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Industrialization and foreign trade: an overview

This Report examines the role of foreign trade in industrialization. The pace and character of industrial development are not simply the result of trade policies. Many other factors matter. A country's size, its natural resources, the skills of its people, the stability of its government and institutions and their ability to promote change, the fiscal, monetary, and exchange rate policies that the government pursues—all these and still more factors influence a country's ability to industrialize.

The role of foreign trade in industrialization is an important issue for several reasons. First, although the relationship between trade policy and industrial development has concerned policymakers and economists for a long time, empirical studies over the past thirty years now make it possible for useful lessons to be drawn concerning the advantages and disadvantages of different trade policies. Second, many fear that slow world growth and rising protection in industrial countries may cloud the prospects for developing countries' exports. Third, continuing debt problems increase the developing countries' need to raise their net earnings of foreign exchange to service debt and maintain adequate growth.

This does not mean that other factors can be ignored. If, for example, a country reduces its trade barriers but fails to make appropriate changes in its fiscal, monetary, and exchange rate policies, the benefits it hoped for may not materialize. Domestic inflation and an overvalued exchange rate could discourage the investment flows needed to respond to the new price incentives. Analysts looking at the past and governments setting policies for the future have to bear in mind the complexity of the relationships among policies.

This Report stresses *efficient* industrialization because there is evidence of inefficiencies in industries in both industrial and developing countries. These industries may not show financial losses because protection allows domestic firms to sell above international prices. Overvalued exchange rates may allow them to buy machinery and intermediate goods from abroad at prices below their true cost to the economy. Such overvaluation of outputs and undervaluation of inputs will exaggerate both the industries' profits and the contribution that their output makes to the national product. At the same time, undervaluation of exports and agricultural products will disguise their potential contribution to growth. The net effect is to magnify industry's part in domestic output and growth. Simple statistics on the share of industry or manufacturing in gross domestic product (GDP) are suspect in many countries.

The term "efficient" begs many questions. It has meaning only in relation to specific objectives: efficiency is measured by the costs of attaining these objectives. Industrialization contributes to economic development. So the question is, What are the ultimate objectives of economic development? Different governments may have different objectives in mind and will certainly disagree about the weight to be attached to them. Generally, however, they will include faster growth of national income, alleviation of poverty, and reduction of income inequalities. How is industrialization expected to contribute to these goals?

Much of the early literature treated industrialization as the key element in economic development. The experience of the industrial economies showed a close association between development

Box 1.1 The World Bank's support for industrialization

"Excessive emphasis on industry for industry's sake, above all heavy industry, may leave an undeveloped country with the symbol of development rather than the substance. There are of course a number of instances where heavy industry may be justified . . . But, in general, capital should be applied where it brings the greatest return" (World Bank memorandum to the United Nations Economic and Employment Commission, May 14, 1949). This 1949 quote is as relevant today as it was then. The Bank has always viewed industrialization not as an end in itself, but as a means to raise productivity and incomes. And it is this view that has shaped and guided the Bank's support for industrialization in its member countries.

The Bank has supported the efforts of its member countries in building new industrial capacity, improving the efficiency of existing capacity, and providing training and technical assistance to accelerate the acquisition and mastery of new skills and new technology. Until the late 1970s, it did this by financing industrial subsector studies, project feasibility studies, project design and engineering, technical assistance, and industrial investments. It also financed industry indirectly by lending to industrial development banks; these loans served the additional purpose of deepening financial markets in developing countries. To complement these efforts, the International Finance Corporation (IFC), an affiliate of the World Bank, supports the projects of private investors through loans as well as equity participation. Last, but not least, the Bank's lending for education and physical infrastructure, in contributing to economic development, has helped build skills, transport, communications, and power—all vital inputs to modern industry.

More recently, however, the Bank's support for industrial development has added a new dimension to its emphasis on projects. It now includes support for improved policies and strengthened institutions. This was in response to the structural adjustment problems faced by developing countries following the international recession and to a growing awareness of the influence of policies and institutions on industrial development. The Bank, jointly with its member countries, devises a lending program that supports policy reforms and structural change across the whole economy, as well as at the level of the individual enterprise or institution. In recent years the Bank has made several structural adjustment and sector adjustment loans to developing countries in support of changes in their macroeconomic, trade, and industrial policies.

The Bank's lending to industry will continue to evolve in response to the needs of its borrowers. Support for industrialization will continue to emphasize policies at both the economy and the project level. The Bank will need to meet the challenge of providing an integrated package of lending, technical assistance, economic analysis, and policy advice that addresses the needs of individual countries and matches their capacity for reform. At the same time, recognizing the importance of skill and infrastructural development to industry, the Bank will continue with project lending in certain areas.

and industrial expansion. But industry was also thought to provide certain spillovers which would benefit other activities: enhancement of skills, training of managers, dispersion of technology, and so on. Moreover, pessimism about the prospects for exports of food and raw materials made the substitution of domestic for imported manufactures seem the most promising route to development.

