

# **Is Industrial Policy Relevant in the 21st Century?**

MEHDI SHAFÄEDDIN



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# CONTENTS

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<b>1</b>	<b>Introduction</b>	<i>1</i>
<b>2</b>	<b>Main Features of the World Economy and Their Implications for Industrialization</b>	<i>4</i>
<b>3</b>	<b>Different Approaches to Industrial Policy</b>	<i>11</i>
<b>4</b>	<b>Contradictions and Double Standards in GATT/WTO Rules</b>	<i>18</i>
<b>5</b>	<b>Shortcomings of the Theory Behind the “Trade Liberalization Hypothesis”</b>	<i>24</i>
<b>6</b>	<b>The World Bank’s Evaluation of the Economic Performance of the MENA Region</b>	<i>28</i>
<b>7</b>	<b>Evidence from History and the Experience of Developing Countries</b>	<i>32</i>
<b>8</b>	<b>A Framework for Development-Oriented Trade and Industrial Policies</b>	<i>37</i>
<b>9</b>	<b>Conclusions</b>	<i>58</i>
	<b>Endnotes</b>	<i>61</i>
	<b>Bibliography</b>	<i>65</i>

## NOTE

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The paper draws to some extent on the author’s book *Trade Policy at the Crossroads: The Recent Experience of Developing Countries* (Palgrave Macmillan, 2005); the last section is a further development of his article “Towards an Alternative Perspective on Trade and Industrial Policies”, *Development & Change*, December 2005.

The author has benefited from comments made by the audience at the conference, to whom go his thanks. Further comments are most welcome and may be sent to him through [M.Shafaeddin@Gmail.com](mailto:M.Shafaeddin@Gmail.com).

# 1

## Introduction

*“... We have learned from mistakes, and I believe we are in a position to make more effective industrial policy.”*  
(Stiglitz, 2005: 27)

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

We have been witnessing two contradictory developments in the world economy and international policy during recent decades. On the one hand, the need for sophisticated trade and industrial policies has increased; on the other hand, economic philosophy has changed against government intervention in the economy. The need for industrial policy has increased because the international market has become increasingly more concentrated; global production, international trade and technology have become more and more dominated by transnational corporations (TNCs); technological

changes have accelerated and production has become more knowledge-intensive. The policy space of developing countries has, however, shrunk due to the dominant views of the orthodoxy. Such views have been reflected in the conditionalities imposed on many developing countries by international financial institutions (IFIs) or bilateral donors and, to a large extent, in GATT/WTO rules. More recently, they have been propagated through the “Washington Consensus”. Meanwhile the across-the-board and universal trade liberalization implemented by developing countries during recent decades has failed, just as the across-the-board import substitution of the preceding decades also failed. Such failures have put trade policy as well as trade diplomacy at the crossroads.

The failure of the top-down approach to trade and industrial policies, through which one-size-fits-all rules are drawn up at the international level and imposed on developing countries, raises a serious question: is there not a need for rethinking trade and industrial policies?

After arguing for the relevance of industrial policy, we will try to present an alternative framework by taking a bottom-up approach in this study. In other words, we will present a relevant framework for what is required at the national level to catch up in the process of industrialization and development and, on that basis, argue briefly for changes in international rules to make them development-oriented. To do so, we will first briefly explore, in Chapter 2, the characteristics of the international economy in the 21st century and their implications for the industrialization of developing countries. In Chapter 3, different views on industrial policy will be examined. Chapter 4 will be devoted to revealing contradictions in the World Trade Organization (WTO) rules and their detrimental impact on development. Subsequently, we will argue that across-the-board and universal trade liberalization is not justified either on theoretical grounds or by historical evidence; by contrast, all successful early and late industrializers have gone through an infant-industry phase. The contradictory views expressed by the World Bank on the economic performance of the Middle East and North Africa (MENA) region are



reviewed briefly before we present an alternative framework for trade and industrial policies. The final chapter is devoted to some reflections on the implications of the alternative framework for international trade rules.

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

# 2

## Main Features of the World Economy and Their Implications for Industrialization

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

### Globalization

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

A global firm enjoys a number of advantages vis-à-vis a newcomer firm from a developing country. Firstly, it has home-based advantages related to technology, experience, market information, marketing and distribution channels, firm-level economies of scale, etc. Secondly, it can benefit from networking and collaboration with other firms. Networking takes place mainly with its own affiliates and allows it to obtain cheaper sources of inputs, technology, intermediate products, distribution channels, etc. (Best, 1990: 260). Its global activities also allow it to expand the scope of the market to enjoy economies of scale, scope and agglomeration. Moreover, a global firm collaborates with other firms through international consortia, cross-licensing

agreements, long-term supply and purchase contracts, joint ventures, strategic and technological alliances and subcontracting. Collaboration with other firms will allow for the sharing of activities such as research and development (R&D), production facilities, marketing, distribution, input procurement, product development and design at the global level without necessarily requiring the firm to directly invest abroad for these activities (Best, 1990: 259-262; and Porter, 1990: 54).

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

**Domination of large global firms**

Global firms (large TNCs) increasingly dominate production and international trade (Table 1). The figures in Table 1 overestimate the share of the top firms in output as the related data at the firm level are measured in terms of output, but those at the global level are quoted in terms of value added. Nevertheless, the data are very telling on the role of TNCs in international trade and provide some indications on their role in world industrial production and total output.

Table 1: The share of top firms in global production and trade (late 1990s)		
Activity	Number	Per cent
All output	200	28
Industrial output	1,000	80
World trade	500	70

**Source:** Mooney (1999: 74).

<b>Table 2: The importance of the largest* industrial enterprises (in or around 2000)</b>					
<i>Description</i>	<i>Total</i>	<i>The share of largest firms with employees more than:</i>			
		<i>10,000</i>	<i>20,000</i>		
			<i>Total</i>	<i>The largest</i>	
				<i>100</i>	<i>25</i>
Number of firms	18,540	8.8	5.1	0.5	0.13
Employees (million)	100.5	77.7	68.0	27.6	7.30
Sales (billion dollars)	2,108.4	76.0	66.8	21.7	6.40

**Source:** Shafaeddin (2005a: 123).

\* In terms of numbers of employees.

Table 2 presents alternative data on industrial enterprises based on a Thomson Financial survey of around 19,000 public listed companies. Again the data are not complete, as they do not include all companies, but the table does provide some information on the degree of concentration of firms at the global level. Accordingly, the largest 945 companies (i.e., 5.1 per cent of the total number of companies surveyed) and the largest 100 firms account for over two-thirds and over one-fifth of total sales of the companies surveyed, respectively. Further, according to the main source, the bulk of large companies are located in the main developed countries, particularly the USA. For example, half of the companies with 20,000 or more employees are located in the United States (accounting for over 62 per cent of their total sales), 22 per cent in six European countries (the United Kingdom, Germany, France, Switzerland, Italy and the Netherlands), 8 per cent in Japan and 19 per cent in the rest of the world. Further, there is greater concentration among United States firms than in the rest of the world. Companies with 20,000 employees or more account for over 85 per cent of sales of all United States companies included in the database, as against 67 per cent for the world (Shafaeddin, 2006b).

