

## Is Industrial Policy Relevant in the 21<sup>st</sup> Century?

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This paper is concerned with the issue of whether "industrial policy" remains appropriate to bring about development in the 21<sup>st</sup> century. Among other things, the paper reviewed the various approaches to the formulation of industrial policies; indicated the contradictions, and double standards, in the laws of the WTO and GATT, and highlighted the lack of theory underlying trade liberalization. In view of its review of the evidence the paper proposed a general framework for the formulation of trade and industrial policies appropriate to country circumstances. It is suggested that industrial policies must be selective and predictable, and that they pay attention to the role of supplementing the non-price factors in the development of the agricultural sector; and noted that the aim of trade policy, as a component of industrial policy, should be to improve productivity rather than relying on the successive devaluation of the exchange rate, the selective use of foreign direct investment and the effective management of capital flows.

### ملاءمة السياسة الصناعية في القرن الحادي والعشرين

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#### ملخص

اهتمت هذه الورقة بقضية ما إذا كانت السياسة الصناعية ملائمة لإحداث التنمية في القرن الحادي والعشرين. وفرقت الورقة بين السياسات التجارية، التي تطال كل قطاعات الاقتصاد وتتنحصر في مجال تدفق السلع والخدمات، والسياسات الصناعية التي تعنى بكل السياسات، بما فيها السياسات التجارية، المتعلقة بتنمية قطاع الصناعة. استعرضت الورقة مختلف المقاربات لصياغة السياسات الصناعية، وبينت التناقضات والمعابير المزدوجة في قوانين منظمة التجارة العالمية وإلجات بالإضافة إلى قصور النظرية الكامنة خلف أطروحة تحرير التجارة. واقتрحت الورقة إطاراً عاماً لصياغة سياسات تجارية وصناعية ملائمة لإحداث التنمية دون أن يكون المقترح وصفاً تصلح لكل زمان ومكان. اقترحت أن تكون السياسات الصناعية إنتقائية وقابلة للتنبؤ بها، وأن تولي اهتماماً للدور المكمل للعوامل غير السعرية في تنمية القطاع الزراعي، كما اقترحت أن تهدف السياسات التجارية، كأحد مكونات السياسات الصناعية، إلى الارتقاء بالإنتاجية عوضاً عن الإعتماد على التخفيض المتعاقب لسعر العملة الوطنية، وأن ترمي إلى الاستخدام الانتقائي للاستثمار الأجنبي المباشر وإلى الإدارة الفاعلة لتدفقات رأس المال.

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## 1. Introduction

The purpose of this paper is to examine whether industrial policy has any place in industrialization and economic development of developing countries in the new world economy. We will argue that the answer to this question depends on the development objective of the country and the role envisaged for international trade. If the role of international trade is to achieve the objective of the integration of developing countries into the world economy purely for the sake of integration, the industrial policy is irrelevant. By contrast, if development is the ultimate objective of their integration to the world economy what is irrelevant is the current dominant economic philosophy and the international rules which govern trade and development. Such rules facilitate globalization but they are not particularly conducive to industrialization and development of developing countries.

We have been witnessing two contradictory developments in the world economy and international policy during recent decades. On the one hand, the need for sophisticated trade and industrial policies has increased; on the other hand the economic philosophy has changed against government intervention in the economy. The need for industrial policy has increased because the international market has become increasingly more concentrated; global production, international trade and technology have become more and more dominated by TNCs; technological changes have accelerated and production has become more knowledge-intensive. The policy space of developing countries has, however, shrunk due to the dominant views of the orthodoxy. Such views have been reflected on the conditionalities, imposed on many developing countries by International Financial Institutions (IFIs) or bilateral donors and to a large extent on GATT/WTO rules. More recently, they have been propagated through "Washington Consensus". Meanwhile the across-the-board and universal trade liberalization implemented by developing countries during recent decades has failed after the failure of across-the-board import-substitution of the preceding decades. Such failures have put trade policy as well as trade diplomacy at the cross-roads.

The failures of the top-down approach to trade and industrial policies through which one size-for-all rules are drawn at the international level and imposed on developing countries raises a serious question: is not there a need for rethinking trade and industrial policies? After arguing for the relevance of industrial policy, we will try to present an alternative framework by taking a bottom-up approach in this study. In other words, we will present a relevant framework for what is required at the national level to catch-up in the process of industrialization and development and, on that basis,

argue briefly for changes in international rules to make them development oriented. To do so, we will first briefly refer to some introductory remarks on the characteristics of the international economy in the 21<sup>st</sup> century and their implications for industrialization of developing countries. In the second section, different views on industrial policy will be examined. The third section will be allocated to revealing contradictions in WTO on development. Subsequently, we will argue that the across-the-board and universal trade liberalization is not justified either on theoretical grounds or by historical evidence; by contrast, all successful early and late industrializers have gone through an infant industry phase. The contradictory views expressed by the World Bank on economic performance of MENA are reviewed briefly before presenting an alternative framework for trade and industrial policies. The final section is devoted to some remarks on the implication of the alternative framework for international trade rules.

Before proceeding further, let us mention the relations between industrial policy and trade policy. Although they are linked, trade policy embraces all sectors of the economy, limiting itself to the international flow of goods and services. In other words, trade policy is a tool of development strategy in general; industrial policies are concerned with all policies, including trade, related to industrial development. Hence, trade policy is only one aspect or instrument of industrialization and expansion of exports of manufactures.

## **2. Main Features of the World Economy; Implications for Industrialization**

Globalization, increasing domination of TNCs in production and international trade and rapid technological changes are three main characteristics of the world economy which, inter alia, affect the prospects for developing countries' firms to enter into the world market and compete with the established international firms.

Globalization: Globalization implies the expansion of activities of global firms across frontiers through networking and product sharing particularly in the manufacturing sector. Global firms locate different stages of production of a specific product in different countries through their subsidiaries and affiliates. Therefore, components of a finished product may cross different frontiers before being assembled in a particular country and sold in different markets<sup>(1)</sup>.

A global firm enjoys a number of advantages vis-à-vis a new comer firm of developing country. First, it has home-based advantages related to technology, experience, market information, marketing and distribution channels, firm-level

economies of scale etc. Second, it can benefit from networking, and collaboration with other firms. Networking takes place mainly with its own affiliates and allows obtaining cheaper sources of inputs, technology, intermediate products, distribution channels etc. (Best, 1990: 260). Its global activities also allow expanding the scope of the market to enjoy economies of scale, scope and agglomeration. Moreover, a global firm collaborates with other firms through international consortia, cross licensing agreements, long-term supply and purchase contracts, joint ventures, strategic and technological alliance and subcontracting. Collaboration with other firms will allow sharing its activities such as R&D, production facilities, marketing, distribution, input procurement, product development, and design at the global level without necessarily investing abroad directly for these activities (Best, 1990:259–62 and Porter 1990:54).

In addition to their home country advantages, global firms can benefit from host country advantages, such as low wages and local markets by locating their activities in different countries. Therefore, they will be in a more favourable competitive position than an independent local firm of a developing country while their importance in world economic activities has been increasing.

**Domination of Large Global Firms:** Global firms (large TNCs) increasingly dominate production and international trade (table 1). The figures in this table overestimate the share of the top firms in output as the related data at the firm level are measured in terms of output, but those at the global level are quoted in terms of value added. Nevertheless, the data are very telling on the role of TNCs in international trade and provide some indications on their role in world industrial production and total output. Table 2 presents alternative data on industrial enterprises based on Thomson Financial survey of about 19,000 listed public companies. Again the data are not complete, as they do not include all companies, but the table provides some information on the degree of concentration of firms at the global level. Accordingly, the largest 1270 companies (i.e. 5.1 per cent of the total number of companies surveyed) and the largest 100 firms, account for over two-third, and one-fifth of total sales of the companies surveyed, respectively. Further, according to the main source, the bulk of large companies are located in the main developed countries, particularly the USA. For example, half of the companies with 20,000 or more employees are located in the United States (accounting for over 62 per cent of their total sales), 22 per cent in six European countries (the United Kingdom, Germany, France, Switzerland, Italy and the Netherlands), 8 per cent in Japan and 19 per cent in the rest of the world. Further, the United States firms are more concentrated than the rest of the world. Companies with 20,000 employees and

more account for over 85 per cent of sales of all United States companies included in the database, as against 67 per cent for the world (Shafaeddin, 2006.b).

Table 1: The Importance of the Largest World Industrial Enterprises  
(in or around 2000)

The share of largest firms with employees more than 20,000					
The Largest					
Description	Total	10,000	Total	100	25
Number of firms	18,540.0	8.8	5.1	0.5	0.13
Employees (millions)	100.5	77.7	68.0	27.6	7.30
Sales (billion dollars)	2,108.4	7.6	66.8	21.7	6.40

Source: Shafaeddin (2005.a:123).

\* In terms of numbers of employees.

Table 2: The Share of Top Firms in Global Production and Trade  
(late 1990s)

Activity	Number	Percent
All output	200	28
Industrial output	1000	80
World Trade	500	70

Source: (Mooney 1999:74).

In recent years, the size of large TNCs has increased due to intensification in mergers and acquisition. For example, one-third of the largest US 500 fortune companies listed in 1980 were merged by 1990 and another 40 per cent were merged by 1995 (Shafaeddin, 2006. b). Moreover, in five years between 1997 and 2001, the number of cross-boarder M&A with values of over \$ 1billion reached 450 cases, almost three times greater than the corresponding number for the preceding ten years. In terms of value, it was 4.5 times greater over the same period (Based on UNCTAD, 2005: 9, table 1.1). The large global firms dominate almost all industrial activities as well as services (Shafaeddin, 2005.a:123-125) and have control over technology particularly that they enjoy patent protection through WTO rules

Technology: During recent decades, technologies have become more sophisticated, more specialized and subject to rapid changes. Such development in technology implies that production has become more knowledge intensive, skills have become more firm specific and specialized, and the period of learning has become longer (Lundvall, 2004).

At the same time, the newcomer firms run higher investment risks because during the gestation period of their investment new technologies may arrive making the existing process obsolete or put the existing product out of the market. As new technology is mainly possessed by large TNCs, the barriers to entry are set at a higher level for newcomer firms.

Strategic Behaviour of Global Firms and their Implications: An important feature of global firms is that in their main activities i.e. networking, intra-firm trade<sup>(2)</sup>, inter-firm cooperation, etc. they do not go through the market (Porter, 1990, 60-62). Further, while the role of large TNCs in economic activities has increased, the role of the government in decision making and allocation of resources has shrunk during the recent decades due to economic liberalization. In other words, the relative role of large firms in the coordination of economic activities has been increasing against markets and governments.

The large firms coordinate their activities not only outside the market, but they also shape the market and create barriers to entry for new comers. They coordinate their activities through strategic planning, strategic actions and vertical and horizontal relationship with other firms. (Galbraith, 1975; Williamson, 1975; Lazonick, 1991; Best, 1990 and Porter 1990). Further, they have the capacity to influence production costs, prices, technology and the quality of goods they produce. They can target their markets; influence the market structure and the environment within which they operate thus limiting the entry of new firms to the market.

The firm level economies of scale of large established firms are, in particular, important, not only because they are sources of cost advantage (Krugman 1984), but more importantly, because they are sources of "strategic behaviour", "dynamic competition" and progressive and cumulative changes over time (Young, 1928). Such a Schumpeterian source of dynamic competitive process and power of "creative destruction" implies that the ability to export would depend on "comparative strategic advantage" rather than comparative cost advantage alone (Best 1990).