Subsequent experience showed most of these ideas to be too simple, or even misleading. Many countries have achieved high standards of living based mainly on the production and export of food and raw materials: Australia, Canada, Côte d'Ivoire, Denmark, Kenya, Malaysia, New Zealand, Sweden, and the oil-exporting countries, to name but a few. Industrialization has certainly been associated with growth, but it is not the only cause of growth. At certain stages in a country's development the highest returns may come from the production of particular types of manufactures, agricultural products, or services. How best to use resources at any time depends on market prospects and costs. So the interesting question is not how fast a country can be industrialized, but how incentives and policies can be designed so that new industries make the maximum contribution to the country's development (see Box 1.1).

Foreign trade preceded industrialization by thousands of years. Early industry relied largely on trade within nations. Yet, as Adam Smith noted, the development of industry is likely to be severely handicapped if it is deprived of the ability to trade widely. The division of labor is limited by the size of the market, and the division of labor is the key to increased productivity.

For small countries—and most developing countries are small in terms of their domestic market for industrial goods—this means that progress depends upon the ability to trade relatively freely with the rest of the world. For large economies domestic trade may provide scope for adequate specialization, economies of scale, and enough competition to keep managers alert. But even large economies, if cut off from international trade, would lack stimuli for efficient industrial development. Competition from abroad forces firms to cut costs, improve quality, and seek new ways of producing and selling their goods. Contacts through trade ease the flow of capital and speed the acquisition of new technology (see Box 1.2).

This is not to deny that throughout history many countries have developed industries behind protective barriers. There are respectable arguments to be made for assisting firms through the difficult learning stages of development. These arguments depend largely on market failures of one sort or another or the existence of external benefits such as the spread of ideas and skills throughout the economy. But history is also full of examples of countries that have given their industries too much protection for too long. Many countries are now struggling to reduce protection in order to improve efficiency and switch resources to more profitable activities.

Much of the bias against trade in developing countries has been unintended. Errors in macroeconomic policy or unexpected changes in the terms of trade have caused balance of payments deficits and shortages of foreign exchange. Domestic inflation, combined with exchange controls, has led to overvalued exchange rates. These damaged

Box 1.2 John Stuart Mill on the gains from trade

In his *Principles of Political Economy* (1848), John Stuart Mill discusses the gains that result from "foreign commerce." Although more than a century has passed, his observations are as relevant today as they were in 1848. In referring to David Ricardo, one of the first to analyze formally the benefits of trade, he notes: "From this exposition we perceive in what consists the benefit of international exchange, or in other words, foreign commerce. Setting aside its enabling countries to obtain commodities which they could not produce themselves at all; its advantage consists in a more efficient employment of the productive forces of the world. If two countries which trade together attempted, as far as was physically possible, to produce for themselves what they now import from one another, the labor and capital of the two countries would not be so productive, the two together would not obtain from their industry so great a quantity of commodities, as when each employs itself in producing, both for itself and for the other, the things in which its labor is relatively most efficient. The addition thus made to the produce of the two combined, constitutes the advantage of trade" (p. 96).

Mill goes on to say: "There is much misconception in the common notion of what commerce does for a country. When commerce is spoken of as a source of national wealth, the imagination fixes itself upon the large fortunes acquired by merchants, rather than upon the saving of price to consumers. But the gains of merchants, when they enjoy no exclusive privilege, are no greater than the profits obtained by the employment of capital in the country itself . . . Commerce is virtually a mode of cheapening production and in all such cases the consumer is the person ultimately benefited; the dealer, in the end, is sure to get his profit, whether the buyer obtains much or little for his money" (p. 98).

Mill also discusses the indirect gains from trade. He states: "But there are, besides, indirect effects, which must be counted as benefits of a high order. One is, the tendency of every extension of the market to improve the processes of production. A country which produces for a larger market than its own, can introduce a more extended division of labor, can make greater use of machinery, and is more likely to make inventions and improvements in the processes of production. Whatever causes a greater quantity of anything to be produced in the same place tends to the general increase of the productive powers of the world. There is another consideration, principally applicable to an early stage of industrial advancement. A people may be in the quiescent, indolent, uncultivated state, with all their tastes either fully satisfied or entirely undeveloped, and they may fail to put forth the whole of their productive energies for want of any sufficient object of desire. The opening of a foreign trade, by making them acquainted with new objects, or tempting them by the easier acquisition of things which they had not previously thought attainable, sometimes works a sort of industrial revolution in a country whose resources were previously undeveloped for want of energy and ambition in the people: inducing those who were satisfied with scanty comforts and little work to work harder for the gratification of their new tastes, and even to save and accumulate capital, for the still more complete satisfaction of those tastes at a future time" (p. 99).

exports and fueled a vicious circle of foreign currency shortages, controls, and overvalued exchange rates. The resulting protection of domestic industries was quite inadvertent. And the levels of protection were often far in excess of any that even the most fervent advocate of infant industry protection could support.

