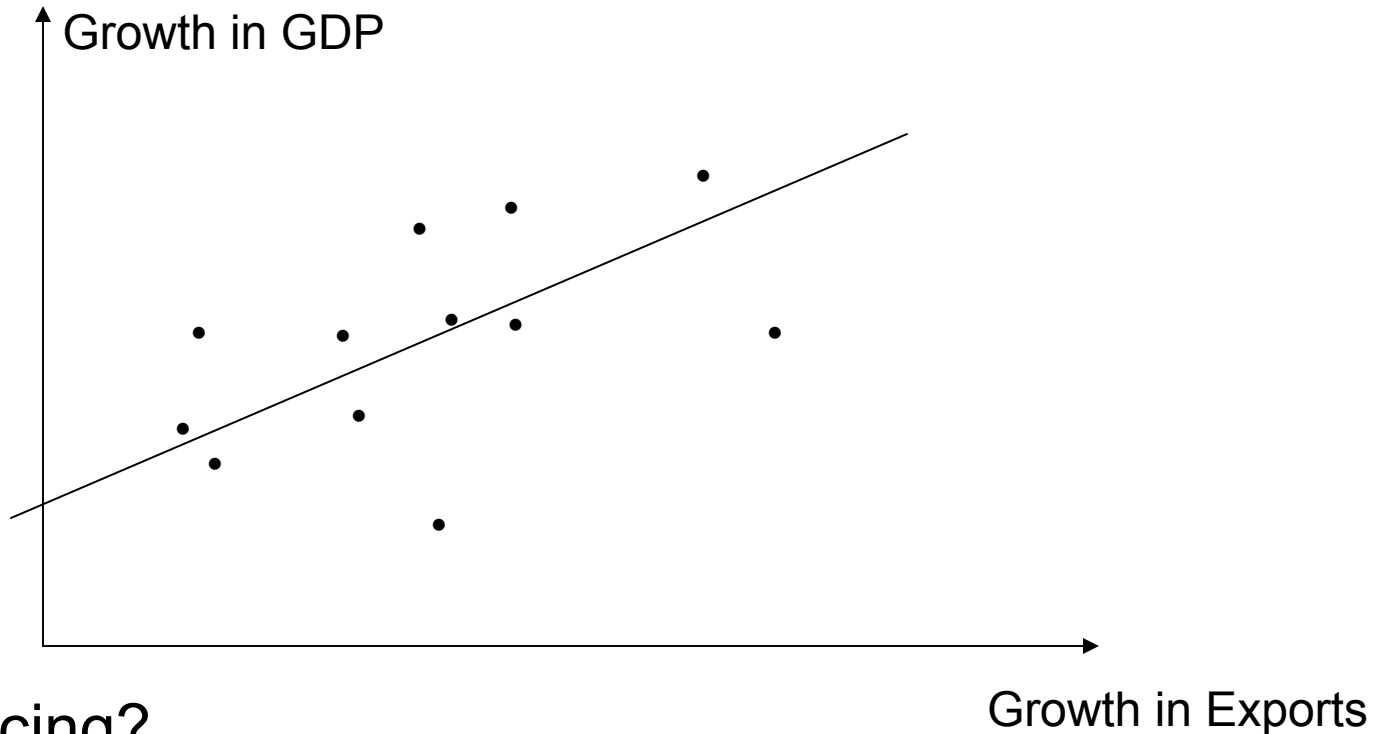
- Openness can accelerate growth:
 - Access to global menu of inputs and capital goods
 - A conduit for technology diffusion
 - Greater incentives to innovate (maybe)
- Openness can also retard growth:
 - Lower incentives to innovate (maybe)
 - Learning by doing in the import-competing industries

The Evidence on Trade and Growth

- The famous Gang of 4 countries experienced spectacular growth with relatively outward-oriented policies during the 1960-80s.
- Some other countries experienced very slow growth with inward-oriented policies (e.g., India, China, N. Korea, Africa)
- But economists don't agree on whether openness was the cause of the rapid growth in E. Asia, or was part of a generally sensible economic package.

The Evidence on Trade and Growth

- Early studies simply related growth in exports to growth in GDP:



- Convincing?

