KEY for POL 2012 Exam

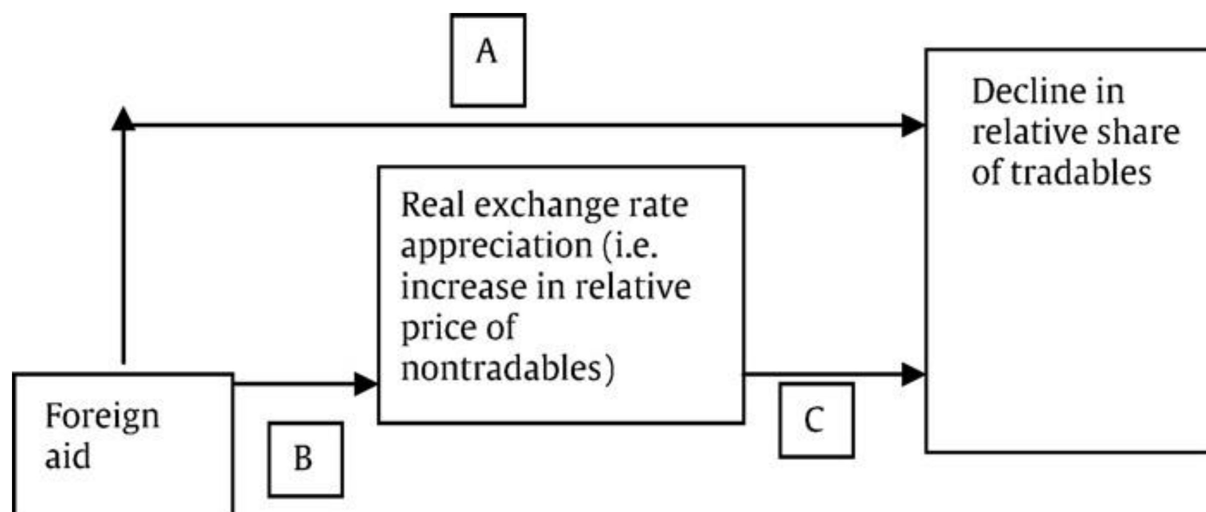
SECTION I Answers

Answer 1: (MANDATORY)

Traditionally, research on democracy and trade openness indicates that democracies prefer free trade because the abundant factor – labor – benefits from open markets. This is a staple view on economic integration based on HeckscherOhlin-Samuelson type models of international trade. Since the size of the 'selectorate' (i.e., those who have a say in policy formation) increases with democracy, a majority will prefer open markets. In authoritarian countries, the policy process is heavily dominated by local capital (a powerful but narrowly-based selectorate). Since capital is the scarce factor in poor countries, control of policy can mean supernormal profits for local capitalists (local industrialists). Under open-economy conditions, the scarce factor within poor countries will lose as local capitalists (local industrialists) are forced to compete with (both vertical and horizontal) FDI for domestic markets and for labor. New entrants, particularly MNCs, which generally offer higher wages than domestic firms, are likely to alter labor market conditions (such as paying high wages for example) in a way that works against monopoly-seeking domestic firms. This forces migration of labor from local firms to foreign firms, from rural areas to urban areas (where foreign firms are largely based) and from non-tradable sector to tradable sector to take advantage of higher wages offered by foreign capital. In order to retain the existing labor force, the local capitalist will also raise the wages. As wages tends to go up across the board, the labor (who is also the median voter in a democracy) stands to gain. As foreign capital is allowed into the country, the monopoly positions of state firms and domestic industrialists are also likely to erode, to the benefit of labor and larger segments of domestic society, or those who make up the 'selectorate' (i.e. the voters) in a democracy. Therefore, it is in the interest of democratic rulers to allow FDI which not only have positive effect on the economy in the medium to long run, but also benefits the labor, which form the electorate base for democratic leaders.

Answer 2: (MANDATORY)

The following is a schematic representation of the effects of aid on prices and quantities. Two key assumptions are needed to be made. First, the country has no access to other forms of foreign capital and is dependent only on development aid (as foreign capital). Second, supply of skilled labor is fixed (meaning, there is no immigration of skilled labor).



