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# RECENT THINKING ON TRADE AND INDUSTRIALIZATION IN DEVELOPING COUNTRIES: A REVIEW[1]

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## 1. Introduction

Like other social sciences, economics is susceptible to the wholesale adoption of currently fashionable theories. Recent thinking on trade and industrialization strategies for developing countries (LDCs) is a good example of this. In the two decades after World War Two, when most African and Asian countries achieved political independence, the prevailing orthodoxy — for almost all LDCs and a good majority of their economic advisors — was to pursue a policy broadly described as import-substituting (IS) industrialization. The IS strategy involved the establishment of industries, behind very high protective barriers (both tariffs and direct controls), to produce goods, which were previously imported, for the domestic market. In the last 15 years, however, there has been a marked shift in thinking. Now the conventional wisdom favours foreign trade regimes variously described as export-promoting (EP), export-oriented or outer-oriented.

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[1] The books reviewed here are:

(a) Bhagwati, Jagdish N. (1978), *Foreign Trade Regimes and Economic Development: Anatomy and Consequences of Exchange Control Regimes*, Cambridge, Ma.: Ballinger Publishing Company, for the National Bureau of Economic Research (NBER).

(b) Garnaut, Ross (ed.), (1980), *ASEAN in a Changing Pacific and World Economy*, Canberra : Australian National University Press.

(c) Krueger, Anne O. (1978), *Foreign Trade Regimes and Economic Development: Liberalization Attempts and Consequences*, Cambridge, Ma.: Ballinger Publishing Company, for the NBER.

(d) Organization for Economic Cooperation and Development (OECD), (1979), *The Impact of Newly Industrializing Countries on Production and Trade in Manufactures*, Paris.

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Three main factors have been responsible for the shift: first disappointment at the generally poor record of IS regimes;[2] second, the spectacular success of a group of LDCs, frequently referred to as Newly Industrializing Countries (NICs), in the export of manufactures; and third, at the intellectual level, the publication of the seven-country OECD study of the late 1960s and, particularly, the main volume by Little, Scitovosky and Scott (1970). The books examined here constitute an important empirical and theoretical contribution to research in this field. The OECD book, prompted by a fear of rising protectionism in industrialized countries, examines the performance of the NICs and their impact on the OECD economies. Bhagwati and Krueger (B-K) are summary volumes of the NBER's ambitious eleven-country research project in the mid-1970s on foreign trade regimes and economic development.[3] The book edited by Garnaut, from the papers and proceedings of the Tenth Pacific Trade and Development Conference, provides a comprehensive review of trade and industrialization strategies in ASEAN, and trends in the region's economic integration and its external economic relations. The purpose of this review is to examine recent thinking on these issues and to raise some important questions which have not been fully resolved.

## 2. The Rise of the NICs[4]

The NICs are a heterogeneous group of countries, ranging from the two high income city-states of Asia and the relatively advanced countries of southern Europe, to the resource-poor economies of Northeast Asia and the resource-rich but underdeveloped Latin American countries of Brazil and Mexico. What they have in common, however, is the pursuit of outward-looking growth policies, which emphasize the export of manufactures, particularly labor-intensive goods such as textiles, clothing and footwear. In most cases, their governments have introduced relatively liberal trade policies (but not free trade), a range of measures to stimulate exports, and fairly tight monetary and fiscal policies accompanied by measures

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[2] For a recent account of the growing disillusionment with IS, see H.W. Arndt, "Trade as the Engine of Growth," a chapter in his forthcoming book *The Development Objective: A Historical Study*.

[3] Nine of the country studies have been published, for Chile, Colombia, Egypt, Ghana, India, Israel, South Korea, the Philippines and Turkey. The Brazil and Pakistan studies were not completed.

[4] There is no generally accepted definition of the NICs, and the selection of countries is inevitably somewhat arbitrary. The OECD study includes 10 countries — Brazil, Greece, Hong Kong, Mexico, Portugal, Singapore, Spain, South Korea, Taiwan and Yugoslavia.

designed to reduce the consumption of imported light manufactures. Economic performance has generally been very impressive, with GNP growing rapidly. Their export of manufactures to the Organization of Economic Cooperation and Development (OECD) countries has increased enormously — in contrast to the virtual stagnation for other LDCs — from US$1.2 billion in 1963 to US$32.8 billion in 1977, while in the same period their share of world industrial output rose from 5.4 per cent to 9.3 per cent. (The four Asian NICs had the fastest growth, their share of OECD imports of manufactures increasing from 1.2 to 4.8 per cent.)

