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The role of export subsidies in balance-of-payment crises

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Abstract

This paper investigates the effects of export subsidies when capital goods are imported for use in production of export goods. Export subsidies increase the demand for foreign capital at the expense of domestic consumption. The increase in the capital stock raises the real wage rate while leaving the real rental rate unchanged. However, if the speed of capital accumulation exceeds the savings rate, deterioration of the trade balance may occur. We show thereby that export subsidies can be linked to balance-of-payment crises.

JEL classification: F1; F10; F13
Keywords: Financial crisis; Export subsidy; Capital accumulation

1. Introduction

It has been estimated by Low (1993) that in 1998, export subsidies amounted to 0.9% of GDP in Japan, 0.9% in the United States, and 2.5% in the European Union. Prior to the early 1960s, commercial policies protected domestic import-competing industries in many developing countries. However, due to limited domestic markets and resources, especially in the East Asian economies, the import-substitution policy changed in the late 1960s to be more export-oriented. Export subsidies were used in these economies to penetrate foreign markets and promote domestic growth.

The literature provides several arguments in support of a policy of export subsidies. An export subsidy lowers the world price but raises the domestic price. From an interest group

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viewpoint, domestic producers gain at the expense of consumers. However, as indicated by Gardner (1996) with regard to US subsidies of wheat exports, the general public remains supportive of export promotion and no buyers of wheat have raised politically significant objections to the subsidy program. In addition, from the social welfare perspective, arguments made to justify export subsidies include: neutralization of export subsidies by trading partners, temporary protection of infant industries, and second-best considerations related to credit-market imperfections.[1]

Many policy economists view export expansion as a key channel for promoting economic growth, and export subsidies are instruments for achieving export growth. Nonetheless, Rodrik (1997) suggested that export-led growth in the East Asian economies is mainly due to investment booms. In resource-scare and technologically laggard economies (e.g., South Korea in the 1960s), the domestic capital-goods industry is poorly developed.[2] Increases in investment mostly come from the imports of foreign capital, which is possible because of foreign exchange provided by exports. Although this linkage between investment, exports, and the trade balance has a crucial role in development process, it remains by and large ignored in the literature. The purpose of this paper is to fill this lacuna by examining the consequences of an export-promotion policy on capital accumulation, income distribution, and the trade balance.[3]

We shall view the home country as using imported capital to produce a single exportable good. Financing of capital imports comes from domestic savings and/or borrowing abroad. A policy of export promotion, such as export subsidies, initially raises intertemporal prices of the exportable good and, thus, leads to more usage of domestic savings for capital investment. However, over a longer period, the increased exports apply downward pressure on the world price of the exportable good. If the deterioration of the terms of trade weakens the intertemporal price gain and reduces domestic savings, the country has to finance domestic investment through foreign borrowing. This suggests that an export-oriented strategy may cause an over-expansion in the imports of capital goods and, thus, deteriorate the country's trade balance. This potential danger of export subsidies should not be overlooked in the longer run.

The description above is consistent with a consensus that at the beginning of the 1980s, lower export prices combined with the higher world interest rates caused a foreign-debt problem in some developing countries.[4] The 1997 financial crisis in South Korea is an example. South Korea achieved high growth due to government subsidization and intervention. At the same time, rapid growth generated domestic investment demand higher than savings. Banks and firms actively borrowed abroad to accommodate the excess of investment over savings, manifested in current account deficits. The loans were, however, mostly short term; 80% of foreign exchange transactions had a maturity date of 7 days or less. On the other hand, there was intensive export competition globally. Korea's

[1] See Panagariya (2000) for a detailed discussion.

[2] According to Lopez and Rodrik (1991), for many developing economies, more than 60% of their imports are capital and intermediate goods.

[3] The welfare effects of export-promotion policies, like export subsidies, have been discussed in the trade literature. See, for example, Caves et al. (1996) for perfect competition and Brander and Spencer (1985) for oligopolistic competition.

[4] See Milbourne (1997) for details.