Lazonick (1991) has shown that the combination of technological innovation and organizational capabilities, resulting from experience and firm-level economies of scale, provides the large established firms with the possibility of pursuing an "innovating strategy" based on high fixed costs rather than an "adaptive strategy". That strategy allows them to invest a large amount to develop and utilize productive resources which can bring about new products with higher quality and/or new process with lower cost.

The economies of scale allow them to reduce unit cost of production by lowering price and selling more. The decline in the production cost and prices in this case is totally different from the production cost related to factor costs.

In contrast to the established firms a new and independent firm of a developing country initially has to follow an “adaptive strategy” which involves lower fixed cost and relies on low cost advantages. The lack of experience, technological capabilities, and marketing and distribution channels as well as small size and barriers to entry would not allow a new firm of a developing country to follow an “innovative strategy”.

The successful firms which follow “innovative strategy” have competitive advantages vis-à-vis those with “adaptive strategy”. An innovative firm usually runs more “productive risks” than an adaptive firm, because there is a risk that other innovative firms come up with similar new products. In comparison, the adaptive firm produces standard products. Nevertheless, the adaptive firms of developing countries run more “competitive risks” than the established firms of developed countries. For the standard light manufacturing goods, there is a risk of fallacy of composition and cutthroat price-cutting by other developing countries in addition to the risk of development of new products or technology by established “innovative” firms. More importantly, the costs and the risks involved in upgrading are particularly greater for the firms of developing countries than those of established firms of developed countries as they have inferior technological capabilities.

In short, globalization has changed the nature of competition in the international market in three main ways. First, it has enhanced “strategic competitive advantage” of large established firms. Second, it has intensified the process of Schumpeterian “Dynamic competition” and “creative distraction”. In such a process firms are continuously active in innovation, product development, quality improvement, shortening of delivery time, etc. As a result, the role of “non-price attributes” of products in competitive advantages has increased. Finally, the growing size, their control of technology, experience and strategic behaviour of established firms place them in a superior “competitive advantage” vis-à-vis newcomer and independent firms of developing countries. Such attribute limits prospects of these firms for entry into the international market because unlike the established firms of developed countries only cheap labour and/or raw materials are their main source of competitive advantage.

The increased cost of technology, the prolonged length of learning, the augmented risks of investments<sup>(3)</sup>—all these factors have increased the need for government support of

infant industries/firms in a developing country unless integration into the world economy through the FDI channel is feasible and conducive to industrialization. In theory, there are two main methods through which governments can provide support to infant industries. One is creating an environment which contributes to prevalence of external economies; the other is the provision of supports for specific industries and firms. External economies can shift the cost curve of firms downward. Specific support can enhance their earnings for a given cost curve in a particular period. External economies can arise from functional intervention in the economy through general government investment in education, training, infrastructure, institutions and back-up services. It can also arise from collective efficiencies resulting from industrial districts and clustering both of which require government support<sup>(4)</sup>. While external economies are important, development of a specific infant industry requires provision of temporary support to that industry either through subsidies or imposition of tariffs or some other means. In practice, the policy space of developing countries has been shrinking in recent decades restricting their ability to use such measures.

Of course, the process of globalization improves, under certain conditions, the possibilities and opportunities for developing countries to enter the international market through FDI by global firms. The question is whether development through FDI path, even where feasible, would allow a country to deepen its industrialization or leaves the country locked in a pattern of specialization based on static comparative cost advantage.

### **3. Different Approaches to Industrial Policies**

There are two main approaches to industrial policy: that of neo-liberals and their opponents. The neo-liberal views are expressed through Washington Consensus, IFIs, and contained to some extent in WTO rules. According to the orthodox approach, industrial policy has no place in economic development. The WTO rules limit the use of industrial policy, and developed countries aim at limiting it even further in the Doha Round of trade negotiation and beyond. A number of scholars, however, believe that industrial policy is an important tool of development, but the approach they take is a top down approach. Let us say a few words about each, but concentrate on the WTO rules which are most directly relevant to the question of policy space of developing countries.

**The Orthodoxy and WTO Rules:** Since early 1980s, there have been changes in the dominant economic philosophy in favour of neo-liberalism, which do not favour government involvement in economic activities beyond some functional intervention in the form of

investment in education, health and securities etc. (See e.g. World Bank, 1987 and 1993). Their argument is that development of a country should be left basically to the operation of market forces; trade liberalization would change the structures of incentives in favour of exports and attract private investment, including FDI, to the areas in which a country has comparative advantage leading to industrialization and growth (see Shafaeddin, 2006.a for a survey). This process, however, has its own limitations in enhancing industrialisation of developing countries (see below); further, it increases the risks and vulnerability of these countries to decisions of global firms in re-location of plants from one country to another.

WTO rules limit policy space of developing countries in a number of ways including:

- The TRIPS agreement restricts application and transfer of technology to developing countries and their development of generic drugs by protecting intellectual property rights, limiting the use of patented technologies or products (patents are protected for 25 years) and restricting the government ability to demand a firm to license a patent to other firms.
- The TRIMs agreement restricts the imposition of “performance requirements” on foreign firms including the local content, export requirements and trade balancing. It also forbids “national preference” i.e. preference for local products in government procurement.
- GATS exposes domestic companies to sever competition with established foreign companies through requirements for most “favoured nations”, “national treatment” in the use of inputs, local employees, and access to local market, etc<sup>(5)</sup>.
- The Agreement on Subsidy and Countervailing Measures (ASCM) prohibits the use of targeted subsidies for supporting domestic industries and export expansion (except for agricultural goods).

Wade (2005) summarizing the impact of the first three agreement, concludes that: “With a touch of hyperbole the agreements could be called a slow-motion Great Train Robbery” (Ibid: 89). Nevertheless, the detrimental impact of the ASCM on manufacturing production and exports is not any less than the adverse effects of those agreements. Subsidies have been a major instrument of infant industry protection and export expansion in many developing countries, particularly East Asian ones. Under Uruguay Round Agreements (URAs), subsidies provided for the expansion of exports and export supply capabilities are not allowed (ASCM, articles 3 and 8). Article 3 of the Agreement prohibits subsidies to be paid to firms (except for agricultural products) “upon export performance” and “upon the use of domestic over imported goods” (inputs). Definition of subsidies for export performance includes “direct subsidy”, currency retention, preferential

internal transport and freight charges on export shipment, as against domestic shipment and preferential provision of “imported or domestic products or services for use in the production of exported goods” (ASCM, annex I).<sup>(6)</sup>

While according to paragraph 2.1.a, a subsidy is prohibited if it is “specific”, i.e. it is limited to specific enterprises or industries, according to para. 2.3, all subsidies falling under the provisions of article 3 are regarded as specific. Hence, even if all industries were provided with subsidies tied to export performance, or which favour domestically produced goods, the subsidy would be regarded as specific. The implication of this article is that a country cannot support its infant industries, whether or not for exports, either across-the-board or on a selective basis, when the subsidy is tied to export performance.

Paragraphs 8.2.a, 8.2.b and 8.2.c, however, provide some exceptions to the subsidy rule. For example, Para. 8.2.a provides exceptions to the specificity clause. It covers research activities (R&D) undertaken by firms and/or research and educational establishments, up to 75 per cent of costs of industrial research, or 50 per cent of the costs of pre-competitive development activity. Para. 8.2.b allows for “non-specific” assistance to a country’s disadvantaged regions, provided that clear and objective criteria is used in the definition of such regions. The criteria should be based on development indicators, which should at least cover a measure of income or employment. Accordingly, the income per capita of the region should be lower than the 85 per cent of the average for the country. The unemployment rate should be at least 110 per cent of the country average.

Paragraph 8.2.c allows, under certain conditions, assistance for the adaptation of existing facilities to new environmental requirements of up to 20 per cent of the related cost on a one-time basis, provided it is available to all firms concerned (Shafaeddin, 2005.a)

The Opponents: The existence of such exceptional clauses has led Amsden (2001 and 2005) to consider the possibility of applying industrial policy within the framework of WTO. She argues that although WTO restricts policy space of developing countries, there are still some room for manoeuvrings in the use of industrial policy. For example, she refers to three specific non-actionable subsidies mentioned above, the use of “trade-balancing”, as an indirect export requirement, and development of mid- and high-technology industries through development of science parks (Ibid:22/)<sup>(7)</sup>. Moreover, she refers to the need for “getting the control mechanism right” to guide and stimulate the private sector in certain direction; in each case the instruments of promotion “...must be tied to monitorable performance standard and operate within a reciprocal control mechanism that disciplines all parties involved in industrial expansion”.

A number of points worth mentioning with respect to the Amsden's proposal. First and most importantly, is that the policy space of developing countries is being limited not only by WTO rules, but also by IFIs and bilateral donors. Therefore, even when the use of a policy tool is allowed under WTO rule, the SAPs, SPs or even bilateral donors, would not necessarily leave a developing country to implement it. Second, under current WTO rules the "control mechanism" (the performance requirements) is limited as mentioned earlier. Third, the provision on subsidies to R&D activities was for a trial period of 5 years and is no longer applicable. Trade balancing requirement is allowed only in accordance with "the balance of payments clause" i.e. for a limited period when a country faces balance of payments problems. Otherwise, it is forbidden under TRIMs Agreement.

Fourth, developed countries are trying to limit the policy space of developing countries even further through the Doha Round and beyond (see below). Finally, the problem is that not only WTO rules are not conducive to development, but they also suffer from many contradictions in design and in implementation of the agreed rules by developed countries. In fact, certain GATT/WTO rules limit policy space of developing countries but leaves the hands of governments of developed countries, relatively speaking, free (see below).

The only possibility under WTO rules to encourage exports indirectly, not mentioned by Amsden, is locating export activities in the "disadvantage" regions. In this case they could benefit from non-specific subsidies provided to all industries in those regions. Nevertheless, the use of such a mechanism would be possible for a short period, because as more industries are located in such regions, they would not remain disadvantaged<sup>(8)</sup>.

According to Rodrik (2004), rumours of "industrial policy's death" are exaggerated. The reality is that industrial policies have run rampant during the last decades—and nowhere more so than in those economies that have steadily adopted the agenda of orthodox reform. If this fact has escaped attention, it is because the preferential policies in question have privileged exports and foreign investment,—the two fetishes of the Washington Consensus era—and because their advocates have called them strategies of "outward orientation" and other similar sounding names instead of industrial policies (Rodrik, Ibid:28–29).

Preferences given to export processing zones and incentives provided to FDI are among main examples of policies favouring exports and FDI because it is presumed that externalities reside in exports and foreign direct investment' (Ibid: 30).

Rodrik argues that the market does not bring about industrialization on its own, and that as market failures prevail government intervention is required. It is in this context that he advocates the need to 'get the policy process right' and maintains that this can be done, through a 'discovery process' by which 'private and public actors come together to solve problems, including those caused by market failure, in the productive sphere, each side learning about opportunities and constraints faced by other' (ibid.: 3). In such a process 'firms and government learn about underlying costs and opportunities and engage in strategic coordination' to remedy market failures which restrict self-discovery (ibid.: 10). Referring to external constraints and the restrictions on policy space imposed by international rules and conditionalities, Rodrik, like Amsden, argues that (external) restrictions are exaggerated; there is also still some room for manoeuvre to implement industrial policy.

Rodrik's proposal on a mechanism for public-private collaboration is welcome, but it is not new. Public-private cooperation has worked relatively well in East Asia (see, for example, Amsden, 1989; Shafaeddin, 2004a; Wade, 1990). The problem with this Approach is to submit to *fait-à-complet*. Further, as already mentioned the remaining policy space of developing countries will be further limited through Doha Round if developing countries agree with the proposals made by developed countries.