The NICs have relatively open economies, which render them vulnerable to 'exogenous shocks' from the global economy. It is therefore not surprising that, apart from the two Latin American NICs, their growth rates fell sharply after the OPEC price increases and the world recession of the mid-1970s. However, it is significant that, despite the sharp deterioration in their terms of trade caused by the continuing commodity boom, they also recovered very quickly from the slump, and by 1977 their economies were again growing more rapidly than those of the industrialized countries.

What effect have increased NIC exports had on the OECD countries? Certainly, as the OECD report observes, the emergence of the NICs has caused "adjustment problems in certain sectors" affected by increased import competition. But the impact should be kept in proper perspective. By 1976, their share of OECD imports of textiles and clothing was 22 per cent, and for manufactures as a whole only 7.9 per cent (the latter up from 2.6 per cent in 1963). Of course, their share of OECD consumption, as distinct from imports, is much smaller. Moreover, trade is a two-way exchange. As NIC exports have risen, so also have their imports, to the extent that their trade deficit with OECD countries has been large and growing. Indeed, the OECD report estimates that increased NIC—OECD trade has probably resulted in a *net* increase of between 200,000 and 500,000 jobs in the manufacturing sectors of the OECD countries between 1963 and 1977, in addition to indirect employment effects.[5] Rapid NIC imports are often overlooked in discussing the impact on employment in OECD countries.

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[5] Estimates of this sort are necessarily crude. They are calculated by estimating the difference between the number of "jobs lost" in OECD countries resulting from increased exports of manufactures from the NICs, and the number of "jobs created" by increased OECD export of manufactures to the NICs. The net effect has been positive because, even though the NICs have generally been exporting more labor-intensive goods, their trade deficit with the OECD has been increasing.

### 3. The Merits of the EP Strategy

The main conclusion of the NBER project is that "a bias towards exports, and particularly a pervasive, well-publicized and stable government commitment to exports, is most favourable to economic growth" (Krueger, p. xv). Its main purpose is to demonstrate the superiority of EP over IS industrialization, both at the theoretical and empirical level. The two books have already become standard references in the field, following the pioneering work of Little *et al.* before them. The exposition is clear and lucid, although a good grasp of basic international trade theory is necessary to understand some sections.

The terms EP and IS are so widely used that their meaning is not always clear. As Corden (Garnaut, ch. 18) points out, EP may be defined in three ways. First, it is a policy that is neutral in its bias as between producing for the domestic and export market. This does not necessarily mean free trade, but it could also refer to a situation where export subsidies are roughly equal to tariffs and the tariff equivalents of quotas, measured in terms of effective rates of protection. Secondly, it is a policy which is biased towards exports, where export subsidies exceed tariffs and quotas. Finally, it may simply refer to policies which promote exports, in a partial equilibrium sense, without considering the effect of tariffs and quotas. B-K emphasize that they are using the first definition. Paradoxically, by EP they mean nothing more than the removal of distortions, such that the incentives to export and substitute for imports are equalized. (Technically, it is a trade regime in which the effective exchange rates for importable commodities and exportable commodities are equalized.)

For the purpose of analysis, five basic phases of exchange control regimes are identified. These are, briefly, from least to most 'liberal':

I. Heavy reliance on quantitative restrictions (QRs) in regulating international trade.
II. Refinement of measures in phase I, including the introduction of some price policies.
III. Greater uniformity of protection between industries, reduced reliance on QRs, and initial attempts at trade liberalization.
IV. Greater reliance on price measures, and reduction of the bias against exports.
V. Exclusive reliance on price measures, and maintenance of an 'equilibrium' exchange rate.

The authors are at pains to distinguish between *devaluation*, that is, a change in the price of foreign exchange, and *liberalization*, that is, a shift from reliance on QRs to price measures. They regard phase V as an "ideal [which] seems to have eluded most countries" (Bhagwati, p. 60); the success stories have rarely got beyond phase IV for any length of time. In principle, these phases do not necessarily correspond to EP or IS policies, but in practice, B-K argue that it is not possible for a restrictionist regime to adopt an EP strategy.

