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Heinrich Dehn*

External Orientation and Domestic Market Promotion

The increasing differentiation among developing countries, revealed by many indicators, also suggests that they have need of differing trade and development strategies. The following article reviews the across-the-board advice offered by agencies including the World Bank to "the" developing countries – "outward-orientation", integration into the world economy, trade liberalisation – in the light of persistent shortages of foreign exchange and the limited capacity for structural adjustment, diversification and raising export levels in low-income primary commodity exporting countries.

The usual recommendations to "the" developing countries that they should integrate into the division of labour in the world economy, should adopt an outward-orientation and liberalise their trade¹ are based on the bad results experienced with a protectionist policy of import substitution which spoon-feeds inefficient industries via an unfathomable variety of import impediments and of subsidies while, at the same time, exports in particular are placed at a disadvantage by unrealistic exchange rates. A clearly positive statistical correlation is then demonstrated especially between high growth rates of national product, industrial production and exports on the one hand and an "outward-looking" economic policy on the other.²

Quite apart from the fact that statistical correlations do not provide evidence of causality, hardly any investigations are made into whether other factors beside different economic policies – such as different start-off opportunities, the level of development, production and export structures – could not also explain differing degrees of economic success, which in its turn is equated with developmental progress. As a matter of fact, the correlations are almost as obvious between start-off opportunities and economic success.

According to the World Development Report, real GDP in the "strongly outward-oriented" countries (Hong Kong, South Korea, Singapore) increased at an annual rate of 7.7 % during the 1973-1985 period, whereas the corresponding figure for the "strongly domestically oriented" developing countries (Argentina plus 5

LLDCs, 4 LICs and 4 countries from the lower middle-income group) was only 2.5 %.

The two groups' figures for GNP per head were 5.9 % and -0.1 % respectively, and for export growth 14.2 % and 3.7 % respectively. In 1985, the poorer developing countries primarily dependent upon raw materials exports (LICs excluding India and China) still depended on those materials for 76 % of their export revenues; they will be referred to below as Low Income Primary Commodity Exporters (LIPCs). In the figures contained in the 1987 World Development Report,³ these make a far poorer showing – irrespective of their economic policies – than developing countries exporting manufactured products, a group which includes all the proponents of the "outward-looking" strategy named above but also a number of Latin American developing countries which, if anything, have "inward-looking" strategies: GNP per head in the period 1965-1985 grew by 0.4 % as against 4 %, GDP in the period 1980-1985 by 3.2 % as against 5.5 %, and exports in the same period by 0.1 % as against 7.9 %. Another point worthy of note is that China and India, both large, poor, primarily inward-oriented developing countries which are only dependent on raw materials for 47 % of their exports, also both show substantially better figures than the LIPCs: their GNP per head grew by 3.5 %, their total GDP by 8.3 % and their exports by 7.6 %.

One can at least see from these statistics that it is by no means possible to recommend an "outward-oriented" strategy to all developing countries with the

* Federal Ministry for Economic Cooperation, Bonn, West Germany. – The author puts forward his own personal opinion, which need not necessarily be in agreement with that of the Ministry.

¹ See, e.g., World Bank: World Development Report 1987, p. 78 ff. and 169 f.

² Cf. *ibid.*, p. 84 ff.

³ *Ibid.*, Tables 1, 2 and 6.

same prospect of economic success. The export outlook would appear to be particularly unfavourable for the poorer developing countries which depend on raw materials exports. Because of the below-average growth in demand in this area and the current oversupply both from industrial countries and from other developing countries unwilling or unable (indebted countries) to take account of the position of poorer developing countries, an increase in raw material export volumes would mainly lead to a further decline in price levels and further terms-of-trade losses.

To this must be added the danger that industrial countries and more advanced developing nations will achieve a further lead over the poorer countries in terms of costs and quality. Given that the dependence on raw materials of poorer developing countries can only be reduced over the longer term because of economic and socio-cultural factors (even so, it did come down from 91 % in 1965 to 76 % in 1985), the LIPCs will go on largely having to rely on a competitive raw materials sector in the 1990's, and it would seem appropriate to encourage cost reduction and quality improvement rather than expansion of volume. Because of the structural decline in raw material intensity in the world economy, the LIPCs must expect to suffer further losses in export earnings through no fault of their own. One can therefore presume that there will be an increasing need for multilateral and bilateral assistance for export earnings stabilisation and for medium-term structural adjustment.