In recent years, the size of large TNCs has increased due to intensification in mergers and acquisitions (M&A). For example, one-third of the largest US companies (Fortune 500) listed in 1980 were merged by 1990 and another 40 per cent were merged by 1995 (Shafaeddin, 2006b). Moreover, in the five years between 1997 and 2001, the number of cross-border M&A with values of over \$1 billion reached 450 cases, almost three times greater than the corresponding number for the preceding 10 years. In terms of value, it was 4.5 times greater over the same period (based on UNCTAD, 2005: 9, Table 1.1). The large global firms dominate almost all industrial activities as well as services (Shafaeddin, 2005a: 123-125) and have control over technology, particularly technology over which they enjoy patent protection through WTO rules.

## **Technology**

During recent decades, technologies have become more sophisticated, more specialized and subject to rapid changes. Such developments in technology imply that production has become more knowledge-intensive, skills have become more firm-specific and specialized, and the period of learning has become longer (Lundvall, 2004). At the same time, newcomer firms run higher investment risks because during the gestation period of their investment new technologies may arrive, making the existing process obsolete or putting the existing product out of the market. As new technology is mainly possessed by large TNCs, the barriers to entry are set at a higher level for newcomer firms.

## **Strategic behaviour of global firms and its implications**

An important feature of global firms is that in their main activities, i.e., networking, intra-firm trade<sup>2</sup>, inter-firm cooperation, etc., they do not go through the market (Porter, 1990: 60-62). Further, while the role of large TNCs in economic activities has increased, the role of the government in decision-making and allocation of resources has shrunk during recent decades

due to economic liberalization. In other words, the role of large firms in the coordination of economic activities has been increasing relative to markets and governments.

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

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

Lazonick (1991) has shown that the combination of technological innovation and organizational capabilities, resulting from experience and firm-level economies of scale, provides the large established firms with the possibility of pursuing an “innovative strategy” based on high fixed costs rather than an “adaptive strategy”. This strategy allows them to invest a large amount to develop and utilize productive resources which can bring about new products of higher quality and/or new processes with lower cost. The economies of scale allow them to reduce the unit cost of production, lowering prices and selling more. The decline in the production cost and prices in this case is totally unrelated to factor costs.

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

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

In short, globalization has changed the nature of competition in the international market in three main ways. Firstly, it has enhanced the “strategic competitive advantage” of large established firms. Secondly, it has intensified the process of Schumpeterian “dynamic competition” and “creative destruction”. In such a process firms are continuously active in innovation, product development, quality improvement, shortening of delivery time, etc. As a result, the role of “non-price attributes” of products in competitive advantages has increased. Finally, the growing size, control of technology, experience and strategic behaviour of established firms place them in a position of superior “competitive advantage” vis-à-vis newcomer and independent firms of developing countries. Such attributes limit the prospects of the latter firms for entry into the international market because unlike the

established firms of developed countries, only cheap labour and/or raw materials are their main source of competitive advantage.

The increased cost of technology, the prolonged period of learning, the augmented risks of investments<sup>3</sup> – all these factors have increased the need for government support of infant industries/firms in a developing country unless integration into the world economy through the channel of foreign direct investment (FDI) is feasible and conducive to industrialization. In theory, there are two main methods through which governments can provide support to infant industries. One is by creating an environment which contributes to the prevalence of external economies; the other is the provision of support for specific industries and firms. External economies can shift the cost curve of firms downward. Specific support can enhance their earnings for a given cost curve in a particular period. External economies can arise from functional intervention in the economy through general government investment in education, training, infrastructure, institutions and back-up services. They can also arise from collective efficiencies resulting from industrial districts and clustering, both of which require government support.<sup>4</sup> While external economies are important, development of a specific infant industry requires provision of temporary support to that industry through either subsidies or imposition of tariffs or some other means. In practice, however, the policy space of developing countries has been shrinking in recent decades, restricting their ability to use such measures.

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



# 3

## Different Approaches to Industrial Policy

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

### **The orthodoxy and WTO rules**

Since the early 1980s, there have been changes in the dominant economic philosophy in favour of neo-liberalism, which do not favour government involvement in economic activities beyond some functional intervention in the form of investment in education, health and security, etc. (see, for example, World Bank, 1987 and 1993). The argument is that the development of a country should be left basically to the operation of market forces; trade liberalization would change the structures of incentives in favour of exports and attract private investment, including FDI, to the areas in which a country has comparative advantage, leading to industrialization and growth (see Shafaeddin, 2006a for a survey). This process, however, has its own limitations in enhancing industrialization of developing countries (see below);

further, it increases the risks and vulnerability of these countries to decisions of global firms to relocate plants from one country to another.

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

- The Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) restricts the application and transfer of technology to developing countries and their development of generic drugs by protecting intellectual property rights, limiting the use of patented technologies or products (patents are protected for a minimum of 20 years) and restricting the government's ability to demand that a firm license a patent to other firms.
- The Agreement on Trade-Related Investment Measures (TRIMs) restricts the imposition of "performance requirements", such as local-content and export requirements and trade balancing, on foreign firms. It also forbids "national preference", i.e., preference for the purchase of local products, a practice pursued sometimes in government procurement.
- The General Agreement on Trade in Services (GATS) exposes domestic services companies to severe competition with established foreign companies through requirements for "most favoured nation" treatment and "national treatment" in the use of inputs, local employees, and access to the local market, etc.<sup>5</sup>
- The Agreement on Subsidies and Countervailing Measures (ASCM) prohibits the use of targeted subsidies for supporting domestic industries and export expansion (except for agricultural goods).

Wade (2005), summarizing the impact of the first three agreements above, concludes: "With a touch of hyperbole the agreements could be called a slow-motion Great Train Robbery" (Ibid: 89). Nevertheless, the detrimental impact of the ASCM on manufacturing production and exports is not any less than the adverse effects of the other three agreements. Subsidies have

been a major instrument of infant-industry protection and export expansion in many developing countries, particularly East Asian ones. Under the WTO rules, subsidies provided for the expansion of exports and export supply capabilities are not allowed (ASCM, Articles 3 and 8). Article 3 of the ASCM prohibits subsidies from being paid to firms (except for agricultural products) contingent “upon export performance” or “upon the use of domestic over imported goods” (inputs). The definition of subsidies for export performance includes “direct subsidy”, currency retention, preferential internal transport and freight charges on export shipment as against domestic shipment, and preferential provision of “imported or domestic products or services for use in the production of exported goods” (ASCM, Annex I).<sup>6</sup>

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

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

least 110 per cent of the country average. Article 8.2(c) allows, under certain conditions, assistance for the adaptation of existing facilities to new environmental requirements of up to 20 per cent of the related cost on a one-time basis, provided it is available to all firms concerned (Shafaeddin, 2005a).

### **The opponents**

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

A number of points are worth mentioning with respect to Amsden’s proposal. Firstly and most importantly, the policy space of developing countries is being limited not only by WTO rules, but also by IFIs and bilateral donors. Therefore, even when the use of a policy tool is allowed under the WTO rules, Structural Adjustment Programmes (SAPs), Stabilization Programmes (SPs) or even bilateral donors may not necessarily permit a developing country to implement it. Secondly, under current WTO rules the “control mechanism” (the performance requirements) is limited, as mentioned earlier. Thirdly, the provision on subsidies to R&D activities was for a trial period of five years and is no longer applicable. The trade-balancing requirement is allowed only in accordance with “the balance-of-payments clause”, i.e., for a limited period when a country faces balance-of-payments problems. Otherwise, it is forbidden under the TRIMs Agreement.

