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## **TRADE, GROWTH AND INDUSTRIALIZATION: ISSUES, EXPERIENCE AND POLICY CHALLENGES**

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## **TRADE, GROWTH AND INDUSTRIALIZATION: ISSUES, EXPERIENCE AND POLICY CHALLENGES**

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the hype about the benefits or costs of trade ... gave the public, policy-makers, and researchers an unrealistic view of the role of trade in economic development and growth.  
Richard Freeman (2003. p. 25)

### **I. Introduction**

The belief that rapid and full integration into the global economy would create more favourable conditions for growth in developing countries has permeated much thinking in development policy in the past two decades. Accordingly, trade liberalization has been a key component of policy advice to developing countries. Openness to international trade was expected to allow these countries to alter both the pace and the pattern of their participation in international division of labour, thereby overcoming balance-of-payments problems and accelerating technical progress and economic growth, to catch up with industrialized countries.<sup>2</sup> This process was expected to be greatly facilitated by the launching of the Uruguay Round. On the one hand, a strong rules-based system would benefit smaller and poorer economies by improving their access to markets in the North and subjecting the conduct of their major trading partners to greater transparency and discipline. On the other hand, a more open trading environment was expected to strengthen the growth prospects of developing countries by pushing their producers to the efficiency frontier.

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<sup>2</sup> For the main arguments and evidence advanced in favour of trade liberalization in developing countries see Sachs

The same thinking has also held sway with respect to foreign direct investment (FDI). Quite apart from the belief that it would provide resources for development and balance-of-payments support, FDI has been seen as a crucial factor for success in trade and industrialization. It is expected to improve industrial competitiveness by bringing new technology and enhancing market access, or providing a better services infrastructure. More importantly, since trade has been taking place increasingly within international production networks (IPNs) organized by transnational corporations (TNCs) by locating different stages of production of a final good in different countries, attracting FDI seeking low-cost locations has become increasingly important for participation in such networks and expansion of trade in manufactures.

Rapid liberalization of trade and capital flows has in fact dominated policy reforms in many developing countries in Latin America and Africa. Starting in the middle of the 1980s many of these countries which faced serious balance of payments and debt servicing difficulties resorted to big-bang liberalization, dismantling non-tariff barriers to imports and sharply reducing tariffs on a wide range of products, rapidly shifting from inward-oriented (import-substitution) to outward-oriented (export-promotion) development strategies. Furthermore, impediments to FDI have been removed and in fact foreign investors have been provided incentives over and above those enjoyed by domestic investors. While some of these “reforms” were implemented as part of stabilization and adjustment programs supported by the Bretton Woods Institutions (BWIs) or in the context of multilateral trade negotiations in WTO, in many developing countries neo-liberal policies have found widespread acceptance and support among policy makers who often resorted to unilateral big-bang liberalization as a way of getting out of the debt and development crisis.

While liberalization has also dominated policy in Asia, the approach pursued there has been quite different. Compared to Latin America many countries in East Asia had already been operating under relatively open trade regimes during the 1970s and early 1980s, and the liberalization that has taken place over the past two decades came after a period of successful

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and Warner (1995), Frankel and Romer (1999), and Dollar and Kraay (2001).

industrialization and development, rather than failed intervention. In South Asia where policies pursued in the past were similar to those in Latin America, liberalization has followed a more gradual and cautious approach, combined with intervention in many areas of policy, including continued support and protection to domestic industry, and direction and guidance of FDI, rather than seeking a rapid and full integration into the global economic system and leaving development to global market forces.

It should thus come as no surprise that there has been considerable diversity among developing countries over the past two decades regarding the impact of trade and investment policies on their economic performance. Many countries with similar trade and investment regimes have had different degrees of success in industrialization and economic growth depending on the conditions under which policy reforms were undertaken. Furthermore, the experience shows not only that the liberalization of imports and FDI does not guarantee a strong export performance, but also that improved export performance is not always mirrored by acceleration of industrialization and growth.

## **II. Trade liberalization: Issues at stake**

Many of the adherents to the view that trade plays a key role in successful development believe that main benefits in this area come from unilateral liberalization in developing countries themselves. This view is held not only by free trade enthusiasts in the academic community. It has also been increasingly defended by multilateral organizations, including the secretariats of the BWIs and WTO. The World Bank, for instance, has argued that while a successful outcome of the Doha Round negotiations greatly improves the growth prospects of developing countries, these benefits would come primarily from reforms in developing countries themselves. In this so-called pro-poor scenario, it is estimated that 50 per cent of the gains from global liberalization of food and agriculture “are reaped by developing countries, of which 80 per cent is the result of own-reform in these two sectors.” The outcome is much the same for manufacturing where

developing countries would “gain significantly more from their own reforms” than market opening in industrial countries (World Bank 2004, pp. 50-51). This belief has also been reaffirmed by the WTO secretariat who argued that “(t)his lesson, that a large part of the economic gains from trade liberalization accrue domestically, should not be overlooked in the context of reciprocal bargaining for market access. (WTO, 2004a, p. 2).

On this view, thus, the success of the Doha Round in promoting development rests primarily with liberalization in developing countries themselves. In a sense this position amounts to a self denial for the WTO as a forum for give-and-take multilateral trade negotiations. If taken seriously, developing country trade negotiators should go back to put their houses in order and open their doors, rather than wasting their time in Geneva!

Until recently, it was believed that trade liberalization on its own would produce considerable benefits, particularly to countries pursuing inward-looking development strategies in Latin America and Africa. However, with the mounting evidence that many of the promises of trade liberalization have not been fulfilled, attention has turned not to possible shortcomings in the underlying premises of the theories advanced in favour of rapid trade liberalization, but to imperfections elsewhere in the economies concerned. It has thus been argued that trade liberalization on its own would not bring benefits if the state continues to intervene in other areas, except for correcting market failures, and if there are imperfections in other markets.<sup>3</sup> In particular, attention has focussed on the role of labour market imperfections in impeding rapid redeployment of labour and adjustment in wages in ways necessitated by the new set of incentives and competitive forces brought about by trade liberalization. Similarly, removing impediments to private investment, including foreign investment, and improving the investment climate is seen as essential in realizing dynamic benefits of trade liberalization through improved productivity and

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<sup>3</sup> For instance it has been argued that the “neoclassical case for free trade (FT) is based on institutional assumptions that include a market structure that is complete and a government that intervenes in the markets only to correct failures, if any, of the market. ... Clearly the efficiency characteristics of FT could fail to hold if any of the institutional or other assumptions underlying them fail to hold. For example, if externalities in production and consumption lead to market failures, and the government fails to correct them optimally, or more generally, if there

growth.<sup>4</sup>

Clearly, some of these imperfections arise from structural weaknesses which cannot be easily rectified by government intervention, but can only be removed throughout a long and sustained process of institutional and economic development. Although such weaknesses provide a legitimate reason for a cautious and gradual approach to trade liberalization, increasingly there has been a tendency to overlook them and assume that if developing countries are not benefiting from trade liberalization, it is because they are not undertaking reforms in other areas of policy: that is, the problems arise from omission not commission. It has for instance been argued by the WTO secretariat that the benefits the developing countries can derive from trade liberalization depend on the implementation of complementary reforms or “getting other policies ‘right’ too ... and using the negotiations to help push through domestic economic reforms” (WTO 2004a, p. 2, Box 1). What is advocated has an uncanny resemblance to the Washington Consensus perspective of “getting prices right”, supplemented by second generation reforms regarding governance and market regulation to enhance competition and efficiency (WTO 2004b, section II). It also carries the implications that negotiations in WTO should determine not only the trade regimes, but policies affecting the broader fabric of social and economic life in developing countries.