Despite initially high rates of growth the prospects for export diversification in the poorer and smaller developing countries should not be overestimated. The industries which predominate in the LIPCs, namely textiles, clothing and agricultural products, are often confronted with stagnating demand from abroad and with protectionism, whereas those countries lack many of the preconditions for the modern growth industries. Even the export of services, tourism included, is an area which demands competitive inputs and the work of qualified personnel, both of which the LIPCs still have to import to a large extent, meaning that the net effect on the current account is less favourable for them than for more advanced developing countries or for industrial countries. When concrete prospects of success are actually ascertained, start-up assistance for export diversification is worth providing, but continuous subsidies are not, for this is something the LIPCs in particular cannot afford.

⁴ Ibid., Tables 10, 22 and 4.

⁵ Basic guidelines of development cooperation policies, Federal Ministry for Economic Cooperation, Bonn, 1986.

Chronic Foreign Exchange Shortages

The LIPCs' weakness on the export side means that their import bill is covered by their own exports to a lesser extent (59.5 % in 1985) than is the average for the developing countries as a whole (90 % in 1985). Since the LIPCs are hardly able to attract purely commercial capital flows and the debt-service burden on their export earnings is rapidly increasing (18.4 % of export earnings on goods and services in 1985, as against only 8.4 % in 1970), official development assistance (ODA) already plays a worrying key role in financing these countries' imports:⁴ ODA to the LIPCs had come to account for 40.4 % of their import expenditure by 1985. In the group of LLDCs, slightly differently defined, ODA import funding already plays the predominant part in the group as a whole, and there are individual cases where this is very marked indeed. This means that what is a true statement for developing countries taken as a whole, and especially for those depending mainly on the export of manufactured goods or oil, namely that exports are "the developing countries' most important source of foreign exchange earnings",⁵ quantitatively applies to the LIPCs only to a limited extent, and does not apply at all to the LLDCs.

With the growing debt-service burden, the fact that the sum of export revenues and ODA grew only very slowly for the LIPCs compelled them to cut back imports by an average of 0.5 % per annum between 1980 and 1985, which undoubtedly had a negative effect on investment (gross domestic investment fell by 2.1 % per annum in the same period). Unless there is some clear easing of their debt-servicing obligations and/or a substantial increase in ODA (which means growing dependence on aid!), further import constraints are inevitable.

As regards their import structure, the LIPCs are not only dependent on imports of industrial products and capital goods as one would expect, but also import a large proportion of food (17 % in 1985) and fuel (21 %), both higher percentages than are found among the remaining developing countries (11 % and 17 % resp.) or the industrialised countries (10 % and 20 %).⁶

The LIPCs' dependence on imports of capital goods has hardly diminished since 1965 and can only be expected to be minimally reduced in future. As against that the share of other industrial products in the LIPCs' total imports has shown a marked decline (from 43 % to 30 % between 1965 and 1985). These products also accounted for a growing share of the LIPCs' exports (9 % in 1965, 23 % in 1985). The dependence on

⁶ World Development Report 1987, Table 12.

imported food has been only marginally reduced (from 19% to 17%), while the fuel share of the import bill – predominantly because of increased oil prices – has clearly increased (from 6% in 1965 to 21% in 1985).

The degree of outward-orientation it is possible for the LIPCs to finance depends to a considerable extent upon both the volume of ODA (including arrangements to ease the debt service burden) and the terms under which it is given. As long as the industrial nations persist in their tendency to prefer granting conditional aid to automatic aid (such as export earnings stabilisation), even though the LIPCs are less able to influence their own economic performance than other developing countries because of each one's dependence on a small number of raw materials, any increase in the LIPCs' dependence on aid to fund their imports would also increase their *de facto* political dependence to a degree which should cause concern not only to the LIPCs themselves but also to the industrial countries.

Implications of Total Liberalisation

The prescriptions of free trade, outward-orientation or integration into the world economy are based upon theoretical arguments (such as the reduction in unit costs through specialisation according to comparative advantage, the allocation of factors of production using price movements on world markets as a measure of efficiency) and upon assumptions (such as a high degree of flexibility of national economies, open product markets ready to absorb higher supply, the absence of balance-of-payments constraints and lasting indebtedness) which, for the LIPCs in particular, would appear to bear little resemblance to the situation in reality.

In addition to the problems with the raw materials markets and import funding already mentioned, among other difficulties the LIPC countries face are deficiencies in the infrastructure (especially with regard to education and training) and the dualism involved in having a small "modern" sector side-by-side with other spheres characterised by their traditional and informal structures

(subsistence agriculture, the informal sector) which allow the majority of the population to survive by providing the domestic market with goods and services which would not be internationally competitive. One must assume, however, that the LIPC economies are less able to adapt flexibly on an international scale than those of the more advanced developing countries or the industrial countries, and that this flexibility will only be able to increase gradually as domestic disequilibria and impediments to integration are reduced.

