



## *Trade policy and industrialization*

Which trade strategies have enabled countries to attain high growth and to develop their industrial potential? This chapter attempts to answer the question in two ways. First it examines the thinking that lies behind different strategies, the circumstances under which governments have adopted them, and the economic performance of countries that have pursued them. Then it discusses the economic costs and benefits of alternative trade strategies and suggests some reasons why economic performance has varied so widely under the different strategies.

Economic growth is fundamental to economic development. Without generating greater output and income, a country cannot make a sustained attack on poverty, unemployment, and other social and economic problems. In the first decades following World War II, economists viewed industrialization as an essential stage in reaching the goal of rapid economic growth. But industrialization cannot be a policy objective in its own right. This chapter suggests that the real question is not how fast an economy can industrialize, but how to structure the industrial sector so that it supports sustained economic growth.

### **Alternative trade strategies**

Economists and policymakers in the developing countries have long agreed on the role of government in providing infrastructure, promoting market efficiency, and maintaining stable macroeconomic policies. But they have disagreed on policies toward trade and industry. The form of government intervention in this area is the distinguishing feature of alternative development strategies.

For analytical convenience, trade strategies can

be broadly divided into two groups, outward oriented and inward oriented. An outward-oriented strategy is one in which trade and industrial policies do not discriminate between production for the domestic market and exports, nor between purchases of domestic goods and foreign goods (see Box 5.1). Because it does not discourage international trade, this nondiscriminatory strategy is often (somewhat inaptly) referred to as an export promotion strategy. By contrast, an inward-oriented strategy is one in which trade and industrial incentives are biased in favor of production for the domestic over the export market. This approach is well known as the import substitution strategy.

Protection switches demand to products produced domestically. Exporting is then discouraged by both the increased cost of imported inputs and the increased cost of domestic inputs relative to the price received by exporters. This rise in the relative cost of domestic inputs may occur through domestic inflation or an appreciation of the exchange rate following the imposition of barriers to imports. In effect, protection puts a tax on exports (see Box 5.2).

This implicit tax is sometimes offset with export subsidies. As far as the trade account is concerned, a 10 percent tariff on all imports together with a 10 percent subsidy on all exports would be equivalent to a 10 percent depreciated exchange rate with no tariff and no export subsidy. Such a policy does not discriminate between exports and imports, so that it too is an outward-oriented strategy. But combining export subsidies and import tariffs involves administrative cost; in practice, the policy is rarely, if ever, designed to simulate liberal trade.

### Box 5.1 Measuring neutrality in trade regimes: nominal and effective rates of protection

The concept of neutrality in trade regimes is straightforward: it means that the aggregate effect of all trade and industrial policies is to offer equal incentives to the production of all tradables. Measuring departures from neutrality, or bias, is not so simple, however. It involves several different indicators.

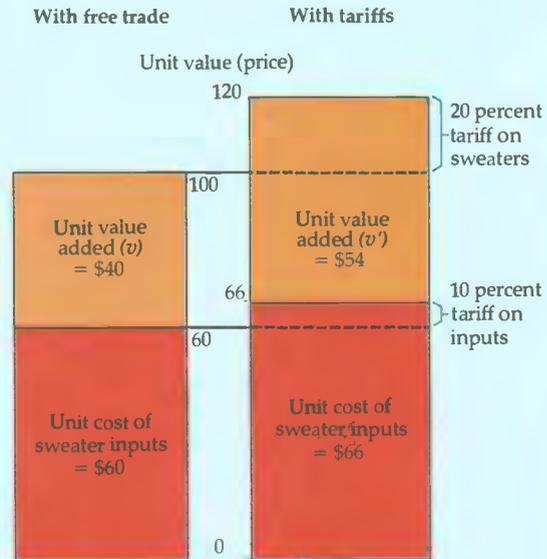
One way of measuring bias starts with the *nominal* rate of protection. For any good, this is the difference between the domestic price and the world price, expressed as a percentage of the world price. The overall bias of a trade regime can then be estimated as the ratio of (a) the average nominal rate of protection for importables to (b) the average nominal rate of protection for exportables. If this ratio is greater than one—that is, if importables have a higher nominal rate of protection than exportables—it reveals a bias in favor of import substitution. A ratio of one implies neutrality. (Exactly the same result can be obtained by using the ratio of the effective exchange rate for importables to the effective exchange rate for exportables. The effective exchange rate for importables must take account of any import duties, import premiums resulting from quantitative restrictions, and other incentives. Similarly, the effective exchange rate for exportables must take account of any export subsidies, tax credits, and other export incentives.)

Nominal rates of protection, however, often fail to measure the degree of protection actually received by domestic producers. This is because protection depends not only on the nominal protection given for the product itself, but also on any taxes or subsidies that there may be on inputs. For this reason, a different measure is more widely used to evaluate the orientation of trade regimes.

The *effective* rate of protection is designed to capture the protection accorded to value added in production, rather than to the finished product. It is defined as the difference between value added (per unit of output) in domestic prices and value added in world prices, expressed as a percentage of the latter. The effective rate of protection for importables is therefore equal to  $\frac{v' - v}{v} \times 100$ , where  $v'$  represents value added at domestic prices, and  $v$  represents value added at world prices. The result can be positive or negative, depending upon whether  $v'$  is greater or less than  $v$ . In an extreme case  $v$  itself could be negative. This represents the case in which domestic production is so inefficient that it is actually destroying value.

As an example, consider the effects of tariffs on the sweater industry. Suppose a sweater sells for \$100 in the absence of import restrictions and that the material inputs—wool and buttons—cost \$60 in world prices. The value added at world prices is therefore \$40. If a tariff of 20 percent is levied on sweaters, raising their imported price to \$120, and inputs remain duty free, the value added in domestic prices is \$60. The effective rate of protection is the difference between the value added in domestic prices (\$60) and the value added in world prices (\$40), as a proportion of the value added in world prices. In other words, the effective rate of protection is 50 percent, as opposed to the 20 percent

Box figure 5.1 Calculating the effective rate of protection



Note: In this example, where the nominal rate of protection is 20 percent on sweaters and 10 percent on inputs, the effective rate of protection is:

$$\frac{v' - v}{v} = \frac{54 - 40}{40} = 35 \text{ percent.}$$

nominal rate of protection. But if this tariff on sweater production is combined with a tariff of 10 percent on inputs, the domestic cost of inputs rises to \$66, which decreases the effective rate of protection to 35 percent (see Box figure 5.1).

The effective rate of protection for export production can be obtained in the same way; now  $v$  includes subsidies to exports. As before, the ratio of (a) the average effective rate of protection for importables to (b) the average effective rate of protection for exportables can be used as an indicator of trade orientation. (And again, the same results can be obtained with ratios of effective exchange rates, this time evaluated on the basis of value added.)

The use of any aggregate measure of protection has a serious drawback. It is possible that nominal or effective rates of protection for importables or exportables vary widely across industries, yet have an average value of zero—implying no protection. But the variation in nominal or effective rates of protection across industries is itself an important distortion. Full neutrality of a trade regime therefore requires no variation in nominal or effective rates of protection across the tradable goods industries.

## Box 5.2 Protection and the taxation of exports

It is not unusual for a country to pursue policies of import substitution and export promotion at the same time. The objectives may be seen as independent. Thus, instruments designed to encourage import substitution may be introduced in the belief that they have no impact upon the export sector. But this is not so.

The most crucial characteristic of protection is that it is a *relative* concept. When a particular protective instrument is introduced, it is intended to alter relative prices in order to protect the chosen activity relative to other activities. For example, if an import tariff achieves its objective, resources will be induced to move from unprotected activities to the protected activity.