For some countries the results of protection have been industries whose contribution to national income was negligible or even negative. Supporting them has burdened other sectors of the economy, in particular the rural community, which contains most of the poorest citizens of the developing countries. The same can be said for many of the industries of the centrally planned economies (CPEs). Lack of exposure to competition from abroad has fostered goods that are expensive and of low quality. The industrialization of the CPEs was impressively rapid, but less efficient than it might have been. Recognizing this, many developing countries and some CPEs are undertaking significant reforms and are trying to reduce their trade barriers, switch more of their efforts into exports, and compete more vigorously in world markets.

From recovery and adjustment to long-term growth (Chapter 2)

Although countries ultimately rise by their own efforts, the world economy conditions their success. The economic recovery that began in 1983 is weakening. For the industrial countries as a group, output growth reached 4.6 percent in 1984, but then dropped to 2.8 percent in 1985 and to an estimated 2.5 percent in 1986. Payments imbalances among the major trading nations persist, as do the debt problems of many developing countries. Real interest rates remain high compared with historical levels, and low commodity prices add to the difficulties of many developing countries. New funds to support the adjustment efforts of the developing countries have been severely limited.

Against this background two positive features stand out. First, inflation is low in most industrial countries and declining in many developing countries. Second, some industrial countries have made steady progress in reducing their fiscal deficits, which leaves more room to expand demand and stimulate growth.

Despite these positive signs, there is the danger that growth may slow further and that payments imbalances will fail to subside. The threat of protectionism might then turn into actual protection on a large scale. Debt difficulties could become intractable, partly because a sluggish world economy will also mean reduced net capital flows to the developing countries. All this will make adjustment much more difficult.

How should governments respond in the short term to avert these risks? The industrial market economies need a reduction in the U.S. current account deficit and in the corresponding surpluses of the major trading partners of the United States. For that to happen there must be both a decline in the U.S. budget deficit and an increase in U.S. exports. But this poses a risk of its own. Expansion in the United States was instrumental in earlier periods of economic growth, and reducing demand in the United States in order to cut its external deficit will slow world growth unless the other industrial countries take steps to offset the decline in global demand. So the policies of the industrial nations need to be carefully coordinated. The task goes beyond replacing the fiscal deficit of one country with a fiscal deficit elsewhere. It requires the careful use of fiscal and monetary policy to smooth the process of adjustment. This adjustment should not be delayed. If the present imbalances persist, they will threaten the stability of the world economy and encourage "beggar thy neighbor" protection.

In the longer term, the industrial market economies need to improve their economic flexibility by lowering their trade barriers and tackling rigidities in their markets for labor and goods. Such rigidities, in effect, resist the changes in comparative advantage, technology, and demography that economies must heed if they are to grow and prosper. Reforms such as these may not be feasible unless governments first address the pressing problems of short-term economic adjustment.

The fundamental goals of long-term structural adjustment in developing countries are to enhance efficiency, achieve equity, and expand the stock of physical and human capital. The problems of the highly indebted countries and Sub-Saharan Africa are particularly urgent, and their task would be easier if world growth were to revive. These and many other developing countries would benefit from policy reforms in three areas, although the precise form of appropriate measures will differ from case to case:

- *Trade reform.* Countries should move toward the adoption of an outward-oriented trade strategy. Such a strategy means removing the bias against exports, replacing quantitative restrictions with tariffs, and adopting more realistic exchange rates.

• *Macroeconomic policy.* Many governments need to reduce their budget deficits and to provide incentives for greater savings. Ensuring positive real interest rates, competitive exchange rates, and low inflation will not only increase the supply of domestic financial resources, but also help to support trade reforms.

• *Domestic competitive environment.* In addition to reforming trade and macroeconomic policies, governments need to improve the supply response of the economy, especially by removing price controls, rationalizing investment regulations, and reforming labor market regulations. These policies will complement trade reforms and promote the adoption of cost-minimizing technology.

But reforms alone will not restore growth in most cases. Complementary increases in capital flows are needed.

All told, then, industrial and developing countries alike face formidable tasks of adjustment. Should their policy efforts succeed, the world economy can return to a high-growth path. The alternative is stagnation, even greater instability, increased protection, and a missed opportunity to raise the living standards of the world's poor.

