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# Trade Liberalization and Development

by Professor Alfred K. Ho, Kalamazoo, Michigan \*

Developing countries have a tendency to maintain a protectionist trade policy as a condition to economic development, in the belief that their technology is not on a level that will enable domestic products to be competitive with imports, or that factor mobility is so low that they cannot quickly make the necessary adjustments to free trade. However, the question often comes to mind, if a developing country is making fast economic progress with great improvements in technology and factor mobility, is the protectionist policy an absolute necessity? Or could the country fare better under free trade?

The very interesting experiment of Japan in the 1960's in embarking on economic development and trade liberalization<sup>1</sup> at the same time is worthy of investigation especially when it was highly successful on both accounts<sup>2</sup>. The Japanese experience certainly suggests a new alternative for developing countries. However, one must bear in mind that this is but a single experiment and Japan, in many respects, is not a typical case. The Japanese ideas and mechanism for trade liberalization would have to be drastically modified to meet the particular conditions of the country where they are to be applied.

## Trade Liberalization in the 1960's

The purpose of this article is to examine the Japanese experience in the 1960's, identifying the issues confronting the Japanese Government in making the decision of combining economic development and trade liberalization and to investigate what adjustments were made in the economy in making the experiment successful. In 1960, Japan, with a per capita income of \$436 a year, was still a developing country by Western standards, although it was quite advanced relative to its Asian neighbours. The move

\* Department of Economics, Western Michigan University. This paper grew out of a study of the Japanese trade liberalization policy under the supervision of Professor William R. Allen of the University of California at Los Angeles.

<sup>1</sup> Trade liberalization here is used in its broad sense including relaxation of import quotas and foreign exchange controls, reducing tariff rates, facilitating capital transaction and allowing foreign investment in some of the country's industries.

<sup>2</sup> The economic conditions for the period 1960 to 1965 bear out the fact that while trade liberalization was being carried out, the country enjoyed 9.2 p.c. annual growth in the GNP after correction for inflation. Balance of international payments has been maintained since 1958 with the exception of the two years 1961 and 1964. In 1968, Japan had a per capita GNP of \$1,000 a year. Japan Information Service, Japan Report, New York, June 1969, Vol. 15, No. 11, p. 2.

into trade liberalization was certainly a daring adventure, breaking away from its protectionist tradition.

From the end of World War II to 1955 was a period of transition for the Japanese economy. Production began to recover to reach the pre-war level. From 1956 to 1960 was a period of fast economic expansion with improvement in technology and rapid accumulation of capital. Starting 1960, the country pursued a Ten Year Plan to Double National Income 1960-1970 with specific goals as follows:

- ☐ Rapid expansion of social overhead such as roads, harbors, railways, water supply and electric power.
- ☐ High rate of growth of secondary industry.
- ☐ Promotion of exports to cope with the growing imports so as to prevent balance of payments difficulties.
- ☐ Improvement of the investment in human resources and of science and technology.
- ☐ Reducing the dualistic structure of the economy and improvement of income distribution<sup>3</sup>.

## Elimination of Quota Restrictions

By 1963, quota restrictions were eliminated for 93 p.c. of the imports by value<sup>4</sup>, and by 1964, foreign exchange transactions were virtually free from controls and foreign investments were permitted in some 50 industries with guaranteed rights for the transmission of incomes and capital<sup>5</sup>. In 1960 when the trade liberalization policy was debated in the Diet, the opposition, Japanese Socialist Party, raised a number of questions on economic grounds concerning the policy.

<sup>3</sup> Economic Planning Agency, the Japanese Government, New Long Range Economic Plan of Japan. 1961-1970, Tokyo, The Japanese Times, 1961, pp. 11, 77 and 80.

<sup>4</sup> The liberalization ratio was calculated on the assumption that had the law been applied in 1959 what would have been the percentage of imports in value being given entry without quota restrictions. Leon Hollerman calculated the actual percentage of imports in value that was liberalized in 1965 to be 85 p.c. Leon Hollerman, Japan's Dependence on the World Trade, the Approach Toward Economic Liberalization, Princeton, Princeton University Press, 1967, pp. 237-239.

<sup>5</sup> In 1964 Japan was granted Article 8 membership of the International Monetary Fund. As a member, Japan was not permitted to practice foreign exchange controls except from time to time Government's buying or selling of foreign exchange on the market to maintain the fixed exchange rate within given limits. By 1969, Capital liberalization was extended to 204 industries where foreign capital was admitted for joint ventures. Keidaren Review, spring 1969.