Recent research has shown that the impact of protection depends on the way it influences the prices of nontradable goods. Although the division of an economy into importables, exportables, and nontradables is somewhat artificial, it is also instructive. (Many service industries and industries with high transport costs may be regarded as nontradable: wages are a large component of their costs.) The introduction of a tariff will raise the domestic price of importables relative to the price of exportables, which will generally be determined by world demand and supply. The manner in which the tariff will cause the price of nontradable

goods to change is less clear. If the factors used to produce importables and nontradables are similar, that is, if they are close substitutes in production, the prices of importables and nontradables would tend to be closely linked and their relative price would not be much affected by an import tariff. The tariff would serve to raise the price of *both* importables and nontradables. Since the price of exportables is externally determined, producers in the export sector would find that the price of their output has fallen relative to both imports and nontradables. The effect is akin to a tax on their production. At the same time, domestic demand will tend to switch to the relatively cheaper products—exportables. Both effects will act to tax exports.

By contrast, if nontradables and exportables are close substitutes in production, the price of exports would still fall relative to imports, but there would be little change relative to nontradables. Tariffs discourage exports to a somewhat smaller extent in this case.

Given information on relative prices for exportable output, import substitutes, and nontradables, the relative price effects of protection can be estimated. Box table 5.2 reports the results of several studies which pertain to Latin American and African economies. The "shift parameter" in the table measures the share of any import protection which, because of relative prices, becomes an implicit tax on exports. This ranges from a low of 43 percent in the case of Côte d'Ivoire to a high of 95 percent in the case of Colombia. In almost every case, more than half of the burden of protection is shifted to the export sector.

Several important points arise from this analysis. First, protecting one sector usually makes another worse off. Second, when export incentives are introduced alongside import restraints, the export incentives may do little more than offset the disincentive effects of import protection. This may be one reason why export processing zones (EPZs) have not lived up to expectations—the EPZ incentives may be insufficient to counteract the implicit tax on exports caused by the restrictions on imports. Finally, the analysis implies that if export promotion is a goal of policy, the most direct means of achieving this goal may be import liberalization.

**Box table 5.2** Estimates of the shift parameter in selected developing countries

Country and period	Shift parameter
Côte d'Ivoire, 1970–84	0.43
Uruguay, 1959–80	0.53
Chile, 1959–80	0.55
Argentina, 1935–79	0.57
Mauritius, 1976–82	0.59
El Salvador, 1962–77	0.70
Brazil, 1950–78	0.70
Côte d'Ivoire, 1960–84	0.82
Mauritius, 1976–82	0.85
Colombia, 1970–78	0.95

*Note:* The lower estimates for Mauritius and Côte d'Ivoire refer to nontraditional exportables; the higher estimates, to traditional exportables.

*Source:* Clements and Sjaastad 1984; Greenaway and Milner 1987.

### Export pessimism

In the early postwar years most developing economies were relatively specialized in the production of primary commodities, which they exported in exchange for manufactured products from industrialized countries. But many economists argued that the producers of primary goods faced a secu-

lar decline in their terms of trade. The income elasticity of demand for primary products was low, synthetic substitutes for natural resources were appearing, and technical innovations were cutting the amount of raw materials needed for industrial production. All this suggested that the real prices of primary goods would fall over time. World demand for manufactures, by contrast, would con-

tinue to grow. To many this provided a justification for encouraging industrial production.

The prediction of declining terms of trade for primary products has been much debated. Critics say it ignored supply conditions: with diminishing returns to limited natural resources, slow growth in demand for primary products will not necessarily cause their terms of trade to decline. The prediction also overlooked the growth of developing countries and their demand for primary products as well as the early industrial transformation of developing economies with poor natural resource endowments, such as Hong Kong, Singapore, and, to a lesser extent, the Republic of Korea. The data in Chapter 2 do show a long-term decline in the terms of trade for exports of primary goods. But they should be interpreted with caution because they take no account of quality improvements in manufactures. And some of the recent surplus in primary commodities arose from investments encouraged by past high prices.

In spite of these uncertainties, it may well be true that the relative price of primary commodities is in long-term decline. The question, however, is whether an inward-oriented strategy is the right response to this prospect. The overriding need is for flexibility in shifting the economy's resources to take account of the changing pattern of comparative advantage. Inward-oriented strategies are unlikely to promote this kind of flexibility.

New arguments against nondiscriminatory trade policies and their implicit encouragement of manufactured exports have recently appeared. One is known as the fallacy of composition; it holds that if all developing countries followed an export-promoting strategy modeled on the example of the newly industrializing countries (NICs) of East Asia, industrial countries would refuse to absorb the resulting volume of imports.

This has been challenged on at least four grounds. First, the capacity of industrial nations to absorb new imports may be greater than supposed. Developing country exports currently account for only a tiny share—2.3 percent as of 1983—of the markets for manufactures in the industrial economies. (Of course, the proportion is much higher for certain products and in certain countries.) Second, the idea that a large number of economies might suddenly achieve export-to-GDP ratios for manufactures like those of Hong Kong, Korea, or Singapore is highly implausible. The resource endowments of the East Asian NICs are quite different from those of countries such as Argentina, Brazil, Indonesia, Côte d'Ivoire, Malay-

sia, and Thailand, which are among the next tier of industrializing countries. Third, export-oriented countries would produce different products, and intraindustry trade (as occurred with the lowering of trade barriers within Europe) is likely to be important. Finally, the first wave of newly industrializing countries is already providing markets for the labor-intensive products of the countries that are following.

### *Policy instruments*

Commercial policy, industrial policy, and exchange rate policy can all be instruments of an inward-oriented strategy. Policymakers often prefer direct controls, such as import licensing and quantitative restrictions, to tariffs. In addition, hidden import duties such as stamp taxes, port duties, and advance deposit requirements are common, as are a number of other quasi-tariff measures. Finally, domestic content requirements for certain industrial products have become increasingly common.

Publicly owned firms or industries have expanded rapidly in many developing countries, particularly in industrial sectors such as steel, fertilizers, cement, or petrochemicals (Chapter 4). These give the policymaker administrative control over investments and purchasing, for example. Governments can also use fiscal policy to provide production subsidies, credit subsidies, wage subsidies, and tax holidays of various kinds. In general, these incentives are offered in a discretionary, and hence discriminatory, way. Administrative allocation of foreign exchange is also common in inward-oriented regimes—sometimes to defend the overvalued exchange rates that are partly due to the import barriers themselves. Certain sectors are given preferential access to foreign exchange.

Thus, inward-oriented regimes are generally characterized by high levels of protection for manufacturing, direct controls on imports and investments, and overvalued exchange rates. By contrast, outward orientation links the domestic economy to the world economy. The discriminatory use of tariffs, quotas, investment licensing, tax and credit subsidies, and so on, would be incompatible with the purest sort of outward-oriented strategy. In practice, however, outward orientation does not necessarily mean less government intervention. Some countries have pursued outward orientation by offsetting some of the anti-export bias of import barriers: they have promoted exports while dismantling import barriers only slowly.

Some governments have tried to promote exports by creating free trade zones. For individual firms, bonded warehouses often offer subsidized facilities. But such zones have had little aggregate effect, since they have applied to only a small segment of the economy. In many countries free trade status has also been provided to the export sector in general, through duty exemptions or other administrative measures to allow exporters access to imported inputs at world prices. But this is usually too little to offset the incentives to produce for domestic markets when import protection is significant.

Positive export incentives fall into three groups: rebates in excess of actual import charges on imported intermediate inputs, or excessive "wastage" allowances on imported inputs; access to loans at below-market rates; and other explicit and implicit subsidies. Such policies require institutional sophistication and budgetary resources. They can be discriminatory and are open to abuse. Even relatively nondiscriminatory schemes have proved difficult to administer. Furthermore, they are increasingly threatened by countervailing measures imposed by some importing countries.