Fourthly, developed countries are trying to limit the policy space of developing countries even further through the Doha Round and beyond (see below). Finally, the problem is not only that WTO rules are not conducive to development, but they also suffer from many contradictions in design and in implementation of the agreed rules by developed countries. In fact, certain GATT/WTO rules limit the policy space of developing countries but leave the governments of developed countries with a relative free hand (see below). The only possibility under WTO rules to encourage exports indirectly, not mentioned by Amsden, is by locating export activities in the “disadvantaged” regions. In this case they could benefit from non-specific subsidies provided to all industries in those regions. Nevertheless, the use of such a mechanism would only be possible for a short period, because as more industries are located in such regions, they will not remain disadvantaged for long.<sup>8</sup>

According to Rodrik (2004), rumours of “industrial policy’s death” are exaggerated.

The reality is that industrial policies have run rampant during the last two decades – and nowhere more so than in those economies that have steadfastly adopted the agenda of orthodox reform. If this fact has escaped attention, it is only because the preferential policies in question have privileged *exports* and *foreign investment* – the two fetishes of the Washington Consensus era – and because their advocates have called them strategies of “outward orientation” and other similar sounding names instead of industrial policies (Ibid: 28-29).

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

Rodrik argues that the market does not bring about industrialization on its own, and that as market failures prevail, government intervention is required.

It is in this context that he advocates the need to “get the policy process right” and maintains that this can be done, through a “discovery process” by which “private and public actors come together to solve problems, including those caused by market failure, in the productive sphere, each side learning about opportunities and constraints faced by the other” (Ibid: 3). In such a process “firms and government learn about underlying costs and opportunities and engage in strategic coordination” to remedy market failures which restrict self-discovery (Ibid: 10). Referring to external constraints and the restrictions on policy space imposed by international rules and conditionalities, Rodrik, like Amsden, argues that (external) restrictions are exaggerated; there is still some room for manoeuvre to implement industrial policy.

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

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

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

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

# 4

## Contradictions and Double Standards in GATT/WTO Rules

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

### Design

According to the preamble to the General Agreement on Tariffs and Trade (GATT, 1947), trade liberalization is the objective of the Agreement. Let us assume for the moment that universal trade liberalization is conducive to industrialization and development of developing countries. Yet, one can find many general and specific “Animal Farm”-type exceptions in the GATT/WTO rules which run contrary to this general principle of trade liberalization and which favour developed countries.

With respect to general contradictions, first of all, the GATT/WTO rules aim at reducing government intervention in the flow of trade, but are silent about eliminating, or at least reducing, the monopoly, or oligopoly, power of TNCs. In fact, if anything, the governments’ controls on these companies have been relaxed through the TRIMs Agreement and GATS, as mentioned above.



According to Wade:

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

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

Thirdly, while trade in manufactured goods was supposed to be liberalized, labour-intensive products of main interest to developing countries have been subject to special restrictions (e.g., textiles and clothing had been subject to the Multi-Fibre Arrangement (MFA) until recently) or tariff peaks and tariff escalation.

There are also specific contradictions in various GATT/WTO agreements which favour developed countries but are detrimental to the interest of developing countries. For example, as mentioned earlier, the ASCM allowed subsidization of R&D, the main infant activity of interest to developed countries, and agriculture, but not for manufactured exports, an infant activity of interest to developing countries. In the Agriculture Agreement, subsidies used by developed countries (as in R&D, crop insurance, and so on) are allowed, but those most used by developing countries (e.g., input and land improvement subsidies) are subject to countermeasures (Das, 1999: 157).<sup>10</sup> Furthermore, a long period (20 years) of infant-industry protection of new technologies and new products is allowed under the TRIPS Agreement, but temporary infant-industry protection of new industries, or new export activities, in developing countries is not allowed (see Shafaeddin, 2005a:

Chapter 8 for details). Again in the TRIPS Agreement, while the developing countries' obligations on the rules governing patents are binding, their rights are not. By contrast, developed countries' rights are binding, but their obligations are not (Wade, 2005: 83-84).<sup>11</sup>

## **Implementation**

Developed countries have not fully implemented the rules to which they have agreed in the GATT/WTO. There has been a lack of proper implementation of, among others, SDT provisions for developing and particularly least developed countries, the Agreement on Textiles and Clothing and the Agreement on Agriculture (the so-called cotton scandal is only one example), while the anti-dumping rules and safeguard measures have been abused. Above all, the major developed countries have provided extensive targeted support for their industries and firms against the WTO rules (see Shafaeddin, 2005a: Chapter 8 for details).

## **Doha Round**

The Doha Round is supposed to be a "Development Round". The outcome of the Round has not been decided yet, and the text of the Round's Hong Kong Declaration of December 2005 is vague in many respects, particularly on "non-agricultural market access" (NAMA, which is concerned with trade in manufactured goods). Nevertheless, many of the proposals which have already been made by developed countries are in contradiction with the stated objectives of the Round. Such contradictions were best expressed by a delegation from a developing country in Hong Kong during the WTO meeting of December 2005: "The developed countries talk in the plenary halls of a round for free for developing countries. Then they move into the green room and continue to ask for a round for free, this time for themselves" (Oxfam, 2005: 8).

Generally speaking, GATT/WTO rules and decisions recognize the need to take into account the special needs of individual developing countries and

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

- The higher the initial tariff rate, the higher is the rate of reduction in the tariff.
- The lower the coefficient, the higher is the rate of reduction in the tariff.
- For high tariff rates the rate of reduction in the tariff under the Swiss formula is higher than it is under a simple linear formula (according to which the same percentage reduction is applied on all tariff lines). The Swiss formula “has lower rates of percentage reduction than those generated by a tariff independent linear reduction in a certain range of low tariff rates” (WTO, 2003: 4).

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

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

There is other evidence of double standards by developed countries. For example, while they try to impose caps on industrial tariffs, they refuse to do so for agricultural products. Similarly, while demanding a significant cut in the industrial tariffs of developing countries, they proposed only a very conservative cut in their agricultural tariffs and abolishment of agricultural export subsidies by 2013, but no change in domestic support to agriculture, which is far more important than export subsidies. Further, the EU proposal

on agriculture exempts European sensitive products from steep cuts, and asked for special safeguard measures for a number of their agricultural products (beef, poultry, butter, fruits, vegetables and sugar). More importantly, both the EU and the USA have made their already conservative proposals for liberalization of agricultural trade subject to drastic liberalization by developing countries of trade in both industrial products and services. This is against the agreed clause on less than proportional liberalization in favour of developing countries in the Doha Round.

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

# 5

## Shortcomings of the Theory Behind the “Trade Liberalization Hypothesis”

*“The argument against industrial policy is based on a naïve reading of economic theory and misreading of economic history.”*

(Stiglitz, 2005: 25)

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

The orthodoxy argues against government intervention in the economy in general, as mentioned above. The theoretical argument against government intervention in production and trade is based mainly on the premise that markets are competitive and function well and there is no market failure, but that government failure is pervasive. In the particular case of international trade, policy reform has been envisaged as being synonymous with “uniform” across-the-board import liberalization, applicable “universally” to all developing countries. This is a general theoretical abstraction which is, in turn, based on the theory of comparative cost advantage according to which universal free trade will lead to an efficient reallocation of world resources. This theory can predict and explain, under free trade and certain assumptions, the division of labour between industrial countries and developing countries

and the specialization of the latter in the production and export of primary commodities and labour-intensive products. But the theory, whether in its static or so-called dynamic version, cannot explain the process of “catching up” and upgrading by latecomers.