Total liberalisation now would mean that the LIPC countries were forced to concentrate their efforts on raw material exports which bring them less and less benefit (the terms-of-trade losses since 1980 have been staggering). On the import side, scarce foreign exchange would, among other things, be put towards the acquisition of consumer goods for prosperous minorities. However, the chronic foreign exchange shortages the LIPCs can be expected to suffer imply that what is really required is a special degree of thriftiness and clear development priorities.

Criteria for Local Production

The conventional protectionist policy of import substitution, erroneously referred to by the World Bank as "inward-looking", attempts to produce, with the aid of a variety of trade barriers and subsidies, as many as possible of the products previously imported in the developing country itself; all too frequently, however, such policies forget that unacceptably high and indeed unaffordable costs may arise, especially in LIPC economies, from producing goods which, to add to the problem, are of little benefit to development (e.g. automobile assembly in small numbers). This policy failed in a tangle of contradictions and rewards for inefficiency. And yet higher absolute costs when compared with imported goods do not represent a sufficient reason in themselves for LIPCs not to produce items such as basic foodstuffs. No generally applicable standard exists for what level of additional cost incurred by local production can be deemed "acceptable" when

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set against competing imports, but among the factors which should be taken account of from case to case are the following:

□ Since LIPCs have higher *absolute* costs for most internationally traded products, the important point in each individual case is that those goods and services which can be *relatively economically* produced under local conditions and which are particularly important for development should chiefly be produced locally.

□ In making a true economic comparison of costs it should be borne in mind that imported products (especially food) frequently have artificially low prices because the industrial countries subsidise their exports and also that the developing countries' scarce foreign exchange, which is vitally needed for certain necessary imports, has to have a shadow price put on it which is higher than its price on the foreign exchange markets.

□ The production needs to hold its own on the market. To achieve this there are many cases where it is sufficient to eliminate barriers and discrimination facing small businesses catering for the needs of the majority of the population as compared to "modern" large-scale companies and those producing for export (examples of this are legal uncertainties with regard to land use and the informal sector, and access to credit or to public services). Beyond that, consideration can be given to selective subsidisation and to providing a limited price advantage over imported products, especially via tariffs. Given that the LIPCs are particularly weak both in financial and administrative terms, they only have a restricted scope available for making sensible use of subsidies. In spite of the economic policy problems posed by price distortions, therefore, the LIPC economies have to rely more on a properly functioning system of customs duties than do the more advanced developing countries or the industrial countries. On the other hand, recourse ought not to be taken to other widely used protectionist instruments such as quantitative restrictions or the arbitrary provision of import licences or foreign exchange, as these are both counter-productive and difficult to administer.

Tariff Protection

External tariff protection in the LIPCs ought to limit import categories or levels of duty to an easily manageable number, even if problems of delineation do occur or if it is impossible to take account of all conceivable effects. Another important point here is the fiscal significance of tariffs, for the LIPCs are more

reliant on this relatively simple source of income than other developing countries and industrial countries. According to the 1987 World Development Report, duties on foreign trade represented 29% of central government revenues for the LIPCs in 1985, whereas for all developing countries taken together the average was only 11.8%, and for the Western industrial countries only 1.3%.⁷ Since export duties which are especially wide-spread in connection with raw materials yield less as raw material prices deteriorate and tend to further weaken what in any case is often an unfavourable market position for the LIPCs a shift towards import duties makes sense. Apart from a normal rate of tariff determined with a view to its fiscal yield – that is, not set too high – two higher levels of duty ought to be sufficient. In poor developing countries, a very high rate of duty on luxury goods is justified. To the extent that the production of import substitutes is accepted as being both worthy of and in need of support, there is also a case for uniform, moderate tariff protection for a predetermined period without automatic extension. It is possible under the GATT rules for imports from other developing countries to be treated more favourably than those from industrial countries. Still closer cooperation with neighbouring developing countries (in a customs union, for example) could help alleviate the disadvantages of unduly small markets, especially for smaller LIPCs but experience with regional cooperation to date points to the great difficulties which would be faced rather than to the prospect of short-term success of cooperation projects between poorer developing countries.⁸

The exporting sector should be neither discriminated against nor especially favoured. In as far as imported raw materials or other means of production are used, businesses which provide proof of their expenditure on such items should have import surcharges reimbursed in order to avoid their being placed at a competitive disadvantage on the international market.

