

# Lectures 6 – 8, 9/22-29

## AAE 374 Fall 2008

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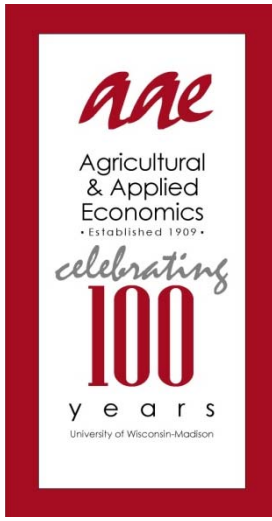
### Critiques of Free Trade

- Is it really free?
- THURS CLASS - SPECIALTIME/PLACE:  
see 3<sup>rd</sup> Slide below!!!
- Structuralist 1: Declining Terms of Trade, Unequal Exchange
- Structuralist Critique 2: Technologically Stagnant
- Resource Curse: Dutch Disease, Institutions, and Foreign Exploitation
- It's Not Free in Cotton – Next week

# Is it really free?

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- Protected Sectors?
  - Agriculture – why is this so important to South?
  - Selective Industries and Services
  - Ideas and technology
- Open Sectors?
  - Mass consumer goods in many places
  - Many natural resources
  - Intra-industry trade – why not so important to S?
- Protected Countries and Regions?
  - Recent industrializers (E Asia, China, India, Brazil) – why is this important to consider?
  - EC, Mercosur, NAFTA, etc.



## Global Food, Trade and the Environment

Agricultural & Applied Economics Centennial Seminar Series

**Biotechnology Auditorium**  
**1111 Biotechnology Center**  
**425 Henry Mall**

**Free – Open to all**  
[www.aae.wisc.edu/](http://www.aae.wisc.edu/)

### **Thurs. – Sept. 24**

### **Reassessing U.S. Trade Policy and Agriculture**

8:30 – 9:15 a.m.

**Joseph Glauber, USDA Chief Economist** — his office issues crop outlook and situation reports, eagerly awaited and scrutinized by agricultural producers, processors and commodity traders worldwide.

9:15 – 10:15 a.m.

Comments and discussion

### **Friday – Sept. 25**

### **Natural Resources: the Crisis in Globalization and the Development Challenge**

8:30 – 9:15 a.m.

**David Kaimowitz, Ford Foundation, Director of Natural Assets and Sustainability** – oversees projects in Mexico and Central America that expand community rights over natural resources and promote rural climate change policies that also meet the needs of poor rural families.

9:15 – 10:15 a.m.

Comments and discussion

# Preview of UW Alum Joe Glauber: How “Free Trade” Can He Be?

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- Lead player in US WTO negotiations on global agriculture
- US position on ag trade is?
  - Will open when others (EC) do.
  - What commodity protection belies this assertion?
  - What do you think he might say and not say on Thursday?
  - What questions can we ask?

# Critiques of Comparative Advantage: Structuralist View

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- Declining Terms of Trade Critique
  - $P_C$  = Export Price of Cotton
  - $P_A$  = Import Price of Autos
- Over time, what happens to  $P_C / P_A$ ?
  - Declines, trends down
  - So What?
  - Same cotton production, buys less autos, and provides less income.
  - Primary product comparative advantage is problematic, earning less over time.

# Logic of Declining $P_C/P_A$ Argument

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## ○ Prebisch

- Uncompetitive supply conditions in N and competitive supply conditions in S
- Unions and companies raise prices through market power in labor markets and product markets, respectively.