The theory of comparative cost advantage is based on unrealistic assumptions such as the existence of competitive and perfect internal and international markets, the small size and “passivity” of firms, the absence of “market inadequacy”<sup>15</sup>, constant returns to scale, and the absence of externalities and other causes of market failure. Moreover, according to this theory, all countries are at the same level of technological development, technology is readily and freely available to their firms, the mix of goods and services is the same in all countries and each product is produced with the same technology in different countries. Further, as all firms are small, they do not play an active role in pricing, technological development, capacity building and the learning process. Full employment, mobility of factors of production between industries, and lack of uncertainty and risks are other unrealistic assumptions of this theoretical abstraction. Accordingly, there is no need for government intervention, whether functional or selective, as no sector or industry plays a particular role in providing positive externalities.

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

Although sometimes they pay lip service to the question of growth, the main concern of neo-liberals is allocative efficiency.<sup>16</sup> For example, John Williamson, the initiator of the Washington Consensus literature, admits that “none of the ideas spawned by ... development literature ... plays an essential

role in motivating the Washington Consensus ...” (see, for example, Williamson (ed.), 1990: 19). In other words, what is recommended by the orthodoxy does not contribute to “catching up”, industrialization and development beyond a short-term gain achieved through allocative efficiency. Concentration on allocative efficiency is, in fact, one of three main interrelated issues in Adam Smith’s theory of international trade which has been the basis of the neo-classical theory of trade and the “trade liberalization hypothesis”. The first is Smith’s “focussing attention on the allocative functions of the markets to the exclusion of their creative functions – as an instrument for transmitting impulses to economic change” (Kaldor, 1972: 1240). The second is his concern with “interchangeable value” (international trade) as against “productive power” (economic development) (List, 1856: 253). Thirdly, Smith introduced his universal theory of free trade for the “cosmopolitan economy”, i.e., the economy of mankind as a whole, believing that free trade would maximize the welfare of the world economy as a whole. He, in fact, did not distinguish between the interests of individuals and of mankind in general. He ignored the fact that some nations may give more weight to their own welfare than to the collective welfare of humanity. Yet, he thought that what was in the interest of Britain was also in the interest of the world as a whole (List, *ibid*: 245-246, 74 and 261).

A number of famous neo-classical economists do admit that free trade is an “ideal” as the theory of comparative advantage is based on abstract assumptions (Haberler, 1950: 227; Corden, 1974: 7-8; Samuelson, 1938: 226 and 1939: 195; and Viner, 1953: 4-5). For example, according to Samuelson, “some trade is better than no trade, but that does not necessarily imply that free trade is the optimum for any country” (Samuelson, 1938: 266).<sup>17</sup> Jacob Viner (1953: 4-5) correctly maintains that Smith and other classical economists took a cosmopolitan approach because they thought that what was in the interest of England was also in the interest of the world as a whole. Viner admits that what was relevant to their time and country may not necessarily be relevant for other times and other countries, and, in particular, it may not be relevant for “economically less advanced countries” at any time. Hence, “it is today always necessary, as it was for the English



classical economists, to be perfectly clear whether we are considering a problem, say, commercial policy from a national or from a cosmopolitan point of view” (Viner, 1953: 5). Despite such reservations by famous neo-classical economists, in the end free trade remains the “religion” of neo-liberals. Such an ideology is, for example, evident in some of the documents of the World Bank on the Middle East and North Africa (MENA) region.

# 6

## **The World Bank's Evaluation of the Economic Performance of the MENA Region**

THE World Bank praises the socio-economic performance of the Middle East and North Africa (MENA) region between 1965-85 as unprecedented in terms of growth of output, poverty reduction, income equality, reduction in mortality rates, increase in life expectancy, literacy levels and school enrolment (World Bank, 2004: 14). By contrast, it regards the economic performance of the region in more recent decades as disappointing, particularly in the areas of trade and private investment, and attributes its weak performance to weak policies and weak governance (World Bank, 2003a: 1-2; 2003b: 2, 8-9 and 10) and high tariffs (World Bank, 2005: 156-162). Accordingly, it advocates deepening and accelerating market-oriented reform and a shift to export-oriented activities (World Bank, 2003a: 2) as trade is “likely to be a key source of growth in the MENA region in the next decade and beyond” (Ibid: 4).

The Bank's reports, however, suffer from some important contradictions. Firstly, it is not clear on what ground it is assumed that the governance capacity of these countries in general became weaker during the 1980s-1990s than in the previous decades. In fact, the World Bank shows that the quality of governance in the region increases with the income level (World Bank, 2003b: 5). As income in all countries of the region increased during the period concerned, although slowly, the governance capacity could not have become weaker. One should search elsewhere for the reason for their sluggish performance.

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

Thirdly, referring to a few successful cases of China, India and Vietnam, the Bank argues that “the content, pace, and sequencing of reforms [should] be tailored to specific settings” (World Bank, 2003a: 5):

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

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

The report does not pay enough attention to a crucial difference between the reforms in China, India and Vietnam and those implemented in Argentina and Brazil. The former group of countries, as well as other East Asian countries, have designed their trade reform programmes – at least until recently on their own – as a part of their long-run industrial policy and liberalized selectively and gradually. By contrast, Argentina and Brazil, and many other developing countries, have been under the influence of the Washington Consensus or under pressure from IFIs and embarked on shock therapy and across-the-board trade liberalization. Let us also mention that the rapid development in the MENA region during 1965-85 was partly due to the growth of oil-exporting countries of the region as a result of increases in oil revenues. Nevertheless, 1965-85 was the period during which the governments of the region heavily intervened in the economy and most countries were engaged in import-substitution industrialization.<sup>18</sup> By contrast, during more recent decades they have been influenced more than before by external pressure, interference or advice in policy-making, as mentioned above.

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

In retrospect, it is *clear* [our italics] that in the 1990s we often mistook efficiency gains for growth. The “one size fits all” policy reform approach to economic growth and the belief in “best practices” exaggerated the gains from improved resource allocation and their dynamic repercussions, and proved to be both *theoretically incomplete and contradicted by the evidence* [our

italics]. Expectations that gains in growth would be won entirely through policy improvements were unrealistic. Means were often mistaken for goals – that is, improvements in policies were mistaken for growth strategies, as if improvements in policies were an end in themselves (Ibid: 11).

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

# 7

## Evidence from History and the Experience of Developing Countries

*“We cannot go back to the past. But neither should we fail to recognize the failures of the present.”*

(Stiglitz, 2005: 32)

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

The experience of all successful countries, whether early industrializers or latecomers – including Great Britain – indicates that industrialization began on a selective basis and continued in the same manner until the industrial sector was consolidated. Further, when their industries matured, they began to liberalize selectively and gradually. In the case of the USA, when the country tried to liberalize prematurely in 1847-61, the industrial sector

suffered and the country had to revert to protectionism against imports from Great Britain. In all successful cases government intervention was not confined to trade, and the state intervened through other means; trade policy was not the only contributory factor to their success. The government directly and indirectly intervened, in particular, to develop the necessary institutions and infrastructure and promote investment. In all cases industrialization was supported by growth in the agricultural sector. The Corn Laws in Great Britain and protection of rice production in East Asian countries are only two examples. While different countries did not follow exactly the same path, all learned from the experience of others; the USA learned from Great Britain, Germany from the USA, Japan from Germany and the Republic of Korea from Japan, etc. (see Shafaeddin, 1998).