Here we also meet a certain degree of circularity in orthodox arguments. It has long been maintained that most developing countries lack the institutions needed for successful policy intervention of the kind practised in East Asia. Government failure has thus been seen as an important reason for leaving matters to markets. But now we seem to have come full circle: in order for trade liberalization and markets to yield the expected benefits, we need good institutions and governance!

The benefits claimed from trade liberalization are twofold: static efficiency gains due to a

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are domestic distortions, a FT competitive equilibrium need not be efficient.” Srinivasan and Bhagwati (1999, p. 11).

<sup>4</sup> See, e.g. World Bank (2002a, p. 164); World Bank (2004, pp. XV-XVI); and WTO (2004b, section III.C).

one-off increase in the level of income, and dynamic benefits due to faster economic growth. The traditional theory of comparative advantages focuses on one-off efficiency benefits resulting from reallocation of resources. Trade liberalization results in a shift in incentives, profitability and competitiveness of different sectors, and it is assumed that resources, including labour with various skills, capital and land, could be shifted rapidly and without large costs from those industries losing competitiveness to those gaining. In this way, part of what was previously produced domestically would now be imported while there would be an increase in production and exports in sectors enjoying increased competitiveness. In this process, there is no change in the rate of utilization of resources, but because of increased efficiency in their allocation, income level is raised once and for all. The composition of output would change in favour of traded goods so that there would be an increase in exports and imports as a proportion of GDP. Trade balance would be maintained throughout as increased imports are matched by expansion of exports.

These are not just heuristic or simplifying assumptions made in theoretical models designed to explore the *potential* benefits of trade liberalization. They are also made in the discussion of trade policy and in simulations designed to explore the likely *actual* static and dynamic benefits of trade liberalization. These include the simulations that gave to extravagant predictions regarding the gains that developing countries would reap from the Uruguay Round (Martin and Winters, 1996). They also include recent simulations by the World Bank about the benefits that developing countries could obtain from further liberalization in the Doha Round.<sup>5</sup> These all use “general equilibrium” models, assuming that markets are always cleared, and resources are rapidly redeployed and remain fully or equally employed after liberalization.

However, the reality is not so simple. Factors of production, including labour, capital and land, are often sector specific or product specific. A car mechanic cannot instantly become a textile machine operator, or a lathe used in machine tools industries cannot be transformed into a

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<sup>5</sup> World Bank (2004, pp. 47-60). See also World Bank (2002a, pp. 166-179) which also summarizes several studies using applied general equilibrium models (pp. 169-170, Box 6.6).

sewing machine to be used in the clothing sector. More generally, expansion in new products and sectors requires investment in skills and equipment, rather than reshuffling and redeploying existing labour and equipment. Unless accompanied by such investment, new activities and industries cannot emerge to the extent needed to replace those displaced by import liberalization. Investment would also be needed for rationalization in existing industries if they are to survive in the face of greater import competition.

The immediate impact of rapid trade liberalization could thus be unemployment, de-industrialization and growing external deficits even though there may be a significant increase in export growth. Some of the old industries may survive through downsizing and labour shedding, and this may lead to improved average productivity. But the overall impact could be a decline in industrial employment and value added as firms that go out of business could not be fully replaced by new firms in sectors enjoying greater competitiveness. More importantly, when the initial damage inflicted on industry is deep, the process of industrial restructuring in response to new incentives may be delayed and the economy could remain depressed for prolonged periods. Avoiding such an outcome would require a gradual and phased approach to import liberalization, properly sequenced with the build up of a strong and flexible industrial and export capacity through a judicious combination of market discipline and policy intervention. The East Asian experience holds useful lessons on how to do this.<sup>6</sup>

The dynamic benefits expected from trade liberalization depend on its impact on sources of economic growth, namely growth in factor inputs and technical progress. However, unlike the comparative advantage theory of static benefits, in growth theory there is considerable ambiguity and little consensus about the impact of trade openness on economic growth. This is certainly the case for traditional neoclassical and Keynesian theories of growth, and there is nothing new in this respect in the “new” growth theory. However, there is a host of ad hoc models designed to show that liberalization may lift not only the level of income but also long-term growth, helping

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<sup>6</sup> Indeed, there is a rich literature on how this was done in East Asia. For some of the key issues see UNCTAD (1994, Part Two, chap. I), Akyüz and Gore (1996), UNCTAD (1996, Part Two, chap. II), and Akyüz (1999).

to close the income gap with rich nations.<sup>7</sup>

Certainly, the one-off increase in efficiency and income that may be brought about by trade liberalization could raise the long-term growth rate if it results in higher rates of saving and capital accumulation. Accumulation could also be accelerated to the extent that trade liberalization accompanies liberalization of FDI and/or encourages a sustained inflow of foreign capital. Clearly, the effect on domestic savings would depend on whether the initial impact on income is positive. Even when the level of income is lifted by trade liberalization, savings may fail to rise to the extent that there is a pent up demand for foreign consumer goods. On the other hand, as recognized by the World Bank (2002a, fn. 17, p. 181), a rise in FDI may not yield long-term benefits in terms of accumulation since “eventually this generates a stream of income repatriated back to the foreign owners”. In any case increases in FDI are not always associated with faster capital accumulation. For instance, a large number of countries in Latin America which resorted to big-bang liberalization of trade and foreign investment after the mid-1980s enjoyed large increases in FDI as a proportion of GDP, but in most of these countries gross capital formation as a proportion of GDP stagnated or fell (UNCTAD 2003, pp. 76-78).

Within the framework of the traditional theories of growth, the impact of faster capital accumulation that may be brought about by trade liberalization on economic growth would be subject to diminishing marginal returns on capital associated with capital deepening. This problem can be avoided if there is unlimited labour supply à la Arthur Lewis. However, even then the effect would be transitory, lasting until the surplus labour is exhausted. Moreover, a poor country with a large amount of underutilised land and labour can benefit from a “vent for surplus” through trade, but what is needed is not so much import liberalization as growth of exports supported by appropriate incentives, including access to material inputs and credit, and favourable exchange rates.

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<sup>7</sup> For a discussion of these issues see Rodrik (1996); Bhagwati and Srinivasan (1999); Rodrik (1999); World Bank (2002a, p. 169, and fn. 17); Winters (2004); and Dowrick and Golley (2004).

A more significant impact of trade on long-term growth could be through technical progress and increased productivity. This can occur in two ways. First, expanding to markets abroad allows specialization and exploitation of scale economies which can, in turn, accelerate learning by doing and productivity growth. Similarly, trade eases firms' access to foreign technology and knowledge, and widens their choice of capital and intermediate goods, and these too can lead to faster productivity growth. Furthermore, if trade liberalization is accompanied by increased greenfield FDI, it could raise productivity growth to the extent that such investment embodies new and more advanced technologies.