Chapter 2 of this Report tries to be a little more precise about the difference between success and failure. It presents two alternative growth paths. These are not projections but the ranges of outcomes possible under alternative assumptions of policy change. Under the High case, it is assumed that the industrial countries are successful in their adjustment efforts. On this assumption, they grow at a rate of just over 4 percent over the next decade. The prospects for developing countries would also improve. Their growth could reach 6 percent a year if their adjustment efforts are combined with a favorable world environment. But if governments in the industrial and developing countries do not take up the challenge of adjustment, the result will be slow growth, increasing protection, and greater instability in the world economy. So, in the Low case, the developing countries grow at around 4 percent, a rate too slow to enable them to tackle their debt problems. Countries which attempted reforms would do better than those that did not, but in any event the Low case represents a missed opportunity which would have drastic effects on the vast majority of the world's poor.

Industrialization: trends and transformations (Chapter 3)

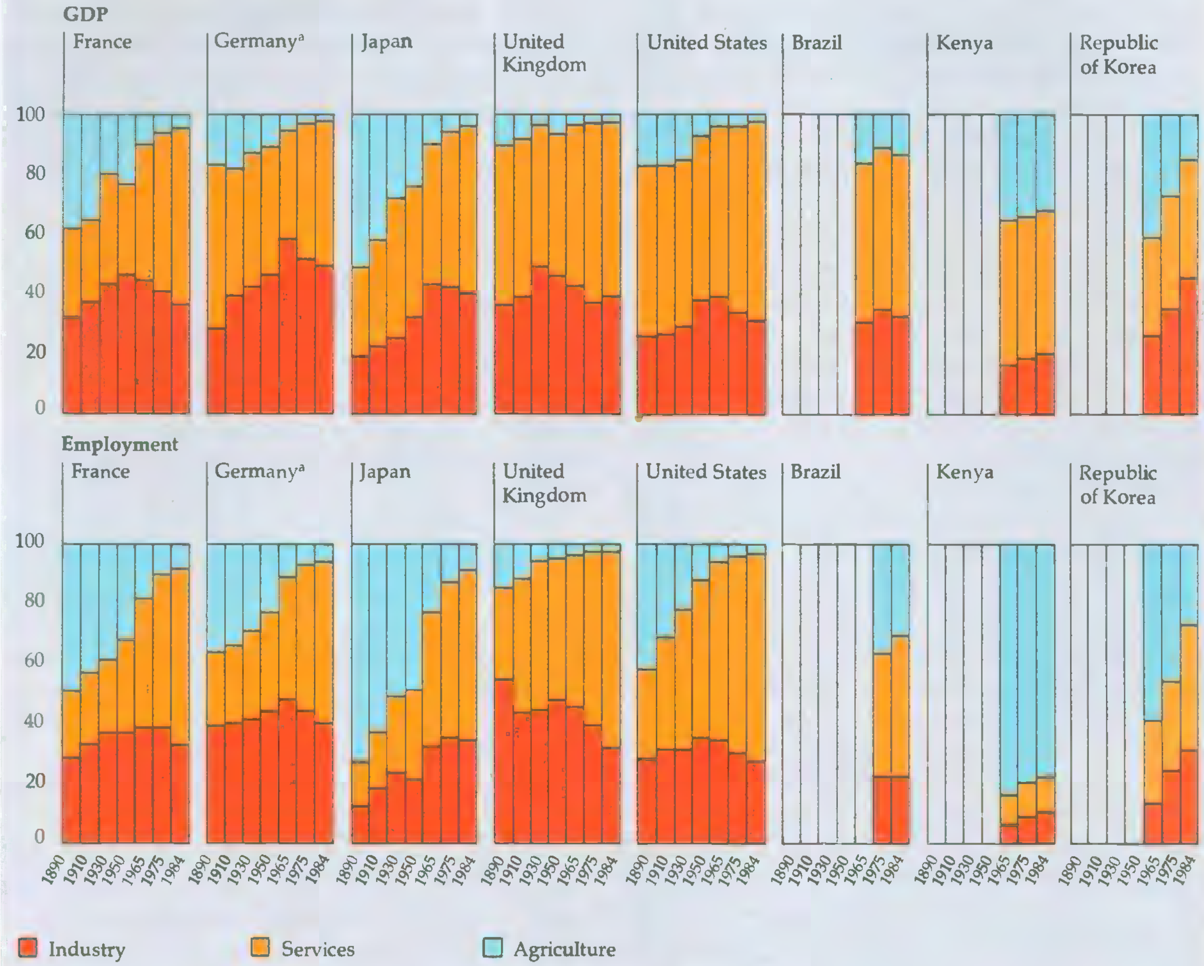
Industrialization is a part of the open-ended process of economic development that began around the middle of the eighteenth century in Great Britain. New methods of spinning and weaving cotton, together with increasing specialization, sharply increased productivity. These were followed by innovations in iron smelting and by the invention of the steam engine. Continuing innovations led to the production of steel and railways, steamships, and other transport. These boosted trade and spread industrialization, first to the major European nations and then to the United States and Japan.