Finally, in all the major early industrializers – Great Britain, the USA, France, Germany – when the industrial sector matured, they used tariffs as a bargaining tool in trade negotiations or pushed for open markets in other countries. In the 19th century 5 per cent rules (according to which 5 per cent was the maximum tariff rate allowed on any import item) were imposed on colonies and semi-colonies through “unequal” bilateral treaties and/or through force (e.g., the imposition of the opium war on China). During recent decades, developing countries have been pushed through multilateral organizations and bilateral trade agreements to open their markets (Chang, 2005a: 10; and Shafaeddin, 1998).<sup>19</sup> Further, in the 19th century, limiting the policy space of the colonies was not confined to the 5 per cent rule. “High value-added manufacturing activities were outlawed in the colonies and competing export items from colonies were banned. Instead, production of primary products was encouraged” (Chang, *ibid*: 7). During recent decades, tariff peaks, tariff escalation and arbitrary anti-dumping measures have been among the means of restricting imports of high-value-added products to developed countries.

The result of forced liberalization on colonies and semi-colonies in the 19th century was slow growth. “In all parts of the developing world, economic growth accelerated dramatically after the end of imperialism” (when they regained their policy autonomy) (Chang, 2005b: 64).<sup>20</sup>

The available evidence on the impact of across-the-board trade liberalization on developing countries during recent decades is similarly disappointing, although the neo-liberals and the neo-liberal-oriented institutions try to convince us to the contrary (see, for example, Sachs and Warner, 1995).<sup>21</sup> The studies presented by the neo-liberals, however, suffer from many methodological problems. In fact, the results of cross-sectional studies have revealed little or no evidence that there was any statistically significant correlation between trade barriers or openness and economic growth in recent decades (Rodriguez and Rodrik, 1999; Wacziarg and Welch, 2003; ECLAC, 2002). More importantly, UNDP (2003) finds a positive correlation between a country's tariff rate and growth rate for the 1990s. There is also some evidence that trade liberalization has led to de-industrialization of low-income countries, particularly in Sub-Saharan Africa (Bennell, 1998; Shafaeddin, 1995; Noorbakhsh and Paloni, 2000; and Thoburn, 2002).<sup>22</sup>

Not only has the experience of across-the-board and universal trade liberalization been disappointing, but the result of the economic reform in general proposed by neo-liberals has also been unsatisfactory. According to Professor Joseph Stiglitz: "Today the inadequacies of Washington Consensus reform are apparent ..." (Stiglitz, 2005: 31). He maintains that stabilization policies do not ensure either growth or stability; the benefits of trade liberalization are questionable – in particular, "workers move from low-productivity jobs to unemployment" instead of moving to high-productivity jobs; capital market liberalization does not necessarily lead to faster growth and exposes the countries to higher risks; privatization often leads to higher prices of utilities; and the adverse social consequences of wrong policies imposed on developing countries have been seen in many countries (Stiglitz, *ibid*: 16-18).

In a study of a sample of about 50 developing countries for the period 1980-2000, the present author has shown that the results of trade liberalization have been mixed (Shafaeddin, 2005a and 2006a). Twenty countries experienced rapid expansion of exports of manufactured goods. In a minority of these countries, mostly East Asian newly industrializing economies (NIEs),



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

The reform programmes designed by the IFIs failed to stimulate private investment, particularly in the manufacturing sector; the ratio of investment to GDP fell even where the inflow of FDI was considerable, such as in a number of Latin American countries including Brazil. While trade liberalization changed the structure of incentives in favour of exports, the

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

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

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



# A Framework for Development-Oriented Trade and Industrial Policies

WE do not intend to present a blueprint for trade and industrial policies, industrialization, upgrading and economic development in general. Each country's particular situation has to be taken into account. Nevertheless, drawing on the experiences of both early and late industrializers, some elements of an alternative trade and industrial policy can be outlined: trade policy should be development-oriented, country-specific and based on the realities of the international market, and allow for the dynamic and changing relative roles of the market, firms and government in coordinating economic activities over time. Further, the policy should be selective, mixed, dynamic and predictable in nature, and pay attention to the complementary roles of “non-price factors” and agriculture. Trade policies should enhance productivity rather than rely on repeated devaluation. Finally, FDI should be used selectively and effective management of capital flows should be ensured.

## **Development orientation**

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

Following Myrdal (1971: 356), we define development as “the movement of the whole social system upward”. Therefore, it is a dynamic process involving, *inter alia*, not only growth but also the raising of the standard of living of the population and providing them with employment. Trade policy should contribute towards achieving these objectives. Export expansion should not take place simply for export’s sake. The aim of export development and competitiveness is not to keep wages and other income of citizens low; otherwise, ends are sacrificed for means (Paus, 1989). Similarly, integration into the world economy should not take place just for the sake of integration. Wade (2005) correctly argues that development is more about internal integration than external integration. Internal and external integration should reinforce each other as external integration is beneficial only if it contributes to internal integration (Wade, 2005: 94-95).

Specialization on the basis of the theory of comparative cost advantage is necessary to begin the process of industrialization, but if a country stops at producing and exporting labour-intensive and resource-based goods, its development objectives will not be met in the long run. In order to convert the industrial sector “into gradual acquisition of retainable industry”, there is a need for upgrading of the industrial structure in accordance with dynamic comparative advantage (Gomory and Baumol, 2000: 71). Such advantage is, however, “made not given”, and it will not be achieved through the operation of market forces alone. A country can develop comparative advantage in an industry of its own choice through government action (Cline (ed.), 1983: 155-156).

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

## **International market structure and the “competence gap”**

The design of trade policy should be based on the realities of the international market and the specific condition of each country rather than on some theoretical abstraction. In a world where the characteristics of the market are different from the premises of the trade liberalization hypothesis, relying on market forces alone will not lead to the achievement of dynamic comparative advantage. In such a world, international prices are distorted by the activities and interests of large oligopolistic firms, governments of industrial countries, maldistribution of income and assets among developed and developing countries, and by the tastes and technologies possessed by the former. Further, as mentioned before, the increasing market concentration, the growing technological competence gap between developing and industrialized countries, and other developments in the world economy have increased the role of knowledge and experience in industrialization. Thus the period of learning has lengthened.

In such a world, the need for infant-industry support has increased. Some support is initially required for penetrating the international market. Whether the necessary support should be provided through protection or subsidization of output, or factors of production, is a secondary issue. The main point is that infant-industry support is needed not only for import substitution but also for export promotion. For a newcomer, the unit cost of production is high not only in industries subject to economies of scale but also in all other industries, due to the lack of experience and knowledge (Fontaine (ed.), 1992). Infant-industry support is therefore unavoidable. List (1856), Mill (1965), Stiglitz (1996), Wade (1990), Dasgupta and Stiglitz (1988), Redding (1999), Buffie (2001), Senghaas (1989) and Shafaeddin (1995 and 2005a) are among those who have argued in favour of *temporary* and selective infant-industry protection.

## Country specificity

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

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

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

dynamic perspective on comparative advantage requiring government intervention.