Some other opponents of neo-liberalism advocate a more radical approach on industrial policy. For example, Lall (2004) refers to rapidity and complexity of technical changes, globalization and market failure in technological capability building, and concludes that developing competitive capabilities requires direct and indirect government intervention. Both selective and functional government interventions are required to address market failures which create obstacles to 'capability building' for industrialization and development. Attraction of FDI, he adds, also requires local capabilities; this is a reason only a limited number of developing countries have attracted FDI. Even where such capabilities exist, the contribution of FDI to industrial development and upgrading is limited; its coverage does not often go beyond simple processing and labour intensive activities unless local capabilities are upgraded rapidly.

There are, in fact, a body of literature showing that FDI has not involved much spill-over in developing countries (Gallagher and Zarsky, 2004, Hanson, 2001) Nevertheless, while Lall advocates the need for the creation of space for industrial policy in developing countries, he concludes that it is not feasible under WTO rules to develop and upgrade the necessary capabilities because of restrictions imposed by WTO rules. This is again a passive approach.

In contrast to Lall, Singh (2005) and Wade (2005), argue for some changes in the WTO rules to provide developing countries with Special and Differential Treatment (SDT). Nevertheless, they still follow a sort of top down approach. What is needed is a totally different framework which would allow for differential treatment of developing countries “as a rule” not as exceptions to the rules i.e. a type of SDT currently requested by developing countries.<sup>(9)</sup> According to WTO, Various Multilateral Agreements contain 145 SDT provisions of which 107 were adopted at the conclusion of UR (Singh, *ibid*: 237). Further, the July 2004 Text of the Doha Round also refers to the issue frequently. Nevertheless, the main concern of SDT measure in the UR has been “to assist developing countries in implementation of the WTO disciplines” (*ibid*: 237). Moreover, the SDT provisions which are already approved are not taken seriously by developed countries as they are voluntary and not legally binding. There were also some provisions which in fact provide SDTs for developed countries, such as the textile agreement, ASCM Agreement and Agricultural Agreements (see below). After all, despite the emphasize in the July text on SDT and less than reciprocity in favour of developing countries, in practice, developed countries are trying to impose unfavourable terms on developing countries during the Doha Round negotiation. The whole philosophy behind WTO rules needs to be changed as it suffers from contradictions and double standards detrimental to developing countries.

#### **4. Contradictions and Double Standards in GATT/WTO Rules**

The GATT/WTO rules suffer from contradictions in design and contradictions between the agreed rules and their implementation by developed countries. as mentioned before. Furthermore, developed countries have been showing further double standards during the so-called “Doha Development Round”. One wonders “...why are there two standards for what is ‘fair? Or ?unfair? trade practices” (Stiglitz, 2005: 17).

Design: According to the preamble to GATT (1949), trade liberalization is the objective of the Agreement. Let us assume for the moment that universal trade liberalization is conducive to industrialization and development of developing countries. Yet, one can find many general and specific “animal farm” type exceptions in GATT/WTO rules in favour of developed countries in contradiction with this general principal of trade liberalization. With respect to general contradictions, first of all, the GATT/WTO rules aim at reducing government intervention in the flow of trade, but are silent about eliminating, or at least reducing, the monopoly, or oligopoly, power of TNCs. In fact, if anything the governments’ controls on these companies have been relaxed through TRIMs and GATS as mentioned above. According to Wade:

These [international] regulations are not about limiting companies' options, as "regulations" normally connotes. Rather they are about limiting the options of developing country governments to constrain the options of companies operating or hoping to operate within their borders. In effect, the new regulations are designed to expand the options of developed country firms to enter and exit markets more easily, with fewer restrictions and obligations, and to lock in appropriation of technological rents" (Wade, 2005: 80).

Second, trade in agricultural products has been so far excluded from liberalization in favour of developed countries.

Third, while trade in manufactured goods was supposed to be liberalized, labour intensive products of main interest to developing countries have been subject to special restrictions (e.g. textiles and clothing has been subject to MFA until recently) or tariff peaks and tariff escalation on products of interests to developing countries.

There are also specific contradictions in various GATT/WTO agreements which favour developed countries but are detrimental to the interest of developing countries. For example, as mentioned earlier, the ASCM allowed subsidization of R&D, the main infant activity of interest to developed countries, and agriculture, and not for manufactured export, an infant activity of interest to developing countries. In the Agricultural Agreement, subsidies used by developed countries (as in R&D, crop insurance, and so on) are allowed, but those most used by developing countries (e.g. input and land improvement subsidies) are subject to countermeasures (Das, 1999: 157)<sup>(10)</sup>. Furthermore, a long period (25 years) of infant industry protection of new technologies and new products is allowed under TRIPs, but temporary infant industry protection of new industries, or new export activities, in developing countries is not allowed (See Shafaeddin, 2005, chapter 8 for details). Again in the TRIPs agreement, while the developing countries obligations on the rules governing patents are binding, their rights are not. By contrast, developed countries' rights are binding, but their obligations are not (Wade, 2005:83-4)<sup>(11)</sup>

Implementations: Developed countries have not fully implemented the rules to which they have agreed in GATT/WTO. Such are the lack of proper implementations of the Differential and Preferential Treatment of developing and particularly least developed countries, the Agreement on Textiles and Clothing (ATC), the Agreement on Agriculture (the so-called cotton scandal is only one example) and the abuse of anti-dumping rules and safe-guard measures. Above all, main developed countries have provided extensive targeted supported for their industries and firms against the WTO rules (See Shafaeddin, 2005: Chapter 8 for details).

Doha Round: The Doha Round is supposed to be “development round”. The outcome of the Round has not been decided yet, and the text of the Hong Kong Declaration of December 2005 is vague in many respects, particularly on Non-Agricultural Market Access (NAMA). Nevertheless, many of the proposals which have already been made by developed countries are in contradictions with the stated objectives of the Round. Such contradictions are best expressed in nutshell by a delegation from a developing country in Hong Kong during the WTO meeting of December 2005: “The developed countries talk in the plenary halls of a round for free for developing countries. Then they move into the green room and continue to ask for a round for free, this time for themselves.” (Oxfam, 2005:8).

Generally speaking, GATT/WTO rules and decisions recognize the need to take into account the special need of individual developing countries and industries, (e.g. Article XXVIIbis of GATT 1994, para 8 of Article XXXVI, part IV, GATT 1994, para 4 and 8 of Annex B to the July 2004 Package)<sup>(12)</sup>. In the particular case of NAMA which is of our particular interest here, the July 2004 package refers to principles of “less than full reciprocity” and “flexibility” in favour of developing countries (e.g. paragraph 8 of Annex B of the text of July Package). In practice, however, the proposals made by developed countries are neither conducive to development nor consistent with those principles. In fact, they push for universal and across-the-board trade liberalization. According, all countries are supposed to apply the same formula to cut average tariffs rates drastically and reduce their dispersion by binding 95 per cent of their individual tariff<sup>(13)</sup> lines at the same rate at the low levels. For example, the USA proposed cutting tariffs to 8 per cent by 2010 and reducing them to zero by 2015. Certain sectors are proposed to be subject to zero tariffs immediately upon conclusion of the Doha Round. The EU has proposed non-linear cuts in tariffs according to the Swiss formula<sup>(14)</sup> and a low and uniform coefficient of 10 chosen for both developed and developing countries. Further it has proposed a tariff cap of 15 per cent for developing and 10 per cent for developed countries for binding all industrial tariff lines. The Swiss formula proposed by EU, and approved in Honk Kong despite the opposition of the majority of developing countries, has four main characteristics:

- The higher the initial tariff rate, the higher the rate of reduction in tariff;
- The lower the coefficient, the higher the rate of reduction in tariff;
- For high tariff rates the rate of reduction in tariffs are higher than the rate of reduction in tariff when simple linear formula ( according to which the same percentage reduction is applied at all tariff lines is applied);
- It “has lower rates of percentage reduction than those generated by a tariff independent linear reduction in a certain range of low tariff rates” (WTO, *ibid*: 2).

Although the coefficients of the formula for developing and developed countries are still subject to negotiation, the proposals so far made is not in the interest of developing countries. As initial tariffs for developing countries are well higher than that of developed countries, they would be subject to significantly greater reduction in their rates not only in absolute terms but also in percentage terms. For example, if the EU proposal is approved, a tariff rate of 5 per cent for developed countries will be reduced to 3.33—a reduction of 33 per cent or 1.67 percentage points. By contrast, a tariff rate of 60 percent for developing countries will be reduced to 8.8—or a deduction of 85 per cent, or 51.2 percentage points. For higher initial tariff rates, the new rate would not exceed the cap of 10 per cent (SUNS, 1 November 2005). This maximum rate will also apply to all unbound tariffs after tariff cuts and binding.

The immediate effect of the proposal by developed countries is that developing countries imports of industrial goods will increase more than their exports as indicated by results of simulations (Fernandez de Cordoba, et.al. 2004). More, importantly, it has a significant detrimental long-term effect on their industrialization. The industrial sector of developing countries is, unlike that of developed countries, underdeveloped, thus they need to apply higher tariffs to some of their industries than developed countries. Therefore, the low tariffs rates, as proposed by developed countries, will make them lose an important policy tool for upgrading their industrial capacity. Further, binding of tariffs at low levels would not allow developing countries to raise them beyond the (low) bound level at the time of balance of payments problems (Shafaeddin, 2006.c).

There are some other evidences of double standards by developed countries. For example, while they try to impose caps on industrial tariffs, they refuse to do so for agricultural products. Similarly, while demanding a significant cut in the industrial tariffs of developing countries, they proposed only a very conservative cut in their agricultural tariffs and abolishment of agricultural export subsidy by 2013, but no change in domestic support to agriculture which is far more important than export subsidy. Further, the EU proposal on agriculture exempts European sensitive products from steep cuts, and asked for special safeguard measures for a number of their agricultural products (beef, poultry, butter, fruits, vegetables and sugar). More importantly, both the EU and USA have made their conservative proposals for liberalization of agricultural trade subject to drastic liberalization of both industrial products and services by developing countries and judged by the outcome of the Honk Kong meeting, they have succeeded so far as para 24 of the Hong Kong Declaration calls, however vague, for balanced and proportionate market access for agriculture and NAMA in the negotiation.

In short, as an African delegation commented: “quite simply, we do not detect the political will of other Members to strengthen special and differential treatment provisions to make them more precise, effective and operational, as we all agreed to do in Doha” (SUNS, 31, October 2005). The lack of political “will” is not, however, the only problem. The philosophy behind “trade liberalization hypothesis” suffers from theoretical shortcomings.

## 5. Shortcomings of the Theory Behind Trade Liberalization

“Trade Liberalization Hypothesis” “the argument against industrial policy is based on a naïve reading of economic theory and misreading of economic history” (Stiglitz, 2005:25).

The philosophy and the theory behind Washington Consensus, trade policies dictated by IFIs (through SAPs and SPs), i.e. the across-the-board and universal trade liberalization, which also governs the GATT/WTO rules to a large extent, is not conducive to industrialization and development of developing countries. Let us for simplicity refer to the idea of “universal and across-the-board trade liberalization as “trade liberalization hypothesis”. We will argue in this section that this hypothesis is not justified by economic theory.