In a simple two-good model, increased aid will have two effects. First, aid could disproportionately be targeted at expanding non-tradable services such as construction, health care, and education for which there is substantial unmet demand. This will increase wages in non-tradable sector (given a fixed supply of skilled labor in the short run), will draw skilled labor into the non-tradable sector, and will increase wages overall. Given that the international price of traded goods is fixed, the higher wage in terms of traded goods will reduce traded sector profitability, competitiveness, and lead to a decline in exports (channel A in figure).

Second, the higher wages will be spent, raising the price of non-traded goods relative to traded goods (the real exchange rate) and further hurting traded sector competitiveness (channel B-C in figure).

Answer 3:

Arguments in favour of trade protection can be classified into the following categories:

1. **Qualified arguments**: = justified under particular conditions
   (valid IF long term benefits of protectionism > short-term costs)
2. **Questionable arguments** = offer short-term solutions to problems.
3. **Incorrect arguments** = incorrect economic reasoning.

(I) Qualified arguments

1. **Infant industry argument**. An *infant industry* is a new domestic industry that has not had the time to become efficient and may therefore be unable to compete with more mature foreign firms. In order to be able to grow in size and achieve economies of scale (lower production costs) a new firm may need protection from imports until it has grown in size. Mainly used by LDCs.

   Problems: 1. Identify the industries; 2. Protected industres may lose the incentive to become more efficient; 3. Governments may continue to protect an industry longer than needed.
2. **Strategic trade policy**. Industries considered to be important to the future growth of an economy should receive protection until they achieve the necessary economies of scale. Ex: computers, telecommunications, semiconductors. This is very similar to the previous one

   Problems: 1. Identification of the industries; 2. Selection of appropriate protectionist policies; 3. It is likely that all or most countris will use protection for the same industries at the same time, wich contradicts the idea of creating comparative advantage; 4. Gov might continue to protect these industries longer than needed.
3. **Efforts of a LDC to diversify.** Diversification means to increase the variety of goods and services produced. It can be thought as the opposite of specialization (basis of comparative advantage). Some countries might be better off diversifying their production and exports, as in the case of LDCs that are highly specialized in the production and export of one or few commodities.

   Arguments against excessive specialization:

- Fluctuations in global D or S → fluctuations in prices of primary goods → unstable export revenues.
- ↓export or export prices → ↓export rev and ↓incomes

4. **National security**. Certain industries that are essential for national defence (aircraft, weapons, chemicals, certain minerals) should be protected so that a country can produce them itself.

   Problem: it can be used by industries that have an indirect use in defence, such as steel, to try to acquire protection against foreign competition. Also, it is difficult to determine what is essential for national defence.
5. **Health, safety and environmental standards**. There is concern that these standards may sometimes be used as a form of 'hidden' protection.

(II) Questionable arguments

1. **Tariffs as a source of government revenue.** More common in LDCs: ease with which imports can be taxed. In contrast, income taxes are more difficult to levy and collect in LDCs for three reasons:
   a. Large shares of the population live on very low incomes.
   b. Large proportion of people self-employed and working in the informal sector.
   c. Poor enforcement of tax collection and high tax evasion rates.
2. **Means to overcome balance of payments deficit**. A balance of payments deficit occurs when the outflow of money from a country is greater than the inflow. It usually happens when imports are greater than exports. Imposing barriers to the entry of imports limits the need to make payments abroad. However: ↓imports→ ↓exports in the exporting countries. There is a risk that these countries may retaliate by imposing protectionist measures of their own. In this case all countries would be worse off: ↓ in international trade and worsening balance of payments problems (↓imports + ↓exports).
3. **Anti-dumping.** *Dumping* is the practice of selling a good in international markets at a price below the cost of production (usually by providing export subsidies). It is considered to be an unfair practice and is illegal according to int'al agreements.

problem: it is difficult to prove that dumping is being practised, so it is often used by many governments as an excuse to protect their domestic producers when this is not necessary or justified.

4. **Protection of domestic jobs**. Import restrictions cause consumers to shift consumption away from imports and towards domestic produced goods. As domestic production increases, unemployment falls.

   Problem: if unemployment in the domestic country falls, this means that unemployment has increased in those countries that now export less. These may retaliate by imposing import restrictions, with the result that all countries will be worse off.

