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DEVELOPMENT SPECTRUM

Aims and Problems of Diversification

by Dr Christian Wilhelms, Hamburg*

Notwithstanding the importance attributed to international commodity agreements, the long-term solution to the developing nations' economic problems must be sought in diversification. On this subject the HWWA-Institut für Wirtschaftsforschung-Hamburg (The Hamburg Institute for International Economics) prepared a study for the Federal Ministry for Economics and Finance. The following article summarises the main results.

The general function of diversification is structural change to reduce dependence on but a few products and markets, to modernise and dynamise the structures. It is only by diversification that the less developed countries' (LDCs) structural problems can be solved effectively since any other approach would equal a mere curing the symptoms and — like international commodity agreements for "problematic products" — were at best to be regarded as short- or medium-term palliatives, but not as a fundamental improvement. Despite the demands for and the importance attributed — not only by LDCs — to international commodity agreements, they seem to present no real solution to the economic and trade problems of LDCs. The experience gained with these agreements indicates that even though they may ensure some measure of price stability for a certain time, they cannot counteract a down-trend in demand¹ nor meet the requirements of the development process. Because in the longer term nobody is in a position to curb technical progress and the advance of substitute materials, a change in the structure of production in the LDCs is the

only means of checking the decline of their share in world exports and of improving their economic situation as a whole.

In a recent study for the German Federal Ministry for Economics and Finance, anticipating an international discussion on diversification in LDCs, two main issues of diversification were analysed²:

Which LDCs stand most urgently in need of diversification?

In what direction should they try to diversify?

In addition to dealing with the market situation prevailing for a number of commodities, approaches to diversification in various LDCs, and the influences resulting from commercial policy or administrative obstacles, the study was to simultaneously attempt to analyse, from the viewpoint of diversification, the effects probably resulting from the general preferential system applicable to LDCs. Furthermore, it was to discuss problems of international harmonisation and establish

investment criteria for diversification projects. While pertinent measures can apply to almost all parts of the economic structure, the study was restricted to questions related with the diversification of production and exports in LDCs. In part, some of the views expressed in the study are outlined here below.

Production and Exports

To economic and development policy, diversification is a means of achieving structural changes on behalf of superior policy objectives.

Thus, the diversification of the LDCs' structures of production and exports is no end in itself but an instrumental target in the process of industrialisation and development to permit economic and social progress.

Diversification of production involves increasing the number of production sectors, along with a relative decrease of primary activities, and diversification within individual sectors by means of starting new product-lines or new stages of production. Essential prerequisite also for export diversification, it aims at completing a country's economic structure for the production of goods and services, and it may be motivated as well by reasons of growth, employment and social policy. *Diversification of exports* means imparting

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¹ Cf. Ahmad Naini, Trade and Development Expectations of LDCs, in: INTERECONOMICS, 3/1972, p. 80.

² Cf. Christian Wilhelms and Dieter W. Vogelsang, „Untersuchung über Fragen der Diversifizierung in Entwicklungsländern“ (Investigation Into Questions of Diversification in Developing Countries), HWWA Report No. 3, HWWA-Institut für Wirtschaftsforschung - Hamburg, (The Hamburg Institute for International Economics), Hamburg, July 1971, 265 pages. — An English summary ("Problems of Diversification in Developing Countries") of the main results of the study is available, on request.

greater flexibility to one-sided export structures by reducing the country's dependence on but a few dominating export products and/or market outlets. Export diversification comprises product diversification, i.e. a widening of the range of goods supplied in compliance with the structure of demand, and market diversification by opening up additional export outlets for the products in supply. It aims at effectively stimulating sustained growth in foreign exchange receipts, and at reducing external instability in the long run. It is intended to relatively diminish exports of traditional products and towards traditional markets, and to gradually shift away from primary commodities to manufactured products in the country's export structure.

Determining Factors

The forms and directions of intentional diversification with a view to effecting systematic structural change are determined by such factors like the concrete target of development policy, the object for diversification, the initial situation, the production structure, resources, and the time available for diversification to be reached. In addition, there are surrounding factors inherent in the particular country's economy that bear upon all its activities. These factors are geographic situation, structure, and size of the country; communications and trade relations to foreign countries; the population as to number, ethnic and religious composition, mentality, educational level, and potential capabilities. Influences finally come from the national and international economic situations.

The problem may be solved, via horizontal, vertical or lateral diversification, in the same or in a different structural sector (intra- or inter-structurally). As to the motivation behind the

endeavours for structural change, a distinction must be made between active diversification (taking the initiative to offset structural deficiencies or seize chances that offer themselves), and reactive diversification (by way of reaction to external developments, as sales difficulties for certain products or active diversification by other countries that may require countermeasures).

International Harmonisation

Diversification of LDCs is implying a rejection of out-of-date views on the international division of labour between raw-material producing countries, on the one side, and suppliers of manufactures, on the other. It stands for the developing nations' complete integration into world economy. Certain conflicts, however, may result out of the divergence of interests of actively diversifying countries and of old-established supplier countries confronted with the need for reactive diversification, in the event of oversupply of a specific product. The exigency of reactive diversification, although welcome on behalf of structural change, of dynamics and productivity of the world economy, might become excessively costly to a country whose economy is still weak, and whose development may be impeded or detained to the benefit of other LDCs. What is needed here is harmonisation of diversification endeavours on an international level.