#### *Defining trade strategy*

Trade strategy has a great influence on industrial performance and economic development. To illustrate this, it is first necessary to classify countries according to their trade policies. In principle, the distinction between an inward-oriented and an outward-oriented strategy is straightforward, a matter of the effective protection provided to production for domestic markets as compared with export markets (Box 5.1). In practice, however, it is rather more difficult, because a trade strategy contains many policies at work simultaneously and because the data are very limited.

An attempt is made here to classify the orientation of a country's trade strategy by combining the following quantitative and qualitative indicators:

- *Effective rate of protection.* The higher the effective protection for domestic markets, the greater the bias toward import substitution (Box 5.1).
- *Use of direct controls such as quotas and import-licensing schemes.* The greater the reliance on direct controls on imports, the more inward oriented the economy.
- *Use of export incentives.*
- *Degree of exchange rate overvaluation.* Inward orientation generally leads to an overvaluation of the exchange rate.

Information for the period 1963 to 1985 has been collected for forty-one countries. (The availability of data limited the choice of countries, but the countries selected nonetheless accounted for 66.5 percent of the total output of developing countries in 1985.) This information was then used to divide the countries into "strongly outward-oriented," "moderately outward-oriented," "strongly inward-oriented," and "moderately inward-oriented" economies. Policies change, and world trade has been unsettled since 1973, so each group was examined for two periods, 1963-73 and 1973-85. The criteria for the four categories follow.

**STRONGLY OUTWARD ORIENTED.** Trade controls are either nonexistent or very low in the sense that any disincentives to export resulting from import barriers are more or less counterbalanced by export incentives. There is little or no use of direct controls and licensing arrangements, and the exchange rate is maintained so that the effective exchange rates for importables and exportables are roughly equal.

**MODERATELY OUTWARD ORIENTED.** The overall incentive structure is biased toward production for domestic rather than export markets. But the average rate of effective protection for the home markets is relatively low and the range of effective protection rates relatively narrow. The use of direct controls and licensing arrangements is limited, and although some direct incentives to export may be provided, these do not offset protection against imports. The effective exchange rate is higher for imports than for exports, but only slightly.

**MODERATELY INWARD ORIENTED.** The overall incentive structure distinctly favors production for the domestic market. The average rate of effective protection for home markets is relatively high and the range of effective protection rates relatively wide. The use of direct import controls and licensing is extensive, and although some direct incentives to export may be provided, there is a distinct bias against exports, and the exchange rate is clearly overvalued.

**STRONGLY INWARD ORIENTED.** The overall incentive structure strongly favors production for the domestic market. The average rate of effective protection for home markets is high and the range of effective protection rates relatively wide. Direct controls and licensing disincentives to the traditional export sector are pervasive, positive incentives to nontraditional exportables are few or non-

**Figure 5.1 Classification of forty-one developing economies by trade orientation, 1963–73 and 1973–85**

Period	Outward oriented		Inward oriented	
	Strongly outward oriented	Moderately outward oriented	Moderately inward oriented	Strongly inward oriented
1963–73	Hong Kong Korea, Republic of Singapore	Brazil Cameroon Colombia Costa Rica Côte d'Ivoire Guatemala Indonesia Israel Malaysia Thailand	Bolivia El Salvador Honduras Kenya Madagascar Mexico Nicaragua Nigeria Philippines Senegal Tunisia Yugoslavia	Argentina Bangladesh Burundi Chile Dominican Republic Ethiopia Ghana India Pakistan Peru Sri Lanka Sudan Tanzania Turkey Uruguay Zambia
1973–85	Hong Kong Korea, Republic of Singapore	Brazil Chile Israel Malaysia Thailand Tunisia Turkey Uruguay	Cameroon Colombia Costa Rica Côte d'Ivoire El Salvador Guatemala Honduras Indonesia Kenya Mexico Nicaragua Pakistan Philippines Senegal Sri Lanka Yugoslavia	Argentina Bangladesh Bolivia Burundi Dominican Republic Ethiopia Ghana India Madagascar Nigeria Peru Sudan Tanzania Zambia

Source: Based on Greenaway (background paper) and World Bank data.

existent, and the exchange rate is significantly overvalued.

Figure 5.1 sets out the forty-one developing economies, classified according to the orientation of their trade strategy in two periods, 1963–73 and 1973–85. Although there may be scope for disagreement over the two intermediate subgroups, the countries which are scored as extreme cases are not likely to be ambiguous.

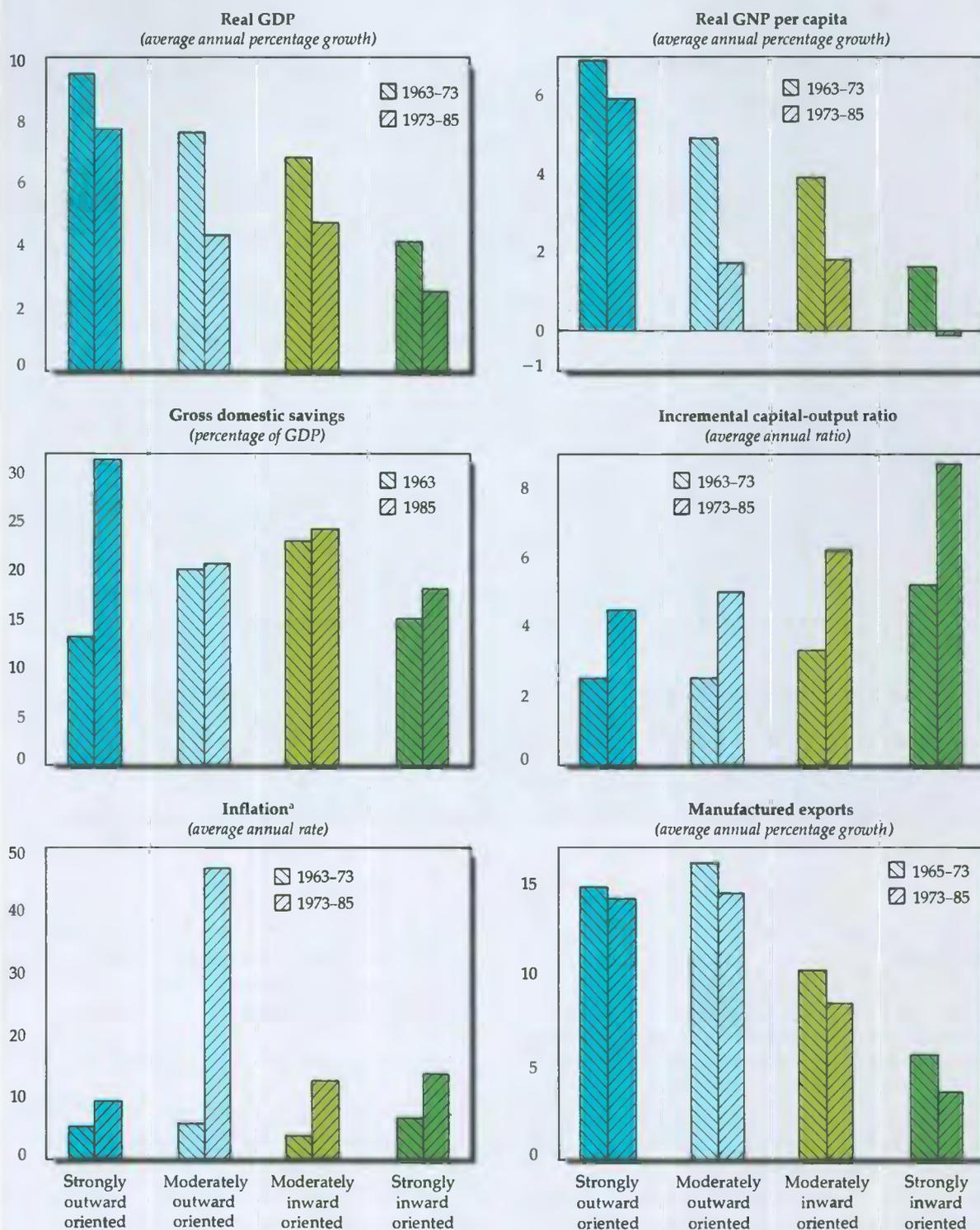
Figure 5.1 is the basis for the analysis in the rest of this section. It shows that, over the period studied, several countries underwent policy shifts toward more outward orientation—Chile, Turkey, and Uruguay, along with Pakistan, Sri Lanka, and

Tunisia. Others moved in the opposite direction, toward more inward orientation—Bolivia, Cameroon, Colombia, Costa Rica, Côte d'Ivoire, Guatemala, Indonesia, Madagascar, and Nigeria.