(III) Incorrect arguments

1. **Wage protection argument**. Some foreign countries can produce at lower costs because of low wages, so that imports from those countries will sell at lower prices and domestic firms will not be able to compete. Protection becomes necessary to restrict imports from low-wage countries.

   Although very popular, this argument is based on incorrect economic reasoning. A low wage country likely has a comparative advantage in producing goods that make use of its cheap labour resources. This is the basis of specialization & trade according to the theory of comparative advantage.

Answer 4:

The IMF conditions are classified into three types namely, Prior actions, Performance criteria, and Structural benchmarks. The prior action conditions are those which the recipient countries are expected to fulfill prior to the approval of the agreement and the necessary financing of the program by the IMF's Executive board. The key feature of prior action conditions is the non-compliance. A country would not receive any funds under the IMF program if they do not comply with conditions under prior actions. Under the performance criteria, the conditions set by the Executive board are required to be met by the recipient country by a specific date under an agreement. Conditions under performance criteria are measured by the Fund on a quarterly basis with specific variables which help monitor the progress. Thus, from time to time, credit disbursements are released in trenches only after the evaluation of compliance on performance criteria conditions. Like prior actions, compliance is the key feature of this condition which needs to be met before disbursements are made. The structural benchmark conditions cover specific structural reforms in the country. Because most of the structural reforms are neither directly measurable nor monitorable, non-compliance of these conditions does not result in either halting loan disbursements or termination of the program.

Usually, conditionalities address the following problems. First, accepting IMF conditions entails ex ante huge political cost. Usually, politicians perceive an electoral cost in committing and adopting economic reforms. A popular perception among policy makers is that governments are afraid of losing votes due to the short-run political costs associated with introducing tough economic reforms. Powerful interest groups who are certain to lose from reforms measures may lobby hard to block it. Assuming the governments accept the IMF conditions then once committed to implementing reform policies as a part of IMF conditions, reneging on those commitments might incur ex post political costs for the incumbent government. One such ex post cost would be to cease the disbursement of future loan tranches

by the Fund and even restraining itself (and its affiliate institutions) from giving further loans to the country. As a result, the reputational damage for the governments both domestically and internationally could be huge. For domestic constituency this could send a signal of incompetence of the government's ability to manage and pull the country out of a rut. Thus, conditions unlock the problem of "reluctance to reforms" by the recipient governments.

Second, conditions also address the problem of "time inconsistency" problem, which is that the recipient countries can renege on the promises made to implement policy reforms when accepting loans/aid. One plausible mechanism with which the IMF can address such problem is to impose conditionalities.

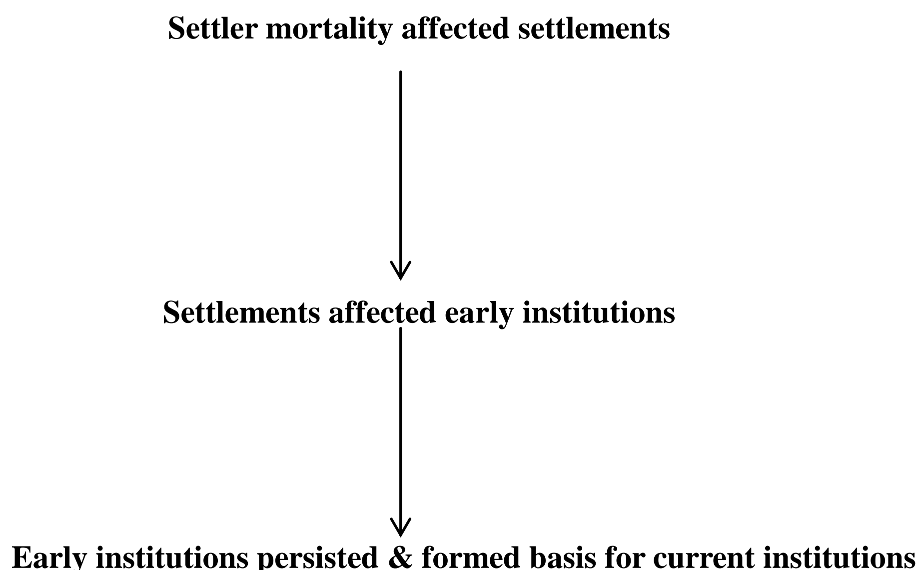
Third, conditionalities can also address the problem of "moral hazard". The idea is that the recipient countries know that IMF financing helps crisis-prone countries stave off default and are therefore willing to lend to such countries at lower interest rate spreads than would prevail if the IMF did not exist. The IMF's presence thus weakens pressure on governments to pursue policies—such as sustainable fiscal policies and sound financial supervision and regulation—that could help prevent crises.

