Industrialization and the world economy: 
a policy agenda

Industrialization results from the interaction of technological change, specialization, and trade. Good transport, efficient communications, and an educated labor force help to promote the rapid development of industries. Well-defined rules reduce the costs of transactions as specialization increases and economies become more complex. When governments seek to improve the working of markets rather than replace them, the economy generally works better.

This Report has stressed policies that facilitate change, overcome constraints imposed by initial conditions, and use natural resources and infrastructure efficiently. Policies that increase international competitiveness and mobilize domestic and foreign resources are crucial for successful industrialization.

A policy agenda for industrial countries

Because of the weight of the industrial countries' share in world output, trade, and capital flows, sustained growth in the world economy as a whole depends on their policies.

Payments imbalances

Sustainable growth in the world economy calls for policies to reduce the growing payments imbalances between the major industrial countries. If these imbalances continue, the threat of protectionism might become a reality. That would cripple world markets, aggravate the debt problem, and thwart the developing countries in their efforts to adjust.

The current account deficit of the United States and the current account surpluses of Japan and the Federal Republic of Germany are the main source of international imbalance. They reflect the fiscal deficit of the United States and an excess of savings over investment in the other two countries. Because of the large role of the United States in the world economy, any slowing down of its growth without compensating policies of expansion in the surplus countries would act as a drag on the growth of the world economy. The required adjustment means that the countries which previously relied on export demand for output growth may need to remove some of their restraints on domestic demand and ease access to their domestic markets. Adjustment will be less painful if the countries on both sides of the imbalance make a contribution to the process.

Structural rigidities

Macroeconomic policies can be the first step back to international equilibrium, but microeconomic policies are essential to reinforce them. Industrial countries need to remove their structural economic rigidities. Resistance to changes in comparative advantage, technology, and demography has inhibited the movement of labor and capital from old to new activities. These rigidities have limited growth, caused higher unemployment, and retarded industrial development.

Three areas of policy are particularly important. First, the reduction of trade barriers in protected sectors such as agriculture, steel, textiles, clothing, footwear, leather, and shipbuilding would go a long way to increase competition and promote flexibility. Simply shifting the form of protection
from quantitative restrictions—such as VERs and orderly market arrangements—toward tariffs would help to restore the influence of prices. Moreover, a reciprocal reduction of trade barriers in the context of the Uruguay Round will ease political resistance by expanding the exports of industrial countries.

The second area of policy concerns labor markets—particularly those in Europe. The lack of flexibility in these markets has significantly added to Europe’s unemployment problems. The tendency to set wages at the level of the most prosperous regions, geographical and occupational immobility, the high costs of dismissing labor, and high payroll taxes have all inhibited the efficient working of labor markets. High unemployment is, in turn, an obstacle to the removal of trade restrictions, because it fuels anxiety over job losses. Partial remedies include abolishing unnecessary labor market regulations and providing financial help for education, training, and job-related relocations.

Third, industrial regulation and subsidies in agriculture distort goods markets. A gradual withdrawal of agricultural subsidies, together with assistance for industries that need to restructure, would improve flexibility. Alongside reduced protection and more efficient labor markets, these measures would provide more room for expansion without inflation.

A policy agenda for developing countries

Growth in the world economy will help the developing countries to industrialize, but for efficient industrialization their own domestic policies are much more important.

Trade policies

Trade policy reform is a top priority. The fundamental goal should be to increase competitiveness in world markets. This Report has shown that the countries which adopted outward-oriented trade strategies have outperformed those that followed inward-oriented trade strategies—in income growth, export growth, employment, and savings. An outward-oriented trade strategy means lowering trade barriers, replacing quantitative restrictions with tariffs, and adopting realistic exchange rates. The objectives are to improve resource allocation, to force domestic firms to become more efficient by having to compete with foreign firms, and to open the economy to new opportunities.