There seems to be a widening agreement on the productivity enhancing effects of trade, but considerable uncertainties remain: "Few dispute that trade openness will improve productivity. There is nonetheless great uncertainty about the channels ) greater domestic competitiveness, imports of technology-laden goods, FDI, export-driven competitiveness ) and the magnitude" (World Bank, 2004, p. 60, fn. 14). While some of these linkages between trade and productivity growth may be important, it should be recognized that trade is not the only conduit for transfer of technology and knowledge. More importantly, activating many of these channels does not require import liberalization but expansion in foreign markets. Particularly, if the main effect of trade on growth in modern economies is due to large scale production and specialization allowing firms to overcome high entry costs and to benefit from learning, what would be needed is an aggressive export strategy based not on the across-the-board liberalization of imports, but on protection and support delivered reciprocally against performance of enterprises in generating exports, productivity growth, value added and employment, of the kind pursued by the first-tier Newly Industrializing Economies (NIEs), notably Korea and Taiwan. Again, access of exporters to technology-laden capital goods at world prices does not require across-the-board liberalization of imports; it could be secured through appropriate duty drawback schemes as successfully practised in East Asia.

The key issue here is the extent to which accumulation and technical progress in developing countries should be left to global market forces. If governed by such forces alone,

developing countries can successfully operate, at any point in time, only those activities which enjoy comparative advantage on the basis of their existing factor endowments, but these forces do not necessarily set off a rapid process of change towards a higher level of industrial and technological capacity. As lucidly explained by Gomory and Baumol (2000, chap. 1), we are no longer in the Ricardian world where comparative advantages are closely linked to natural advantages, with England, lacking sunny slopes, being unable to match Portugal in wine but enjoying relative advantage in clothing due to its green pastures and woolly sheep. In a modern world, the place of most countries in international division of labour is determined not so much by their natural advantages as their success in building capacity and acquiring skill and experience in industries which enjoy economies of scale and specialization. But “entry into one of these industries, against an entrenched competitor, is slow, expensive, and very much an uphill battle if left entirely to free market forces.... In the wine-wool world, market forces, driven by demand and natural advantages, led the world to a single outcome. In today’s world, market forces do not select a single, predetermined outcome, instead they tend to preserve the established pattern, whatever that pattern may be.”<sup>8</sup>

Thus, ironically, the arguments advanced in favour of trade liberalization as a way of facilitating learning and productivity growth call for support and protection in the early stages of development of large scale, specialized enterprises, not full exposure of them to foreign competition. These arguments in fact tally with the proposition first advanced by Friedrich List that the “superiority of one country over another in a branch of production, often arises from having begun it sooner. There may be no inherent advantage on one part, or disadvantage on the other, but only a present superiority of acquired skill and experience.”<sup>9</sup> In other words, the recent debate and experience regarding the role of trade in growth reinforce, rather than refute, the arguments long advanced in support of infant industry protection. It is also notable that in most

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<sup>8</sup> Gomory and Baumol (2000, p. 6). The authors maintain that, for the same reasons, “there are in fact *inherent conflicts in international trade*. This means that it is often true that improvement in one country’s productive capabilities is attainable at the expense of another country’s general welfare” (p. 4; italics in the original).

<sup>9</sup> Quoted in Gomory and Baumol (2000, p. 156).

of today's industrial countries, including Britain, the United States, Japan and many others, "the policies that were used [for catch-up] are almost the opposite of what the present orthodoxy says they employed 'and currently recommends that the currently developing countries should also use'"(Chang 2002, p. 19 *et seq.*).

### **III. Trade liberalization and economic growth**

As in theory, there is also considerable controversy over the empirical evidence regarding the benefits of trade liberalization in developing countries. A number of studies which used cross- country data in establishing a positive empirical link between trade and growth have come under strong criticism because of their methodological and conceptual weaknesses. In particular, it has been shown that positive linkages found between trade and growth in such studies depend critically on specification and measurement.<sup>10</sup>

A common problem confronted in these studies relates to the concept of openness. While openness should be defined in terms of the policy regime governing imports and exports, in reality measures used included a number of indicators (such as black market exchange rate premium, real exchange rate distortions, state monopoly over exports, exchange rate volatility, or geographical conditions) which have little to do with trade policy regimes. These measures are poorly correlated among them, and it is often the non-trade components of such measures that provide the link with growth.

These difficulties cannot be overcome by using the alternative measure of what is called "revealed openness"; that is, the ratio of trade (imports+exports) to GDP (Dowrick and Golley 2004, p. 40). While this measure is certainly influenced by the import regime, there is no one-to-

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<sup>10</sup> Sachs and Warner (1997) have offered the most cogent version of the "open economies converge" thesis. For a critical assessment see Rodriguez and Rodrik (2001). For a discussion of the problems encountered in cross-country studies see Freeman (2003), Winters (2004), and Dowrick and Golley (2004). For a survey of the earlier literature

one correlation. The trade orientation of a country depends not only on its trade policies but also on a host of other factors including economic size, geographical features and natural resource endowment. For instance, in some accounts the resistance of African policy makers to trade liberalization is advanced as an explanation of the poor overall economic performance of the continent (Dollar 1992; and Sachs and Warner 1997). However, estimates strongly suggest that countries in Africa trade as much as expected if account is taken of these factors; those in Latin America on average trade less than expected, while the East Asian NIEs trade more.<sup>11</sup> And the high level of trade orientation in East Asia was based on considerable state intervention, not *laissez faire*.

A second set of problems relates to causality. A positive link between trade openness and growth does not necessarily indicate that the causation runs from the former to the latter. It can be quite the other way round. A successful industrialization strategy based on a judicious combination of market forces and policy intervention would not only produce rapid and sustainable growth, but would also allow imports to be liberalized without generating adverse effects for industry and growth. By contrast poor growth can lead to increased pressures for protection. On the other hand, while there can be little doubt that trade policy itself has an independent influence on the chances of success of an industrialization strategy, empirical techniques used cannot always separate its effects from those of a host of other factors, including macroeconomic and financial stability, exchange rate policies, and savings and investment.

Some authors who otherwise believe in the virtues of trade liberalization have also criticised cross-country regression methodology for reasons of their weak theoretical foundations, poor quality of their data base and their inappropriate econometric methodology, expressing a preference for case studies in demonstrating the benefits of free trade (Srinivasan and Bhagwati,

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see Harrison and Revenga (1995).

<sup>11</sup> UNCTAD (1998 pp. 70-72). A similar conclusion was also reached by Rodrik (1998).

1999).<sup>12</sup> However, the evidence from case studies is no more conclusive in demonstrating that countries with lower levels of trade protection grow faster than others, since they too are often unable to disentangle the effects of many other factors from those of trade reforms (Greenway 1993; and Rodrik, 1999).

It has also been noted that actual outcomes from free trade treaties rarely matched the expectations of their supporters or opponents (Freeman, 2003). Thus, the European Union performed less well in the decade (1992-2002) following its move to the single market than in the preceding decade; almost immediately after signing the Free Trade Agreement with the United States, Canada suffered its worst economic slide since the Great Depression; and the Mexican economy collapsed shortly after the United States Congress passed the NAFTA Treaty. Certainly there were several factors influencing the outcome in such cases. Nevertheless, a number of studies that tried to isolate the effect of trade liberalization from other factors by focussing on micro data found no conclusive evidence on the link between trade liberalization and growth: “Virtually all of the studies find that productivity rises in import-competing sectors... In some cases they attributed the increased productivity to the exit of less efficient importers, in other cases firms invested in capital or squeezed inefficiencies out of their production process. But in no country was the liberalization episode followed by a noticeable change in the growth rate. From the data on growth, you could not identify that there had been a policy change” (Freeman, 2003, p. 7).

The more recent studies have focussed on the impact of trade on capital accumulation and productivity growth. Such dynamic linkages have also been incorporated in the computable “general equilibrium” models used for simulating the dynamic benefits of trade liberalization.<sup>13</sup> While a number of studies show that a reduction in import barriers is followed by increases in productivity, this is not always associated with an acceleration of growth. A recent study found

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<sup>12</sup> The studies in question are older detailed country studies done in OECD, NBER and World Bank.