Answer 5:

The variation in economic development among countries today can be traced back to the different types of colonization policies which were created by the colonial powers which in turn created different sets of institutions.

- Extractive states vs. Neo-European states (replicating institutions at home)

The Colonization strategy was influenced by: Feasibility of settlements. So, in places where settlers mortality was high saw FEW new settlers visit. Where colonizers settled down there the institutions were modelled after home country's institutions. Eamples include: Democratic culture, Law and order institutions, Legal structures, separation of powers, checks & balances, property rights rules, engaging in trade, business regulations, etc. When European-like institutions did not arise naturally, the settlers fought for them against the wishes of Home County (eg. Australia, NZ). On the other hand, the *extractive strategy* set-up authoritarian and absolute statists so as to facilitate the extraction of resources from colonies to the colonizers. Thus, once the institutions created by the colonizers were put in place, those institutions persisted even after independence. The costs of introducing new/good institutions (at independence) were very high for local ruling elites because the ruling elite size was often small and revenues are large. So the new elite (post-independence) don't want 'extractive state' to let go! Thus, colonies where European settlers faced higher mortality are today substantially poorer & regressive than colonies where Europeans settled (this can also be depicted in the schematic diagram below).



Answer 6:

Wealth in natural resources not only hinders growth but also stifles political modernization! A country with no resources to get rich means making people rich. So, in return governments' must provide public goods & services, governance, accountability ending up with democracy and liberty! On the other hand, a country with access to natural resources just amass the wealth and buy the consent of the majority masses by initiating various welfare schemes without actually developing (a) non-extractive industries and (b) institutions and laws. As people in resource rich states are not taxed, the government (& officials) are not accountable to the people and hence stave off any demands for democratization process.

SECTION II Answers

1 Answer:

- **a.** FDI is investments with managerial controls; FPI has no managerial control
- **b.** FDI is investments in physical assets, FPI is investments only in financial assets
- **c.** FDI is investments with long term perspective; FPI with only short term perspective
- **d.** FDI is stable and predictable; FPI is volatile
- **e.** FDI is immobile and involve sunk cost; FPI is highly mobile

2 Answer:

- **a.** Cheap food == inhibit agricultural development == limit agricultural exports
- **b.** Establish dependence on foreign food sources
- **c.** Changes tastes & preferences away from local foods
- **d.** Food aid may have been provided to establish a market and dumping of surpluses from donor countries.
- **e.** Food aid can effect competing farmers in recipient countries because food subsidies farmers in donor countries get (due to price support system)
- **f.** Can food aid dependence lead to civil war as it provides incentives for the rebels to capture food aid.

3 Answer:

It is that labour which is not counted in the employment and unemployment numbers in the country and hence is out of labour market for a long period of time.

Formula:

[(Working age population between 18-65 years – Students enrolled in universities & colleges) – total labor force] / Working age population between 18-65 years * 100

4 Answer:

Three direct supply side constraints:
- Capital
- Labor
- Technology

Three indirect supply side constraints:
- Innovation or R&D
- Human capital
- Skilled labor

Three demand side constraints:
- Interest rates (or cost of capital)
- Consumer spending
- Competition from imports

5 Answer:

- A **specific duty** is a tariff levied on imports, defined in terms of a specific amount per unit, such as cents per kilogram.
- An **ad valorem duty** is a charge levied on imports defined in terms of a fixed percentage of value.
- A **compound duty** is a combination of both specific duty and ad valorem duties.
- A **countervailing duty** is levied on imported goods to offset subsidies made to producers of these goods in the exporting country
- The **Voluntary Export Restriction** is a government-imposed limit on the quantity of some category of goods that can be exported to a specified country during a specified period of time.

SECTION III Answers

1. D
2. A
3. D
4. A
5. E
6. E
7. B
8. A
9. G
10. B
11. B
12. D
13. D
14. D
15. E