#### *Trade strategy and economic performance*

The links between trade strategy and macroeconomic performance are not entirely clear. Does outward orientation lead to better economic performance, or does superior economic performance pave the way for outward orientation? Nevertheless, Figure 5.2 provides indicators of the macroeconomic performance of the forty-one countries, grouped by the strategies defined above. The spe-

**Figure 5.2 Macroeconomic performance of forty-one developing economies grouped by trade orientation**



Note: Averages are weighted by each country's share in the group total for each indicator. See Figure 5.1 for a listing of the economies in each of the trade groups.

a. Inflation rates are measured by the implicit GDP deflator. Values are group medians.

cific indicators, given for weighted group averages, are the average annual growth rates of real GDP and per capita income, the gross domestic savings ratio, the average incremental capital-output ratio, the average annual growth rate of real manufactured exports, and the group median of average annual rates of inflation.

The figures suggest that the economic performance of the outward-oriented economies has been broadly superior to that of the inward-oriented economies in almost all respects. First of all, growth rates of GDP show a clear descending pattern from the strongly outward-oriented to the strongly inward-oriented economies. For the 1963–73 period the annual average was 9.5 percent for the strongly outward-oriented group, more than double the 4.1 percent attained by the strongly inward-oriented group. The respective rates for 1973–85 (7.7 percent and 2.5 percent) show that the gap has widened.

As a result of these trends in GDP, the average annual growth rate in real per capita income for 1963–73 was highest in the strongly outward-oriented economies (6.9 percent) and lowest in the strongly inward-oriented economies (1.6 percent). Despite the economic slowdown during 1973–85, per capita income in the strongly outward-oriented economies grew by an annual average of 5.9 percent, whereas in the strongly inward-oriented countries it fell on average by 0.1 percent a year. Performance differences are less marked between the moderately outward-oriented and the moderately inward-oriented economies; this reflects the relatively modest differences in their policy environments. (Figure 5.3 shows the per capita growth performance of each of the forty-one economies.)

GDP growth is influenced by the level of savings as well as by the efficiency of investment. The average ratio of gross domestic savings to GDP of the strongly outward-oriented economies was exceeded by all other groups in 1963, registering only 13.0 percent. By 1985, however, the strongly outward-oriented economies had more than doubled their savings ratio to 31.4 percent, whereas the savings ratios of the other three groups grew only slightly, or stagnated.

Given the gross savings rate, efficiency in the use of additional capital resources in an economy can be reflected in the economy's incremental capital-output ratio—the ratio of gross investment to the increase in GDP. Lower values suggest more productive investment. For both periods, there is a clear association between lower incremental capital-output ratios and increased outward orien-

tation. The average for both strongly and moderately outward-oriented groups for 1963–73 is 2.5, while the moderately and strongly inward-oriented groups averaged 3.3 and 5.2, respectively. In the 1973–85 period, the data register a substantial deterioration for all groups—incremental capital-output ratios are 4.5 and 5.0 for the outward-oriented groups and 6.2 and 8.7 for the inward-oriented groups.

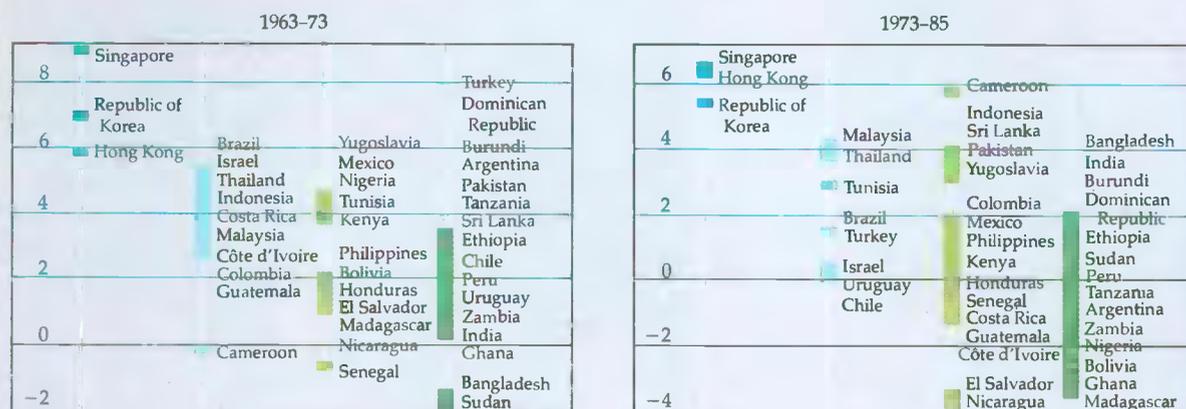
By removing barriers, outward-oriented economies tend to tie themselves to the inflation rates of the international economy. This may restrain their own inflation rates; however, at times of rapid inflation in the world economy, it can result in imported inflation, unless the exchange rate appreciates. In 1963–73, median inflation rates differed little between any of the groups; moderately inward-oriented economies had the lowest rate. In 1973–85, the median inflation rate reached double digits in all groups. The highest median inflation rate is that of the moderately outward-oriented group; four of the eight economies experienced high or hyperinflation in the 1980s—Brazil, Israel, Turkey, and Uruguay. The other economies in the sample with particularly high inflation—Argentina, Bolivia, and Peru—are in the strongly inward-oriented group. In the higher inflation environment of the 1970s and early 1980s, however, the strongly outward-oriented economies were able to maintain relatively low and stable rates of inflation.

The last graph in Figure 5.2 shows the average annual growth of manufactured exports from 1965 to 1973 and from 1973 to 1985. Again, the strongly outward-oriented economies performed best. Between 1965 and 1973 the manufactured exports of the two outward-oriented groups grew by 14.8 and 16.1 percent, compared with 10.3 and 5.7 percent for the inward-oriented groups. Between 1973 and 1985 the growth rates were 14.2 and 14.5 percent versus 8.5 and 3.7 percent. This growth of manufactured exports was probably an important factor in producing rapid overall economic growth.