<sup>13</sup> The World Bank simulations emphasize the impact of trade on productivity growth; see World Bank (2002a, pp.

evidence that an increase in the overall trade share does have long-term benefits on economic growth primarily through productivity increases, but such impact varies over time and across levels of development (Dowrick and Golley 2004). These benefits were greater for poorer countries than for the more advanced economies during the 1960s and 1970s, thereby promoting convergence. After 1980, as a result of faster liberalization, trade shares of poorer countries increased much more rapidly than those of rich countries, but trade generated substantially greater benefits to more advanced countries, leading to income divergence. Indeed, in the period 1980-2000, the impact was negative or negligible for countries with an initial (1980) per capita income of less than \$3,000. A plausible explanation is that in previous decades trade liberalization was combined with pro-growth policies and institutions, and that it was the latter rather than trade per se which promoted growth. This was not the case in the 1980s and 1990s when trade liberalisation was introduced in a big-bang fashion, often under external pressures, without accompanying policies and institutions.

Looking at the broader experience since the 1980s, rapid liberalization of trade and FDI in developing countries has indeed resulted in a sharp increase in the share of trade in GDP as predicted by free trade models. More important, these countries have become major players in world trade. Their exports have grown faster than the world average and now account for about one third of world merchandise trade, rising from less than one fourth in the 1970s (Akyüz 2003, pp. 1-2). Furthermore, by any count, there have been significant improvements in macroeconomic policy discipline and overall economic governance throughout the developing world. However, the success of developing countries in expanding their exports and attracting export-oriented FDI, and their progress in “getting other policies right” have not always been accompanied by faster growth of their GDP. At some 4.8 per cent per annum, the average growth rate in developing countries during the 1990s was well below the average of 5.7 per cent achieved during the 1970s. Although this is mostly due to poor performance of rapidly liberalizing countries in Latin America and Africa, several countries in Asia too had slower growth in the 1990s compared to the 1970s. Two notable exceptions are China and India which have adopted a

gradual approach to liberalization, opening up to trade and investment without abandoning selective and proactive policy intervention. If these two countries are excluded, the decline in the average growth in developing countries as a whole is much more pronounced.

More generally, the evidence does not support the claim by the World Bank (2002b, p. 4) that more-globalized developing countries increased their growth rates over each of the past four decades. This result is due to the inclusion of India and China as more-globalizers in the World Bank definition, a treatment which cannot be justified either in terms of the trade shares of these countries,<sup>14</sup> or, for that matter, in terms of their trade regimes. As a result, if China and India are excluded from the World Bank group of more-globalizers, it turns out that the “remaining group of ‘more-globalized’ developing countries actually grew more slowly than the ‘less globalized’ over the period 1980-2000 (Dowrick and Golley 2004, p. 54).

#### **IV. Trade liberalization and balance of payments**

As noted, one of the claims of the orthodoxy is that liberalization would not lead to trade deficits because reallocation of resources would ensure that increased imports would be matched by faster export growth. In reality, little attention has been given to the impact of trade liberalization on imports and balance of payments in the mainstream literature. Rather, there has been a tendency to link balance of payments problems to macroeconomic conditions alone, as for instance maintained recently by the WTO (2004b, p. XXI): “Balance-of-payments imbalances are a reflection of macroeconomic conditions and cannot be effectively addressed through trade policy”.

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<sup>14</sup> In the World Bank definition more globalized countries are those which displayed the highest proportional increase in their trade share between the late 1970s and the late 1990s. Thus India, which increased its trade share from 14 to 22 per cent is defined as ‘more globalized’ even though its trade share is well below the average in both periods. Again the same definition has the effect including China (with its trade share increasing from 14 to 34 per cent) in the Bank’s ‘more globalized’ group; Dowrick and Golley (2004, pp. 53-54).

While macroeconomic conditions including the pace of domestic demand, fiscal deficits, private savings-investment imbalances and exchange rates dominate the behaviour of balance of payments, there can be no denying that trade policy can have an independent influence on structural deficits. For the reason already discussed, import liberalization can result in output loss and increased trade deficits, and these may not be adequately addressed by currency adjustments, particularly when the capital account is open and the exchange rate is influenced primarily by capital flows. Under such circumstances, macroeconomic adjustment to higher trade deficits would mean depressing the level of economic activity and sacrificing growth.

UNCTAD (1999, chap. IV) research indeed shows that trade liberalization in developing countries has generally resulted in a structural deterioration in the balance of payments. After a sharp cutback in imports necessitated by the debt crisis of the 1980s, both exports and imports accelerated during the 1990s in most developing countries, but spending on imports generally rose faster than export earnings. This gap between import and export growth rates was particularly large for Latin America. Asia also saw some acceleration in its exports and imports in the 1990s, but here too, imports rose much faster than exports, partly due to a surge in capital inflows and currency appreciations, which eventually culminated in a crisis in East Asia in 1997-1998. China stood as a major exception; its exports in the 1990s rose faster than imports, contrary to the trends observed in previous decades. For developing countries as a whole (excluding China), the average trade deficit in the 1990s was higher than in the 1970s by almost 3 percentage points of GDP, while the average growth rate was lower by 2 per cent per annum. An econometric examination showed that big-bang liberalization of trade in developing countries, notably in Latin America, together with declining terms-of-trade and slower growth in industrial countries, played a key role in the structural deterioration in the relation between growth and trade balance measured as a proportion of GDP.

The adverse impact of trade liberalization on balance of payments has also been confirmed by a recent study which examined the effects of liberalization on imports and exports separately in a sample of 22 developing countries (Santos-Paulino and Thirlwall 2004).

Accounting for all measures taken to reduce anti-export bias and import controls, including non-tariff barriers and exchange rate distortions, the study finds that liberalization has raised export growth by some 2 per cent and import growth by 6 per cent with the result that the trade balance worsened by 2 per cent of GDP. While the effect is similar across all regions, including Africa, Latin America and East Asia, it is greater in countries with a high initial level of protection ) i.e. those resorting to big-bang liberalization. It is concluded that “countries (and international organizations that promote trade liberalization in developing countries) need to take great care in the sequencing of the liberalisation of exports and imports to achieve a better balance between export and import performance if countries are to realise their potential growth performance. Free trade and flexible exchange rates are no guarantee that unemployed domestic resources are easily converted into scarce foreign exchange (Santos-Paulino and Thirlwall 2004, p. 70).

A similar exercise shows that trade liberalization has widened balance of payments deficits in Least Developed Countries (LDCs) too, although its impact on imports, exports and the trade balance has been smaller than for developing countries as a whole: it “has worsened the trade balance by 1.3 of GDP in the LDCs compared with 2 per cent in developing countries” thereby exacerbating aid dependence and the problem of external financing (UNCTAD, 2004, p. 202).