A second industrial revolution began between 1870 and 1913. During this phase technological advance came to depend on scientific progress. The demands of the new technologies linked industrial growth to supplies from Africa, Asia, and the Caribbean. After World War II a period of unprecedented expansion in output and trade began. The postwar growth in manufacturing was fueled by the widespread use of such prewar innovations as assembly line production, electricity, the automobile, and consumer durables. Entirely new technologies also emerged: synthetic materials, petrochemicals, nuclear energy, jet aircraft, telecommunications, microelectronics, and robotics. Many observers believe that the world is now on the threshold of a third industrial revolution.

From the outset, then, industrialization has involved the interaction of technology, specialization, and trade. This interaction provokes structural change within economies. For example, early industrialization is usually associated with an increase in the share of industry in GDP (see Figure 1.1). Higher agricultural productivity is needed to accommodate that shift. Of course, there are exceptions to the pattern. Some economies have remained agricultural and still achieved high per capita income—Australia and New Zealand, for example. Others have become industrialized without increases in agricultural productivity but through exports of labor-intensive manufactures—Hong Kong, the Republic of Korea, and Singapore, for example.

Within these broad sectoral shifts, early industrialization moved through another series of changes. First it centered on textiles, then iron, steel, and engineering products based on steel. Later the focus shifted to electronics and microelectronics. But today's developing countries need not follow the same sequence. Now that technology is so portable, they can create an engineering industry without producing iron and steel or leap to microelectronics without building large industrial complexes.

Figure 1.1 Long-term trends in GDP and employment by sector, selected years, 1890–1984
(percent)



Note: The years are approximate time periods only. Industry includes manufacturing, mining, and construction (the data for Kenya also include electricity, gas, and water). The services category includes all output and employment not counted as part of industry and agriculture.
a. Data from 1950 onward refer to the Federal Republic of Germany.
Source: Kuznets 1957, appendix tables 2 and 4; International Labour Organisation 1970, 1980, 1985; and OECD and World Bank data.

The lessons of history, therefore, need to be interpreted with care. There is no unique path to industrialization. That said, some common themes emerge from past experience and point the way for countries that are embarking on industrialization today. For example, countries with large domestic markets are in a better position to establish industrial plants and take advantage of economies of scale. A rich endowment of natural resources provides financial means to support industrialization efforts. But neither size nor natural resources guarantee that a country can industrialize successfully. Indeed, they can lull countries into complacency.

Policy seems to matter more. All countries have protected industry at one time or another, but the successful early industrializers benefited from periods of free trade, and their levels of protection were for the most part low compared with those found today in many developing countries.

Thus far, all of the countries that have industrialized began the process with relatively skilled labor forces. And all except Britain acquired technologies from abroad. The two factors are linked, because technical skills are necessary to make intelligent choices of technologies, and the gains are much greater when those choices are efficiently adapted to each country's special circumstances. Governments have played a key role in this—and in the provision of physical infrastructure. Advances in transport and communications expanded markets, increased specialization, and brought about an integrated industrial world. Except in the United Kingdom, most of the early transport networks were publicly funded. Another key role for government has been the provision of stable yet flexible social and economic institutions: this includes everything from microeconomic "rules of the game" (property rights and so forth) to noninflationary macroeconomic policy.

The role of government (Chapter 4)

Markets and governments have complementary roles in industrialization. Markets are adept at dealing with the growing economic complexity that comes with industrialization, but they are rarely perfect. Government must sometimes intervene to achieve an efficient outcome.

First, governments have to set the rules of the game, which define the use, ownership, and conditions of transfer of physical, financial, and intellectual assets. Irrespective of the type of economy—whether it favors private enterprise or is a command economy—these rules impinge on economic activity. The more they are certain, well defined, and well understood, the more smoothly the economy can work. In many developing countries these rules are often unclear, interpreted in unpredictable ways, and managed by a cumbersome bureaucracy. This tends to raise the costs of doing business and therefore discourages the transactions that are essential for industrial specialization.