## ○ Singer

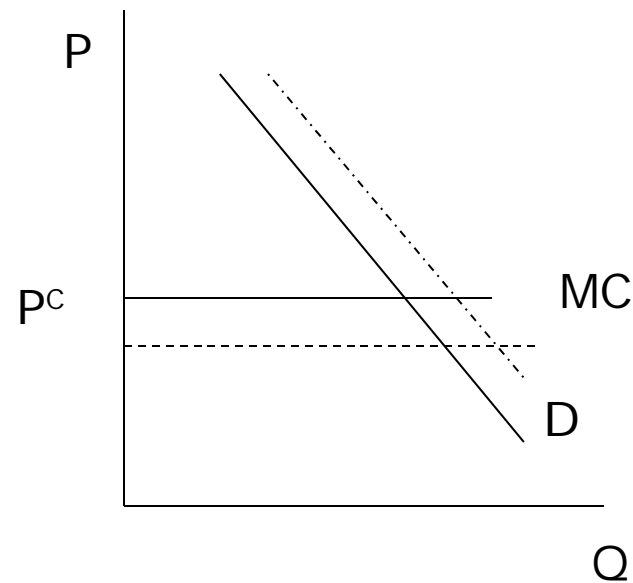
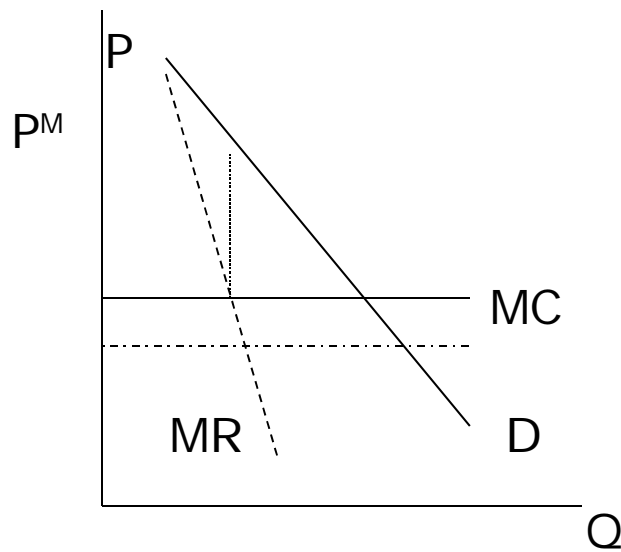
- High income elasticity of demand for manufactured goods, low income elasticity of demand for primary products
- Relative demand rises faster for manufactured goods, pushing their prices up compared to primary products.

## ○ Prebisch-Singer Hypothesis:

- Supply and demand conditions push terms of trade down over time.
- Declining terms of trade reduce benefits of comparative advantage in primary products.

# Prebisch – Supply Side Argument

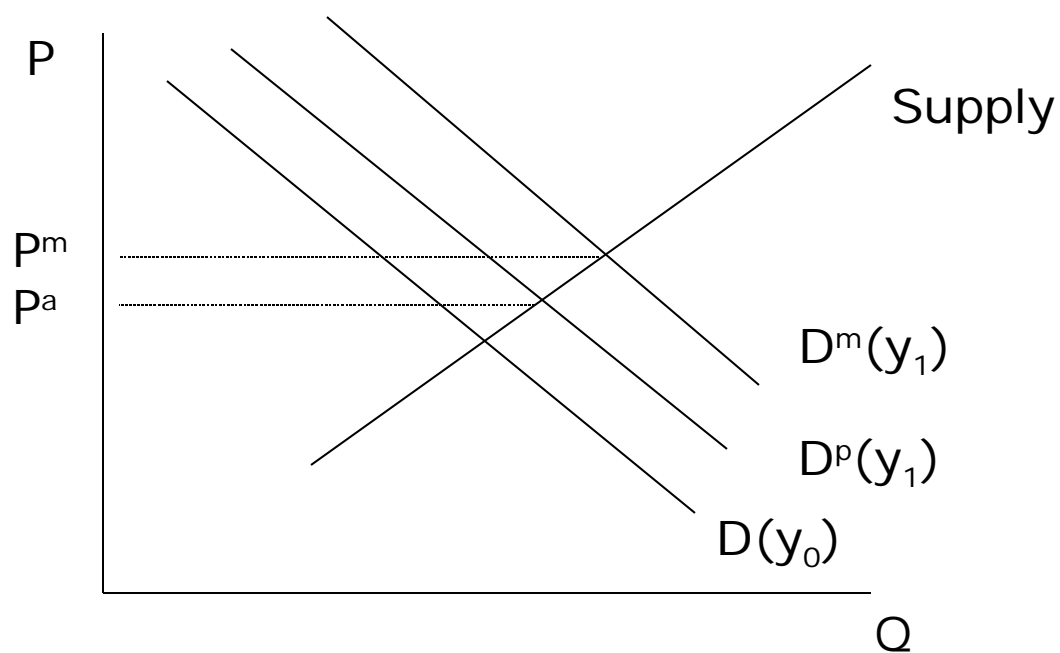
- North Monopoly                      South Competitive  
North prices higher and less responsive



# Singer – Demand Side Argument

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- Income elasticity higher for manufactured goods than for primary goods means price of manufactured good rises more w/ income growth.