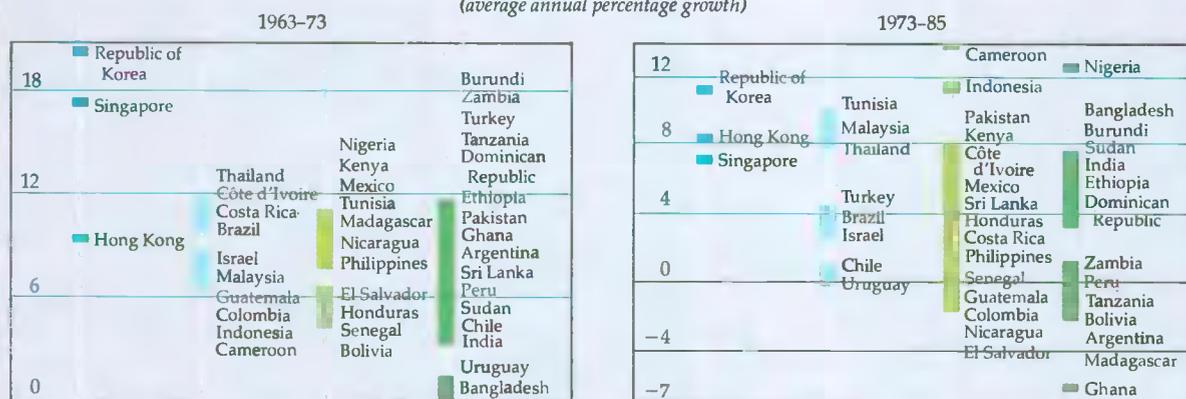
Finally, a good case can be made for suggesting that outward orientation leads to a more equitable distribution of income. First, the expansion of labor-intensive exports means higher employment. Second, reinforcing this, outward orientation removes the bias in favor of capital-intensive industries which is often implicit under inward-oriented policies. Third, the direct controls of an inward-oriented strategy generate rents that channel income to those with access to import licenses or subsidized credits.

**Figure 5.3 Economic and industrial performance by trade orientation**

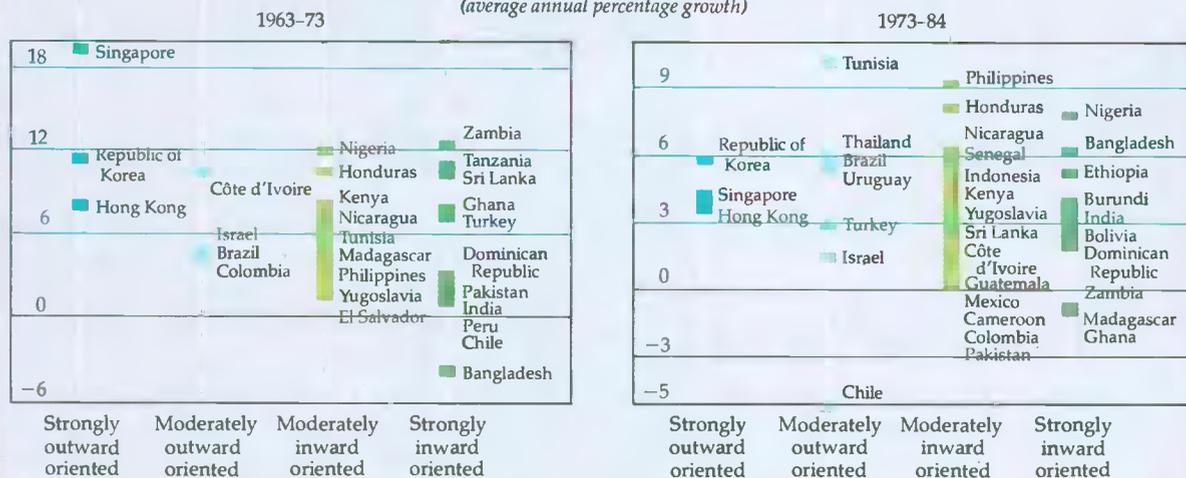
**Real GNP per capita, 1963-73 and 1973-85**  
(average annual percentage growth)



**Real manufacturing value added, 1963-73 and 1973-85**  
(average annual percentage growth)



**Employment in manufacturing, 1963-73 and 1973-84**  
(average annual percentage growth)



Empirical evidence also indicates that an outward-oriented strategy can improve the distribution of income. For example, the Gini coefficient (a measure of income inequality) declined in Hong Kong from 0.49 in 1966 to 0.45 in 1981 and in Singapore from 0.50 in 1966 to 0.46 in 1980. The Gini coefficient declined in Korea from 0.34 in 1964 to 0.33 in 1970, but it increased to 0.38 in 1976, partly because of credit subsidies to promote certain priority investments during the 1970s (Fields 1984).

#### *Trade strategy and industrialization performance*

Governments often adopt an inward-oriented strategy in order to promote industrialization through import substitution. But it seems that countries have industrialized faster under outward orientation. Table 5.1 sets several indicators of industrialization against the four categories of trade strategy. The indicators are the growth of manufacturing and agricultural value added, the share of manufacturing value added in GDP, the share of the active labor force employed in industry (defined to include mining, construction, and utilities, in addition to manufacturing activity), and the growth of employment in manufacturing.

During both periods, average annual growth of manufacturing value added was highest in the strongly outward-oriented group and lowest in the strongly inward-oriented group—15.6 percent versus 5.3 percent during 1963–73 and 10.0 versus 3.1 percent during 1973–85. Although both the moderately outward-oriented and the moderately inward-oriented economies achieved fairly high rates for 1963–73 (9.4 and 9.6 percent respectively), both saw a strong decline in the following period.

The smallest decline was in the strongly inward-oriented economies—but this group's manufactures had grown at a substantially slower rate than all other groups in the 1963–73 period. Even with a one-third fall in the growth of manufacturing in 1973–85, growth in the strongly outward-oriented economies remained higher than in any of the other groups during the more favorable economic climate of the previous period. The strongly outward-oriented economies have clearly coped better than the others with the economic shocks since 1973. (Again, Figure 5.3 shows the growth of manufacturing value added in the individual economies.)

The outward-oriented economies also achieved a higher share of manufacturing value added in GDP in 1963 (20.1 percent compared with 15.2 percent for the inward-oriented economies) and in 1985 (23.0 percent compared with 15.8 percent). The strongly outward-oriented and moderately inward-oriented groups both increased the share of manufacturing value added in their GDP by more than half from 1963 to 1985. The increase in the moderately inward-oriented economies, however, merely brought their share of manufacturing to a level achieved by all other groups two decades before. The share of manufacturing declined by 1.7 percent in the strongly inward-oriented group. The gap between the outward-oriented economies taken together and the inward-oriented economies taken together increased slightly.

Industry provides more of the jobs in the outward-oriented economies than it does in the inward-oriented ones. The share of labor in industry reached 30.0 percent in the strongly outward-oriented economies in 1980, considerably more

**Table 5.1 Characteristics of industrialization for forty-one developing economies grouped by trade orientation**

<i>Trade strategy<sup>a</sup></i>	<i>Average annual growth of real manufacturing value added<sup>b</sup></i>		<i>Average annual growth of real agricultural value added</i>		<i>Average share of manufacturing value added in GDP<sup>b</sup></i>		<i>Average share of labor force in industry</i>		<i>Average annual growth of employment in manufacturing<sup>c</sup></i>	
	1963–73	1973–85	1963–73	1973–85	1963	1985	1963	1980	1963–73	1973–84
Strongly outward oriented	15.6	10.0	3.0	1.6	17.1	26.3	17.5	30.0	10.6	5.1
Moderately outward oriented	9.4	4.0	3.8	3.6	20.5	21.9	12.7	21.7	4.6	4.9
Outward oriented (average)	10.3	5.2	3.7	3.3	20.1	23.0	13.2	23.0	6.1	4.9
Moderately inward oriented	9.6	5.1	3.0	3.2	10.4	15.8	15.2	23.0	4.4	4.4
Strongly inward oriented	5.3	3.1	2.4	1.4	17.6	15.9	12.1	12.6	3.0	4.0
Inward oriented (average)	6.8	4.3	2.6	2.1	15.2	15.8	12.7	14.1	3.3	4.2

*Note:* Averages are weighted by each country's share in the group total for each indicator.

a. See Figure 5.1 for a listing of the economies in each of the trade groups.

b. Data not available for Yugoslavia.

c. Data not available for Costa Rica and Malaysia (1963–73, 1973–84); nor for Thailand and Mexico (1963–73).

than in the moderately inward-oriented (23.0 percent) and the moderately outward-oriented (21.7 percent). In the strongly inward-oriented economies, manufacturing was a source of employment for only 12.6 percent of the work force.