Governments must continue to be the main providers of certain services that have facilitated industrialization in the past:

- All governments play a major role in education, especially in providing the basic skills of literacy and numeracy that are vital in a modern industrial labor force. Lack of education, rather than physical assets, is the main bottleneck in industrialization.
- Most governments provide the physical infrastructure of industry: transport, communications, and power systems. Although some parts of such systems can be, and are, profitably operated in the private sector in many countries, government provision of large systems in most developing countries is usually the only feasible option.
- Most governments provide economic information and regulation of standards (weights, measures, safety at work). But there is a limit to the information they can make available in time to be useful, and regulations can often be ineffective or counterproductive.
- Governments in the industrial economies promote scientific and technological research. For developing countries, where it usually makes sense to acquire foreign technology, the arguments for a large government role in industrial research and development are less compelling. But public support may be justified in some cases.
- State-owned enterprises were established to carry out some of these tasks. Some have performed well, but many have disappointed. Efforts are under way to reform them. Such reforms are high on the agenda for structural adjustment in developing countries.

In addition to these forms of direct participation, governments intervene somewhat less directly in the running of their economies. Trade policy, fiscal incentives, price controls, investment regulations, and financial and macroeconomic policies are their instruments. Capital market failures and externalities are the most cited justifications for direct intervention. Both concepts have been used, for example, to defend policies toward infant industries.

Suppose a potentially profitable young firm is unable to find the funds to tide it over the period before it becomes financially viable and can recoup its costs. Without government support such firms would not be able to start production. Or suppose that the firm could generate economic benefits to the rest of the economy—for example, in the form of trained workers who leave and take their skills elsewhere. Again some form of government support is warranted. Import protection is never the best form of intervention in principle, but sometimes there may be no practical alternative.

Different forms of intervention will have different effects on the economy. Indeed, the important question often is not whether to intervene, but how. Quantitative restrictions on imports may be used to protect infant industries, for instance. But they will raise social costs more than a tariff will, because they encourage unproductive activities such as the efforts of producers to avoid or exploit the controls. Tariffs, however, raise prices to consumers. Subsidies to the industry could give the same assistance without raising prices—although not without raising public spending and, possibly, budget deficits.

Trade policy and industrialization (Chapter 5)

Economists and policymakers in developing countries broadly agree that governments need to provide infrastructure, promote market efficiency, and foster a stable macroeconomic environment. Trade policy is a much more contentious issue.

Trade policies can be characterized as outward oriented or inward oriented. An outward-oriented strategy provides incentives which are neutral between production for the domestic market and exports. Because international trade is not positively discouraged, this approach is often, although somewhat misleadingly, referred to as export promotion. In truth, the essence of an outward-oriented strategy is neither discrimination in favor of exports nor bias against import substitution. By contrast, in an inward-oriented strategy trade and industrial incentives are biased in favor of domestic production and against foreign trade. This approach is often referred to as an import substitution strategy. In some countries the bias against trade has been extreme.

An inward-oriented strategy usually means overt protection. What is less obvious is that sheltering domestic industries puts exports at a great disadvantage because it raises the costs of the foreign inputs used in their production. Moreover, an increase in the relative costs of domestic inputs may also occur through inflation—or because of an appreciation of the exchange rate—as the import restrictions are introduced.

In practice, trade policy contains elements of both approaches. Differences arise as much from the choice of instruments as from the absence or presence of intervention. Outward-oriented policies favor tariffs over quantitative restrictions. These tariffs are usually counterbalanced by other measures, including production subsidies and the provision of inputs at "free trade" prices. Governments aim to keep the exchange rate at a level that provides equal incentives to produce exports and import substitutes. Overall protection is lower under an outward-oriented strategy than under inward orientation; equally important, the spread between the highest and lowest rates of protection is narrower.

Inward-oriented strategies typically prefer quantitative restrictions to tariffs, and they involve a higher overall level of protection, together with greater variation across activities. Exchange rates are generally overvalued because of high protection and the use of quantitative restrictions. Industrial incentives are administered by an elaborate and expensive bureaucracy.

This Report presents a study of forty-one economies which shows that outward-oriented economies tend to perform better than inward-oriented economies. Their overall output grew faster. They industrialized more smoothly, even though their explicit interventions in support of that goal were far fewer. For the economies that followed more mixed strategies, however, differences in average performance were small; since many factors apart from trade policy influence economic success, this is scarcely surprising. The important lesson is that the strongly inward-oriented economies did badly.

Trade policy reform (Chapter 6)

Like most policy changes, the shift toward outward orientation inevitably involves transitional costs. Major shifts in resources accompany trade liberalization, as some activities contract and others expand in response to the changes in prices that the reforms must entail. If the economy is highly distorted to begin with, larger changes are more likely to be necessary. One visible cost is unemployment, although recent research on trade reform shows that it has caused less unemployment than is generally supposed.

More often than not, trade liberalization comes in the wake of economic crises that are associated with budget and balance of payments deficits and inflation. Such crises may create the political will for change—an important ingredient in undertaking trade liberalization. A government's long-term commitment to reform needs to be credible if economic agents are to respond to the incentives the reform creates. Trade liberalization may therefore be more likely to succeed when the initial shifts in policy are substantial: this adds to the credibility of reform. Moreover, a strong initial shift in policy can quickly boost exports enough to create vested interests in support of further liberalization.