It is generally recognized that rapid import liberalization should be combined with currency devaluation in order to prevent payment difficulties (Edwards 1989; Dornbusch 1990). Furthermore, such a one-off adjustment should be followed by appropriate management of the exchange rate so as not to allow the erosion of the effects of devaluation over time. More generally, the experience strongly suggests that management of exchange rates is considerably more important than import policy for successful exporting (Agosin and Tussie 1993, p. 22). However, the practice in developing countries during recent years has often departed from such fundamental principles. Despite greater exposure to foreign competition, there have been serious shortcomings in exchange rate management in most developing countries, even compared to the interventionist regimes of the 1970s and 1980s (UNCTAD 1999, pp. 128-131). In particular,

liberalization of capital flows, often prompted by the need to finance growing external deficits, has aggravated payments difficulties brought about by rapid trade liberalization, leading to currency appreciations and instability, thereby undermining trade and growth performance.<sup>15</sup>

In this respect the experience of China since its accession to WTO at the end of 2001 is worth noting. China agreed to make a considerable reduction in its tariff barriers, remove a series of non-tariff measures, eliminate trade-related subsidies, apply equal treatment of domestic and foreign firms and remove restrictions related to local content. By contrast it received very little concessions from existing WTO members in terms of greater market access, particularly over the short-term.<sup>16</sup> In a sense, therefore, China's accession to WTO has been similar to the kind of unilateral trade liberalization undertaken by many developing countries during the past two decades. It is true that this did not constitute a big-bang liberalization of the kind adopted in Latin America, not least because it was the continuation of gradual liberalization pursued over the past ten years. Again, China's liberalization-cum-accession came out of a position of strength not weakness. But more importantly, China has resisted pressures to liberalize its currency market and capital account, and indeed enjoyed considerable effective depreciation of its currency as a result of the weakening of the dollar to which it has remained pegged. This has certainly been a factor in facilitating adjustment to a more liberal trade regime and avoiding a sharp deterioration of its trade balance. Nevertheless, even though the export surplus that China has been enjoying since 1993 has so far not disappeared, its imports have grown faster than exports and its trade surplus has fallen as a proportion of GDP.<sup>17</sup>

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<sup>15</sup> For an analysis of how this has happened in Latin America see UNCTAD (2003, chap. VI).

<sup>16</sup> For a discussion of China's terms of accession to WTO see Akyüz (2003, chap. 3), Shafaeddin (2002) and Li (2002).

<sup>17</sup> China's exports and imports both more than doubled since joining WTO. According to preliminary estimates by the Ministry of Commerce (<http://english.mofcom.gov.cn>) import growth between 2001 and 2004 exceeded export growth by 8 percentage points on a cumulative basis. In 2002 China enjoyed an export surplus of some \$30 billion, which dropped to around \$25 billion in 2003. During the first half of 2004 China's trade balance turned negative, but it recovered rapidly in the latter part of the year, estimated to have produced a surplus of around \$30 billion for the year as a whole. Even then, as a percentage of GDP, trade surplus appears to have fallen from over 2.5 per cent in 2002 to below 2 per cent in 2004. In agriculture where liberalization was more abrupt and response to new incentives

## V. Trade and industrialization

### a. *Manufactured exports and value-added*

The basic policy challenge facing most developing countries is how to establish a broad and robust industrial base as the key to successful development, and how best to channel investment and trade to this end. Shifting away from dependence on the production and export of primary commodities towards industrial products has often been viewed as a means of more effective participation in the international division of labour. Manufactures are expected to offer better prospects for export earnings not only because they allow for a more rapid productivity growth and expansion of production, but also because they hold out the promise of greater price stability even as volumes expand, thereby avoiding the declining terms-of-trade that has frustrated the development efforts of many commodity-dependent economies.

Indeed, one area of consensus in recent work on trade is that specialization in primary exports is bad for growth (Dowrick and Golley 2004, p. 47). In this respect the recent trade performance of developing countries should be a reason for considerable optimism, since much of the increase in their exports has taken place in manufactures, which today account for more than 70 per cent of their total exports, after hovering around 20 per cent during much of the 1970s and early 1980s.<sup>18</sup> The share of developing countries in world manufactured exports now exceeds 25 per cent, compared to some 10 per cent in the 1970s. More important still, many developing countries appear to have succeeded in moving into technology-intensive manufactured exports, which have been among the most rapidly growing products in world trade over the past two decades. For some products such as transistors and conductors, computers and office machines, and electric power machinery, developing country exports now account for between 40 and 50 per cent of total world exports.

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is typically more sluggish, China has started to run a deficit in the order of \$5.5 billion after enjoying an export surplus by a similar amount in previous years; see *Asia Times*, January 14, 2005.

<sup>18</sup> The evidence cited in this section is from Akyüz (2003, chap. 1).

However, on closer examination, the picture is much more nuanced and less sanguine. Most countries which shifted from inward-oriented to outward-oriented development through a rapid liberalization of imports and FDI, particularly in Latin America, have not shared in the expansion of manufactured exports, but have experienced surges in imports and mounting trade deficits, resulting in increased dependence on private capital inflows for growth. Much of the expansion in manufactured exports of developing countries has concentrated in East Asia and, to a lesser extent, Central America. This expansion has taken place primarily as a result of the growing participation of these countries in labour-intensive processes in IPNs organized by TNCs seeking low-cost producers for export to world markets. As a result, with the exception of a few East Asian first-tier NIEs, mainly Korea and Taiwan, which have already reached income levels as high as some industrialized countries, the exports of developing countries are still concentrated on products derived essentially from the exploitation of natural resources and the use of unskilled or semi-skilled labour which have limited prospects for productivity growth and lack dynamism in world markets.

Trade statistics showing a rapid expansion of technology-intensive, high value-added exports from developing countries are misleading, because of double-counting of trade among countries linked through IPNs. Such products appear to be exported by developing countries, but in reality those countries are often involved only in the low-skill, assembly stages of production, using technology-intensive parts and components imported from more advanced countries. As trade flows are measured in gross-value rather than value-added, imported parts and components are counted among the exports of the countries assembling them. Consequently, although developing countries appear to have become major players in world markets for supply-dynamic, high-tech products, they still account only for 10 per cent of world exports of products which score high in R&D content, technological complexity and/or economies of scale.

In the past two decades the increased mobility of capital, together with continued restrictions over labour movements and various incentives provided by the recipients of FDI, has extended the reach of IPNs particularly in three sectors: clothing, the automotive industry and

electronics. Trade based on specialization within such networks is estimated to account for up to 30 per cent of world exports. In the clothing sector although FDI has played some role, the major form of production relocation is sub-contracting to domestic enterprises. The electronics industry is the most globalized of all industries, and trade in electronics products is underpinned by an increasing geographical dispersion of TNC-driven production networks. Relocation of production in the automobile sector is constrained by physical distance to the final market, and is greatly influenced by preferential regional trade agreements, such as NAFTA and Mercosur.

Almost three quarters of the increase in the share of developing countries in world manufacturing exports have taken place in the three sectors in which IPNs have expanded rapidly in recent years. In these networks, notably in electronics and the automotive industries, most of the technology and skills are embodied in imported parts and components, and much of the value-added accrues to producers in more advanced countries where these parts and components are produced, and to the TNCs involved. The share of developing countries in value-added is determined by the cost of the least scarce and weakest factor, namely unskilled and semi-skilled labour, whereas the rewards to scarce but internationally mobile factors such as capital, management and know-how are reaped by their foreign owners. It is in effect the labour itself, rather than the product of labour, that is exported.