# Declining T of T/Unequal Exchange: Lewis Critique

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- Stagnating wages and Falling T of T
  - Low productivity in food/subsistence agriculture lowers wages in S relative to N (see handout)  
 $a_f^N < a_f^S \rightarrow w^N > w^S$
  - $P_T = a_t^S w^S$  Price of primary product (tropics)
  - $P_I = a_i^N w^N$  Price of industrial product (temp)
- Productivity improvements in primary products (falling a's) in S lead to falling prices.
- Rising productivity of labor in food agriculture in N pushes up  $w^N$  which pushes up prices of  $P_I$ .
- S-S migration reinforces low wages, reverse is true for N-N migration in late 19<sup>th</sup> century.

# Discussion of Structuralist Critique 1: Prebisch-Singer and Lewis

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- Are they logically coherent?
- Which are the most persuasive?
- What assumptions about factor mobility underlie the structuralist view?

# Discussion Continued:

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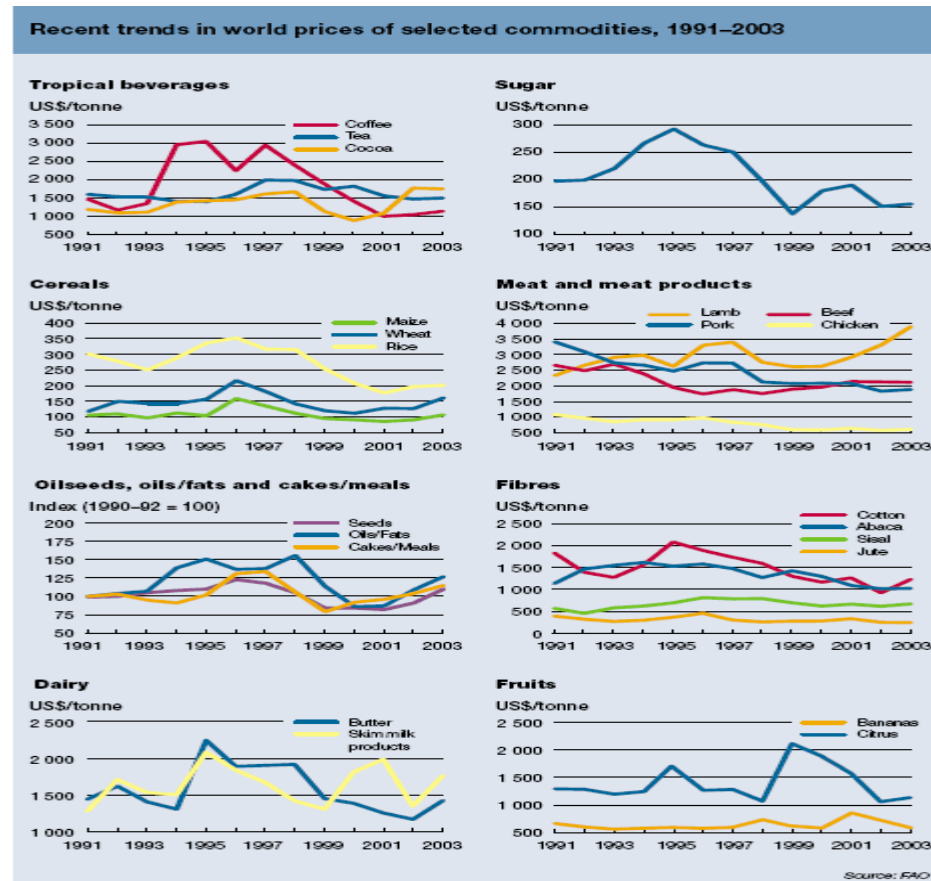
- Empirical Evidence for Declining Terms of Trade?
  - Volatility of primary product prices is non-controversial.
  - Major periods of declining T of T.
  - But, empirical issue hinges a lot on starting and ending point of comparison.