The orthodoxy argues against government intervention in the economy in general as mentioned before. The theoretical argument against government intervention in production and trade is based mainly on the premise that markets are competitive and function well and there is no market failure, but government failure is pervasive. In the particular case of international trade, policy reform has been envisaged as synonymous with “uniform”-across-the-board import liberalization, applicable “universally” to all developing countries. This is a general theoretical abstraction which is, in turn, based on the theory of comparative cost advantage according to which universal free trade will lead to an efficient reallocation of world resources. This theory can predict and explain, under free trade and certain assumptions, the division of labour between industrial countries and developing countries and the specialization of the later in production and exports of primary commodities and labour intensive products. But it, whether in its static or so-called dynamic version, can not explain the process of “catching-up” and upgrading by late-comers.

The theory of comparative cost advantage is based on unrealistic assumptions such as the existence of competitive and perfect internal and international markets, the small size and “passivity” of firms, no “market inadequacy”<sup>(15)</sup>, constant returns to scale, no externalities and no other causes of market failure. Moreover, according to this theory, all countries are

at the same level of technological development, and technology is readily and freely available to their firms, a mix of goods and services are the same in all countries and each product is produced with the same technology in different countries. Further, as all firms are small, they do not play an active role in pricing, technological development, capacity building and the learning process. Full employment, mobility of factors of production between industries, lack of uncertainty and risks, are other unrealistic assumptions of that theoretical abstraction. Accordingly, there is no need for government intervention, whether functional or selective, as no sector or industry plays a particular role in providing positive externalities.

The afore-mentioned assumptions related to internal market structure are particularly unrealistic for low-income countries and those at the early stages of industrialization where markets are missing or market failure is pervasive and the industrial production and export base is usually very small. In these countries the existing industrial capacity often reflects the production of scattered, light manufactured goods, produced at high cost owing to across-the-board import substitution and low capacity utilization; the latter being due to a shortage of foreign exchange and skilled manpower.

Although sometimes they pay lip service to the question of growth, the main concern of neo-liberals is the allocative efficiency.<sup>(16)</sup> For example, John Williamson, the initiator of the Washington Consensus literature, admits that “none of the ideas spawned by ... development literature ... plays an essential role in motivating the Washington Consensus ...” (see e.g. Williamson, 1990: 19). In other words, what is recommended by the orthodoxy, does not contribute to “catching up”, industrialization and development beyond a short-term gain achieved through allocative efficiency.

Concentration on the allocative efficiency was in fact, one of three main interrelated issues in Adam Smith theory of international trade which has been the basis of the neo-classical theory of trade and the “trade liberalization hypothesis”. The first is Smith’s “focussing attention on the allocative functions of the markets to the exclusion of their creative functions – as an instrument for transmitting impulses to economic change” (Kaldor, 1972: 1240). The second is his concerns with “interchangeable value” [international trade] as against “productive power” [economic development] (List, 1856: 253). Third, Adam Smith introduced his universal theory of free trade for “cosmopolitan economy”, i.e. the economy of mankind as a whole believing that free trade would maximize the welfare of the world economy as a whole. He, in fact, did not distinguish differences between the interest of individuals, and mankind in general. He ignored the fact that some nations may give more weight to their own welfare than to the collective

welfare of humanity. Yet, he thought what was in the interest of Britain was also in the interest of the world as a whole (List, *Ibid.*: 245–6, 74 and 261).

A number of famous neo-classical economists do admit that free trade is an “ideal” as the theory of comparative advantage is based on abstract assumptions (Haberler, 1950:227; Corden, 1974:7–8; Samuelson 1938:226 and 1939:195 and Viner (1953:4–5). For example, according to Samuelson: “some trade is better than no trade, but that does not necessarily imply that free trade is the optimum for any country” (Samuelson 1938:266)<sup>(17)</sup> Jacob Viner (1953: 4–5) correctly maintains that Smith and other classical economists took a cosmopolitan approach because they thought that what was in the interest of England was also in the interest of the world as a whole. Viner admits that what was relevant to their time and country may not necessarily be relevant for other times and other countries, and, in particular, it may not be relevant for “economically less advanced countries” at any time. Hence, ‘it is today always necessary, as it was for the English classical economists, to be perfectly clear whether we are considering a problem, say, commercial policy from a national or from a cosmopolitan point of view’ (Viner 1953: 5). Despite such reservations by famous Neo-classical economists, in the end free trade remains the “religion” of neo-liberals. Such an ideology is, for example, evident in some of the documents of the World Bank on MENA.

## 6. World Bank’s Evaluation of Economic Performance of MENA

The Bank praises the socio-economic performance of the MENA region between 1965–1985 as unprecedented in terms of growth of output, poverty reduction, income equality, reduction in mortality rate, increase in life expectancy, literacy levels and school enrolment (World Bank, 2004:14). By contrast, it regards the economic performance of the region disappointing in more recent decades particularly in areas of trade and private investment and attributes its weak performance to weak policies and weak governance (World Bank, 2003.a:1–2; 2003.b:2, 8–9 and 10) and high tariffs (World Bank, 2005:156–162). Accordingly, it advocates deepening and accelerating market oriented reform and a shift to export-oriented activities (Ibid: 2) as trade is “likely to be a key source of growth in MENA region in the next decade and beyond” (Ibid: 4). The Reports, however, suffer from some important contradictions. First, it is not clear on what ground, it is assumed that the governance capacity of these countries in general has become weaker during 1980s–1990s than the previous decades. In fact, the World Bank shows that the quality of governance in the region increases with the income level (World Bank, 2003, b: 5). As income in all countries of the region has increased during the period concerned, although

slowly, the capacity of the governance could not have become weaker. One should search for the reason for their sluggish performance elsewhere.

Secondly, while slow growth performance of the region is attributed to high tariffs, it is not clear why “resource-rich, importing labour” countries [a number of oil exporting countries], which according to the Bank have had significantly low tariffs rates (their median tariff rates was around 5 per cent) (World Bank, 2005:160, figure D.3), have shown according to the Bank (Ibid: 156–162) the worse growth performance.

Thirdly, on the one hand referring to a few successful cases of china, India and Vietnam, the Bank argues that “...the content, pace, and sequencing of reform should be tailored to specific settings” (World Bank 2003.a:5):

...China, India and Vietnam which have often undertaken ...incomplete (or non-orthodox) approaches [read approaches different from those recommended by IFIs] to liberalizing trade and investment. But they have produced outcomes that are often better than in other cases where reform have been orthodox and complete (as in Argentina and Brazil) (Ibid: 5).

It is not clear if “incomplete” and non-orthodox reform succeed in China, India and Vietnam, why it did not succeed in Argentina and Brazil and why it should not succeed in MENA and elsewhere. It is not clear because after admitting the success of the “non-orthodox approach” and recommending tailoring the “content [our italics], pace and sequence of the reform to specific settings, the Bank immediately advocates its own typical policy package. Accordingly, it recommends “across-the-board”, uniform and “accelerated” (except for the sector in which job losses are likely to be significant) trade and financial liberalization, significant devaluation, deregulation of domestic and foreign investment, etc. (Ibid: 6 and 7). It is emphasized that “F[aster growth of output, productivity, and job is available if MENA countries tackle deep seated barriers to trade and investment” (Ibid: 17). For example a “magic” uniform tariff rate of 10 per cent is proposed for labour-abundant, resource rich countries of the region (Ibid: 10).

The report does not pay enough attention to a crucial difference between the reforms in China, India and Vietnam and their contrast with those implemented in Argentina and Brazil. The former group of countries, as well as other East Asian countries, have designed their trade reform programmes—at least until recently on their own— as a part of their long-run industrial policy and liberalized selectively and gradually. By contrast, Argentina and Brazil, and many other developing

countries, have been under the influence of Washington Consensus or the pressure of IFIs and embarked on a shock therapy and across-the-board trade liberalization. Let us also mention that the rapid development in the MENA region during 1965–85 was partly due to growth of oil exporting countries of the region as a result of increase in oil revenues. Nevertheless, 1965–85 was the period during which the Governments of the region intervened in the economy heavily and most countries were engaged in import substitutions industrialization<sup>(18)</sup>. By contrast, during more recent decades they have been influenced more than before by external pressure, interference or advice in their policy makings as mentioned before.

In another report, the World Bank (2005) is blunt in self-criticism of its own policy recommendations on economic reform during the last quarter of century, yet in the final analysis “openness” remains a must for all developing countries irrespective of their level of development. For example, it is admitted that “reform policies of 1990 did not provide incentive for expansion of production capacity”; that market failure prevails (p.10); that “one size fits all” policies fail (p.12); that means [reform] were mistaken for goals [growth] (p.11), etc.:

In retrospect, it is clear [our italic] that in the 1990s we often mistook efficiency gains for growth. The “one size fits all” policy reform approach to economic growth and the belief in “best practices” exaggerated the gains from improved resource allocation and their dynamic repercussions, and proved to be both theoretically incomplete and contradicted the evidence[our italics]. Expectations that gains in growth would be won entirely through policy improvements were unrealistic. Means were often mistaken for goals—that is, improvements in policies were mistaken for growth strategies, as if improvements in policies were an end in themselves (ibid: 11).

Further, recognition is made of the risk in indiscriminate opening of capital account (Ibid: 14), the importance of “country specificities” in drawing policies (Ibid: 15), the role of trial and error and experiment (p.16). Nevertheless, in the end the idea of universal free trade seems to be sacred: “trade openness [remains] a key element of successful strategy” (Ibid: 18) and (protection is not good for economic growth” (Ibid: 135). The only qualification to this sacred formula, which is to be universally applied to all countries irrespective of their level of development, is that it has to be combined with other policies i.e. it should be a part of a comprehensive package (ibid:18–21 and 135) which are mainly elements of Structural Adjustment Programmes.

## 7. Evidence From History and Experience of Developing Countries

“We cannot go back to the past. But neither should we fail to recognize the failures of the present.” (Stiglitz, 2005:32).

Not only, the theoretical approach of the Bank and the Washington Consensus to “openness” is shaky, but the empirical evidence provided by the experience of other developing countries which have undertaken across-the-board and universal trade has also been disappointing. The history of industrialization of both early industrializers and latecomers teaches us a couple of important general lessons. First, with the exception of Honk Kong (Province of China), no country has managed to industrialize without going through infant industry protection phase. In all successful cases government intervention, both functional and selective, in the flow of trade and in the economy in general has played a crucial role. Second, across-the-board import substitution and prolonged protection have also led to inefficiency and failure. Third, the experience of premature and across-the-board trade liberalization, whether during the colonial era or in more recent decades, has been disappointing. Let us say a few words about each.

The experience of all successful countries, whether early industrializers or latecomers— including Great Britain—indicates that industrialization began on selective basis and continued in the same manner until the industrial sector was consolidated. Further, when their industries matured, they began to liberalize selectively and gradually. In the case of USA, when the country tried to liberalize pre-maturely in 1847–61, the industrial sector suffered and the country had to revert to protectionism against imports from Great Britain. In all successful cases government intervention was not confined to trade, the state intervened through other means; trade policy was not the only contributory factor to their success. The government directly and indirectly intervened, in particular, to develop the necessary institutions and infrastructure and promote investment. In all cases industrialization was supported by growth in agricultural sector. Corn Law in Great Britain and protection of rice production in East Asian countries are only two examples. While different countries did not follow exactly the same path, all learned from the experience of others ; USA learned from GB, Germany from USA, Japan from Germany and Republic of Korea from Japan, etc. (See Shafaeddin, 1998)

Finally, in all main early industrializers—GB, USA, France, Germany— when the industrial sector was matured, they used tariffs as a tool of bargaining in trade negotiations or pushed for opening markets in other countries. In the 19<sup>th</sup> century 5 per cent rules

were imposed on colonies and semi-colonies through “unequal” bilateral treaties and or through force (e.g. the imposition of the opium war on China). During recent decades, developing countries have been pushed through multilateral organizations and bilateral trade agreements to open their markets (Chang, 2005.a:10 and Shafaeddin, 1998)<sup>(19)</sup>. Further, limiting the policy space of the colonies, in the 19<sup>th</sup> century, was not confined to 5 per cent rule. “High value-added manufacturing activities were outlawed in the colonies and competing export items from colonies were banned. Instead, production of primary products was encouraged” (Chang, Ibid: 7). During recent decades, tariff peaks and escalations and arbitrary anti-dumping measures were among means of restricting imports of high-value added products to developed countries.