Yet, to demand total coordination of all measures for diversification relevant to the world market seems utopian, and practically no less problematic were international coordination, would the interests of a number of countries become decisively disturbed. Opinions on the problem of an international harmonisation of diversification policy are as diverse as the interests

defended, and in particular the imperiled and weak interests of the less favoured high cost producing countries, it sometimes appears, are not adequately receiving attention. Anyway it seems as though national "catch-as-catch-can" policies will be hardly compatible with international harmonisation.

International coordination of diversification policy, as a prerequisite for harmonising both national and international activities, would have to observe a number of guiding aspects, as e.g.:

- neutrality and objectivity of international technical assistance in problems of diversification;
- maximum transparency of market conditions and diversification projects;
- initiatives for diversification to be kept free from paralysing or impeding effects as potentially resulting from obligatory international coordination;
- priority of international technical assistance to smaller countries not disposing of the pertinent national staff;
- fixing of diversification priorities near the lines of a "priority scale"³
- formulation of international agreements as to "good conduct in problems of diversification" for products relevant to the world market, as a guideline of diversification policy;
- establishment of special commissions for diversification problems on the levels of the UN Regional Commissions or of UNCTAD.

In its effects the diversification of LDCs implies also structural

³ As a guideline to international diversification policy, the following scale of diversification priorities was proposed in the a.m. study: LDCs, (1) the situations of which are directly critical, (2) the structures of which are liable to crises, (3) are needing dynamisation, (4) appear unfavourable in the long run, (5) are capable of becoming dynamised.

changes in the developed countries which in complementarily restructuring their economies by abandoning or reducing comparatively unproductive industries would open the LDCs additional chances for industrialisation and diversification.

Industrial Countries

A-priori-adaptations, however, in anticipation of corresponding reactions on the part of LDCs do not appear to be advantageous to either side. Restructuring in industrial countries, as a natural consequence of diversification in LDCs, should rather be a result of competition originating. No doubt competition to be workable requires, in addition to the industrial countries being prepared to open their markets, the removal of internal and external obstacles to exportable products from LDCs. On the other hand, to compete with the industrial countries' productions would mean raising the level of industrial efficiency in LDCs which thus would benefit both as regards internal supply and export performance.

By simply giving up production and leaving the domestic or foreign markets of the sectors concerned to the LDCs, in the absence of competition, the industrial countries probably would benefit the former but little since this would not entail an increase of efficiency to the LDCs' industries, needed for their own sake and that of world economy. Finally, it presently also seems unreasonable that the industrial countries completely change to supplies from LDCs in replacing certain of their old-established productions. Not only because of welfare losses possibly resulting for consumers in industrial countries to be exclusively dependent from LDCs would appear not unproblematic for some time to come still.

This summary of the study on the diversification issue cannot but deal with a limited number of partial aspects. This applies also to the formulation of investment criteria for the implementation of diversification activities. What is meant here is investments promoting the diversification of the production structure — being a prerequisite also to export diversification. One has to distinguish here between the industrial and the agricultural sectors.

Investment Criteria

As to diversification by *industrialisation*, in the broadest sense, the following criteria can be established here:

- Priority of the technically less complicated consumption goods industries, shifting gradually to basic industries and to technologically more complicated capital goods;
- priority promotion of industries tending to improve the balance-of-payments structure, in particular those industries using domestic inputs (raw materials or intermediaries);
- application of competitive technologies, utilising comparative advantages — e.g. abundance of cheap labour existent — to compensate for other disadvantages in competition;
- priority of multi-sectoral industrialisation to create a broad industrial basis, and promotion of export industries when opportunities for import substitution are approaching exhaustion;
- preferment for investment projects entailing maximum linkage effects;
- priority of projects disposing of ample domestic or integration markets;
- investments in the tourism sector only after due consideration of the conditions of infrastructure and of the economic and social implications.

For diversification via *agricultural productions*, the criteria to be observed should be:

- Priority development of those export products characterised by comparatively favourable world market prospects;
- investment in export productions requires the existence of comparatively favourable conditions for production (due consideration of the capability to produce competitive product qualities);
- priority for productions offering permanent diversification effects (considering temporary contributions to diversification as additional activities and momenta for dynamisation);
- utilisation of short-term chances for diversification exclusively through non-perennial cultures;
- priority promotion of new foodstuff productions for domestic consumption;
- establishment of processing industries in the case of distant locations and inferior quantities of production;
- preference to comparatively unproblematic product markets on the part of newcomer export producers.

To the LDCs' diversification endeavours, in addition to the more general need for international harmonisation for the sake of avoiding future inadequate developments, two basic requirements appear to be important. Firstly, projects intended to diversify the domestic production structure must observe, on behalf of overall efficiency of the economy, the principle of productivity and efficiency of the individual project. Secondly, projects oriented towards export markets have to examine and observe the world market situation for the respective product. This applies in the first place to agricultural primary products.