# Terms of Trade 1991-2003, FAO Data

What if we compare  
Coffee 1991-1997?  
Coffee 1997-2002?  
Coffee 1991-2000?

What about bananas?

What about citrus?



# Structuralist Critique 2: Technological Change/Stagnation

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- Growth is not just about capital accumulation but also tech change or improvements in productivity.
- Are primary products a dead-end?
  - Learning spillovers?
  - Labor skills?
  - Linkages to other more technologically advanced activities?
  - Is there a primary product → manufacturing path?



# Resource Curse: Overview

([http://en.wikipedia.org/wiki/Resource\\_curse](http://en.wikipedia.org/wiki/Resource_curse))

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○ Countries with rich natural resource bases have worse growth and development outcomes. Why?

- Dutch Disease (distorts structure of economy) +
- Excessive borrowing (on promise of future \$\$) +
- Lack of Diversification (back to Dutch Disease)
- Rent-seeking – Conflict +
- Feeble taxation systems (Guatemala example) +
- Corruption (back to Rent-seeking) = →

Lack of attention to human capital & democracy

# Why Called “Dutch Disease”? Why Not the Venezuela Disease?

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## ○ Dutch Disease Story

## ○ Venezuela (<http://www.state.gov/r/pa/ei/bgn/35766.htm>)

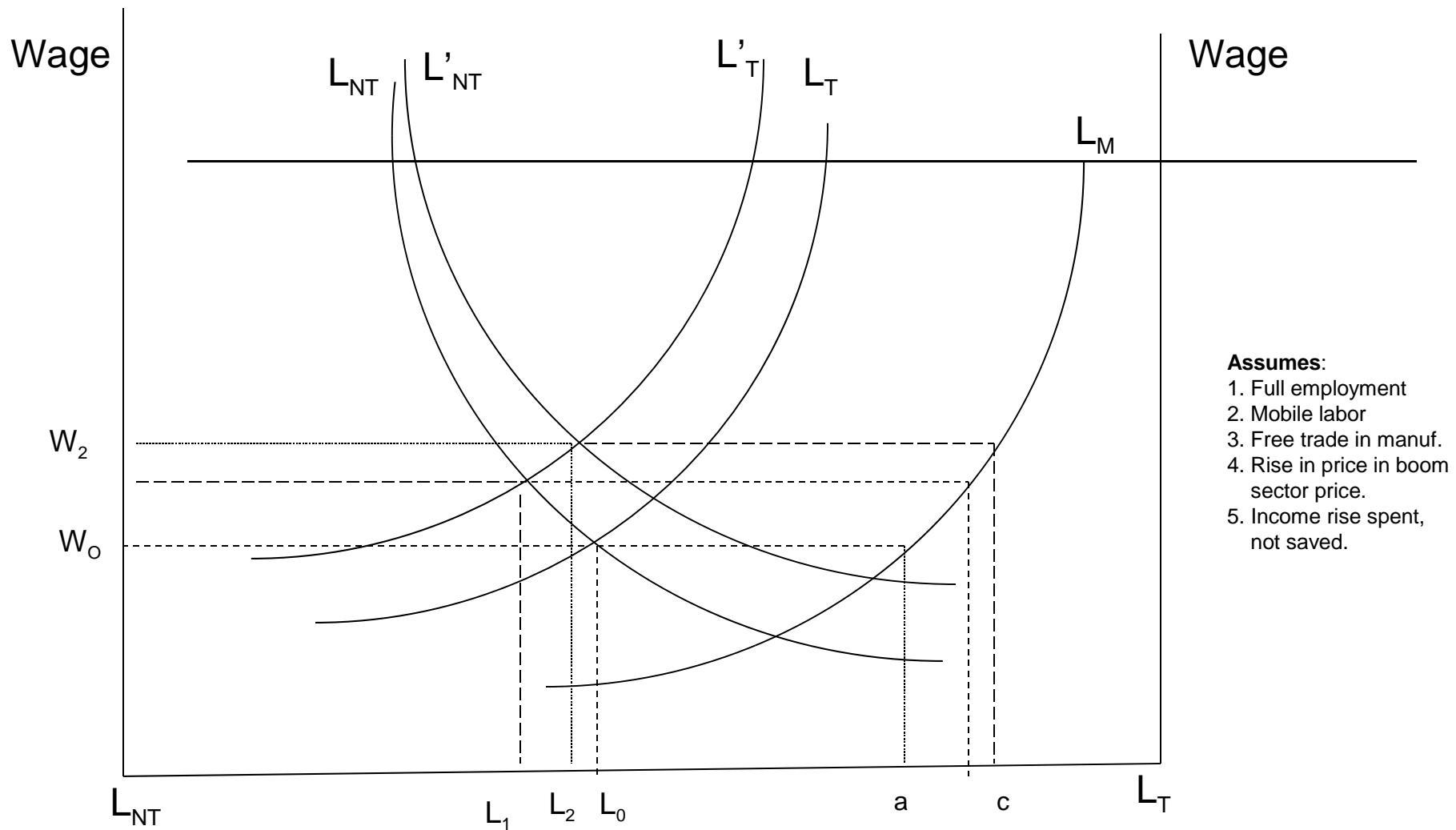
- Exports (2006) = \$64.5 billion, oil = \$57.8 billion
- GDP = \$6,250 per capita, 15% = petroleum, 17% = manufacturing, ag = 3%