The results of forced liberalization on colonies and semi-colonies in the 19<sup>th</sup> century was slow growth; “in all parts of developing world. Economic growth accelerated after the end of imperialism” (when they regained their policy autonomy) (Chang, 2005. b:32)<sup>(20)</sup>.

The available evidence on the impact of a cross-the-board liberalisation on developing countries during recent decades is similarly disappointing despite the fact that the neo-liberals and the neo-liberal oriented institutions try to convince us to the contrary (see e.g. Sachs and Warner, 1995)<sup>(21)</sup>. The studies presented by the neo-liberals, however, suffer from many methodological problems. In fact, the results of cross-sectional studies have revealed no, or little, evidence that there was any statistically significant correlation between trade barriers or openness with economic growth in recent decades (Rodriguez and Rodrik, 2001; Wacziarg and Welch, 2003; ECLAC, 2002). More importantly, UNDP (2003) finds a positive correlation between a country’s tariff rate and growth rate for the period 1990s. There is also some evidence that trade liberalization has led to de-industrialization of low income countries, particularly in Sub-Saharan Africa (Bennel, 1998; Shafaeddin, 1995; Noorbakhsh and Paloni, 2000; and Thoborn 2001)<sup>(22)</sup>.

Not only the experience of across-the-board and universal trade liberalization has been disappointing, but the result of the economic reform in general proposed by neo-liberal has been unsatisfactory. According to Professor Stiglitz: “Today the inadequacies of Washington Consensus reform are apparent...” (Stiglitz, 2005:31). He maintains that stabilization policies do not ensure either growth or stability; the benefits of trade liberalization are questionable particularly that “workers move from low-productivity jobs to unemployment” instead of moving to high-productivity jobs; capital market liberalization does not necessarily leads to faster growth and exposes the

countries to higher risks; privatization often leads to higher prices of utilities; the adverse social consequences of wrong policies imposed on developing countries has been seen in many countries (Stiglitz, *Ibid*:200516–18).

In a study of a sample of about 50 developing countries for the period 1980–2000, the present author has shown that the results of trade liberalization have been mixed (Shafaeddin, 2005.a and 2006.a). Twenty countries experienced rapid expansion of exports of manufactured goods. In a minority of these countries, mostly East Asian NIEs, rapid export growth was also accompanied with fast expansion of industrial supply capacity and upgrading. In these countries, at least until recently, economic reform, particularly trade liberalization, has taken place gradually and selectively as part of a long-term industrial policy after they had reached a certain level of industrial maturity and development. By contrast, the performance of the remaining countries, mostly in Africa and Latin America (majority cases), has not been satisfactory. These countries embarked, in the main, in the 1980s, on a process of structural reform including uniform and across-the-board and often pre-matured liberalization and intensified their liberalization efforts in the 1990s. Consequently, half of the sample countries, mostly low income ones, have faced de-industrialization. Even in some cases where manufactured exports grew extremely fast, e.g. Mexico, MVA did not accelerate and little upgrading of the industrial base took place. During 1990s Mexico achieved annual average growth rate of manufactured exports of about 30 per cent, yet its corresponding growth rate of MVA did not exceed beyond 4 per cent as against an average of 7.5 per cent for Malaysia, Thailand, Indonesia, and Singapore (Shafaeddin, 2005.a, table 2.1) and its own MVA growth rate of about 7 per cent in 1960s. Notwithstanding its deep reform and significant inflow of FDI, Brazil's exports of manufactured goods and MVA grew only by 5.4 per cent and 1.1 per cent a year, respectively during the same period. Despite two decades of reform, Ghana's growth in MVA was significantly negative during 1990s (–35 percent). Further, the liberalization efforts did not encourage exports of manufactured goods beyond some wood processing the production capacity of which in fact remained still below the level of mid-1970s (ibid:46–48). Although the growth performance in both Ghana and Brazil has somewhat improved in last few years, the sustainability of recovery is questionable as their investment has not picked up much.

The reform programmes designed by IFIs failed to simulate private investment, particularly in the manufacturing sector; the I/GDP ratio fell even where the inflow of FDI was considerable—e.g. in the case of a number of Latin American countries including Brazil. While, trade liberalization changed the structure of incentives in favour of

exports, the balance between risks and return changed against the manufacturing sector. In contrast to traditional MS, the outward orientation strategies reduced the incentive for investment in manufacturing sector due to reduction in its profit margin resulting from import liberalization. At the same time, it increased the risks of investment due to increased competition in the domestic market and the lack of sufficient market information and marketing channels for exports.

Generally speaking, in the “majority cases” trade liberalization has led to the development and re-orientation of the industrial sector in accordance with static comparative advantage. Resource-based industries and some labour intensive activities, such as assembly operations, expanded in most countries and little up-grading took place. At the same time some labour intensive industries shut down leading to significant lay offs. The performance of two categories of industries was, however, exceptional. These include industries that were near maturity and/or those which had been dynamic during the import substitution era. Both categories continued to be dynamic in terms of production, exports and investment. For example, the aerospace industry in Brazil, benefited from liberalization as the competitive pressure that emerged made it more efficient despite the initial difficulties it encountered (Shafaeddin, 2006.a). Otherwise, many industries were destroyed without necessarily leading to the emergence of new ones.

The mixed results obtained from the above-mentioned study and the historical experience of successful cases prompted the author to conclude that there is a need for an alternative approach to trade and industrial policies as comparative advantage has to be created; it is not god given.

## **8. A Framework for Development Oriented Trade and Industrial Policies**

We do not intend to present a blueprint for trade and industrial policies, industrialization, upgrading and economic development in general. Each country’s particular situation has to be taken into account. Nevertheless, drawing on the experiences of both early and late industrializers, some elements of an alternative trade and industrial policy can be outlined: trade policy should be development-oriented, country specific, based on the realities of the international market, and allow for the dynamic and changing relative roles of market, firms and governments in co-ordinating economic activities over time. Further, they should be selective, mixed, dynamic and predictable in nature; pay attention to the complementary role of ‘non-price factors’ and agriculture. Trade policies should enhance productivity rather than relying on repeated

devaluation. Finally, FDI should be used selectively and effective management of capital flows should be ensured.

**Development Orientation:** Trade policy is a means to achieving the general development objective of a country including building up supply capacity and industrialization. So are, in fact, international trade, market, industrial policies, FDI, technology, etc. The “means” and “ends” or objectives should not be confused. Therefore, trade policy is not necessarily synonymous with trade liberalization and success in “liberalization”, or “protection”, per se is not a guarantee of “success” in development.

Following Myrdal (1971:356) we define development as “the movement of the whole social system upward”. Therefore, it is a dynamic process involving, inter alia, not only growth but also raising of the standard of living of the masses of population and providing them with employment. Trade policy should help achieving these objectives. Export expansion should not take place simply for exports’ sake. The aim of export development and competitiveness is not to keep wages and other income of citizens low; otherwise, ends are sacrificed for means (Paus 1989). Similarly, integration to the world economy should not take place for the sake of integration. Wade (2005) correctly argues that development is more about internal integration than external integration. Internal and external integration should reinforce each other as external integration is beneficial if only it contributes to internal integration (Wade, 2005: 94–5).

Specialization on the basis of theory of comparative cost advantage is necessary to begin with the process of industrialization, but if a country stops at producing and exporting labour intensive and resource based industries, those objectives will not be met in the long-run. In order to convert the industrial sector “into gradual acquisition of retainable industry” there is a need for upgrading of the industrial structure in accordance with dynamic comparative advantage (Gomery and Baumol, 2000:71). Such advantage is, however, “made not given”, and it will not be achieved through the operation of market forces alone. A country can develop comparative advantage in an industry of its own choice through Government action (Cline 1983:155–56).

To achieve dynamic comparative advantage and serve the purpose of development, therefore at any point in time, trade policy may comprise protection accorded to some industries though tariffs and/or quantitative restrictions, payments of subsidies, or any other measures necessary to achieve the objectives of development. At the same time it may also include liberalization of trade in some other goods as appropriate.

International Market Structure and the “Competence Gap”: The design of trade policy should be based on the realities of the international market and the specific condition of each country rather than on some theoretical abstraction. In a world where the characteristics of the market are different from the premises of trade liberalization hypotheses, relying on market forces alone will not lead to the achievement of dynamic comparative advantage. In such a world international prices are distorted by the activities and interests of large oligopolistic firms, governments of industrial countries, mal-distribution of income and assets among developed and developing countries and by the tastes and technologies possessed by the former. Further, as mentioned before, the increasing market concentration, the growing technological competence gap between developing and industrialized countries and other developments in the world economy have increased the role of knowledge and experience in industrialization. Thus the period of learning has prolonged. In such a world, the need for infant industry support has increased. Some support is initially required for penetrating into international market. Whether the necessary support should be provided through protection or subsidization of output, or factors of production, is a secondary issue. The main point is that infant industry support is needed not only for import substitution but also for export promotion. For a newcomer, the unit cost of production is high not only in industries subject to economies of scale, but also in all other industries due to the lack of experience and knowledge (Fontaine 1992). Their infant industry support is therefore unavoidable. List (1865), Mill (1965), Stiglitz (1996), Wade (1990) Dasgupta and Stiglitz (1988), Redding (1999), Buffie (2001), List (1865), Mill (1965), Senghaas (1989) and Shafaeddin (1995.a and 2005.a) are among those who have argued in favour of temporary and selective infant industry protection.

Country Specificity: There is no universal rules and blueprint for trade policy as mentioned earlier in this section. Economic policies, including reform programmes need to be geared to each country's needs, the degree of market development, initial industrial capacity, level of development, development objectives and socio-economic characteristics. In each point in time, for developing countries with little or no industrial capacity, such as the low-income countries that are mostly located in Africa, the vital issue is to develop supply capacity and to lay the foundation for expanding export. For countries which have already undertaken some degree of import substitution, such as some Latin American and the Middle Eastern ones, the main requirement is to make their industries efficient and competitive and to expand exports. The challenge for those with some export capacity – the NIEs – is to develop their technological capabilities to upgrade their industrial structure in order to exploit new opportunities in the domestic and international markets.

The existence of “competence gap”, risks involved in new activities and prevalence of positive externalities related to training and skill development were the main argument put forward by F. List (1856), the founder of theory of temporary infant industry protection, who challenged the classical theory of trade. Nevertheless, his emphasis was on the need for taking into account the industrial capacity and other specific conditions of each country. The aim of protection according to him is to develop the “productive power” of a newcomer country which lags behind early industrializers. But the development of the productive power of a nation depends mainly on development of “mental capital” [human capita] which in turn depends on specific soci-economic, institutional and moral factors, etc. (see Shafaeddin, 2005.b, for more details).

