Development policies

industrial, financial and commercial policies

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Growth determinism

. . . of its sustainability and inclusiveness

Huge swath of the economic research are dedicated to the identification of exogenous causes of growth

- physical capital, technical progress, human capital
- institutions, incentives, markets, productive structures, capacity to trade
- culture, attitude vis-á-vis new ideas
- social structure and demography
- geographic determinants, luck

Outline of the sequence

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Justifications for regulation

Consensual justifications of state intervention: market failures

- Information asymmetries (moral hazard, adverse selection)
- Noncompetitive markets (natural monopolies and rent seeking)
- (positive and negative) externalities
- Public goods provision

A non consensual justification:

- intervention in the sector structure of the economy

Arguments in favor of an industrial policy

- the state only can take into account the positive externalities of an investment and the public good dimension of certain productions
- the state only can undertake certain investments
  - too risky
  - too big
  - too long term
- and a consensual argument: protection of infant industries

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Arguments against an industrial policy

- Frequent failure of big public industrial projects
- Crowding-out effect on private investment
- It is questionable that moral hazard in the public sector is lesser than the one in the private sector

A successful industrial policy: Mauritius

- negotiation of the Lomé agreements
- public infrastructures and training agencies in the tourism sector fiscal and financial incentives to attract investors
- creation of a buffer zone
- services to firm development in the *offshore* sector
- communication infrastructures

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Insufficiency of industrial policy: Botswana

- importance of the diamond industry
- success of the livestock sector
- before 1982 development of a context favorable to investment
- after 1982
  - extension of financing facilities
  - Government White Papers

Conclusion on the industrial policy

For the record: conclusion that does not commit the institutions

- No country ever developed without some form of industrial policy.
- Many industrial policies were unsuccessful
- Limits of the comparative advantages theory
- Simultaneous objectives:
  - encourages sectors generating economies of scale and positive externalities
  - intervenes in labor, capital and goods markets
  - encourages private investment and innovation
  - protects infant industries, exposes mature industries to international competition

Outline of the sequence

Trade $\Longrightarrow$ growth?

Several mechanisms establish a causal link between trade openness and growth

- direct gains from trade
- trade openness $\Longrightarrow$ incentives for FDI
- FDI $\Longrightarrow$ technological transfers
- protection of vulnerable sectors and exposure of competitive sectors

The tools of commercial policy

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- tariffs
  - ad valorem
  - specific
- non-tariff barriers
  - subsidies
  - quotas (and embargoes)
  - norms, rules and standards
  - entry delays, bureaucratic and administrative obstacles
  - capital controls

The objectives of trade policy

- encourage international trade
- protect country's crucial markets
- favor exports of a good
- avoid imports of another good
- encourage imports of industrial machinery
- stabilize trade by establishing trade agreements

Export promotion

The Japanese example in the 1950s and 1960s

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Measures related to industrial policy

- allocation of credit, aid, subsidies, licenses and public contracts
- exemptions of certain rules (cartels, monopolies, foreign currency access)

Accompanied by trade specific measures until the 1970s

- complete fiscal exemptions on export revenues
- complete control by MITI over foreign currencies aimed at financing imports
- progressive trade liberalization only from the 1970s onwards

Import substitution

Objectives
- reduce external dependence
- artificially create a market for the local industrial production

Tools
- active industrialization policy
- tariffs and quotas

Results
- The Brazilian and Mexican miracles in the 1940-50-60s
- vs. the lost decade in South America

Outline of the sequence

Reminder: the roles of finance

Finance pursues an array of objectives in the economic structure:

- it creates information
- it exerts corporate governance
- it diversifies risk
- it mobilizes savings
- it facilitates transactions

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The financial instability

A stylized vision of the financial instability hypothesis

Finance produces instead specific risks

- increasing asset value $\Longrightarrow$ credit growth exceeds economic growth
- decrease of capital return $\Longrightarrow$ increase of firms debt leverage
- deterioration of banks balance sheets and of their solvency $\Longrightarrow$ contraction of credits
- $\Longrightarrow$ economic recession

Financial repression

The 5 tools of financial repression

- ceilings on nominal IR
- quantitative controls on credit allocation
- reserve requirements
- public control of banks
- liquidity requirements

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The aim of financial repression

Political economy arguments

- favor the development of easy-to-tax activities
- finance the fiscal deficit at a lesser cost
- to protect incumbent firms and banks against new entrants