Replacing quantitative restrictions with tariffs is a useful first step. It lets firms operate in a less restrictive environment, allows them to buy imported inputs more easily, and removes the incentives for unproductive activities. The next step is to lower the level and variation of rates of protection. The simpler the scheme, the better. Getting off to a bold start seems to strengthen the credibility of reform.

Macroeconomic policies

In many developing countries, expansionary fiscal policies have led to inflation, which in turn has distorted relative prices, raised nominal interest rates and the real exchange rate, discouraged savings, and stimulated capital flight. All too often in such circumstances, trade barriers are quickly reintroduced. Experience suggests that macroeconomic stability is a precondition for successful liberalization of financial markets. But seeking macroeconomic stability by cutting government expenditure requires care to protect essential spending on health, education, and the maintenance of infrastructure. Improving the efficiency of public enterprises so as to reduce the need to subsidize them should also help to cut the budget deficit and aid stability.

Complementary policies

For efficiency in resource allocation, prices should reflect the true costs of production. So price controls should be reduced as quickly as possible and eliminated altogether over the medium term. In many developing countries private investment is channeled to specific activities. Direct investment by foreigners is usually controlled even more stringently. If, as far as possible, governments offer similar incentives to all investors, they will increase competition, promote efficiency, and help businesses select technology that fits the country’s resource endowments. Minimum wage regulations have been introduced in many developing countries to protect the wages of particular groups of workers. Reforming these regulations so that they act as a safety net for only the lowest-paid workers will meet equity objectives while reducing the distortionary effects.

The international environment for trade and finance

Steady growth in the world economy would make it much easier for the industrial countries to tackle
their economic rigidities and for the developing countries to adjust their trade policies while pursuing complementary reforms. At the same time, such reforms would help the world economy to grow faster. The aim must be to prevent a vicious circle of stagnation and growing protection and establish instead a virtuous circle of lower trade barriers and faster growth.

The Uruguay Round

The agenda for the Uruguay Round negotiations cover areas of great interest to developing countries: trade in agriculture, tropical products, and textiles and clothing are all included. The developing countries would also benefit from an end to VERs and from the introduction of an effective safeguard code that would ensure that restrictions are limited, temporary, degressive, and nondiscriminatory. The "standstill and rollback" provisions of the Uruguay Round could increase developing countries' access to markets in industrial countries and to the markets of other developing countries.

The Uruguay Round provides a valuable opportunity to prevent domestic protectionist forces from gaining further ground. The timing is opportune. If trade can be liberalized, that will support increased growth in the world economy, reduce payments imbalances, allow countries to address debt repayment difficulties through increased exports, and provide an environment which makes long-term adjustment easier.

Availability of new funds

If developing countries are to adopt the reforms proposed, most will need increased external finance to sustain their adjustment efforts. Trade policy alone cannot achieve much without infrastructure, new investment, and finance for education, health, and human resources. Reforms take time to bring about increased output and exports. Besides, there are limits to how much consumption can be cut in order to free the resources for increased investment. Additional funds will be imperative for the highly indebted countries and for Sub-Saharan Africa. The highly indebted countries need to grow and to service debt at the same time, and without drastic cuts in consumption. They have already made substantial adjustments; without fresh funds to sustain growth their efforts will be in danger. A slowing down of their demand would retard world trade, and their debt problems could become intractable. This would put financial stability in both debtor and creditor countries at risk. Additional finance to support their adjustment efforts should be a high priority for the international community.

The need for concessional assistance for Sub-Saharan African countries is clear. The need to recover from a famine and restore income levels poses a formidable challenge for these countries. Many have undertaken substantial policy reforms despite the handicaps of low commodity prices, inadequate domestic savings, poor infrastructure, and insufficient social expenditures. Policy reforms in these countries need the backing of external finance for education, health, and institution building.

In sum, to improve the world economic outlook and promote efficient industrialization in developing countries, major policy reforms will be needed. Their success will depend to a substantial degree on the commitment of all nations to make the Uruguay Round a success and on the provision of financial support for the adjustment efforts of the developing countries.