It is interesting to note that although he was a classical economist, J.S. Mill fully endorsed the infant industry argument on the basis of the same reasoning provided by List (competence gap, risks, externalities) and referred to country specificity as is evident from the following passage.<sup>(23)</sup> Mill also adopted a dynamic perspective on comparative advantage requiring government intervention.

The only case in which, on mere principles of political economy, protecting duties can be defensible, is when they are imposed temporarily (especially in a young and rising nation) in hopes of naturalizing a foreign industry, in itself perfectly suitable to the circumstances of the country. The superiority of one country over another in a branch of production often arises only 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. A country which has this skill and experience yet to acquire, may in other respects be better adapted to the production than those which were earlier in the field; and besides, it is a just remark of Mr. Rae, that nothing has a greater tendency to promote improvements in any branch of production than its trial under a new set of conditions. But it cannot be expected that individuals should, at their own risk, or rather to their certain loss, introduce a new manufacture, and bear the burden of carrying it on until the producers have been educated up to the level of those with whom the processes are traditional. A protecting duty, continued for a reasonable time, might sometimes be the least inconvenient mode in which the nation can tax itself for the support of such an experiment (Mill 1965: 918–19).

The Role of Market, Firms and Government: The market definitely has a role to play in the process of industrialization and development. Nevertheless; it can deal only with gradual and marginal changes. It is “inadequate” on its own to accelerate growth

of supply capacity, promote dynamic comparative advantage and upgrade technological capabilities. There is a need for government intervention. Moreover, "...there is no way that the government can avoid forming a 'vision' of where the economy is going" (Stiglitz, 2005:29).

The price mechanism is slow to create market and develop "non-price factors". By non-price factors we mean institutions, infrastructure, information and back-up services necessary for the efficient operation of markets. The response to incentives will be limited especially when non-price factors are lacking. The market also fails to make inefficient industries efficient and competitive, particularly through shock therapy, i.e. by sudden and drastic trade liberalization. Large and sudden changes in the price structure create uncertainty.

Similarly, technological upgrading is not an automatic process. It involves a learning process for generating specific technical and managerial skills in the chain of production and distribution. Technological learning requires time and experience; it is costly and involves risks as well as externalities. It necessitates a deliberate effort and a systemic and comprehensive approach to policies and actions at all levels: enterprises, sectors, national and international.

Learning plays a vital role in industrialization,<sup>(24)</sup> and takes various forms: learning by studying and training; learning-by-doing; learning-by-using, imitating and adapting; learning by experience; and most of all learning by trial and error. While learning has to be promoted at various level of the economy, specialized capabilities are developed at the firm and activity levels. It is efficient firms which are able to export, as knowledge and skills are firm-specific and activity-specific. Hence, not only functional intervention, through education, but also selective and targeted interventions are required by the government to promote specific skill and learning at the industry and activity levels.

Although there is a risk of government failure, this is not an argument in favour of leaving everything to the mercy of market forces. After all, market is not and cannot be the only coordination mechanism. The coordination of economic activities at both domestic and international levels takes place through a "coordination system" (Shafaeddin 2004.a); that is the combination of markets, state and firms, complemented and supported by "non-price factors". Nevertheless, in contrast to the orthodox approach according to which firms are passive, the firm is the driving force in such a coordination system, around which the other coordination mechanisms operate. Hence, government action and policies, should complement the market, it should not replace it.

The relative role of each element of the coordination system and the degree of the interaction among various mechanisms vary from one country to another and in each country over time, depending on the level of development, structural, historical and socio-political conditions of the country, and on the interrelation among various sectors of the economy. Similarly, the role of the private and public sectors may change over time, although close cooperation between the two is essential throughout the process of development.

In each country and in each period, the relative role of each element of the coordination system also depends on the existence of various markets and the degree of market failure which is, *inter alia*, influenced by the nature and the degree of development of “non-price factors”. At the early stages of their development, developing countries face a dilemma, because all coordination mechanisms run a high risk of failure. Market failure is pervasive because of the lack, or underdevelopment of markets; the risk of entrepreneurship failure is large because of the lack of experienced entrepreneurs and underdevelopment of the formal sector; the risk of government failure is significant because of the low capacity of the bureaucracy. The lower the level of development, the higher is the risk of coordination failure. Moreover, there is a vicious circle. The country is underdeveloped because of the failure of the coordination mechanisms, the coordination mechanisms fail because of the low level of development. To break this circle, action should be taken on all fronts: to create or improve markets, to increase the organizational capacity of entrepreneurs, to develop the necessary infrastructure and institutional framework of the country and to increase the capacity of the State.

Nevertheless, to break the vicious circle, initially the key role is to be played by government. As we mentioned earlier in this paper, market forces *per se* will develop neither the market nor the “non-price factors” rapidly. During the early stages of development, the direct participation of the public sector in industrialization may become essential, particularly in areas where the private sector is not prepared to invest because of existence of high risks or in industries which involve significant externalities. As the private sector and the market develop, public ownership and the role of the government may gradually be reduced. Experience, however, indicates that the development of infrastructure, institutions and back-up services and provision of information cannot be left to the private sector entirely because of the need for significant overhead investment and involvement of externalities. Further, “Government could, in principle, enhance the efficiency of the market” (Stiglitz 2005: 25) and make it more development friendly (Wade, 2005, Lall 2004, Stiglitz, 2005 and Shafaeddin, 2004.a). Yet more, the “government

has the responsibility, and the opportunity, for shaping the economic environment” (Stiglitz, 2005:31).

It is sometimes argued that even if the application of industrial policy of one type or another is justified, the capacity of the state in developing countries is insufficient for their efficient implementation. It is partly for this reason that, it is argued, the East Asian experience is not replicable in other countries. A couple of points worth mentioning in this respect. First, the state capacity of many developing countries today is not necessarily inferior to that of Republic of Korea, or Thailand, in 1950s and 1960s. Second, even if it were the capacity of the state can be improved, but missing market will not develop by itself and market failures will not correct themselves automatically. Third, and more important, there is a contradiction in the logic used in the argument on the capacity of the state in developing countries. Wade correctly states that:

“...ironically, the world is proceeding on the assumption, in the TRIPS agreement, that developing country states do have a considerable capacity to enforce patents and copyrights. It is not obvious that a state that can do this would not also be able to implement effective protection and other forms of policy” (Wade, 2005:94).<sup>(25)</sup>

Hence, the key issue in development of an efficient coordination system, particularly for countries at early stages of industrialization and development is to improve the learning capacity and efficiency of the government machinery in formulating, implementing and correcting its policies. It is not easy but feasible, as the experience of both early industrializers and NIEs indicate. Since design of trade and industrial policies differ from one country to another, nobody knows what the “right policy” might be (as nobody knows what the “right prices” are) exactly in each specific case. It is a question of trial and error – of learning by doing. This is why the learning capacity of the government is vital indeed.

Therefore, it is a fallacy that there is no, or limited, role for government in the process of industrialization. Some government intervention is required to compensate for market deficiencies and inadequacies, to build up and upgrade production capacity, whether or not for export, to create markets, to establish complementary “non-price factors” and to correct market failure. Furthermore, the market is a “servant” – the means – and not a “master”. As prices are to serve the long-term objectives of development, a wrong, i.e. distorted short-term price structure may be the right one if it serves to achieve the long-term objective of dynamic comparative advantage (Fontaine 1992, Amsden 1989 and Paus 1989).

In other words, the question is not “market or government”: it is to what extent the government should intervene, in what form; and how the efficiency of the government intervention could be improved to minimize government and market failures. Nevertheless, unnecessary, rigid and prolonged government intervention in the economy should be avoided; the government should not replace the market when it operates well.

Features of Trade and Industrial Policies: Trade and industrial policy should be selective, mixed, dynamic, and predictable and supplemented by development of “non-price factors” and agriculture. The scarcity of resources, existence of market failure, different externalities and different learning effects and linkages in different industries would imply that industrial development should start on a selective basis. Some consumer goods that are most commonly in demand in the internal market and which preferably also involve significant learning effects could be chosen as a first group of industries for capacity building. Whereas the final products of selected industries are protected, imported inputs for these industries should be free of duties.

The provision of protection to the selected industry should not, however, be given without conditions and without limit. The government should insist on performance in exchange for the incentives and sanction the industrialists in cases where their performance is not satisfactory. In other words, any industrial strategy should embody elements of both rewards and pressure from the government, market or both. As firms develop their production capacity, the government should introduce or gradually increase the pressure of competition in the internal market by allowing new entrants to the field. In industries where economies of scale are important, however, the competitive pressure should not be at the cost of production at an inefficient scale. One criterion for performance should be cost reduction and quality improvement.

F. List clearly spoke of providing rewards and prizes in addition to tariffs or subsidies to enterprises which perform well in terms of product quality improvement, efficiency, acquisition of knowledge etc. and introduce pressure on industries which are provided with incentives:

If a government observes that manufacturers are producing goods lower in quality and higher in price than those made abroad and if it is satisfied that this is the fault of the local industrialists it should offer substantial prizes as a reward to those manufacturers who, within a specified period, are able to make goods which approach those made abroad in quality and price. The ability to manufacture such goods regularly should also be considered when awarding prizes. Acceptance of such an award should be conditional

upon a firm allowing workers employed elsewhere to visit its factory so as to improve their technical knowledge. (F. List quoted in Ho, 2005: 739).

Similarly, should a government decide that manufacturers have failed to make products which are as good as those made abroad simply because they have not been able to secure the services of a sufficient number of hardworking skilled men it should offer prizes to workers who reach a high standard of technical skill. It should also offer prizes to firms which, in a particular period, have succeeded in attracting foreign workers of proven skill and reliability into their employment. (ibid, 740.).

According to List, the pressure on enterprises to perform is applied first through the introduction of domestic competition followed by gradual import liberalization (see Shafaeddin, 2005.b for details).

Almost all successful industrializers applied some sort of performance requirement, or “control mechanism” to discipline the protected industries or manage the foreign companies. For example, in East Asian countries subsidies were provided in exchange for performance including export performance (Amsden, 2005 and 2001)). As far as FDI is concerned, in Japan and other East Asian countries the right of foreign firms to sell in the domestic market was linked to the increase in production of parts and components or, in the case of Thailand, for hiring local managers (Amsden, 2005:222). USA and other developed countries also have applied requirement of one kind or another even during 1990s (Kumar, 2005:182–5). Amsden distinguishes three major types of performance standards:

First, techno-standards [which] ties subsidies ... to the professionalization of managerial practices. Second, policy standards [which] ties subsidies to the promotion of major national strategic priorities, such as maintaining price stability, increasing local content, raising the level of exports and not worsening income distribution. Third, both types of performance standards, as they operate in the arena of science and technology, [and which] are designed to increase national skill formation and the generation of firm-specific knowledge-based assets (Amsden, 2005:227).

To continue, as domestic capacity is developed in an industry, all measures should be taken to allow the firms involved to enter into the foreign market rapidly. At this stage the relevant firms need to improve efficiency and quality if they are to compete in the internal and international markets. But the disadvantages of cost, external economies in market search and marketing, lack of experience in exporting and marketing and risks related to entry barriers require “infant export protection/support” through export subsidy, tax holiday

and/or fiscal incentives. Infant industry support is not confined to the import substitution phase of production. Government intervention should be more evident during the second stage of infancy, i.e. when the infant industry starts to cut into the international market.

Once again incentives should be provided in exchange for performance – this time for export performance. One policy practised in Japan and other East Asian countries was to give preference in the allocation of foreign exchange for the import of inputs to those firms which showed satisfactory export performance.