Arguments in favor of the economic development

- Encourage (force) savings to finance industrialization
- capital allocation according to free trade criteria is not necessarily favorable to development
- Counterbalance the procyclicality and instability inherent to the banking sector

The dangers of financial repression

Empirically, financial repression is associated to several negative consequences

- lower real interest rates
- credit rationing
- lower quality and quantity of investment

A successful case of financial policy

The forced industrialization of Korea

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- 1962: the BOK is put under the administrative supervision of the Ministry of Finance
- 1963: partial capital account opening
- 1970: 96,4% of financial assets are under government control
- credit rationing $\Longrightarrow$
  - priority to exporters on ST credits
  - priority to strategic sectors (manufacturing – 63-73 – then heavy industry – 73-79) on LT credits

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Financial globalization

A few historical dates

- 1973 and 1978 oil shocks
  - currency inflows in developing countries
- 1979 US monetary policy tightening
  - investors withdrawal – foreign currency dry-up – debt service increases
- 1982 Mexican debt crisis / lost decade in South America
  - "Good-bye Financial Repression, Hello Financial Crash": procyclicality impact

Measure capital account openness

Measures of capital control – de jure measures

- controls on inflows / outflows
- controls on quantities / prices
- controls on flows / stocks
- IMF AREAER data

Measures of real flows and stocks – de facto measures

- gross and net financial flows
- gross / net stocks of foreign liabilities and assets
- in absolute terms or in share of GDP

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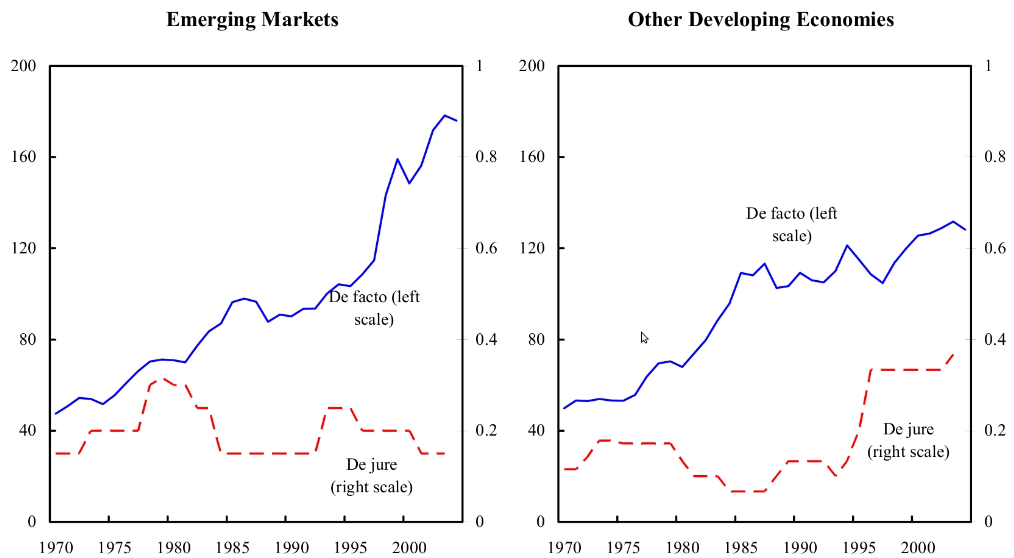
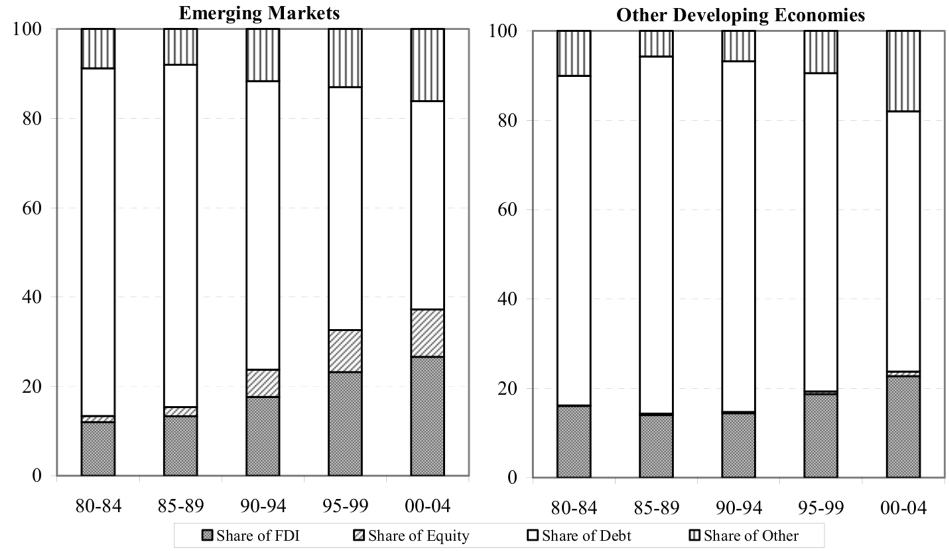
Measure financial globalization