# Resource Curse: Excessive Borrowing and Profligacy

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- Logic of borrowing?
  - Resource reserves (esp. when prices are high) provide high revenue stream
  - Borrowing allows govts to move faster on development, redistribution, or corrupt actions (often all 3)
- Examples of excessive borrowing:
  - Mexico, Venezuela, Algeria, Nigeria, and Ecuador with oil riches. One of the main roots of the 1980s debt crisis in many developing countries.
- Why is it a problem?
  - Exacerbates Dutch Disease (increases spending effect)
  - Set up debt traps with volatile commodity prices
  - Undercuts prudent taxation and expenditure policies.

## Dutch Disease Model of Labor Allocation during a Boom



**Assumes:**

1. Full employment
2. Mobile labor
3. Free trade in manuf.
4. Rise in price in boom sector price.
5. Income rise spent, not saved.

1. Rise in boom sector price shifts out the  $L_T$  curve – Resource Movement Effect
2. Rise in demand shifts out the  $L_{NT}$  curve – Income Spending effect
3. Net Effect – Decline in labor in manufacturing ( $ac$ ), shifted to NT and Boom sector

# Dutch Disease Distortions

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- Increased Dependence on Boom and Non-Tradable (NT) Sectors →  
**VULNERABILITY TO PRICE SHOCKS**  
but only if what?
- Rising NT prices means inflation.
- Decline of Tradable Sector:  
**Dynamic issue loss of competitiveness**
- Technology and learning associated with NT and boom sector
- Again, these issues assume what about learning and factor mobility?

# Your Views on Dutch Disease?

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- Conceptually

- Strengths

- Weaknesses:

- Empirically – How about Venezuela?

- Exports = \$64.5 billion, 2006, oil = \$57.8 billion, 90%
- GDP/Capita=\$6,250; Petroleum = 15% of GDP, Man. = 17%.
- Inflation = 15% per year recently compared with 3-4% US.
- Big Trade Surpluses recently with lots of capital flowing where? Into local construction and development projects and assistance in S America.
- More? (<http://www.state.gov/r/pa/ei/bgn/35766.htm>)

# Resource Curse: Lack of Diversification

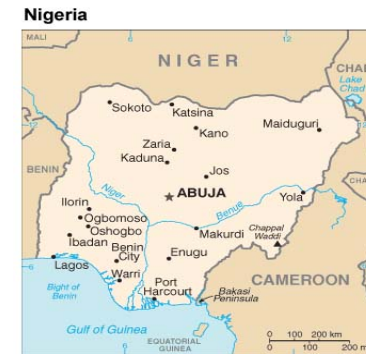
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- Basic logic of why?
  - Dutch Disease model explains
  - Expectations of easy wealth
  - Incentives for entrepreneurs and innovators shifted to wealth-grabbing
- Evidence of lack of diversification  
(boom sectors dominating exports, Boom and non-tradables sector dominating GDP)

# Empirical Evidence on Lack of Diversification

## ○ Nigeria

- Petroleum, 95% exports, 20% GDP, once a food exporter now importer,
- 70% labor in agriculture, 17% of GDP.