The crux of the two books is to explain why economic performance appears to be generally superior under more liberal trade regimes, when the bias against exports is removed or substantially reduced. Neo-classical trade theorists have long emphasized the importance of countries specializing in the production of those goods best suited to their factor endowments (the principle of comparative advantage). An EP policy also permits firms to exploit economies of scale through exporting — an important consideration for small low-income LDCs. Many countries pursuing IS industrialization achieved impressive rates of growth initially. But after the completion of the 'easy' phase of IS, when the backlog of consumer demand was overcome and the economy began to diversify into more complex industries, industrial growth slackened, scarce resources were allocated to high cost industries and balance of payment problems — which IS was designed to alleviate — became more severe. In most cases, IS, far from reducing imports, has proved to be very import-intensive.

B-K assemble much empirical evidence to demonstrate that, in terms of static efficiency, the performance of EP has been superior to IS: capacity underutilization is generally less; industries are likely to adopt more labor-intensive techniques and more labor-intensive industries are likely to be encouraged; unnecessarily high holdings of inventories are discouraged. Then there is the sheer cost of administering a complex and cumbersome set of controls and regulations which are part of the QR regime (Bhagwati documents these extensively in ch. 4). Moreover, they argue, exposure to the rigours of a competitive international market (even with government support) is likely to encourage greater efficiency because, in contrast to the 'quiet life' of the IS regime, firms are forced to become more cost conscious and to pay more attention to quality.

Some advocates of IS industrialization concede that restrictionist regimes are likely to be statically inefficient, but argue that longer run dynamic efficiency considerations are more important. B-K find little evidence to support this view. IS does not

necessarily encourage higher rates of capital accumulation. (Bhagwati devotes almost one-third of the main part of his book to an investigation of the empirical evidence.) High protection may encourage domestic entrepreneurship, but it is just as likely to create "a rentier, as against a Schumpertarian capitalist, entrepreneurial class" (Bhagwati, p. 193), because the success of firms depends as much on political patronage in securing scarce input and increased protection as on business efficiency. Innovation and technical change are unlikely to be encouraged by the existence of highly protected 'captive' markets.

However, the authors readily admit that the superior performance of EP policies cannot be explained only by the simple neo-classical free trade arguments. They hypothesize that an additional merit of EP is that it is likely to be conducive to better economic policies. EP policies impose greater restraint and financial discipline on governments because the costs of promoting exports are more *visible* (in the government budget), and thus policies are more likely to be neutral among industries. This is in contrast to the "chaotic non-neutrality of incentives that arises in the IS strategy" because the costs (for example, to the consumer, of higher priced goods) are largely hidden and do not require government outlays directly. Moreover, in non-socialist societies at least, there is some evidence to suggest that firms are likely to be more responsive to price incentives rather than government controls. Whether the controls are 'socially desirable' or not, firms may well expend some of their resources in attempting to circumvent onerous government restrictions, rather than improving operating efficiency.

The authors present a persuasive and comprehensive case in favour of EP, but the data and measurement limitations of a full empirical investigation of the issues should not be underestimated. First, as Krueger (pp. 62-63) herself mentions, there is no generally accepted method of determining empirically the 'equilibrium' exchange rate, because world prices for each commodity and monetary and fiscal policies are changing constantly. (However, a 'second-best' measure, which is operationally adequate, can be devised.) Secondly, trade statistics during phases I and II are notoriously unreliable, because there exists a strong incentive for physical and technical smuggling. Thirdly, although in principle it is possible to delineate the five phases fairly easily, in practice the task is much more difficult. So many aspects of government policy affect the overall trade regime, and implementation procedures vary over time and among government agencies, such that the distinction between phases can become rather blurred. (Readers familiar with Philippine economic policy in the 1950s and 1960s will appreciate the signifi-

cance of this point in the case of the volume on the Philippines by Baldwin.) Yet, for the purposes of statistical testing, different periods are assumed to be identical as regards the trade regime. Finally, statistical investigation of the effects of trade regimes on various economic variables is frequently unsatisfactory because of the complex interplay of a range of factors. In many cases it is difficult to determine the strength (let alone the direction) of causality between changes in trade policies and improved economic performance. This applies, for example, to attempts to establish a link between liberalization measures and improved factor market performance (Krueger, ch. 11), and greater dynamic efficiency (Bhagwati, chs. 6 and 7). Frequently, B-K are forced to conclude that the alleged benefits of EP industrialization must remain as hypotheses — certainly persuasive hypotheses — which cannot be tested rigorously.