Stable macroeconomic policies—aimed at reducing inflation and preventing the currency from appreciating—are also crucial for the success of trade reforms. Many trade liberalization efforts have foundered owing to poor macroeconomic policies rather than poor trade policies. Once the reforms are undertaken, their fate often rests mainly with the balance of payments—and this is the outcome of macroeconomic policy.

Experience suggests that export performance is closely related to the level and stability of the exchange rate. Conversely, using the exchange rate to stabilize domestic prices is inconsistent with trade reform. In the countries of the Southern Cone of Latin America, capital inflows led to the appreciation of exchange rates, which offset the incentives for increasing the production of exports and import substitutes. Large capital inflows were in some cases the result of liberalization of the financial markets in which domestic interest rates rose very sharply. This provoked heavy borrowing from abroad.

A review of the recent history of trade policy reforms suggests that three elements seem to matter most in their design. The first is the move from quantitative restrictions to tariffs. This links domestic prices to foreign prices. The second is the reduction of the variation in rates of protection alongside reductions in its overall level. Otherwise, protection accorded to value added in some sectors may increase, because as a result of reduced tariffs and quotas the prices of inputs may fall faster than the prices of outputs. The third element is the direct promotion of exports to offset the bias arising from import tariffs. Specific measures to promote exports risk acquiring a permanent status, however, and often lead to the postponement of more fundamental changes relating to the exchange rate. They may also contravene the General Agreement on Tariffs and Trade (GATT), create lobbies that will oppose their removal, and risk countervailing duty actions from importers.

Complementary policies for industrial development (Chapter 7)

Trade policy is only one of the many instruments used by governments to influence the pattern of industrialization. The others fall into four broad categories:

- *Price controls* are used to achieve income distribution goals, to protect consumers from monopoly, to promote industry through their influence on input prices, and to control inflation. They are pervasive in many developing countries. Although they can have some short-run beneficial effects by lowering price expectations in periods of high inflation, their usual long-run effects harm rather than promote efficiency. They restrict supply, encourage the emergence of dual markets, distort cost relationships, entail high administrative costs, and create vested interests in their permanence. Programs targeted to support the poor directly are a better way to attack poverty.
- *Regulations,* of which licensing is the most common, attempt to influence the pattern of private investment in line with government priorities. Investments by foreigners are often subject to more stringent regulations than those of nationals. The result is a distorted pattern of prices and incentives. For example, investments in capital-intensive technology are in many cases the result of the low price of capital and overvalued exchange rates. High domestic protection encourages "tariff jumping" by foreign investors, which in turn leads to investments in activities with low or negative social returns.
- *Financial policies* are another important influence on the pattern of industrialization, through their effects on savings and the cost of capital. Interest rate controls are common in developing countries. They encourage investment at low rates of return and excessively capital-intensive technology. They also discourage financial savings. But dismantling these controls must be done carefully: macroeconomic stability, low public sector deficits, and proper exchange rate management may have to precede attempts to liberalize financial policies.

Because medium- and long-term finance is often found inadequate for industrial investments, governments in developing countries have established medium- and long-term financial institutions such as development banks. They have also tried to promote bond and equity markets. In many cases these institutions have depended heavily on public resources and have been unsuccessful in mobilizing resources for themselves.

- *Labor market policies* involving highly regulated wages, payroll taxes, and rules governing job security are common in developing countries. Minimum wage regulations are particularly prevalent, but they carry certain risks. If minimum wages are set too high, they deter employment by favoring the use of capital over labor, they increase inequalities between the formal and informal sectors, and they reduce returns to education and training by narrowing differentials between skilled and unskilled labor. The other popular forms of intervention—such as payroll taxes, wage policies for the public sector, and rules on job security—all risk, to some extent, distorting the labor market in ways that reduce employment and overall living standards.

The combined effect of trade and domestic policies

Trade and domestic policies jointly influence prices of capital and labor. For example, exchange rate overvaluation increases the demand for capital in relation to the demand for labor. Import licensing systems, which often give priority to capital imports, reinforce this bias. Interest rate controls work in the same direction.

Another aspect of the interaction between trade and domestic policies is their influence on the competitive environment. On the one hand, barriers to entry brought about by import restrictions can create monopolies. On the other hand, stringent laws to limit the size of firms make it harder to achieve economies of scale. Rigid job security regulations, laws against mergers and acquisitions, and the absence of bankruptcy laws can make it difficult for firms to leave an industry. Exit barriers maintain inefficiency and inhibit structural change. And many studies indicate that trade, industrial, and financial policies discriminate against small firms.