## ○ Ecuador

- Petroleum, 56% of exports, Bananas 12%
- Oil-mining, 24% of GDP
- Ag 6% GDP, 8% of labor
- Services 60% of GDP, 68% of Labor



## ○ Iran

- Petroleum, 80% of exports,
- Ag 11% of GDP 30% of labor
- Unemployment 20%



# Resource Curse: Rent-Seeking Behavior

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- Huge incentives to capture the “rents” (excess profits of resources). Foreign exploitation potential is high.
  - Ex: \$80/bbl of oil versus \$8/bbl prod costs.
  - Rents = Super-normal profits (graph in class)
- Political economy of country dominated by efforts to control, co-opt, & capture rents.
- Crowds out other kinds of political and economic initiatives.
- Conflict becomes central (as does potential for dictators or authoritarian regimes).

# Resource Curse: Feeble Taxation Systems

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- State control of resources (nationalization or taxation) reduces need for development of other tax systems.
  - Oil-rich countries get almost all of their government revenues from state oil company or taxes.
- Lack of public commitment to taxation system makes government vulnerable to volatile prices of oil or other leading resource.
- Also undercuts commitment to public expenditures.
  - Low investment in public education very common in resource rich countries (competitiveness of workers lower priority when resource rents are main source of wealth).  
Low commitment to democracy as well if public sector not viewed as carrying out allocation of people's tax revenues.

# Resource Riches Not Always a Curse

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- Empirical examples
  - U.S., Canada, Australia
  - Chile (copper, fruits, lumber)
  - Norway and Sweden
  - Botswana
  - Malaysia
  - Brazil?
- Why?
  - Types of resource riches (ag/ind. Links)
  - Types of institutions in place
  - Size of economy
  - Timing of booms
  - Policy Choices

# Cursed by Resources or Institutions?

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- Institutions hurt by resource riches?  
Or
- Institutions don't matter  
Or
- **Resources interact with good/bad institutions to be blessing/curse**
- Mehlum et al view rents as an opportunity or curse depending on how they are allocated which depends on quality of institutions.

# Institutions hurt by resource riches

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- Conflict/civil wars to control resource rents:
    - Sudan, Chad, Nigeria, Angola, Congo
    - Afghanistan, Colombia, Iraq
- Could be dependent on type of resource and potential for “rents”, but not always and everywhere leading to conflict.

Commander Fara Dagogo is a member of the biggest rebel group, the Movement for the Emancipation of the Niger Delta, or MEND. The commander talks with The Takeaway about why he is sabotaging his country's oil production.

<http://www.thetakeaway.org/archives/2008/09/17/6>  
Press listen with control key on.



# Institutions as Neutral?

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- If we cannot prove institutions as always bad, then they are neutral, and it must be about Dutch Disease distortions.

- Mehlum et al say what about a dynamic between

Resources  $\longleftrightarrow$  Institutions

where the feedback can be positive or negative...

# Institutions as foundational to good and bad outcomes

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- Key distinction:
  - Productive push (entrepreneurs)
  - Rent-seeking push (warlords)
- Use two graphs to explore the balance between producer profits and grabber profits (see board)
- Growth paths of resource rich countries likely to be more heterogeneous than resource-poor countries.

# Growth Paths of Resource Rich/Poor Countries with Good/Bad Institutions

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Country B, B\* - Resource rich

Country A, A\* - Resource poor

- A\* refers to good institutions
- No\* refers to bad institutions

All start from original income level  $Y_0$ .

Heterogeneity of growth path – Resource rich has higher variance than poor.

Could help to explain why simple statistical comparisons of mean growth rates would not work.

FIGURE 4  
Growth Paths