### 4. Further Considerations in the EP/IS Debate

Although a strong case is established for EP policies and for greater reliance on price measures, many points of contention remain. This section briefly draws attention to some of these.

Many economists, while agreeing in principle that EP is desirable, have reservations about the ability of the international economy to accommodate the increase in exports if many LDCs embark on the EP strategy. There are two main elements here. First, the total export market for labor-intensive manufactures is more or less given at any point of time; it is simply not large enough to support many "Koreas." As Findlay (Garnaut, p. 46) observes, "outward and onward is a slogan that is less relevant the greater the fraction of the globe to which it is applied." Bhagwati (p. 216), recognizing this, states in his penultimate paragraph that:

> "one cannot suppress the thought that the success stories [of the NICS] would not have been quite so impressive if they had not been built partly on the failures of the countries sticking overly long to the IS strategy and their consequent export lag."[6]

Conversely, it is misleading to treat LDCs as a homogeneous entity, because there is greater complementarity — and thus scope for increasing trade — among them than is generally recognized. One

[6] But in his final parting shot, he argues that even if countries are going to maintain protectionist regimes, price measures are preferable to QRs.

aspect of this is highlighted by Garnaut and Anderson (Garnaut, ch. 13). The very success of the NICs is reducing their comparative advantage in the production of labor-intensive manufactures. Increasingly, countries in ASEAN and elsewhere will be able to move into these industries being vacated by the NICs, as the Asian NICs did in the 1960s when Japan's comparative advantage shifted to more capital and skill-intensive industries.

The second element relates to the vexed issue of protectionism in developed countries. The NICs industrialized rapidly in the context of a relatively liberal international trade environment (the decade or so prior to 1974). Structural adjustment in the developed countries, occasioned by growing NIC import penetration, was relatively painless because of the maintenance of high rates of economic growth. Owing to the sluggish world economy since the mid-70s, however, the international environment is now much less favourable.[7] There has been a significant 'hardening' in the commercial policies of developed countries, and a shift from tariffs to direct price and quantity controls. Shipping costs — which are an even greater barrier to LDC exports than tariffs — are rising, and there is evidence that they discriminate against LDCs.[8] Moreover, tariff and non-tariff barriers are particularly severe for labor-intensive products. Most Generalized Systems of Preferences (GSPs), introduced as part of the trade liberalization measures in the early 1970s, specifically exclude textiles and clothing. Trade in these products is regulated by the Multifibre Agreement, a departure from the more liberal GSP provisions, which a recent World Bank report has suggested is likely to be strictly enforced in the early 1980s. Assessments vary regarding the impact of the 'protectionist revival.' Hughes (Garnaut, ch. 12) takes a broadly optimistic view, arguing that continued LDC import penetration is inevitable, and that increased protectionism will affect only the *rate* of penetration. Other economists are less optimistic, although some take the view that the consequences of protectionism are not entirely negative, at least from the point of view of regional cooperation schemes. For example, Bautista (Garnaut, ch. 7) suggests that it may hasten moves towards greater economic cooperation in ASEAN.

There are many other points to consider in the debate on

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[7] So much so that in a recent review of Krueger, H.W. Singer (in the 1950s an influential advocate of IS) asked "Is her book more than economic history?"

[8] Much of the research on these issues has been conducted by UNCTAD economists. On trends in commercial policies, see Sampson, 1980, pp. 113-127. On shipping costs, see Yeats, 1979.

foreign trade regimes. First, the importance of the international trade sector and trade policies should be kept in perspective. For most non-OPEC LDCs, trade is less than 15 per cent of GNP. Little himself frankly acknowledges that "the truth is that trade is *relatively* unimportant . . . the attention it receives is thus perhaps rather disproportionate (1975), [his italics]. Moreover, the formulation of appropriate trade policies is no substitute for general economic reform; indeed the former is predicated on the latter. McCawley (Garnaut , p. 234) observes that, in the case of Indonesia,

> "To focus on the [EP/IS] debate . . . is to pass over some of the more important problems . . . The real issue is that Indonesian businessmen must operate within a chaotic internal environment . . . It is doubtful whether healthy, self-sustaining economic growth can occur in the manufacturing sector unless there is a change in this situation."