The opposition held that trade liberalization would retard economic growth, while the Government's position was that trade liberalization could be consistent with and promote economic growth<sup>6</sup>. The major issues are as follows:

### Major Issues of Discussion

□ The opposition feared that trade liberalization would stimulate the growth of imports to exceed that of exports and thus create problems in the balance of payments. The Government was confident that exports could expand fast enough to keep pace with the increasing imports. Of course both sides were speculating on the reaction of Japanese business to the liberalized trade. The outcome, one may assume, would depend on how industries competing with imports would be able to improve their efficiency to defend their position, and how the resources of the country could be re-allocated to accommodate the necessary production adjustments.

□ The opposition took the position that trade liberalization would cause the imports of consumer goods to rise and thus encourage consumption and reduce personal savings and as a consequence economic growth would be retarded. The Government was confident that investments would be adequate to maintain fast economic growth and the increasing inflows of foreign capital would supplement domestic capital accumulation<sup>7</sup>. The outcome would depend largely on the effect of the liberalized trade on the decision making of the people in allocating their income between current consumption and investment.

□ The opposition believed that trade liberalization would reduce employment in the country, as the backward sectors, which could not withstand foreign competition, might be ruined thereby bringing market disruptions and unemployment. The Government was confident that through trade liberalization the country would benefit from the free flow of materials, capital goods, and technology, and the overall employment would rise rather than decline. The effect of the liberalized trade on employment would depend a great deal on whether there would be adequate economic incentive generated for the production factors to overcome social, cultural, and institutional barriers in making their re-allocation adjustments. In the case of labor, the barriers would be family ties, preference for certain tra-

ditional professions, inadequate transportation and communications facilities and the lack of training and specialization.

□ The opposition believed that trade liberalization would worsen the dualistic structure of the economy in that the policy would benefit the modern sector which stood a better chance to compete in the world market, but would ruin the backward traditional sector. The Government believed that trade liberalization would first improve the modern sector, but when the modern sector would continuously recruit workers from the traditional sector, it would force the traditional sector to utilize its labor force more effectively. Eventually the wages of the traditional sector would rise to narrow the wage gap between the two sectors<sup>8</sup>. Of course, the effect of the liberalized trade on the backward traditional sector would depend on whether the productive activities of the traditional sector could be coordinated to the modern sector for the externality effect, and whether capital and technology could be channeled to the traditional sector.

### Behavioral and Structural Patterns

In order to find out what was happening to the economy, while trade liberalization was being carried out, it is necessary to take a closer look at the behavioral and structural patterns of the economy involving significant economic variables. It is hoped that by examining the changes in the behavioral and structural patterns, some insight can be gained on the effects of trade liberalization on the economy and the adjustments of the economy to meet the challenge of liberalized trade<sup>9</sup>. The results of my calculations are given as follows:

□ There has been a faster rate of growth of the secondary industry relative to the GNP in the period under trade liberalization than before, indicating that trade liberalization has promoted the growth of the secondary industry. While the GNP grew at 9.3 p.c. a year for the period 1948 to 1960 under trade controls and 9.2 p.c. a year

<sup>6</sup> Because trade liberalization was not introduced in one package, but by a series of bills, the Government and its opposition in the Diet were engaged in a number of debates which lasted for a period of six years from 1960 to 1966.

<sup>7</sup> Consumer goods imports amounted to 2.2 p.c. of total value of imports in 1958. This percentage increased to 3.2 p.c. in 1962 and 4.5 p.c. in 1966. The *Oriental Economist*, Japan Economic Yearbook, 1967, Tokyo, 1968, p. 93.

<sup>8</sup> See the testimony of Mr Yoshio Kuriyama in the Upper House, May 13, 1960, Records of the Diet, 34th Session, Upper House Proceedings, No. 21, pp. 404-414; the testimony of Mr Kitayama in the Lower House, August 31, 1962, Records of the Diet, 41st Session, Lower House Proceedings, No. 10, pp. 238-243; and the testimony of Mr Masao Hori in the Lower House, March 11, 1966, Records of the Diet, Lower House Proceedings, No. 26, pp. 442-446 (in the Japanese language).

<sup>9</sup> An econometric model of 11 equations involving 15 variables is used. A two stage linear regression is performed to estimate the structural and behavioral relations. For each equation, there are two calculations, first using the information of the period 1948 to 1960 when the country was under trade controls and then using the information of the period 1960 to 1965 when the country practiced trade liberalization. The purpose is to see whether trade liberalization has caused changes in structural and behavioral patterns in the Japanese economy. In order to determine whether the changes are statistically significant, statistical tests are performed. The econometric and statistical analysis parts will be furnished to the reader by the author on request.

for the period 1960 to 1965 under trade liberalization, the secondary industry grew at 12.3 p.c. a year and 12.5 p.c. a year for the two periods.

□ There has been a faster rate of growth of imports relative to the GNP in the period under trade liberalization than before.