Technological development and industrialization

Technological development involves the acquisition and adaptation of technology. Prices strongly influence the process. Governments have attempted to provide public support for technological development in many ways—for example, through systems of patents to protect proprietary rights in technological advances and through subsidized research. Greater contact with producers would increase the impact of the public research institutes. There is little hard evidence on which approaches work best, but a combination of undistorted market signals with targeted public support seems most promising.

The threat of protectionism (Chapter 8)

Since World War II, tariffs in industrial countries on most manufactures have fallen so far that they are no longer significant barriers to trade. But recent years have seen a resurgence of protection in the form of nontariff barriers. The proportion of North American and European Community imports affected by various nontariff restrictions has risen by more than 20 percent from 1981 to 1986. Such restrictions cover large volumes of imports and affect developing countries' exports in particular. Nontariff barriers in clothing and footwear have proved porous, so developing countries have been able to go on increasing their exports to the industrial economies, but at a cost, and with increasing difficulty as leaks in the nontariff barriers are plugged.

Nontariff protection is concentrated on a few industries. Textiles, clothing, footwear, leather goods, steel, and shipbuilding use standard technology and, in many instances, labor-intensive methods. This has made them vulnerable to competition from the newly industrializing countries (NICs—defined here as the economies of Brazil, Hong Kong, Mexico, the Republic of Korea, and Singapore) in recent years. As new entrants, the NICs were able to absorb the existing technology and combine it with labor that was much cheaper and highly productive. Labor in the NICs not only was willing to operate at lower wages than in the industrial countries, and with fewer safeguards for health and safety at work, but also was exempt from the overmanning, job demarcation, and restrictive working practices which were common in the industrial countries.

Management and labor in the industrial countries' traditional industries have a common interest in gaining protection—management to maintain profits, and workers to retain jobs and incomes. Labor unions have the additional motive of retaining members who would be lost to the union if they became unemployed or switched to other industries. Overvalued exchange rates (in some cases) and world recession added to the pressures and led to increased demands for protection. These spread beyond the parties directly involved to others who, in a climate of rapidly rising levels of unemployment, saw protection as a general solution. Yet protection has not, as a rule, saved jobs.

An alternative response to changes in the structure of trade is to ease the movement of resources out of the industries which have lost competitiveness, while providing compensation to workers who need to retrain, move to new forms of work, or opt for early retirement. Protection is justified only if it is necessary to slow the speed of adjustment, and then only if subsidies are not available for the purpose. Even so, the protection could be damaging if it is not designed to be temporary and degressive. Otherwise it will not promote adjustment, but simply delay the shift of resources from dying industries to more productive uses.

Toward a more open trading system (Chapter 9)

A big danger is that industrial countries will act in a negative and defensive way toward increased imports of manufactures from developing countries. This would mean raising trade barriers of the more discriminatory type—that is, more nontariff barriers more effectively administered. This would further undermine the integrity of the GATT system and would restrict the growth of developing countries' exports. Many developing countries are already heavily in debt, so a reduction in their export earnings would aggravate the problems of world debt.

Developing countries—with limited foreign exchange and facing unusually low commodity prices—may soon face even higher barriers against the manufactures which have traditionally been their first industrial exports. Should that happen, there could be widespread disillusion with the outward-oriented trade strategies which have proved so successful for the NICs in recent years. If countries such as the United States or the United Kingdom increase their protection, it would hardly be surprising if many developing countries followed suit. Unfortunately, increased protection will still mean poor economic performance in all countries.

If industrial countries become more protectionist, this would force developing countries to explore a range of second-best options. These would include trying to expand trade with the centrally planned economies, and with other developing countries, on a discriminatory basis. But the prospects of greatly improved trade in either of these directions are not good. Neither could replace trade with the industrial market economies.

The best option for most developing countries is outward orientation, even though the benefits would be reduced in a more protectionist industrial world. But politically it would then be very difficult for them to follow an outward-oriented strategy, even if it were objectively their best bet. In other words, there is a serious risk that increased protection by the industrial nations will set back economic development for many years and inflict unnecessary suffering on some of the poorest people in the world. In any case, the industrial nations themselves stand to gain from open trade.

The risks make it crucial that all countries strive for a successful outcome from the Uruguay Round of multilateral trade negotiations (MTN). For some developing countries that may mean offering to reduce, or at least bind, some of their trade barriers in order to encourage the industrial nations to open markets to them. Most of the ways to achieve greater and more secure access are on the agenda for the MTN. Implementation of the "standstill and rollback" provision of the MTN would immediately help developing countries. A reduction in tariff escalation would also aid their exports of manufactures. A more effective safeguard procedure in a reformed Article XIX would contribute to increased security of market access, as would a more liberal Multifibre Arrangement and improved procedures for settling disputes.