Consequently, while the share of developing countries in world manufacturing exports, including high-tech products, appears to have been expanding rapidly, incomes earned from such activities by these countries do not share in this dynamism. On this score, a comparison between developed and developing countries is highly revealing. In G-7 countries as a whole, manufacturing value-added consistently exceeded manufactured exports over the past two decades, but the opposite was the case for the leading exporters of manufactures in the South. Between 1980 and 1997 both developed and developing countries increased their shares in world manufactured value-added at the expense of the former socialist block, but there was actually a decline in the share of developed countries in world manufactured exports, from more than 80 per cent to about 70 per cent. Developing countries achieved a steeply rising ratio of manufactured

exports to GDP, but without a strong upward trend in the ratio of manufacturing value-added to GDP. As a result, the increase in the share of developing countries in world manufacturing exports has not been accompanied by a concomitant increase in their shares in world manufacturing value-added.<sup>19</sup>

These comparisons relate to value-added generated in developed and developing countries, rather than incomes earned from manufacturing activities. The value-added left in developing countries is still smaller and the income earned by industrial countries is larger if account is taken of profits earned by TNCs on their investment in developing countries (see section III).

***b. A stylized picture of diversity in trade and industrial development***

This general picture no doubt hides diversity among developing countries in their experience regarding trade and industrialization over the past two decades. In this respect, it is possible to distinguish among four categories:<sup>20</sup>

§ *Mature industrializers:* This group includes the first-tier NIEs, notably Korea and Taiwan, which have already achieved industrial maturity through a rapid accumulation of capital, growth in industrial employment, productivity and output, as well as manufactured exports. These economies have seen a large increase in their shares in both world manufacturing income and exports over the past two decades. They still have a share of industrial output in GDP above the levels of advanced countries, but as expected, industrial growth has started to slow down.

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<sup>19</sup> For a more detailed account see Akyüz (2003, pp. 39-46).

<sup>20</sup> For the evidence cited in this section see Akyüz, Kozul-Wright, and Mayer (2004).

- § *New generation of industrializers:* These are countries with a rising share of manufactures in total output, employment and exports, based on strong investment and upgrading from resource-based activities to labour-intensive manufactures and middle-range technology products. This group includes the second-tier NIEs (notably Malaysia and Thailand) and China, all extensively participating in IPNs. However, in these countries industrial deepening has advanced much less than that suggested by their manufactured exports. In Malaysia, for instance, between 1980 and 2000 the share of manufactured exports in GDP increased by 42 percentage points while the increase in manufacturing value-added as a proportion of GDP was around six percentage points. In China manufacturing value-added as a proportion of GDP fell over the same period as a result of rationalization associated with a move away from central planning, while the share of manufacturing exports in GDP increased by some 10 percentage points. Again the share of all these countries in world manufactured exports increased much faster than their share in world manufactured value added (Akyüz 2003, p. 45, table 1.5).
- § *Enclave industrializers:* This group includes countries which have also moved away from dependence on commodity exports by linking to IPNs with a heavy reliance on imported inputs and machinery. However, their overall performance in terms of investment, value-added and productivity growth is poor. Two countries stand out in this group, namely Mexico and the Philippines, where manufactured exports as a proportion of GDP rose rapidly during 1980-2000 while manufacturing value-added stagnated or declined. It appears that deindustrialization in traditional manufacturing sectors brought about by rapid liberalization has not been compensated by expansion in assembly industries, but as the latter are more export-oriented, there has been a sharp increase in manufactured exports as a proportion of GDP.
- § *Deindustrializers:* This group includes most middle-income countries in Latin America, notably Argentina and Brazil, which have achieved a certain degree of industrialization but have been unable to sustain a dynamic process of structural change through rapid

accumulation. In a context of rapid liberalization, there have often been declining or stagnant shares of manufactured exports, employment and output, and a downgrading to less technology-intensive activities. In some countries in this group, notably Chile, there has been a less destructive pattern of deindustrialization as a result of a fast pace of investment, accelerating growth based on natural resources. However, this process now appears to have reached its limits.

With the notable exception of the first-tier NIEs, therefore, recent expansion in manufacturing exports of developing countries has generally been associated with their increased participation in IPNs, and generated a more modest growth in manufacturing value-added in these countries. As a result, developing countries appear to be a lot more successful when their performance is measured in terms of manufacturing trade than in terms of manufacturing value-added and income.

The contrast between the two measures becomes even more evident when a comparison is made between the structures of trade and industrial output, using five broad categories of products: primary commodities, labour and resource-based manufactures, and low, medium and high technology-intensive manufactures. Such a comparison shows that developing countries are becoming increasingly similar to developed countries in the structure of their manufactured exports, but not in the structure of their manufacturing value-added. But, again, there is diversity:

§ Korea and Taiwan stand out for having reached a manufacturing value-added structure that is by far the closest to that prevailing in the leading developed countries. In these countries productivity growth over the past two decades has exceeded the growth in the northern technological leaders, notably the United States, in almost all manufacturing industries.

§ The manufactured export structure of a large number of developing countries extensively participating in IPNs, including China, Malaysia, Mexico, and the Philippines, has also

begun to resemble that of the major developed countries, but the similarity is much less so for the structure of their manufacturing value-added. In most of these countries productivity growth has been faster than in the United States in the lower end of manufacturing but not in the upper end.

§ For the majority of Latin American countries, not only the structure of manufacturing value-added but also that of exports is much less similar to those in the more advanced industrial countries. In many of these countries productivity in labour-intensive manufacturing has been falling, and the processing of natural resources continues to dominate production and export activities.

## **VI. Pros and cons of participation in international production networks**

Taken together, the evidence suggests that among the major developing countries, only a few first-tier NIEs have succeeded in simultaneously upgrading their production and export structures by upgrading and raising productivity in technology-intensive sectors and closing the gap with the industrial leaders. Many developing countries relying on FDI and TNCs for expansion of industrial production and exports appear to be far behind in upgrading their production structures, but they are more successful than commodity-dependent South American and African economies in moving to manufacturing.

Clearly, participation in the labour-intensive segments of IPNs can yield considerable benefits for countries in the early stages of industrialization and with a great deal of surplus labour. It can enable them to increase employment and per capita income even when the value-added generated is low. This has certainly been happening in China where transfer of unemployed and underemployed labour from agriculture to export-oriented industries has been an important factor in raising per capita income. Furthermore, increased employment of low-skilled labour in activities linked to IPNs can widen the possible range of sectors where industrialization

can begin, and help acquire the basic techniques and organizational skills needed for a more broad-based growth. Participation in such networks can also help facilitate access to foreign markets.

However, it is also important to recognize the limitations of participation in such production networks. Industrial upgrading and increased productivity are essential for improvements in the living conditions of active labour force employed by such industries and there are limits to do this when there is a high degree of dependence on foreign capital. This is particularly true for middle-income countries which have been successful in early stages of industrialization but which now need rapid upgrading and productivity growth in order to advance further along the development path. These networks allow TNCs a good deal more flexibility in, and control over, their choice of investment locations. Moreover, their productive assets, such as know-how, design and technology, can be locked more tightly inside the firm thanks to barriers of entry that result from the high costs of managing and coordinating such complex units. The packaged nature of FDI can, in these circumstances, be the cause of a highly skewed distribution of the gains from trade and investment unless local bargaining power can bring a more balanced outcome, as it did for the first-tier NIEs. However, replicating the success of early industrializers is all the more difficult where such investment is highly mobile: locational advantages are easily won and lost through small cost changes or the emergence of alternative sites, giving rise to the danger of enclave economies where there is a persistently high dependence on imported intermediate and capital goods.