□ There has been a faster rate of growth of exports relative to world exports in the period under trade liberalization than before. While imports grew at 10.2 p.c. a year for the period 1948 to 1960 under trade controls and 12.3 p.c. a year for the period 1960 to 1965 under trade liberalization, exports grew at 21.9 p.c. and 15.7 p.c. a year

**Average Annual Growth Rates (p.c.)<sup>1</sup>**  
(After correction for inflation)

	1948-1960	1960-1965
Exports	21.9	15.7
Imports	10.2	12.2
GNP	9.3	9.2
Output of Primary Industry	3.5	6.6
Output of Secondary Industry	12.3	12.5
Output of Tertiary Industry	11.0	7.9
Population	1.3	1.0
Labor Force	2.3	0.8
Primary Industry Labor Force	-2.5	-6.1
Secondary Industry Labor Force	3.7	5.4
Tertiary Industry Labor Force	8.1	1.8
Output Per Worker Primary Industry	6.0	12.6
Output Per Worker Secondary Industry	8.6	7.0
Output Per Worker Tertiary Industry	2.8	6.2
Capital	8.3	10.0
Personal Savings	11.8	6.7

<sup>1</sup> Bureau of Statistics, Office of the Prime Minister, Japanese Government, Japan Statistical Yearbook, Tokyo, 1964, 1966; The Oriental Economist, Japan Economic Yearbook, Tokyo, 1965, 1966, 1967, 1968, 1969; Economic Planning Agency, Japanese Government, Economic Survey of Japan 1964-1965, Tokyo; Ministry of Foreign Affairs, Japanese Government, Statistical Handbook of Japan, Tokyo, 1961, 1967.

for the two periods. Since 1958 the balances of payments have been maintained with the exception of two years, 1961 and 1964, and there was a large net export balance in 1965.

□ There has been no significant decline in the growth rate of personal savings under trade liberalization as compared to the period under trade controls.

□ There has been a faster rate of capital accumulation in the period 1960 to 1965 under trade liberalization at 10.0 p.c. a year as compared to that in the period 1948 to 1960 under trade controls at 8.3 p.c. a year. This is largely due to the inflows of foreign investments as promoted by trade liberalization.

□ In the period 1948 to 1960 under trade controls, employment grew with population, as new workers came from new entrants into the labor force. In the period 1960 to 1965 under trade liberalization, population growth has slowed down to 1.0 p.c. a year, and as business was prosperous, new workers have been recruited by

taking the slack of unemployment and underemployment.

□ In the period 1948 to 1960 under trade controls, the primary industry was losing manpower at the rate of 2.5 p.c. a year, while the tertiary industry was gaining the most at 8.1 p.c. a year, and the secondary industry was gaining at 3.7 p.c. a year. In the period 1960 to 1965 under trade liberalization, the primary industry has been losing manpower at the rate of 6.1 p.c. a year, while the tertiary industry has been gaining at 1.8 p.c. a year and the secondary industry has been gaining the most at 5.4 p.c. a year. This continuous recruiting of manpower out of the primary industry by the other two industries has forced the primary industry to use its labor force more effectively. In 1960, the average output per worker was 136,000 yen per year for the primary industry, 369,000 yen per year for the secondary industry and 354,000 yen per year for the tertiary industry. However, in the period 1960 to 1965, the annual growth rate of the average output per worker has been 12.6 p.c. for the primary industry, 7.0 p.c. for the secondary industry and 6.2 p.c. for the tertiary industry. This indicates that the labor force of the primary industry has been making impressive improvements in performance to try to catch up with that of the other two industries.

### Effects of Trade Liberalization

We can summarize the effects of trade liberalization on the behavioral patterns of the Japanese economy. Trade liberalization has promoted technology in the country, which in turn has resulted in an improvement of the productivity of labor in all industries<sup>10</sup>. The production frontier of the country has expanded yielding continuous fast growth of the GNP and rapid expansion of exports which have enabled the country to cope with the increasing imports.

Trade liberalization has particularly promoted the rapid growth of the secondary industry which has been drawing its labor force from the primary industry. Eventually labor shortage is felt in the primary industry causing it to use its labor force more effectively. As the primary industry is making impressive improvements to catch up, there is the beginning of a correction of the dualistic structure of the Japanese economy. Trade liberalization has been consistent with the goals of economic development and has helped the country in achieving these goals.

<sup>10</sup> Trade liberalization has facilitated the import of technology. From 1952 to 1959, Japan paid in these eight years a total of \$ 246 mn on fees, royalties and dividends for the use of imported technology. From 1960 to 1967, Japan paid again in eight years \$ 1,212 mn for the same purpose. Statistical Department, Bank of Japan, Economic Statistics Annual 1969, Tokyo, p. 242.