The only case in which, on mere principles of political economy, protecting duties can be defensible, is when they are imposed temporarily (especially in a young and rising nation) in hopes of naturalizing a foreign industry, in itself perfectly suitable to the circumstances of the country. The superiority of one country over another in a branch of production often arises only from having begun it sooner. There may be no inherent advantage on one part, or disadvantage on the other, but only a present superiority of acquired skill and experience. A country which has this skill and experience yet to acquire, may in other respects be better adapted to the production than those which were earlier in the field; and besides, ... nothing has a greater tendency to promote improvements in any branch of production than its trial under a new set of conditions. But it cannot be expected that individuals should, at their own risk, or rather to their certain loss, introduce a new manufacture, and bear the burden of carrying it on until the producers have been educated up to the level of those with whom the processes are traditional. A protecting duty, continued for a reasonable time, might sometimes be the least inconvenient mode in which the nation can tax itself for the support of such an experiment (Mill, 1965: 918-919).

### **The role of the market, firms and government**

The market definitely has a role to play in the process of industrialization and development. Nevertheless, it can deal only with gradual and marginal changes. It is “inadequate” on its own to accelerate growth of supply capacity, promote dynamic comparative advantage and upgrade technological capabilities. There is a need for government intervention. Moreover, “... there is no way that the government can avoid forming a ‘vision’ of where the economy is going” (Stiglitz, 2005: 29).

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

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

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

The risk of government failure is not an argument in favour of leaving everything to the mercy of market forces. After all, the market is not and cannot be the only coordination mechanism. The coordination of economic activities at both domestic and international levels takes place through a “coordination system” (Shafaeddin, 2004a), that is, the combination of markets, state and firms, complemented and supported by “non-price factors”.



Nevertheless, in contrast to the orthodox approach according to which firms are passive, the firm is the driving force in such a coordination system, around which the other coordination mechanisms operate. Hence, government action and policies should complement the market, but not replace it.

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

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

Nevertheless, initially the key role in breaking the vicious circle is to be played by the government. As we mentioned earlier in this paper, market forces *per se* will develop neither the market nor the “non-price factors” rapidly. During the early stages of development, the direct participation of the public sector in industrialization may become essential, particularly in areas where the private sector is not prepared to invest because of existence of high risks, or in industries which involve significant externalities. As the private sector and the market develop, public ownership and the role of the government may gradually be reduced. Experience, however, indicates that the development of infrastructure, institutions and back-up services and provision of information cannot be left to the private sector entirely because of the need for significant overhead investment and the involvement of externalities. Further, the “government could, in principle, enhance the efficiency of the market” (Stiglitz, 2005: 25) and make it more development-friendly (Wade, 2005; Lall, 2004; Stiglitz, 2005; and Shafaeddin, 2004a). Moreover, the “government has the responsibility, and the opportunity, for shaping the economic environment” (Stiglitz, 2005: 31).

It is sometimes argued that even if the application of industrial policy of one type or another is justified, the capacity of the state in developing countries is insufficient for its efficient implementation. It is partly for this reason that it is argued the East Asian experience is not replicable in other countries. A couple of points are worth mentioning in this respect. Firstly, the state capacity of many developing countries today is not necessarily inferior to that of the Republic of Korea in the 1950s and 1960s, or Thailand in the 1960s and 1970s. Secondly, even if it were, the capacity of the state can be improved, but missing markets will not develop on their own and market failures will not correct themselves automatically. Thirdly, and more importantly, there is a contradiction in the logic used in the argument on the capacity of the state in developing countries. Wade correctly states that:

... ironically, the world is proceeding on the assumption, in the TRIPS agreement, that developing country states do have a considerable capacity to enforce patents and copyrights. It is not

obvious that a state that can do this would not also be able to implement effective protection and other forms of policy (Wade, 2005: 94).<sup>25</sup>

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

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

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

## Features of trade and industrial policies

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

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

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

If a government observes that manufacturers are producing goods lower in quality and higher in price than those made abroad and if

it is satisfied that this is the fault of the local industrialists it should offer substantial prizes as a reward to those manufacturers who, within a specified period, are able to make goods which approach those made abroad in quality and price. The ability to manufacture such goods regularly should also be considered when awarding prizes. Acceptance of such an award should be conditional upon a firm allowing workers employed elsewhere to visit its factory so as to improve their technical knowledge (List, quoted in Ho, 2005: 739).

Similarly:

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

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

Almost all successful industrializers applied some sort of performance requirement, or “control mechanism”, to discipline the protected industries or manage the foreign companies. For example, in East Asian countries subsidies were provided in exchange for performance, including export performance (Amsden, 2005 and 2001). As far as FDI is concerned, in Japan and other East Asian countries the right of foreign firms to sell in the domestic market was linked to the increase in production of parts and components or, in the case of Thailand, hiring local managers (Amsden, 2005: 222). The

USA and other developed countries also have applied requirements of one kind or another even during the 1990s (Kumar, 2005: 182-185). Amsden distinguishes three major types of performance standards:

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

To continue, as domestic capacity is developed in an industry, all measures should be taken to allow the firms involved to enter the foreign market rapidly. At this stage the relevant firms need to improve efficiency and quality if they are to compete in the internal and international markets. But the disadvantages of cost, external economies in market search and marketing, lack of experience in exporting and marketing, and risks related to entry barriers require “infant export protection/support” through export subsidies, tax holidays and/or fiscal incentives. Infant-industry support is thus not confined to the import-substitution phase of production. Government intervention should be more evident during the second stage of infancy, i.e., when the infant industry starts to cut into the international market.

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

The enterprises must be made to know in advance that infant-industry support during its first and second phases is temporary. They should also know the

schedule of the phaseout of this support. The pressure for improved efficiency should eventually take the form of gradual liberalization of imports of final goods.

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

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

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

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

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



technology in turn necessitates “infant” support because of the risks and dynamic external economies of learning involved.

To exemplify the evolution of dynamic and mixed trade policy over the period of industrialization, we have presented the example of tariffs, as an instrument of trade policy, in Table 3. (Note that the figures provided are only for the purpose of exposition.) As can be seen, in each phase some industries are protected and others benefit from free trade; an industry will not be subject to protection permanently and, after a while, will be liberalized gradually; and the average tariff rate for the manufacturing sector rises first before declining and reaching zero eventually.

Hence, for some time a combination of import substitution, export promotion, infant-industry support and import liberalization is at work for a mix of

<b>Table 3: Evolution of average tariffs for various groups of industries at different phases of industrialization</b>					
Phase	RB&LI	LT	MT	HT	Manufactures (Average)
I	20	0	0	0	5
II	10	40	0	0	12.5
III	0	30	50	0	20
IV	0	20	40	40	25
V	0	10	30	40	20
VI	0	0	15	25	10
VII	0	0	5	15	5
VIII	0	0	0	0	0

**Source:** Akyüz (2005: 27).

Notations:

RB: Resource-based industries

LI: Labour-intensive industries

LT: Low-technology-intensive industries

MT: Medium-technology-intensive industries

HT: High-technology-intensive industries

consumer goods, intermediate products and capital goods. Nevertheless, there is no “quick fix”. Industrialization is a long and tedious process. It took over 250 years in the case of Great Britain and over 200 years in the case of the USA and Japan.

In short, the framework for trade and industrial policies which we have proposed is not a recipe for protection; on the contrary, it is a means of industrialization before liberalizing trade completely. As F. List stated some 170 years ago: “... restrictions are but means, and ... liberty, in its proper sense, is the end” (List, 1856 [1841]: 64). What he implies is: we should first aim at liberty from underdevelopment, then liberty from trade restriction.