Source: Kose & al. (2010)

Decompose financial globalization



Source: Kose & al. (2010)

Capital account openness $\Longrightarrow$ growth

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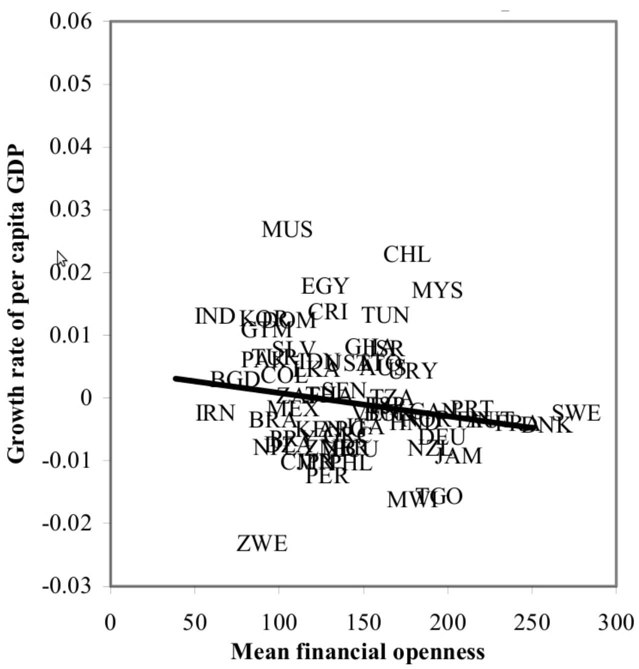

Source: Kose & al. (2010)

Capital account openness $\implies$ volatility

Contradictory mechanisms

- risk diversification when the productive base is narrow
- but incentive to specialize more
- and bigger exposure to imported financial shocks

And secondary predictions associated with the theory of real cycles

✗ smoothing of consumption relative to income

✗ reinforcement macroeconomic aggregates co-cyclicality

Domestic and external financial liberalization

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The capital account opening contributes to the domestic financial sector development

- more capital $\implies$ financial deepening
- imported financial sophistication

Financial development favors the positive aspects of the financial opening

- a greater efficiency in the allocation of capital
- financial depth $\implies$ reduces the vulnerability to capital flight

Trade and financial liberalization

Opening the capital account offers new trade perspectives

- financial depth, sophistication of financial instruments and financial integration favor trade
- the specialization of economies can lead to an expansion of trade

The commercial integration helps absorb financial shocks

- openness to trade facilitates a current account adjustment when needed
- a financial crisis is cushioned by the beneficial impact of a devaluation on exports

Financial opening and economic policies

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- free capital flows + budgetary deficit = crisis
- Mundell's incompatibility triangle

Conclusion on the capital account opening

The capital account opening becomes beneficial for a developing country only

- above a certain level of fiscal capacity
- above a certain level of financial development
- above a certain level of institutional development

and it is generally admitted that trade liberalization must precede financial liberalization.

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Purchasing Power Parity

- Price convergence through market mechanisms and
- foreign currency flows rebalancing
  - via a deficit or surplus of the current account balance (monetarist model)
  - via capital movements

$\Longrightarrow$

- prices of goods relatively equal between countries at an equivalent level of development
- price catching up in converging countries (with technological progress)