The competitiveness of LIPC exports can be improved by way of infrastructure investment, advisory services, basic and additional training as well as studies on raw materials processing and the development of new export products. To reduce competitive disadvantages in comparison to industrial and more advanced developing countries, export credit financing and insurance could be expanded and basic finance provided from ODA funds. Export earnings stabilisation could be carried out not only multilaterally but also bilaterally, in order to ease the drastic structural change

⁷ Ibid., Table 24.

⁸ Cf. Wolfgang Zehender: Regional Cooperation through Trade and Industry, Deutsches Institut für Entwicklungspolitik, Berlin 1987.

in raw materials production generated by large-scale revenue losses. Particularly in the LIPCs, however, there can be no case for the continual subsidisation of unprofitable export production; nor is it possible to finance such subsidies from ODA.

A final aspect of sensible support for the domestic market is that care needs to be taken not to allow the tariff protection and the neutrality towards the exporting sector to be undermined by overvaluation of the national currency with its implicit bias towards imports. Although market-oriented exchange rates do not actually do much to improve the LIPCs' limited export opportunities, they must nevertheless be recommended to these countries in particular because they avoid creating incentives to import and hence engaging in unnecessarily capital-intensive production.

Increase in Self-sufficiency

Which areas of production for the domestic market are worthy of support from the development policy point of view is a matter which, even from an individual LIPC's perspective, cannot be "objectively" decided but is ultimately a political question for the country concerned, although the high aid dependency of the LIPC group in general implies that ODA "donors" also play a responsible part. It is true, though, that a broad international consensus exists to the effect that more food should be provided from self-sufficient production in order to reduce the – in many cases unnecessary – dependence on food imports.

Any success in this regard would necessarily improve purchasing power in LIPCs, especially among small farmers. This generates additional domestic demand for agricultural means of production, for simple consumer goods, and for infrastructure and services in rural regions. In LIPC countries as elsewhere, this demand, like that flowing from the rapidly growing poor urban population, can be met to a considerable degree using existing labour (with a small amount of extra training in some cases), local raw materials, a small amount of capital, and "capital goods" (tools and simple machinery) produced mainly in poorer developing countries, all with a positive employment effect.

It is obviously generally "better" in development policy terms if "the poor", whether individuals, disadvantaged groups or entire developing countries, can help themselves – which means that they work, learn as they go, more or less satisfy their basic needs, save and invest on a modest scale, in other words carry out their own development – than if their needs are catered for, however "efficient" this may be, by the

industrial countries as part of a "world social welfare scheme" (which in any case is not in place)!

Shift in State Activities

A clear distinction needs to be drawn between the promotion of the domestic market necessary to improve self-sufficiency, taking the route of increased production by farmers and small-scale nonfarm businesses to meet the needs of the majority of the population, on the one hand, and import substitution policies with an industrial bias which favour privileged urban groups, systematically neglecting the domestic market of the rural communities which represent the majority of the LIPCs' population, on the other. The encouragement of the domestic market which could be advocated in development policy terms relies on external protection on the trade front only in individual cases of need and as a complementary measure. On the domestic market itself, competition, equality of opportunity and private initiative should be encouraged in order to counteract monopolistic positions and rewards for inefficiency.

The pursuit of such a policy by the LIPCs demands an active state economic policy working in favour of neglected regions and sectors or of those which have been forced into rapid structural change (especially the agricultural and raw materials sectors). In conjunction with this, however, LIPC governments must be relieved of their mostly inefficient activities in public and parastatal enterprises by a process of decentralisation and privatisation in order to allow those governments better to fulfil those service and compensatory functions throughout the country which are indispensable.

In the context of the policy dialogue, the governments of LIPC countries should be encouraged to promote the development of their home markets with an eye towards self-help, and should be supported by more flexible forms of ODA. Apart from the start-up and adjustment assistance in the export sector discussed earlier, support should be given to the sections of public administration which are willing and able to improve, particularly by meeting part of the local costs and (on a degressive basis) also recurrent costs, to cut down the gross deficiencies in services and infrastructure – whether of a regional, sectoral or social nature – despite the expected further deterioration of the LIPCs' external economic positions and to ensure that the infrastructure is operated and maintained throughout the country. This support should be set up in such a way that the LIPCs themselves employ a greater proportion of their human and financial resources in those domestic market areas which have been neglected up to the present.