Moreover, employment has grown faster in the outward-oriented economies. Manufacturing employment grew by 6.1 percent a year in 1963–73 (compared with 3.3 percent in the inward-oriented economies) and by 4.9 percent in 1973–84 (compared with 4.2 percent). In the first period, manufacturing employment grew three times faster in the strongly outward-oriented economies than in the strongly inward-oriented economies, 10.6 percent a year versus 3.0 percent. Growth slowed in the strongly outward-oriented group in 1973–84, narrowing the gap between the two extreme groups. But manufacturing in the strongly outward-oriented economies still increased employment at a faster rate (5.1 percent) than the strongly inward-oriented group (4.0 percent) and at a slightly faster rate than the moderately outward- and moderately inward-oriented economies (4.9 percent and 4.4 percent, respectively).

The outward-oriented countries fared better not only in industrialization and manufactured export growth, but also in agriculture. Their agricultural value added grew by 3.7 percent in 1963–73, compared with 2.6 percent in the inward-oriented economies, and by 3.3 percent in 1973–85, compared with 2.1 percent.

### Why outward orientation works

The evidence of the previous section strongly suggests that outward-oriented trade policies have been more successful than inward-oriented trade policies. It is a harder task to explain precisely why. The two regimes confront economic decision-makers with radically different signals and incentives. A full answer would call for an analysis of the effect of each of these elements. The best that can be achieved in practice is to consider the broad economic themes that seem to be at work.

It is well known that the protection associated with inward-oriented policies imposes economic costs, not least on the country that puts the policy into effect. Some of this economic burden, which is part of the reason inward-oriented policies have failed, can be seen from the structure of incentives that have resulted from tariffs and other protective measures (see Box 5.3). These incentives are bound to have important influences on the efficiency of resource allocation.

### Box 5.3 Trade orientation and the structure of protection

Although estimates of effective rates of protection are widely available for many developing countries, they are not strictly comparable for various reasons. For instance, estimates available for different economies pertain to different years; some are based on tariffs only, whereas others include the effects of other policies that encourage or discourage production; and in some cases the protection-induced exchange rate effects are netted out, but in other cases they are not. These shortcomings notwithstanding, estimates may be suggestive of the relationship between the structure of protection and the trade strategies they followed.

Box table 5.3 provides a glimpse of typical structures of effective protection by sector and by sales destination. Several features are noteworthy. First of all, the structure of protection clearly shows that there was, on average, bias against exports in all countries for which data are available—with the possible exception of Singapore and the Republic of Korea, where the bias was so small that it could easily have been offset by assistance (although the data are insufficient to say whether this was the case). For the rest of the sample countries, the extent of such bias, measured by the difference of effective protection between domestic and export sales, ranges from 9 percentage points for Colombia (1969) to 229 percentage points for Chile (1967).

The data also reveal that there was a clear bias against the primary or agricultural sector and favoring the manufacturing sector in every country considered except Korea, where the opposite was true because of the rising price support for rice production. In the case of Colombia, the negative rate of protection for agriculture in 1969 was largely due to the export tax applied to coffee. Such a negative rate of protection for primary exports may be justifiable when import demand is inelastic so that disincentives to export sales can provide larger export revenues. But such cases are probably exceptional. The extent of bias against the primary sector in relation to the manufacturing sector is more conspicuous in the inward-oriented sample of countries. These figures indicate the negative incentives provided to export sales in countries in which primary goods constituted major exports.

Finally, the range of effective protection rates measures the scale of discrimination between different industries. As indicated in the table, the ranges for the countries are based on different numbers of sectors and are therefore not strictly comparable. Nonetheless, they reveal that ranges tend to be greater in countries where the overall level of protection is higher.

**Box table 5.3 Structure of effective protection in selected economies by sector and sales destination**  
(percent)

Economy and year	Trade orientation	Effective protection rates by sector			Range and number of sectors	Effective protection rates by sales destination	
		Primary	Manufacturing	Overall		Domestic market	Export market
Singapore 1967 <sup>a</sup>		5	0	0	-7 to 21 (9)	2	-5 <sup>b</sup>
Korea, Republic of 1968 <sup>a</sup>		11 <sup>c</sup>	-17	-1	31 to 119 (11)	-1	-3 <sup>b</sup>
1978		77 <sup>c</sup>	5	31	-38 to 135 (11)	31	18 <sup>b</sup>
Brazil 1967 <sup>a</sup>		-4 <sup>c</sup>	45	19	-4 to 123 (12)	..	..
1980-81 <sup>a</sup>		-21 <sup>c</sup>	23	..	-48 to -17 (3 primary) -85 to 219 (67 manufacturing)	..	..
Colombia 1969 <sup>a</sup>		-23 <sup>c</sup>	4	-15	-23 to 161 (10)	-14	-23 <sup>b</sup>
1979 <sup>d</sup>		39	55	44	22 to 88 (5 primary) 25 to 127 (29 manufacturing)	..	..
Philippines 1965 <sup>a</sup>		-13 <sup>c</sup>	99	0	-34 to 238 <sup>e</sup> (10)	..	..
1980		9	44	36	..	..	..
Chile 1967		-7 <sup>c</sup>	217	168	-23 to 1,140 (22)	233	4
Nigeria <sup>a</sup> 1980		-12	82 <sup>f</sup>	..	-4 to 31 (7 primary) -62 to 1,119 (107 manufacturing)	..	..

-  Strongly outward oriented
-  Moderately outward oriented
-  Moderately inward oriented
-  Strongly inward oriented

a. Estimates are net of exchange rate overvaluation (compared with a hypothetical free trade situation) owing to import protection.

b. Estimates are adjusted for subsidies through credit and tax preferences.

c. Includes agriculture, forestry, and fishing only.

d. These estimates are based on tariff observations only, whereas all other estimates are based on direct price comparisons between domestic and world prices at the border.

e. An extreme case with negative value added in world prices is excluded.

f. Estimate is for 1979-80.

Source: For Brazil 1967 and Philippines 1965: Balassa and others 1971; for Korea 1968, Singapore 1967, and Colombia 1969: Balassa and Associates 1982; for Colombia 1979: Echeverri 1979; for Chile 1967: Krueger and others 1981; for Korea 1978: Nam 1981; and for others: World Bank data.

It may well be, however, that other policies not necessarily part of the inward- or outward-oriented strategies as they have been defined here account for some of the differences in performance. Chapter 4 has already examined the appropriate role of government. Chapter 7 will examine the ways in which other policies affect the allocation of resources and hence the prospects for growth. The rest of this chapter focuses on the links between trade policy and economic growth.

#### *Trade policies and growth*

The advantage of an outward-oriented strategy over an inward-oriented strategy is that it promotes the efficient use of resources. The gains from this go well beyond the ones which are re-

vealed by conventional analyses of the costs of protection (see Box 5.4). The rationing of import licenses, credit, and foreign exchange has invariably generated premiums and, in turn, rent seeking. By dismantling these administrative systems entrepreneurs could direct their energies away from unproductive activities, such as lobbying for changes in regulations. Further gains derive when firms achieve economies of scale: in an outward-oriented regime, the size of the domestic market does not limit the output of exporting firms.