An important motive in seeking to attract FDI in export industries is its potential contribution to balance-of-payments. Indeed, as long as the entire production is exported, participation in IPNs can make a positive contribution to the balance-of-payments in developing countries, barring such practices as transfer pricing, even if these activities are heavily dependent on imported parts and components, and the value-added left in the country is no more than the wages of unskilled labour. However, the picture can change when the goods and services produced are sold in domestic markets. More generally, the contribution of FDI to balance-of-

payments varies inversely with the share of TNCs profits in value-added, the extent of their reliance on imports, and the proportion of final product sold in domestic markets.<sup>21</sup> In general, since an important part of the value-added goes to profits, the import content is high, and the goods and services produced are partly sold in domestic markets, the contribution of FDI to balance-of-payments in developing countries is often negative.

This is the case even in China, one of the most successful countries in attracting export-oriented FDI. At the end of the 1990s, total profits earned by foreign-funded enterprises (FFE) in China were in the order of \$20 billion, of which \$12 billion was reinvested in the country and the rest was taken out. In the same period, these enterprises generated a net export surplus of \$2 billion. Thus, the FFE sector as a whole was in the red by some \$6 billion even on cash-flow basis (Akyüz 2003, p. 144). Available evidence suggests that a similar situation existed in Malaysia in the late 1980s and early 1990s when such deficits were covered simply by relying on new FDI, in much the same way as engaging in a process of Ponzi financing – that is, previous investors are paid with the money brought in by new investors (UNCTAD 1999, pp. 120-123 and table 5.6).

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<sup>21</sup> Let :

$$Q = (W + P) + (M + D) = X + S$$

where Q stands for gross output; W for local wages; P for gross profits on foreign investment, M and D for imported and domestically provided inputs respectively; X for exports and S for domestic sales. The BOP effect is given by:

$$B = (X - M) - P = W + (D - S)$$

where B is the net foreign exchange receipts. Clearly:

$$X = Q \text{ and } S = 0 \implies B > 0$$

that is, if the activity is entirely export oriented, then the BOP effect is always positive regardless of the import content of output and the division of the value added between local wages and foreign profits. On the other hand, when FDI is in non-traded good sectors, BOP effect is always negative, that is:

$$X = 0 \text{ and } S = 1 \implies B < 0.$$

## **VII. Competition and the fallacy of composition**

As a result of the increased participation of several highly populated, low-income countries in world trade in recent years, as much as 70 per cent of the labour force employed in sectors participating in world trade is low-skilled. Besides, there is still a considerable amount of surplus labour in such countries, and many large countries are not yet fully integrated into the international trading system. Thus, a simultaneous export drive by developing countries in labour-intensive manufactures, or increased competition among them to attract FDI as locations for labour-intensive processes, could rekindle the fallacy of composition or the adding-up problem: on its own a small developing country can substantially expand its exports without flooding the market and seriously reducing the prices of the products concerned, but this may not be true for developing countries as a whole, or even for large individual countries such as China and India. The dangers of overproducing standardized mass products with high import dependence are typified by the electronics sector, where developing country export prices appear to be more volatile and to have fallen more steeply after 1995 than similar products traded among developed countries.

There are also more general signs that the prices of manufactured exports from developing countries have been weakening vis-à-vis manufactures exported by industrialized countries in recent years (Akyüz 2003, pp. 83-92; Mayer 2003). For instance it has been estimated that China's net barter terms of trade in manufactures deteriorated by more than 10 per cent over the period 1993-2000, and the deterioration was greater vis-à-vis developed than developing countries, and more pronounced in products such as electronics and office equipment (Zheng and Yumin, 2002). Such evidence suggests that productivity gains in labour-intensive manufactures exported by developing countries do not always go to labour as higher wages, but often benefit consumers in western markets in lower prices. These trends suggest increased commoditization of many labour-intensive manufactures exported by developing countries.

Differences in the behaviour of prices of manufactures exported by developing and

developed countries appear to arise primarily from differences in global market structures and domestic labour market conditions. Because of the existence of significant barriers to entry in technology intensive product lines associated with their high R&D contents and the high costs involved in organizing production chains, markets for such products are dominated by oligopolistic producers in industrialized countries usually competing on the basis of quality, design, marketing, branding and product differentiation, rather than price. In such products, export market shares are much more concentrated than in manufactures exported by developing countries. This is also true for products that require very large and specific investments, such as machinery or transport equipment.

By contrast, there is much stiffer competition in markets for labour-intensive manufactures produced by developing countries. While these products provide opportunities for the new generation of industrializing economies, most middle-income developing countries also persist in these sectors because their producers find it difficult to upgrade and diversify. Industrialized economies also continue to operate in such sectors behind protection, as weak growth and high unemployment have slowed the closure of their sunset industries, thereby restricting the size of the market for developing country producers.

Competitive pressures are further compounded by the way labour markets in developing countries accommodate the additional supply of labour-intensive manufactures through flexible wages, allowing firms to compete on the basis of price without undermining profitability. Competition among firms, including TNCs, in developing countries becomes competition among labour located in different countries.

With a growing number of low-income developing countries, including some with very large unskilled labour pools, turning to export-oriented strategies, the middle-income countries in Latin America and Asia appear most vulnerable to these dynamics. In particular, greater price competition in products of the electronics sector appears to have increasingly exposed traditional developing country exporters to the emergence of more competitive suppliers in countries with

lower costs. This is also expected to happen in textile and clothing with the dismantling of non-tariff barriers. In the absence of a rapid upgrading to high-skill, high value-added manufactures needed to enable them to compete with more advanced industrial countries, the middle-income exporters may face a squeeze between the top and bottom ends of the markets for manufactures.

These challenges facing developing countries in international trade have been seen in recent years through the lens of international competitiveness. However, a degree of caution is needed in applying this concept in the present context. In the first place, strictly speaking, the concept may be useful to define the position of individual enterprises vis-à-vis each other, but not for comparisons among economies as a whole or even among industries comprising many firms with different characteristics: for, it is not countries but firms that trade (Krugman, 1994). From a private perspective it may matter little whether the international competitiveness of an enterprise is improved through productivity growth, wage cuts or a devaluation of the currency, but from a broader socio-economic point of view, these have totally different implications for economic growth, and social stability and welfare.

Evidence shows that wage suppression or sharp currency devaluations are not viable responses to the emergence of low-cost producers. Many countries which sought to increase the international competitiveness of their firms in this way have failed to achieve sustained improvements in their manufactured export and value-added performance. On the other hand, while productivity growth is a more secure way of gaining a competitive edge for an individual country, a simultaneous drive by a large number of countries to improve productivity and to gain competitiveness in labour-intensive manufactures can create gluts in the markets for these products and, hence, run against the problem of fallacy of composition, in much the same way as has happened in a number of primary commodities.

### **VIII. Policy challenges**

The basic policy issue facing developing countries in the trading system is not, fundamentally, one of more or less trade liberalization, but how best to extract from their participation in that system the elements that will promote economic development. In this respects policy challenges faced by countries differ according to various factors including the stage of development reached, resource endowments, size and geography. For some the main challenge is switching from primary commodities while for many others it is a question of advancing further in industrial development. In the latter group, many countries, particularly those with large populations, still have large numbers of unemployed workers, to be absorbed in industry and services. Given the global glut in low-skilled labour, there is a risk of excessive competition among developing countries in world markets for labour-intensive manufactures and for FDI as locations for labour-intensive segments of IPNs. This could disrupt the development process by causing significant terms-of-trade losses and create serious frictions in the global trading system.

A factor increasing this risk is continued protectionism in industrial countries against labour-intensive manufactures exported by developing countries. It was estimated by UNCTAD (1999, chap. VI) that developing countries would be able to earn an additional \$700 billion per annum from exports of labour-intensive manufactures if protectionist barriers in industrial countries were dismantled. This amounts to some 50 per cent of earnings from manufactured exports that the developing countries registered in recent years.