Price competitiveness

A depreciation of the currency changes the relative attractiveness of

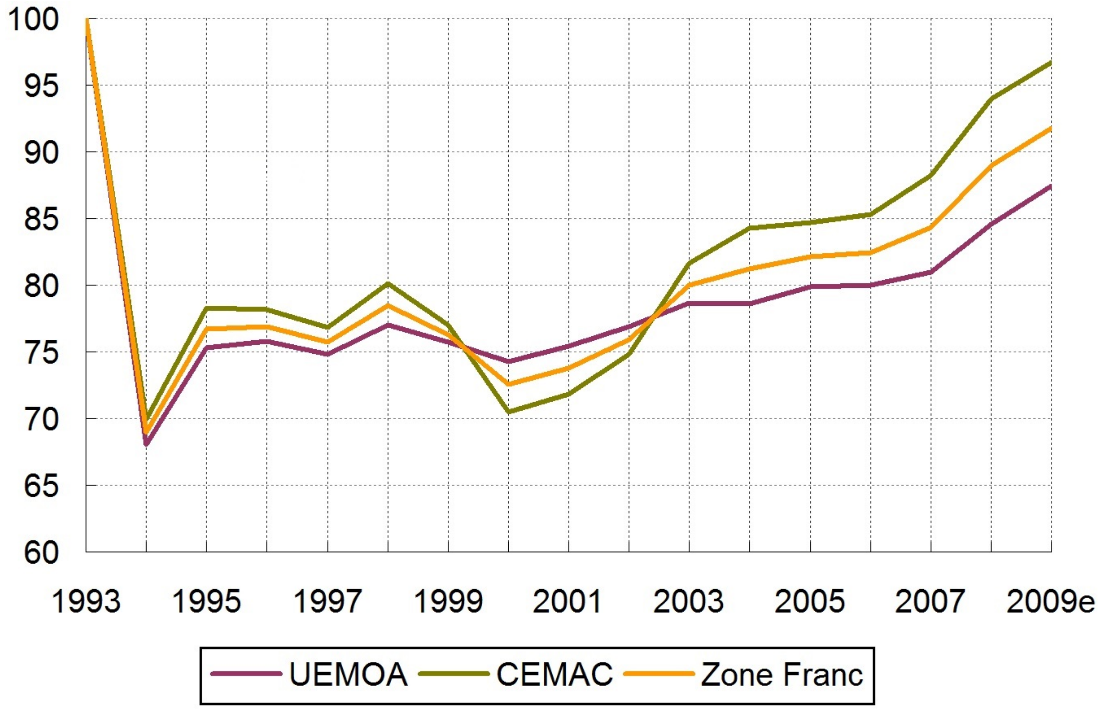
- exported goods vis-á-vis their international competitors
- locally produced goods vis-á-vis their imported competitors
- export sectors vis-á-vis non-market sectors

In the long run,

- inflation and exchange rate rebalancing

Exchange rate rebalancing

Franc zone REER, author's computation for AFD



Exchange rate overvaluation

A growing consensus that among the most systematic and most robust determinants impeding the sustainability of growth episodes are:

- the lack of institutions dedicated to export promotion
- an overvalued exchange rate

Some hints that the link between trade openness and growth is actually a link between the overvaluation of thhe ER and export growth

Undervaluation of the exchange rate

On the contrary, Rodrik shows that a undervaluation of the ER promotes exports, in particular in developing countries.
an undervaluation of ER as a "second-best industrial policy":

- weaker institutions
- market imperfections
  - credit and labor markets
  - vertical and horizontal integration of sectors

Example: Mauritius

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The Mauritius rupee, an undervalued currency

- 1994 implementation of the floating ER regime
- nominal depreciation continues ever since

Two consistent and competing explanations to the development of Mauritius

- FTZ success (25% of GDP, 36% of employment)
  - fiscal incentives
  - customs duties exemptions
  - employment market flexibility
- Undervaluation of the ER

Counter-example: Botswana

- the Rand official currency until 1977
- introduction of the Pula, which globally remains at parity with the Rand, despite an occasional appreciation corrected in 2002
  - 80% of imports come from South Africa, Rand zone
  - over 50% of exports (diamonds, meat) target the USD zone
- continuous depreciation of Rand w.r.t. the dollar
- Nevertheless, some symptoms of the Dutch disease:
  - high unemployment rate
  - the manufacturing sector represents 4% of GDP (decreasing)

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Conclusion of the sequence

- Free competition can sometimes hinder the development of sectors likely to generate sustainable and inclusive growth
- several public policies can be used to favor sectors specifically
  - the direct tools of the industrial policy
  - a differentiated trade policy (infant industries)
  - a financial policy to support industrial policy
  - a partial and specific opening of the capital account
  - undervaluation of the exchange rate
  - institutional reform

General conclusion

Several aspects of growth

- Sustainability
- Resilience
- Inclusiveness (employment and redistribution)

Two key objectives of the economic policy

- stabilization (policy mix)
- development (all set of policies supporting – or related to – the industrial policy)