Foreign investment is often attracted to the protected domestic markets of an inward-oriented economy—in the form of so-called tariff-jumping investments. But this kind of investment may actually reduce rather than improve the recipient's welfare. An outward-oriented policy will not at-

#### **Box 5.4 Measuring the costs of protection**

The objective of import tariffs and quotas is generally to raise the domestic price of a product above its world price and thereby stimulate increased domestic production. The attainment of this objective will not be costless, however. Protection generally imposes costs on the citizens of the protecting economy. Moreover, the magnitude of these costs differs between one instrument of protection and another. For example, quantitative restrictions are likely to impose substantially greater costs on society than tariffs that restrain imports to an equal extent.

Protection imposes a variety of costs on society. Economists frequently divide the efficiency costs into consumption losses and production losses. Consumption losses refer to the losses in real income of consumers of the protected product that occur because protection generally induces consumers to buy less of the protected product while paying a higher price. Producers benefit from the higher price and will often respond by increasing their output. A production loss is involved here to the extent that resources have to be drawn from other activities (including production for export), where they can be more efficiently used. Many studies on the cost of protection have attempted to estimate the magnitude of these production and consumption losses: estimates of less than 1 percent of GDP are common. It should be noted that these are annually recurring costs which apply for as long as protection is in force.

These production and consumption losses are not, however, the sole costs of protection. In addition, there can be losses associated with so-called X inefficiency when protection leads to domestic monopoly. For example, monopoly can permit the entrepreneur to relax

and not undertake the necessary effort to minimize costs. Moreover, monopoly can also cause conventional inefficiencies by restricting output.

The cost of protection is also underestimated if the costs of rent seeking and directly unproductive profit seeking are ignored (Box 4.7 in Chapter 4). Lobbies spend resources enacting protection. Similarly, once protection is enacted, it may lead to further resource-wasting lobbying—for example, in pursuit of import quotas carrying scarcity premiums.

Most of the earlier studies which measured the costs of protection have been conducted using "partial equilibrium" methods. In other words, the analysts focused attention only on the industry or sector being protected. But protection has effects which reverberate beyond the sector or sectors in which the initial restraint is imposed. Some analysts have attempted to estimate the costs of protection in models where such secondary effects are allowed for, that is, using "general equilibrium" methods. In principle, such models incorporate *all* the repercussions of protection on production and consumption, including effects on X inefficiency, the terms of trade and income, and employment beyond the industry under consideration. These studies generally provide substantially greater estimates of the cost of protection than do the partial equilibrium studies. For example, recent studies show that removing quotas alone in Turkey in 1978 would have increased its GDP by as much as 5.4 percent (Grais, de Melo, and Urata 1986) and that eliminating tariffs, quotas, and export taxes in the Philippines in 1978 would have increased its GNP by as much as 5.2 percent (Clarete and Whalley 1985).

tract investment projects which depend on the retention of import barriers.

While protected firms are sheltered, often within monopolistic markets, firms under outward orientation face greater competition—and hence incentives to increase their production efforts. So-called X inefficiency—the economic cost of a quiet life—is likely to be greater under inward orientation than under outward orientation.

All of these factors are important, but the scale and persistence of the growth rate differentials between the strongly outward-oriented economies and the others suggest that more subtle economic forces might also have been at work.

**INNOVATIONS.** It is tempting to argue that a more competitive environment for firms could lead to more incentives for increased productivity through technological innovations. Equally, it can be argued that “uncompetitive” profits might be needed before firms will engage in the efforts of technological innovations. Little is known about technological innovation in relation to trade policy. Nonetheless, there is increasing evidence that adoption of new technology has been faster in outward-oriented than in inward-oriented developing economies (see the section below on productivity growth). It is worth noting that exporting firms often benefit from a considerable transfer of technology from abroad, including advice on production engineering and aid in product design and marketing. Exposure to foreign know-how may help to speed innovations.

**SELF-CORRECTING POLICIES.** Arguably, outward-oriented regimes provide self-correcting mechanisms to align the macroeconomic variables that affect growth. For instance, if the exchange rate is permitted to become overvalued, the misalignment is quickly obvious under outward orientation because the balance of trade goes into deficit. In an inward-oriented regime the effect of the misalignment would take the subtler form of rising premiums on import licenses.

### *Savings, investment, and productivity*

Growth performance can be looked at in another way: what has happened to the stock of capital and to its level of productivity? Much work remains to be done on this question, but there are a few indications that outward orientation might have encouraged higher savings rates and productivity growth.

**SAVINGS RATES AND TRADE STRATEGY.** As noted earlier, some outward-oriented economies have achieved spectacular growth in savings rates (Figure 5.2). Lack of empirical work makes it difficult to establish the relationship between savings rates and trade strategies, but several links seem plausible. First, a policy shift from inward to outward orientation should generate additional real income, partly by reducing the misallocation of resources and partly by raising income through multiplier effects as rising exports bring spare capacity into use. In developing countries the marginal propensity to save tends to exceed the average propensity to save, so that the increase in real income would help to raise the average propensity to save.

Another possibility is that domestic savings rise further under outward orientation because a higher-than-average share of income generated by exports is saved. Several studies found a strong positive correlation between export growth and domestic savings, but the issue remains unresolved.

A third link between trade policy and savings may be that high real interest rates are an important incentive for personal (and especially small-scale) savers. Capital markets are often highly distorted and underdeveloped in developing countries, and they tend to be more so in inward-oriented than in outward-oriented economies, even to the point of offering negative real interest rates in some instances. This could discourage savings in some inward-oriented countries (see Chapter 7).

Investment may be financed by foreign savings as well as by domestic savings. Under inward orientation, tariff-jumping foreign investment is common. In contrast, foreign investment is often attracted to exporting industries in outward-oriented economies. Foreign capital is more likely to generate the income (and exports) for its own servicing in export-oriented countries. Overvalued exchange rates maintained by exchange control systems, which are so common in inward-oriented economies, also deter foreign capital inflow.

**PRODUCTIVITY GROWTH.** Proponents of import substitution base their policies partly on the infant industry argument. They argue for temporary protection while firms raise their technical efficiency by creating industrial skills and mastering modern technology. But high protection may have the opposite effect. By limiting competition in sheltered domestic markets, it may inhibit specialization and promote risk aversion among managers (see Box

### Box 5.5 Productive inefficiency under import protection: an example at the plant level

An intensive examination of the cotton spinning and weaving sector in Kenya and the Philippines illustrates some of the productivity losses that can occur in countries in which import substitution is the dominant strategy. Productivity of individual plants in these countries was calculated in relation to productivity in textile mills using identical equipment in industrial countries. Total factor productivity in the two sets of developing country plants ranged from 55 to 73 percent of that in the industrial country factories. On the basis of both engineering and economic analyses, the source of the difference in productivity was decomposed into three factors: the absence of horizontal specialization; technical expertise in management; and task-level productivity in the work force. The results of this decomposition are shown in Box table 5.5. Each number in the table shows the percentage of best-practice productivity in industrial countries realized in each activity. The sources of deviation from best practice are multiplicative, so that the product of the bottom three rows yields the relative total factor productivity shown in the top row.