The enterprises must be made to know in advance that infant industry support during its first and second phases is temporary. They should also know the schedule of the phase out of this support. The pressure for improved efficiency should eventually take the form of gradual liberalization of imports of final goods.

While the first group of industries go through the second infancy phase, an attempt should be made to use their exports proceeds for a parallel development of the second group of industries; again on a selective basis. These industries may include some other consumer goods and/or intermediate inputs used in the production of the first group of industries. A system of drawbacks should apply to the products of these industries when they are exported. As the second group of industries matures in the production process, some sophisticated and durable consumer goods, some inputs to the second group of industries and some machinery used in production of the first group could be added to the list of infant industries for support. Eventually, some of these industries become subject to infant export protection.

Infant export protection/support also takes place on a selective basis for each group of industries which, over time, would themselves be subject to the same modalities as that of the first group. The choice of machinery may be influenced by the size of the country and the type of existing industries. The process of deepening industrialization could continue until an industrial base is established, export capabilities developed and capacities for efficient production of machinery are acquired. During such a process for each industry while the role of government intervention is gradually reduced, the responsibilities of the firms and the role of the market are increased. Inter-firm relations, through trade and industrial associations, could be developed to help undertake these responsibilities. Clustering of industries would be useful to exploit externalities in institutions, infrastructure, marketing, skill development, etc. Nevertheless, clustering also requires support and guidance from the government. A close government-business

relationship for drawing and implementing the related rules and guidelines would facilitate the process of industrialization and interchange of information.

For example, if textiles were chosen as a first group of industries for industrial development, in the first phase textiles would be supported and supplied with a free flow of imports of yarn and machineries. In the second phase the protection of production should be gradually reduced, but assistance and incentives should be provided to promote exports of textiles. In this phase, exports can be accompanied with import substitution of yarns. Ultimately, assistance to exports of textiles should be reduced to zero as the industry matures and penetrates into the international market. In the meantime textile machines can be produced domestically and possibly be exported. When a number of industries are developed in this manner over time, the related process is said to resemble “flying geese”, an expression first used in the context of Japanese industrialization. Nonetheless, almost all successful industrializers followed more or less a similar process.<sup>(26)</sup>

Not all industries selected for import substitution could be necessarily candidates for exportation. Nonetheless, this should not imply that protection should continue forever, the industries developed through import substitution should be made efficient so that they could compete at least in the domestic market.

As the industrial base widens the expansion of investment in production and export capacity takes on more importance. Specialization in production and exports of standard manufactured goods is subject to the fallacy of composition if a large number of developing countries produce similar products. Therefore, to avoid terms of trade losses the industrial deepening should follow industrial widening. Industrial deepening requires the upgrading of products and the production process, quality improvement, and introduction of new products or a new variety of the same products. This process requires a technological innovation which is different from innovation at early stages of industrialization. At the early stages, innovation could take the form of introducing and operating a new machine or imitation and adaptation of technologies to local conditions. Innovation required for upgrading the industrial structure, necessitate R&D and eventually development of new and frontier technology. The development of new technology in turn necessitates “infant” support because of the risks and dynamic external economies of learning involved.

To exemplify the evolution of dynamic and mixed trade policy over the period of industrialization, we have presented the example of tariffs, as an instrument of trade

policy, in table 3 (Note that the figures provided are only for the purpose of exposition). As can be seen, in each phase some industries are protected and others benefit from free trade; an industry will not be subject to protection permanently, after a while it will be liberalized gradually; the average tariff rate for the manufacturing sector rises first before declining and reaching zero eventually.

Table 3: Evolution of Average Tariffs for Various Groups of Industries at Different Phases of Industrialization

Phase	RB&LI	LT	MT	HT	Manufactures (Average)
I	20	0	0	0	5
II	10	40	0	0	12.5
III	0	30	50	0	12.5
IV	0	20	40	40	25
V	0	10	30	40	20
VI	0	0	15	25	10
VII	0	0	5	15	5
VIII	0	0	0	0	0

Source: Akyuz (2005: 27)

Notations:

RB: Resource-based industries

LI: Labour-intensive industries

LT: Low-technology-intensive industries

MT: Medium technology-intensive industries

HT: High technology-intensive industries

Hence, for sometime a combination of import substitution, export promotion; infant industry support and import liberalization is at work for a mix of consumer goods, intermediate products and capital goods. Nevertheless, there is no “quick fix”. Industrialization is a long and tedious process. It took over 250 years in the case of Great Britain and over 200 years in the case of USA and Japan.

In short, the framework for trade and industrial policies which we have proposed is not a *récepti* for protection; on the contrary it is a means of industrialization before liberalizing trade completely. As F. List stated nearly two century ago: “..restrictions are but means, and liberty, in its proper sense is an end” (List, 1856:64). What he implies is: we should first aim at liberty from underdevelopment, then liberty from trade restriction.

Foreign direct Investment and capital flows: The experience of developing countries indicates that FDI can acts as an important channel for export. It may also make

a notable contribution to financing investment temporarily. Nonetheless its longer term contribution would be often limited in relation to total domestic investment and would involve little technological spill over (Gallagher and Zarsky, 2004, Huang, 2000, Grether, 1999, Buitelaar and Pérez, 2000, Moltimore, 2000 and Hanson 2001). The recent experience of China indicates that FDI could play an important role in industrialization, by contributing to the skill development of local manpower and expansion of domestic value added, if it is guided and targeted toward specific areas where foreign technology is most needed. In fact, China's experience, unlike Mexico's, would teach us that one could think of a process of export promotion through FDI that could eventually lead to import substitution if it is managed by the Government (Pizarro and Shafaeddin 2006). China started assembly operation in a number of industries, particularly electronics and telecommunication, based on imported input and gradually has been increasing domestic production and exports of components (Shafaeddin 2004b). For example, the share of components in exports of manufactured goods (excluding chemicals) of the country increased from about 6.4 per cent in 1992/1993 to 14.5 per cent in 1997/1998; and, 16.7 per cent in 2002/2003 after the accession to WTO. More importantly, the corresponding share of imports of components, which had increased continuously between 1992/1993 until 1997/1998 from 17.7 per cent to 23.2 per cent, first increased more slowly (reaching nearly 24 per cent in 2000/2001) and then declined to 22.3 per cent in 2002/2003 despite the accession to WTO.<sup>(27)</sup>(Pizarro and Shafaeddin, *ibid*).

Finally, capital flows should be also controlled and managed. Otherwise, erratic movement in capital flows will lead to erratic changes in the flow of imports, the exchange rate, interest rate, production cost, and the price structure. The ensuing chaos and confusion makes the price structure and the exchange rate lose their function as a guide to investment for the expansion of output and export, thus leading to instability in all significant economic variables – including MVA and GDP. In particular, the instability in the flow of imports would also severely affect the growth of MVA and GDP.<sup>(28)</sup> In fact, in violently changing conditions and for large maladjustments, exchange rate devaluation may be harmful and would not be desirable (Arndt 1988 and Henderson 1948).

**Limits of Devaluation:** Devaluation of the local currency can temporarily provide some incentives for the production of tradeable goods, particularly exports.<sup>(29)</sup> It may also serve other purposes but, for a number of reasons, it is not necessarily the most desirable measure as a tool of industrial policy when it is used repeatedly. First, it is used as a tool of uniform (nominal) price changes over the whole range of tradeable goods rather than for selected products.<sup>(30)</sup> Supply response to prices is much lower when all the outputs of a sector are equally affected; it is stronger when relative prices increase only

for one good, or for a few goods (Streeten 1987). Even in industrialized countries there is some evidence that reallocation of resources from non-tradable to tradable sectors, and within tradables from importables to exportables (and in the latter from traditional to new products), might be more responsive to targeted incentives such as subsidies than to exchange rate adjustment (Schydrowsky 1982).

Second, the direct impact of devaluation on production cost in manufacturing products, particularly exports, is greater than on the other sectors of the economy because of their higher import intensity which has, in fact, increased significantly due to import liberalization. Industrial production in low income countries, in particular, is dependent on imports often for more than half its inputs. Therefore, in countries with a high ratio of imports to GDP, where manufactures are a small fraction of total exports and the manufacturing sector is highly import-intensive, incentives for exports of manufactures should be provided by other measures than devaluation. These may include e.g. subsidies, tax holidays and other fiscal and financial measures targeted to particular industries.

Further, the indirect contribution of devaluation on the cost of production in the manufacturing sector could be also higher than the other sectors if devaluation is accompanied by, or result in, a decline in productivity in this sector due to supply or demand factors or a combination of both. When devaluation involves contractionary effects,<sup>(31)</sup> or is accompanied by contractionary macroeconomic management, the demand for domestically produced goods will be reduced. Similarly, export may not increase in response to devaluation when the structure of supply is rigid, when export supply is constrained by import compression or low quality and inappropriate product for foreign markets, or when there is the lack of marketing channels. Similarly, export may not increase much because of low price elasticity of demand or recession abroad. As a result, the combination of reduced effective domestic demand and little or no expansion in export may lead to lower capacity utilization and a decline in productivity. The neglect of the need for enhancing productivity and the overemphasis on devaluation has been important weaknesses of the neo-liberal reform programmes.

Third, devaluation could disrupt the economy through its inflationary impact, particularly in low-income countries. In fact, we have estimated that for every 10 per cent nominal devaluation during the period 1980–1987, in countries where per capita income was less than \$400 (in 1986), the real exchange rate declined only by 3 per cent within a year (Shafaeddin 1992; see also Edward and Wijnbergen 1989).<sup>(32)</sup>

Fourth, devaluation, as well as import liberalization, tends to turn the domestic terms of trade in favour of primary commodities and against the manufacturing sector because of differences in the nature of price determination in the two sectors (Shafaeddin 1991)<sup>(33)</sup>. While this may have a welcome positive effect on food production, it would seem that cash crops have benefited more than foods in many developing countries which have applied structural adjustment programmes (Stewart et al. 1992). Further, simultaneous currency devaluation by a large number of countries that produce the same commodity may result in terms-of-trade losses and decline in real wages due to the “fallacy of composition”.

Finally, the available empirical evidence indicates that other factors are more important in export competitiveness than exchange rate and costs and prices. For example, Fagerberg (1988) has shown that the contribution of cost competitiveness resulting from low wages was far less than technological competitiveness and the ability to compete on delivery (ibid.371). An empirical study by Kaldor (1978) for the period 1963–1975 indicates that countries with the fastest rate of growth of exports, e.g. Japan were those which at the same time experienced faster rates of increase in their relative unit labour cost (RULC) than others. On the basis of this study he also concluded that in the long run relative changes in exchange rate can be the result of competitiveness, rather than its cause. Thus, he added, relying on changes in RULC alone as a policy tool for improving competitiveness would be a simplistic view.<sup>(34)</sup> Amendola et al. (1993) reached similar results for the period 1967–1987.<sup>(35)</sup>

In the long run, enhancing productivity rather than repeated nominal devaluation is a key to success in industrialization as mentioned earlier. Nonetheless, with the presence of strategically active international firms, the concept of productivity takes on a different meaning. It is not merely concerned with the volume of output produced. It involves creating value to the consumers through factors which contribute to the lowering of the price elasticity of demand. Such are, for example, a reputation for reliability, the supply of high quality products, timely and rapid deliveries, etc. Productivity enhancement requires continuous learning, skill development, innovation and upgrading.