In a similar vein, the OECD report (p. 11), in strongly supporting the policies of the NICs, cautions that they are likely to be successful only if there exists a "disciplined, educated and skilled labor force," "an active and efficient entrepreneurial class" and "an adequate degree of political stability." This raises an additional point, largely neglected in the studies: why have certain countries adopted an EP strategy, while other countries have not? It is significant that the four Asian NICs are resource-poor countries, heavily dependent on exports to finance their required imports, and that they all possess a strong entrepreneurial class. But a deeper comparative investigation of the nature of the political systems and decision-making environments would be required to answer this question.

Secondly, the debate should properly be conducted on a sector-by-sector basis, and be related to the stage of a country's development. In practice, as B-K recognize, most countries combine elements of both strategies. Clearly, there is a good case for pursuing a measure of IS in certain sectors — energy is a good example, and perhaps also basic food items and defense industries. Moreover, IS may be a sensible strategy at an early stage of development. Many economists are skeptical of 'infant industry' arguments for protection, but there is usually a "learning curve" present, whereby it takes time for firms to efficiently adapt best-practice techniques to the local environment. In this sense, the key issue is the timing of the transition from IS to EP. Nevertheless, the difficulties of the transition stage should not be underestimated; there are many instances of "infants which did not grow up." Vested interests (an entrenched bureaucracy, businessmen operating in lucrative, protected industries) develop during the IS stage. The welfare gains from increased liberalization are not

evenly distributed throughout the economy, and structural adjustment schemes are not easy to implement. Countries adopting a more liberalized trade regime in the 1980s will have greater difficulty than those which made the transition in the 1960s and early 1970s, both because of the less favorable international economic environment and because the vested interests wishing to maintain IS are longer established.

Thirdly, while EP usually ensures that the worst excesses of government policies are avoided, it is still possible to overdo the strategy. The export sector can be over-promoted, in the sense that it receives a disproportionate share of resources. There is evidence to suggest that this has occurred in Korea, and the government has promoted the development of heavy industries too quickly. The recent slump in the economy (it experienced negative growth in 1980) cannot be attributed wholly to the instability following the assassination of President Park.[9]

Finally, two particular criticisms have been levelled against EP regimes. First, while recognizing the failures of IS, some critics maintain that rapid output growth has been achieved only through increased involvement of multinational corporations (MNCs). These regimes are alleged to have achieved 'shallow,' 'dependent' industrialization, which does not contain the basis for self-generating growth in the future. Moreover, the tendency for MNCs to vertically integrate on a global scale through international subcontracting has, it is argued, resulted in 'footloose' foreign investment with weak linkages to the rest of the economy.[10] A contrary view would argue that MNCs can play a positive role by acting (purely through self-interest) as a pressure group to reduce protectionist barriers in developed countries.[11]

It is difficult to reach any firm conclusions regarding the relationship between foreign trade regimes and the contribution of

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[9] In passing, it may be noted that just two of the countries in the NBER study — Brazil and Korea — completed a sustained transition from phases I and II to IV and V, and that Krueger's final chapter comparing the performance of IS and EP regimes is based largely on these two countries. Yet their economic performance in 1980 was decidedly less impressive than that prior to the mid-1970s. In addition to Korea's problems, Brazil has accumulated a massive overseas debt. For 1980/81 the World Bank has projected its debt service ratio to be almost 60 per cent, and that debt repayments plus oil imports are likely to exceed export earnings.

[10] See for example Landsberg (1979) and Vaitsos (1974).

[11] See Helleiner (1973, pp. 21-47).

MNCs. The role of direct foreign investment has varied considerably among the NICs, being very significant in the Asian NICs, but relatively unimportant in the southern European NICs. There is some evidence to suggest that MNCs may well play a more positive role in EP regimes because they must operate in a more competitive environment. With their superior technology and efficiency, MNCs competing with local firms in a protected IS regime may be able to appropriate 'monopoly rents' that are not present in a more open economy.

A second criticism of EP regimes is that they are alleged to be politically more repressive. Efficiency considerations, it is suggested, require that real wages be closely checked, while no similar constraints are placed on returns to capital and land, and increasing concentration of the ownership of these factors. But the link between the achievement of increased efficiency and greater political repression has not been established theoretically. Moreover, there is no evidence overall to suggest that political freedom is any greater in inward-looking regimes.[12]

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[12] For a discussion of these issues, see Sheehan (1980, pp. 267-291).

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