The Evidence on Trade and Growth

- $GDP = C + I + G + X - M$
- So random shocks to exports will naturally lead to a positive association between output growth and export growth.
- Better to focus on policy variables. But what constitutes an open (i.e., export-oriented) economy?

The Evidence on Trade and Growth

Sachs and Warner (1995): An economy is *not* open if

- average tariff rate exceeds 40% (TAR)
- Non-tariff barriers covered more than 40% of imports (NTB)
- socialist economic system (SOC)
- state monopoly of major exports (MON)
- black market premium exceeds 20% during either the decade of the 70s or the 80s (BMP)

The Evidence on Trade and Growth

Sachs and Warner, continued:

Growth during 1970-89:

Continuously closed versus continuously open economies

	<i>Always open</i>	<i>Not always open</i>
Average growth rate > 3.0 %	11	4
Average growth rate < 3.0 %	4	70

Evidence on trade and growth

Sachs and Warner, continued

- Open developing countries grew particularly fast (4.45 percent);
- Open developed countries grew respectably (2.29 percent);
- Closed countries grew slowly: .74 (developed) and .69 (developing), respectively.
- S&W suggest that the failure of rich and poor countries to converge in per capita incomes might be blamed on those poor countries that remained closed during this time period.
- Looking at 15 countries that switched from being closed to being open after World War II, average growth rate during the closed period was -0.45 percent; during the open period it was 3.88 percent.
- regressions show OPEN to be strongly associated with growth, even when the standard set of control variables is included

Evidence on trade and growth

Dani Rodrik and Fernando Rodriguez (2000) counter that:

- Two variables essentially drive the S&W openness index: black market premia and export taxes. The rest, including the commercial policy variables, can be excluded from the analysis without changing the results much at all.
- The export tax variable is basically an index for troubled African economies. S&W take this index from a World Bank study that identifies only African countries under structural adjustment programs with state marketing boards.
- BMP is correlated with a wide range of macro problems; not simply trade protection. These problems tend to be associated with low growth.
- So what do S&W really show? That African countries in need of structural adjustment programs and countries with ongoing macro crises tend to grow slowly.

Multinationals: An overview

- What are multinationals?
 - Own a significant equity share of a company operating in another country (“subsidiary” or “affiliate”)
- Two types of multinational investment:
 - Horizontal FDI: This occurs when firms essentially replicate abroad some of the activities that it continues to pursue at home.
 - Vertical FDI: This occurs when firms shift a stage of its production process abroad.

Why horizontal FDI instead of licensing or exports?

The OLI conditions

1. Ownership advantage The parent firm must have a product or process to which other firms don't have access.
 - Knowledge capital (patents, blueprint, or trade secrets)
 - Reputation and brand name

Why horizontal FDI instead of licensing or exports?

2. Location advantage It must be more profitable to produce the product abroad than at home.
- shipping is costly (packing, freight, time),
 - there are advantages to being close to one's clients (e.g., custom products),
 - trade barriers (tariffs, NTBs)
 - special government-sponsored enticements in the host country.
 - labor is cheap in the host country (need to adjust for worker quality, of course)
 - plant-level scale economies are modest relative to firm-level scale economies
 - cost savings due to factors above can have strategic effects on output of other firms in the host market

Why horizontal FDI instead of licensing or exports?

3. Internalization advantage There must be some reason that the rents from proprietary assets (private expertise or brand) are better extracted by maintaining direct control of the production.
- Potential licensees may not sign up unless they know the details of what they're getting. Once you tell them, however, they don't need a license to produce your product.
 - Even if a licensing agreement is reached, turnover among skilled workers, technicians, etc. may diffuse your proprietary knowledge to competitors.
 - A licensee may debase the company reputation in order to earn SR profits.

Why horizontal FDI instead of licensing or exports?

3. Internalization advantage (continued)

- The “hold-up problem:” It is not possible to draw up contracts with suppliers that cover all contingencies. So:
 - Once the supplier has invested in producing the input, the U.S. firm could hold up payment, “saying that some contingencies uncovered by the contract have occurred.
 - The contract then has to be renegotiated, and if the investment is specific to the relationship (i.e., has no other use), the supplier’s bargaining position will be weak.”
 - Suppliers anticipate this, and under-invest in the project. Subsidiaries don’t pose this problem