The Role of “Non-price Factors” and Other Influences: Trade and industrial policy alone cannot succeed unless they are accompanied by a host of other factors. The process of industrialization requires what we call “COU-Ps-INs” (Shafaeddin, 2006.b) and development of agriculture. COU stands for: Create capacity, Operate it efficiently and Upgrade the industrial structure. To do so incentives is necessary but not sufficient. There is a need for a number of INs and Ps. The INs include Investment, Input, Infrastructure, not only transport and communication

but also other facilities such as marketing channels, distribution network etc.; Institutions, Innovation and Information (Streeten 1987). We use information here in its wide sense of the term which includes knowledge, science as well as market information which requires investment in human resources through education, skill and training. In fact, investment is essential for all other INs as well as for the expansion of supply capacity and creation of organizational capabilities and learning. Most of INs outlined here are elements of “non-price factors” mentioned earlier.

The Ps stands for Political stability, Predictability of policies, Participation by the citizens in the process of development and Pressure for performance as previously explained. There are also two INs which are to be avoided. These are instability in exchange rates and inflation which are largely related to agricultural development, devaluation of the currency, capital flows and macroeconomic policies.

Development of agriculture is essential, particularly during the early stages of industrialization, to increase the supply of food, where feasible, in order to contribute to the availability of wage goods and to ease the pressure on the balance of payments and ease inflationary tendencies. For the same reason, an ample availability of other basic consumer goods is also important, as availability of wage goods not only eases inflation, but also contributes to competitiveness of manufactured goods in the international market.

## 9. Some Concluding Remarks

The alternative approach we have proposed above looks idealistic as it is not in conformity with WTO rules, the “Washington Consensus” and the practices of IFIs and main bilateral donors in their dealings with developing countries. Nevertheless, the existence of such rules, Consensus and practices are not an argument against what is required for achieving industrialization and development. These rules are not God given; they can and need to be revised to become conducive to development according to the bottom-up approach we have suggested in this study.

Like Helleiner, “I am realistic enough to recognize that re-conceptualization of WTO as a development institution may not happen quickly (although I am fully confident that it eventually [my emphasis] will).” It will take time (Helleiner 2000:19). We are also well aware that such a reconceptualization will involve hard bargaining since experience has shown that developed countries will not give in purely on moral grounds (Shafaeddin 1984). Nevertheless, two points are worth emphasizing. One is the realization by all parties involve, particularly

developing countries, that there is a need for reconceptualization. Fortunately there are signs that the dominant neo-liberal economic philosophy propagated by Washington Consensus is shifting in favour of a development oriented philosophy. The failure of the American States in Buenos Aires in late October–early November 2005 to agree on American Free Trade Area of America (FTAA) proposed initially by the USA in 1994, is one example. The difficulties encountered in international trade negotiations since the WTO meeting in Seattle is another. It has become evident that developing countries do not bow to pressure easily any more. They are better informed and better prepared than they were during the Uruguay Round although they continue to be bullied by developed countries. Further, their experience of trade liberalization during the last two decades must have been influential in removing their illusions about benefits of universal and across-the-board trade liberalization.

The second point is that developing countries do have some bargaining power in international trade. After all they absorb about 23 per cent of exports of developed countries (when intra-trade of the EU is excluded, the figure reaches well over 30 per cent).<sup>(36)</sup> The question is how to mobilize these bargaining chips and strengthen their negotiation position (Shafaeddin 1984).

A detailed redesign of WTO rules and other international trade and industrial policies relevant to developing countries<sup>(37)</sup> has to be a subject of a separate paper. Nevertheless, a couple of general points are worth mentioning with respect to a required framework for an international trade policy. First of all, the whole philosophy behind WTO rules, as well as practices of IFIs, needs change. It is not “policy space” as such within the existing framework of WTO rules that developing countries require. What is needed is a totally different approach and framework which allows for a mixed, flexible and dynamic trade policy with a broader dimension of space and time rather than one which is a one-size-for-all and for-all-time. This dimension of space would imply that trade policy should allow for different levels of development and industrialization of the various countries at each point in time as a rule and not as exceptions to the rules, i.e. not in the way it is sometimes requested by developing countries within the context of the so-called “special and differential treatment”. For each country at each point in time some industries may be protected while some others may be subject to free trade or trade liberalization. The dimension of time would imply that the international rules should allow for dynamic trade policy of each developing country as the country develops leading ultimately to free trade on the line we have explained in this study.

Second, export performance requirements and domestic content clauses should be allowed in the relation between host countries and TNCs.

Third, while some protection of intellectual property is needed to encourage invention and innovation, the TRIPs agreement should be changed in order not to create severe barriers to the diffusion of new technology to the firms of developing countries because these barriers could render industrial deepening and upgrading difficult.

In short, the international community should aim at achieving more equitable international economic systems and policies in which the needs and different situation of countries at different levels and various stages of development are taken into full consideration.

## Footnotes

- <sup>(1)</sup>The share of parts and components in total exports of manufactured goods increased from 13.2 per cent for the period 1981–90 to 18.8 for 1990–2000 (World Bank, 2003.c):55; table 2.2.
- <sup>(2)</sup>In 2001 the share of intra-firms trade in total exports of USA and Japan was 37 per cent and 31 per cent, respectively.
- <sup>(3)</sup>One should add also the higher risks and costs related to instability in exchange rates of main international currencies.
- <sup>(4)</sup>Another source of external economy is the sheer expansion of the industrial sector as a whole i.e. the Marshallian external economy. Nevertheless, this sort of external economies achieves only ex-post as the industrial sector develops.
- <sup>(5)</sup>Some exceptional limitation on commitments in particular service activities can be acceptable on the basis of a clear list. For more details on the three Agreements mentioned above see Wade (2005).
- <sup>(6)</sup>If, however, subsidy is provided to an enterprise without being made legally contingent upon export performance, it would not be prohibited: "The mere fact that a subsidy is granted to enterprises which export shall not for that reason alone be considered to be an export subsidy..." (ASCM, para. 3.1. a, footnote 4).
- <sup>(7)</sup>In addition the use of export subsidies is allowed for countries with per capita incomes below \$1000.
- <sup>(8)</sup>All fifty American states in the USA use subsidies for regional development in order to attract industry (Amsden; 2005: 221). In this case it is definitely against the WTO rules as all states can not be disadvantaged!
- <sup>(9)</sup>See, for example, the text of the G-20 Ministerial Declaration Adopted on 19 March 2005 at the conclusion of the Ministerial meeting of G-20 in New Delhi, 18–19 March 2005: <http://www.twinside.org.sg/title2/twninfo190.htm>.
- <sup>(10)</sup>The validity clause related to technology which was agreed upon for a trial period of five Years was not however extended.
- <sup>(11)</sup>In addition, countries which are involved in bilateral trade agreements with the USA and EU are subject to tougher TRIPs' standards (Wade, 2005:83–4).
- <sup>(12)</sup>See Khor and Yen, 2005:10–12 for details.
- <sup>(13)</sup>Five per cent of tariff line can be excepted provided the related imports do not exceed

5 per cent of the total value of member's imports (para 8, annex B of the WTO July Package).

<sup>(14)</sup>The Swiss formula is:  $T = (a \cdot t) / (a + t)$  and  $R = t / (a + t)$  where T and t and a are the new and initial tariff rates and constant coefficient, respectively, and R is the rate of tariff reduction (See WTO, 2003:2).

<sup>(15)</sup>Note that the concept of "market inadequacy" is different from "market failure". (see Arndt 1988).

<sup>(16)</sup>According to the dynamic version of the theory, first introduced by H. Johnson, as production and exports of labour intensive products increases, wages will go up and the country will lose comparative advantage in labour intensive products and produce capital intensive goods. The example of East Asia is often given for such a development! The theory however assumes that things happen automatically; it is not clear how the losses of advantage in labour intensive products should imply gains in advantage in capital intensive goods and how the adjustment takes place for creation of dynamic advantage.

<sup>(17)</sup>For details see Shafaeddin (2005.a:118–133).

<sup>(18)</sup>Note that during this period a number of the countries of the region suffered from the Middle East wars directly or indirectly.

<sup>(19)</sup>The USA currently has a number of bilateral free trade agreements with other countries and is in the process of negotiating a number of others.

<sup>(20)</sup>For details see Chang, 2005.b<sup>ii</sup>:30–34)

<sup>(21)</sup>See also various literature by the World Bank and IMF particularly World Bank (1987) and (1993). For a brief survey see Shafaeddin (2006.a).

<sup>(22)</sup>For a Survey see Shafaeddin, 2006.a).

<sup>(23)</sup>Alfred Marshall did not object to protection of infant industries, but he was not as supportive as Mill (see Shafaeddin, 2005.b for more details.

<sup>(24)</sup>See e.g. Nelson and Winter (1982), Noland and Pack (2003), Lundvall (2004), Westphal (2000), Lall (1996) and Lall (2004).

<sup>(25)</sup>Further, if developed countries have recently discovered that protection and industrial policy is not justified, how could they explain heavy protection of their agriculture? Similarly how could they explain protection of patents for their new products/technologies for as long as 20 years through TRIPS while denying developing countries temporary protection of their new-infant-industries, or export products?

<sup>(26)</sup>See Akamatsu (1961), also Kasahara (2004) for a survey.

<sup>(27)</sup>Based on the UN COMTRADE database.

<sup>(28)</sup>Helleiner (1986) has shown that in the case of African countries there was a strong negative relationship between instability in the volume of imports and GDP growth rates.

<sup>(29)</sup>For example, Bautista (1982) examining a sample of developing countries for the period 1973–1979 has shown that currency depreciation, both small and large, did not lead to a permanent improvement in export competitiveness.

<sup>(30)</sup>Nevertheless, for a given rate of nominal devaluation, the implied real exchange rate depreciation will be different in different sectors, industries and firms as their import intensities are different. The higher the import intensity, the higher the increase in the cost of production for a given rate of nominal devaluation, thus the lower the real exchange rate depreciation achieved as a result of a given rate of nominal devaluation. Usually the import intensity for manufacturing sector is higher than that for other sectors; within the manufacturing sector, it varies from one industry to another and it is higher for modern industries and large firms and within these industries it is higher for export production than for the home market. Further, for each industry and firm the effective exchange rate could be yet different to the extent that the directions of trade of firms are different. Hence, devaluation, as it is claimed, cannot even work as a uniform price incentive. To achieve uniform effective exchange rate, a complex nominal rate structure would be needed.

<sup>(31)</sup> A study by Edward and Wijnbergen (1989:1526–1528) indicates that the contractionary impact of devaluation is important.

<sup>(32)</sup> Edward and Wijnbergen (1989) have shown, on the basis of a survey of the literature, that nominal devaluation

leads to relatively high real depreciation temporarily, but the effect of nominal devaluation on real exchange

rate erodes slowly taking between 8 to 16 quarters depending on the type of macroeconomic policies undertaken.

<sup>(33)</sup> The price of primary commodities is demand-determined, but that of manufactured goods is normally cost-determined. As a result, devaluation by a small commodity producer changes the domestic price of the product without influencing its international price. By contrast, devaluation by the same country changes its international (export) price of manufactured goods but does not change its domestic price immediately. Of course, the impact of the devaluation on domestic price due to changes in the price of imported input etc will ultimately follow as explained in the text.

<sup>(34)</sup> The simultaneous increase in RULC and market share is referred to as the Kaldor paradox in the literature.

<sup>(35)</sup> See Fetherston et al. (1977) and Kellman (1983) for similar views expressed for the period 1970s and early-1980s. See also Amable and Verspagen (1995).

<sup>(36)</sup> Based on UN, COMTRADE database.

<sup>(37)</sup> For a detailed list of restrictions imposed by international rules and bilateral trade relationships on trade and industrial policies of developing countries see, e.g. Rodrik (2004), table 2.

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