### **Foreign direct investment and capital flows**

The experience of developing countries indicates that FDI can act as an important channel for export. It may also make a notable contribution to financing investment temporarily. Nonetheless, its longer-term contribution would often be limited in relation to total domestic investment and would involve little technological spillover (Gallagher and Zarsky, 2004; Huang, 2002; Grether, 1999; Buitelaar and Pérez, 2000; Mortimore, 2000; and Hanson, 2001). The recent experience of China indicates that FDI could play an important role in industrialization, by contributing to the skill development of local manpower and expansion of domestic value added, if it is guided and targeted toward specific areas where foreign technology is most needed. In fact, China’s experience, unlike Mexico’s, teaches us that one could think of a process of export promotion through FDI that could eventually lead to import substitution if it is managed by the government (Pizarro and Shafaeddin, 2006). China started assembly operations in a number of industries, particularly electronics and telecommunication, based on imported inputs and gradually has been increasing domestic production and exports of components (Shafaeddin, 2004b). For example, the share of components in the country’s exports of manufactured goods (excluding chemicals) increased from about 6.4 per cent in 1992/1993 to 14.5 per cent in 1997/1998, and to 16.7 per cent in 2002/2003 after its accession to the

WTO. More importantly, the corresponding share of imports of components, which had increased continuously between 1992/1993 and 1997/1998 from 17.7 per cent to 23.2 per cent, first increased more slowly, reaching nearly 24 per cent in 2000/2001, and then declined to 22.3 per cent in 2002/2003 despite the accession to the WTO<sup>27</sup>(Pizarro and Shafaeddin, *ibid*).

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

### **Limits of devaluation**

Devaluation of the local currency can temporarily provide some incentives for the production of tradeable goods, particularly exports.<sup>29</sup> It may also serve other purposes but, for a number of reasons, it is not necessarily the most desirable tool of industrial policy when it is used repeatedly. Firstly, it is used as a tool of uniform (nominal) price changes over the whole range of tradeable goods rather than for selected products.<sup>30</sup> Supply response to prices is much lower when all the outputs of a sector are equally affected; it is stronger when relative prices increase only for one good, or for a few goods (Streeten, 1987). Even in industrialized countries there is some evidence that reallocation of resources from non-tradeable to tradeable sectors and, within tradeables, from importables to exportables (and, in the latter, from traditional to new products) might be more responsive to targeted incentives such as subsidies than to exchange rate adjustment (Schydlosky, 1982).

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

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

Thirdly, devaluation could disrupt the economy through its inflationary impact, particularly in low-income countries. In fact, we have estimated that for every 10 per cent nominal devaluation during the period 1980-87, in countries where per capita income was less than \$400 (in 1986), the real

exchange rate declined only by 3 per cent within a year (Shafaeddin, 1992; see also Edward and Wijnbergen, 1989).<sup>32</sup>

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

Finally, the available empirical evidence indicates that other factors are more important in export competitiveness than exchange rate and costs and prices. For example, Fagerberg (1988) has shown that the contribution of cost competitiveness resulting from low wages was far less than that of technological competitiveness and the ability to compete on delivery (Ibid: 371). An empirical study by Kaldor (1978) for the period 1963-75 indicates that countries with the fastest rate of growth of exports, such as Japan, were those which at the same time experienced faster rates of increase in their relative unit labour cost (RULC) than others. On the basis of this study, he also concluded that in the long run relative changes in the exchange rate can be the result of competitiveness, rather than its cause. Thus, he added, relying on changes in RULC alone as a policy tool for improving competitiveness would be a simplistic view.<sup>34</sup> Amendola et al. (1993) reached similar results for the period 1967-87.<sup>35</sup>

In the long run, enhancing productivity, rather than repeated nominal devaluation, is a key to success in industrialization, as mentioned earlier. Nonetheless, with the presence of strategically active international firms, the concept of productivity takes on a different meaning. It is not merely

concerned with the volume of output produced. It involves creating value to the consumers through factors which contribute to the lowering of the price elasticity of demand, such as a reputation for reliability, the supply of high-quality products, timely and rapid deliveries, etc. Productivity enhancement requires continuous learning, skill development, innovation and upgrading.

### **The role of “non-price factors” and other influences**

Trade and industrial policy alone cannot succeed unless they are accompanied by a host of other factors. The process of industrialization requires what we call “COU-Ps-INS” (Shafaeddin, 2006b) and the development of agriculture. COU stands for: Create capacity, Operate it efficiently and Upgrade the industrial structure. To do so, incentives are necessary but not sufficient. There is a need for a number of INs and Ps. The INs include INvestment, INput, INfrastructure (not only transport and communication but also other facilities such as marketing channels, distribution network, etc.), INstitutions, INnovation and INformation (Streeten, 1987). We use “information” here in the wide sense of the term which includes knowledge, science as well as market information, which requires investment in human resources through education, skill development and training. In fact, investment is essential for all the other INs as well as for the expansion of supply capacity and creation of organizational capabilities and learning. Most of the INs outlined here are elements of the “non-price factors” mentioned earlier.

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

Development of agriculture is essential, particularly during the early stages of industrialization, to increase the supply of food, where feasible, in order

to contribute to the availability of wage goods and to ease the pressure on the balance of payments and ease inflationary tendencies. For the same reason, ample availability of other basic consumer goods is also important, as availability of wage goods not only eases inflation, but also contributes to the competitiveness of manufactured goods in the international market.

# 9

## Conclusions

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

Like Helleiner, “I am realist enough to recognize that reconceptualization of the WTO as a development institution may not happen quickly (though I am fully confident that it *eventually* [my emphasis] will).” It will take time (Helleiner, 2000: 19). We are also well aware that such a reconceptualization will involve hard bargaining since experience has shown that developed countries will not give in purely on moral grounds (Shafaeddin, 1984). Nevertheless, two points are worth emphasizing. One is the realization by all parties involved, particularly developing countries, that there *is* a need for reconceptualization. Fortunately there are signs that the dominant neo-liberal economic philosophy propagated by the Washington Consensus is shifting in favour of a development-oriented philosophy. The failure of the western hemispheric states in Buenos Aires in late October-early November 2005 to agree on a Free Trade Area of the Americas (FTAA), proposed initially by the USA in 1994, is one example. The difficulties encountered in international trade negotiations since the WTO meeting in Seattle in 1999 are another. It has become evident that developing countries do not easily



bow to pressure anymore. They are better informed and better prepared than they were during the Uruguay Round although they continue to be bullied by developed countries. Further, their experience of trade liberalization during the last two decades must have been influential in removing their illusions about the benefits of universal and across-the-board trade liberalization.

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

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

Secondly, export-performance requirements and domestic-content clauses should be allowed to be introduced in the relationship between host countries and TNCs.