The mounting pressure in industrialized countries to raise the level of protection stems from the coincidence of high unemployment levels and growing wage inequality in these countries with sharp increases in labour-intensive manufactures exported by developing countries. These are sectors in which industrial countries have no chance of regaining competitiveness even with a major adjustment in wages, given that productivity in many developing countries in such sectors are relatively high and wage levels are considerably lower. Rather than trying to address

the difficulties arising from increased competition by employing the full range of macroeconomic and structural policies to accelerate growth, upgrade skill levels and reduce unemployment, most industrial countries have chosen to protect such industries by tariff and non-tariff barriers, and abuse of anti-dumping measures and technical, health and safety standards. Rolling back protectionism in such sectors would certainly provide considerable space for labour-abundant exporters of manufactures in the South, but it remains to be seen whether major progress can be made in this area without a return to high-growth, full-employment policies of the kind employed during the 1950s and 1960s which greatly helped absorb the entry of low-cost producers such as Japan and Italy.

The persistence of several middle-income countries in labour-intensive manufactures is another reason for the excess supply in world markets for such products. Thus, industrial upgrading in more advanced developing countries would help overcome difficulties in markets for labour-intensive products by allowing new players to take over labour-intensive activities in world trade and by stimulating trade among developing countries. This has happened to a certain extent. Countries like China that have adopted more export-oriented strategies have gained much of the market share given up by the first-tier NIEs when they shifted to more technology-intensive exports. However, because of the failure to undertake timely industrial upgrading, some exporters in the middle-income countries have been negatively affected. Their problems can be aggravated if large countries such as China and India rapidly expand their exports in labour-intensive manufactures.

Upgrading in many of these middle-income countries extensively participating in IPNs should involve the replacement of imported parts and components with domestically produced ones. In this process, the shares of both imports and exports in GDP would be expected to fall as domestic value-added grew faster, reversing the trend observed in countries participating in IPNs. What is needed here is that resources generated by employing surplus labour in such networks should provide the basis for the expansion of indigenous production capacity, entrepreneurship, skill and technology. Certainly, success depends, to a large extent, on the policies pursued in

areas such as trade, finance, industry and technology. Many of the policy measures successfully used in the past for this purpose, not only by the first-tier NIEs but also by industrialized countries, are no longer available because of multilateral commitments made by developing countries in the WTO, notably in TRIPs, TRIMs and subsidies. Moreover, effective substitutes for such measures may not always be easy to find. There is, thus, a need to reconsider, in the WTO review process, the full impact on development of limiting the policy options open to developing countries. It is also important that developing countries resist attempts to narrow their policy space further by extracting new commitments from them in areas such as FDI, competition policy and government procurement, and use fully the policy space available to them.

It is often suggested that services provide new opportunities for middle-income countries with well-educated populations and skilled labour force in maintaining growth momentum in the face of increased competition in labour-intensive manufactures. However, expanding the services sector alone is unlikely to ensure income convergence with advanced countries except for economies with massive hinterlands such as Hong Kong. The historical experience shows that the services sector takes over and a process of benign de-industrialization starts at much higher income and productivity levels than those achieved by middle-income countries; that is, around \$9,000 (Akyüz, Kozul-Wright and Mayer 2004). Indeed a problem facing many developing countries today is that deindustrialization has been occurring and the share of services rising at much lower levels of industrial productivity and per capita income. More important, this has been happening in the context of erratic and slow growth. It would be a fallacy to think that middle-income countries could converge towards the income levels of highly industrialized countries by rapidly moving into services, before achieving industrial maturity.

Similarly, the limits of services in providing new trade opportunities would need to be recognized. A number of services, such as those related to data processing, communication and health have been moving to middle-income developing countries with required skills and infrastructure. However, the pros and cons of this are very much like those entailed by participation in IPNs. Their competitive edge in such services comes from lower wages. But low

wages have very little to do with the efficiency of labour in the services performed. A data analyst or a doctor in India or Malaysia is not necessarily less skilful or productive than their counterparts in Europe, but he or she earns a lot less because the overall productivity of the economy is much lower. And for most countries, there is no other way of raising overall productivity than industrial development.

To avert potential difficulties in world markets for labour-intensive manufactures, larger developing economies, such as China and India, will need to find ways of utilizing domestic sources of growth more fully. It is true that growth of manufacturing and industrialization in the first-tier NIEs depended heavily on expansion of exports, particularly at the early stages of their development. However, these countries were poor in natural resources, and this necessitated a rapid move into labour-intensive manufacturing to earn the foreign exchange needed for imports essential for development. Moreover, they were small in size; collectively their population is smaller than that of Guangdong Province in China. Thus, their industries needed to seek markets abroad in order to achieve the necessary economies of scale in production. Indeed, historical evidence demonstrates, in general, an inverse relationship between trade orientation and economic size; among countries with similar levels of per capita income, the ratio of trade to income tends to be lower in countries with larger populations. Therefore, countries such as China and India can rely less on foreign markets for their industrialization than did the first-tier NIEs. Indeed, the most dynamic markets for labour intensive manufactures can be established in these countries themselves provided that policies emphasize broad-based growth as opposed to growth driven by enclave export sectors.

A strengthening of regional economic ties among developing countries could also help avoid many difficulties developing countries are facing at the global level. Conventional economic thinking tends to dismiss regional arrangements as a second-best solution for meeting development goals, and a potential stumbling-block on the road to a fully open and integrated multilateral system. However, this conclusion is based on a somewhat utopian view of the global economy. Where domestic firms still have weak technological and productive capacities, and the

global economic context is characterised by biases and asymmetries, regional arrangements may well provide a more supportive environment in which to pursue national development strategies. In particular, for manufacturing sectors which are traditionally oriented towards domestic markets, the regional context is useful for learning to adapt to the pressures of international competition, and can provide a first step towards close integration into the world economy.

In East Asia the regional pattern of industrialization, sometimes described as a “flying geese development paradigm”, has involved a progressively deeper regional division of labour where trade and investment flows link countries at different levels of development, and industries are relocated from one country to another in response to shifts in productive capabilities and competitiveness (UNCTAD 1996, Part Two, chap. I). While this process is driven primarily by markets, policy has also an important role to play in facilitating integration and ensuring its stability and sustainability. In the current conditions of sharply increased global financial instability, greater regional economic integration should also include increased monetary cooperation designed to ensure stability of the regional pattern of exchange rates.<sup>22</sup> In this respect useful lessons can be drawn from the experience of Europe after the collapse of the Bretton Woods arrangements, which allowed the region to move successfully from various mechanisms designed for intra-regional exchange rate stability to the EMU and the introduction of the euro in 1999. The arrangements should go beyond establishing a regional Fund with contributions from reserves to help countries facing speculative attacks on their currencies, as proposed during the 1997 East Asian crisis. They should also aim at reducing the likelihood of financial crisis and fluctuations among the bilateral exchange rates, and helping expand intra-regional trade and prevent intra-regional exchange rate conflicts of the kind observed in Mercosur during the devaluation of the Brazilian real in 1999 (Fernández-Arias, Panizza and Stein 2002; Eichengreen 2002). Consideration should thus be given to effective intra-regional surveillance over financial markets, macroeconomic policy coordination, and mechanisms to sustain stable intra-regional exchange rates.

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<sup>22</sup> For a discussion of the issues involved see Akyüz and Flassbeck (2002).

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