The main cause of low total factor productivity was the inability of firms to obtain the benefits that specializing in a narrow range of products brings. Inadequate managerial skills reduce total factor productivity by 9 to 25 percent. Surprisingly, once the other productivity-reducing factors are taken into account, labor produc-

**Box table 5.5 Total factor productivity relative to best practice in Kenyan and Philippine textile plants, 1980**

Relative productivity and sources of deviation	Spinning		Weaving	
	Kenya	Philippines	Kenya	Philippines
Relative total factor productivity	0.70	0.73	0.68	0.55
Sources of deviation from best practice				
Horizontal specialization	0.85	0.79	0.63	0.70
Technical expertise in management	0.93	0.91	0.99	0.75
Task-level productivity	0.85	1.03	1.11	1.03

Note: The values are a productivity index of developing country plants relative to best practice in industrial countries.  
Source: Pack 1987.

tivity is close to industrial country levels. Productivity losses from excessive product variety and from inadequate incentives to obtain technical competence have been a standard criticism of import-substituting industrialization. Although it is not correct to attribute all of the shortcomings shown in Box table 5.5 to this strategy, it was undoubtedly an important factor.

5.5). To maintain or improve their market position, however, exporting firms need to keep up with modern technology and bring managerial skills up to international standards.

The empirical evidence is far from conclusive, but postwar experience of productivity growth in developing countries suggests that trade policy is important. Table 5.2 presents data on factor productivity and factor growth in selected developing economies. It shows that total factor productivity increased much faster in the strongly outward-oriented economies than in the strongly inward-oriented economies. The annual growth rate was more than 4.0 percent in Hong Kong and Korea during the 1960s and early 1970s, compared with 1.5 percent or less in Argentina, Chile, and Peru. In India, total factor productivity declined in 1960–79. Singapore is an exception: its total factor productivity declined between 1972 and 1980. But this was a period when the government put an increasing emphasis on industries that required high levels of skill, capital, and technology. The productiv-

ity growth rates of the moderately inward- and outward-oriented groups were similar.

Recent World Bank studies of Turkey and Mexico show that total factor productivity growth was low or declined during periods when foreign exchange control and protection increased. At the level of the individual industry, another World Bank study (covering Korea, Turkey, and Yugoslavia) found that total factor productivity grew faster in most exporting industries than it did in most import-substituting industries.

#### Trade strategy in perspective

The evidence discussed in this chapter suggests that rapid economic growth and efficient industrialization are usually associated with outward-oriented policies on trade. Outward orientation encourages efficient firms and discourages inefficient ones. And by creating a more competitive environment for both the private and public sectors, it also promotes higher productivity and

**Table 5.2 Growth of GDP, inputs, and total factor productivity**  
(percent)

Trade strategy and period	Average growth of GDP	Total factor productivity		Factor inputs		
		Growth rate	Share in GDP growth	Growth of capital	Growth of labor	Share of total inputs in GDP growth
<i>Strongly outward oriented</i>						
Hong Kong 1960–70	9.10	4.28	47.0	7.60	2.97	53.0
Korea, Republic of 1960–73	9.70	4.10	42.3	6.60	5.00	57.7
Singapore 1972–80	8.00	–0.01	–0.1	9.48	5.52	100.1
<i>Moderately outward oriented</i>						
Brazil 1960–74	7.30	1.60	21.9	7.50	3.30	78.1
Colombia 1960–74	5.60	2.10	37.5	3.90	2.80	62.5
Israel 1960–65	11.00	3.40	30.9	13.10	5.00	69.1
<i>Moderately inward oriented</i>						
Mexico 1960–74	5.60	2.10	37.5	3.90	2.80	62.5
<i>Strongly inward oriented</i>						
Argentina 1960–74	4.10	0.70	17.1	3.80	2.20	82.9
Chile 1960–74	4.40	1.20	27.3	4.20	1.90	72.7
India 1959/60–1978/79	6.24	–0.18	–2.9	4.77	1.65	102.9
Peru 1960–70	5.30	1.50	28.3	4.40	2.70	71.7
Turkey 1963–75	6.40	2.23	34.8	6.82	1.02	65.2

Note: Total factor productivity measures the growth of GDP above and beyond the growth in the use of both labor and capital inputs.  
Source: Adapted from Chenery, Robinson, and Syrquin 1986, pp. 20–22.

### Box 5.6 Alternative outward-oriented policies

Ideally, the shift to an outward-oriented strategy from an inward-oriented one can best be accomplished by removing existing trade barriers, devaluing the exchange rate, and relying on the price mechanism to allocate productive resources. In practice, many developing countries—including, for example, the Republic of Korea, Brazil, and Mexico—have used export incentives to offset bias against exports without dismantling all of their import barriers and without devaluing their currencies.

There are several ways to justify this approach. First, devaluations are feared because they may be inflationary. Compared with import restrictions, however, it is unclear whether this is so. Import prices under protection already reflect scarcity premiums, which the devaluation could simply cut into. Second, where import tariffs rather than quantitative restrictions are used, the loss of fiscal revenue in shifting to outward orientation may be a problem for some governments. Third, import tariffs and quantitative restrictions can be used selectively, which stimulates focused resistance to their removal.

Empirical studies, however, underscore the folly of resorting to export subsidies to offset antiexport bias. The selectivity of import barriers is economically damaging. Often governments are not aware of this. A study of the incentive system in Korea shows, for ex-

ample, that effective rates of protection ranged from –38 to 135 percent for eleven sectors in 1978, although average effective rates of protection did not significantly differ between domestic and export sales (Nam 1981). Second, when export subsidies are used to offset the antiexport bias, they have sometimes been captured by selective interests. Third, if import subsidies are used through preferential loans at below-market rates, the choice of production technique may also be distorted in favor of capital, which adversely affects employment. Finally, using import tariffs and export subsidies puts a heavy strain on the government's administrative machinery and encourages evasion, rent seeking, and other directly unproductive profit-seeking activities (Box 4.7 in Chapter 4).

In any event, the alternative route to outward orientation in trade—subsidizing exports—faces two problems. First, where the overvaluation of exchange rate caused by high import protection is large, as in Brazil and Mexico, the export subsidies required to offset the antiexport bias are simply too great. Second, subsidies by developing countries have increasingly become subject to countervailing duties in some industrial countries. The developing countries most frequently subject to countervailing measures by the United States include Brazil, Korea, and Mexico—although export subsidies had been removed in Korea by the early 1980s.

hence faster economic growth. Economies that have followed inward-oriented trade policies have performed poorly.

Many arguments for industrialization through import substitution have been advanced at various times. They are questionable, however, for several reasons. For example, suppose that export pessimism were justified, in the sense that when a country expanded its exports of a primary commodity, the price fell in world markets. The appropriate policy response would then be to levy an export tax on that commodity, not provide blanket import protection for the industrial sector as a whole. Or suppose that the infant industry argument applies and that some sort of government assistance is therefore in order. A policy of restricting imports is unlikely to be the best answer. Subsidies directed at the source of any external benefits avoid the costs of protecting an entire industry from import competition.

The new protectionism in some industrial countries (see Chapter 8) raises an important question for developing countries: can an outward-oriented strategy be successfully adopted in these adverse circumstances? Protection by industrial countries reduces the gains from trade both for themselves and for the developing countries, but developing

countries may only make matters worse by turning inward. In other words, however protectionist the industrial countries, from an economic standpoint the best choice for developing countries is an outward-oriented strategy. But as protection increases, such an orientation becomes much more difficult politically. Note that outward-oriented policies involving export subsidies are increasingly threatened by countervailing actions by some industrial countries. This tilts the balance even more in favor of the policy which, on economic grounds, is in any case the better one: import liberalization combined with currency devaluation, rather than protection offset by export subsidies. Often countries such as Korea have adopted the second approach for their transition from inward- to outward-oriented policies, and it is still in use in such countries as Brazil and Mexico (see Box 5.6).

The evidence in favor of outward-oriented over inward-oriented policies may be convincing, but the issue of *how* an economy may be successfully moved from one to the other is a separate question. Recent experience in Argentina, Chile, and Uruguay suggests that the transition to outward-oriented policies should be carefully phased. Chapters 6 and 7 examine this in greater detail.