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

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

## Endnotes

- 1 The share of parts and components in total exports of manufactured goods increased from 13.2 per cent for the period 1981-90 to 18.8 per cent for 1990-2000 (World Bank, 2003c: 55, Table 2.2).
- 2 In 2001 the share of intra-firm trade in the total exports of the USA and Japan was 37 per cent and 31 per cent, respectively.
- 3 One should add also the higher risks and costs related to instability in the exchange rates of the major international currencies.
- 4 Another source of external economy is the sheer expansion of the industrial sector as a whole, i.e., the Marshallian external economy. Nevertheless, this sort of external economy is achieved only *ex-post* as the industrial sector develops.
- 5 Some exceptions to the commitments in particular service activities can be acceptable on the basis of a clear list. For more details on the three agreements mentioned above, see Wade (2005).
- 6 If, however, a subsidy is provided to an enterprise without being made legally contingent upon export performance, it would not be prohibited: "The mere fact that a subsidy is granted to enterprises which export shall not for that reason alone be considered to be an export subsidy..." (ASCM, Article 3.1(a), footnote 4).
- 7 In addition, the use of export subsidies is allowed for countries with per capita incomes below \$1,000.
- 8 All 50 states in the USA use subsidies for regional development in order to attract industry (Amsden, 2005: 221). In this case it is definitely against the WTO rules as all states cannot be disadvantaged!
- 9 See, for example, the text of the G-20 Ministerial Declaration adopted on 19 March 2005 at the conclusion of the Ministerial meeting of the G-20 grouping of developing countries in New Delhi, 18-19 March 2005: <http://www.twinside.org.sg/title2/twninfo190.htm>.
- 10 The validity clause related to technology which was agreed upon for a trial period of five years was not however extended.
- 11 In addition, countries which are involved in bilateral trade agreements with the USA and the European Union (EU) are subject to even tougher intellectual property standards (Wade, 2005: 83-84).
- 12 See Khor and Goh (2005: 10-12) for details.
- 13 Five per cent of tariff lines can be exempted provided the related imports do not exceed 5 per cent of the total value of the member state's imports (paragraph 8, Annex B of the WTO July Package).
- 14 The Swiss formula is:  $T=(a.t)/(a+t)$  and  $R=t/(a+t)$ , where T, t and a are the new and initial tariff rates and constant coefficient, respectively, and R is the rate of tariff reduction (see WTO, 2003: 2).

- 15 Note that the concept of “market inadequacy” is different from “market failure” (see Arndt, 1988).
- 16 According to the dynamic version of the theory, first introduced by H. Johnson, as production and exports of labour-intensive products increase, wages will go up and the country will lose its comparative advantage in labour-intensive products and produce capital-intensive goods. The example of East Asia is often given for such a development! The theory however assumes that things happen automatically; it is not clear how the loss of advantage in labour-intensive products should imply gains in advantage in capital-intensive goods and how the adjustment takes place for the creation of dynamic advantage.
- 17 For details see Shafaeddin (2005a: 118-133).
- 18 Note that during this period a number of the countries in the region suffered from the Middle East wars, either directly or indirectly.
- 19 The USA currently has a number of bilateral free trade agreements with other countries and is in the process of negotiating a number of others.
- 20 For details see Chang (2005b: 30-34).
- 21 See also various literature by the World Bank and the International Monetary Fund (IMF), particularly World Bank (1987) and (1993). For a brief survey see Shafaeddin (2006a).
- 22 For a survey see Shafaeddin (2006a).
- 23 Alfred Marshall did not object to protection of infant industries, but he was not as supportive as Mill (see Shafaeddin, 2005b for more details).
- 24 See, for example, Nelson and Winter (1982), Noland and Pack (2003), Lundvall (2004), Westphal (2000), Lall (1996) and Lall (2004).
- 25 Further, if developed countries have recently discovered that protection and industrial policy are not justified, how could they explain heavy protection of their agriculture? Similarly, how could they explain protection of patents for their new products/technologies for as long as 20 years through the TRIPS Agreement while denying developing countries temporary protection of their new infant industries or export products?
- 26 See Akamatsu (1961) and also Kasahara (2004) for a survey.
- 27 Based on the UN COMTRADE database.
- 28 Helleiner (1986) has shown that in the case of African countries there was a strong negative relationship between instability in the volume of imports and GDP growth rates.
- 29 However, Bautista (1982), examining a sample of developing countries for the period 1973-79, has shown that currency depreciation, both small and large, did not lead to a permanent improvement in export competitiveness.
- 30 Nevertheless, for a given rate of nominal devaluation, the implied real exchange rate depreciation will be different in different sectors, industries and firms as their import intensities are different. The higher the import intensity, the higher is the increase in the cost of production for a given rate of nominal devaluation, and

thus the lower is the real exchange rate depreciation achieved. Usually the import intensity for the manufacturing sector is higher than that for other sectors. Within the manufacturing sector, it varies from one industry to another and it is higher for modern industries and large firms; and within these industries, it is higher for export production than for the home market. Further, for each industry and firm, the effective exchange rate could be different to the extent that the directions of trade of firms are different. Hence, devaluation, it is claimed, cannot even work as a uniform price incentive. To achieve a uniform effective exchange rate, a complex nominal rate structure would be needed.

- 31 A study by Edward and Wijnbergen (1989: 1526-1528) indicates that the contractionary impact of devaluation is important.
- 32 Edward and Wijnbergen (1989) have shown, on the basis of a survey of the literature, that nominal devaluation leads to relatively high real depreciation temporarily, but the effect of nominal devaluation on the real exchange rate erodes slowly, taking between 8 and 16 quarters depending on the type of macroeconomic policies undertaken.
- 33 The price of primary commodities is demand-determined, but that of manufactured goods is normally cost-determined. As a result, devaluation by a small commodity producer changes the domestic price of the product without influencing its international price. By contrast, devaluation by the same country changes its international (export) price of manufactured goods but does not change its domestic price immediately. Of course, the impact of the devaluation on the domestic price due to changes in the price of imported inputs, etc. will ultimately follow, as explained in the text.
- 34 The simultaneous increase in RULC and market share is referred to as the Kaldor paradox in the literature.
- 35 See Fetherston et al. (1977) and Kellman (1983) for similar views expressed for the 1970s and early 1980s. See also Amable and Verspagen (1995).
- 36 Based on UN COMTRADE database.
- 37 For a detailed list of restrictions imposed by international rules and bilateral trade relationships on trade and industrial policies of developing countries, see, for example, Rodrik (2004: Table 2).



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## IS INDUSTRIAL POLICY RELEVANT IN THE 21<sup>ST</sup> CENTURY?

The author argues, in this study, that in recent decades the need for industrial policy in developing countries has increased because of globalization and the evolving nature of the world economy. This is because international production and trade have been increasingly dominated by large transnational corporations, technological innovation has accelerated and production has become more knowledge-intensive. Yet, developing-country governments' capacity to promote the entry of domestic firms into this competitive environment has been eroded. It has been eroded by international trade rules and conditionalities imposed by international financial institutions and bilateral donors which have, in turn, been influenced to a large extent by the prevailing neo-liberal orthodoxy. The neo-liberals advocate that industrial policy has no place in economic development; trade and industrial development should be left to the operation of market forces.

This study contends that the neo-liberal approach is seriously flawed. The policies of universal, across-the-board and premature trade liberalization dictated under this approach suffer from several theoretical shortcomings, which have been borne out in the actual experience of developing countries in recent years. Neither does the experience of successful early industrializers support the neo-liberal hypothesis on trade liberalization.

In light of the failure of the neo-liberal approach, the author advances an alternative framework of trade and industrial policy aimed at spurring industrialization and development in developing countries. Eschewing a "one size fits all" and pure market orientation, his proposed policy framework envisages dynamic and flexible trade and industrial policies. In such a framework, he allows mixed roles for the market, firms and the state in industrialization and in coordinating economic activities in different countries at different levels of development and in each specific country over time. Further, he strongly advocates changes in the World Trade Organization (WTO) rules in order to allow what he calls a "bottom-up" approach.

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