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THE ROLE OF THE GOVERNMENT IN THE PROMOTION OF FOREIGN TRADE

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I. INTRODUCTION

International trade has always played a key role in the development of the world economy. Interruptions of trade relations as experienced, for instance, during the Great Depression in 1929, are associated with substantial income losses. It was Adam Smith who, in 1776, wrote in his famous book **The Wealth of Nations** that “between whatever places foreign trade is carried on, all of them derive two distinct benefits from it. It carries out that surplus part of the produce of their land and labour for which there is no demand among them, and brings back in return something else for which there is a demand.” Smith goes on saying that “by opening a more extensive market for whatever part of the produce of their labour may exceed the home consumption, it encourages them to improve its productive powers, and to augment its annual produce to the utmost, and thereby to increase the real revenue and wealth of society.” Even countries with a significant domestic market as the United States, India or China, have to engage in foreign trade in order to satisfy domestic demand. In the case of countries with smaller domestic markets, as the Federal Republic of Germany, trade has substantially

contributed to the so called "German miracle", it has been nothing less than the main engine of growth and development. In the 1970s and 1980s, the Asian countries known as the "four dragons" (Hong Kong, Korea, Singapore and Taiwan), made a similar experience when they embarked on a world-market oriented strategy of economic development.

The historically impressive contribution of international trade to economic development placed trade policy among the key areas of public policy in both developed and developing nations. This paper will give an overview over the different aspects of trade policy, nowadays sometimes referred to as the trade regime. What are the building blocks of the trade regime? The trade regime is influenced by

- the development strategy and
- the prevailing structure of economic incentives.

II. DEVELOPMENT STRATEGY AND TRADE ORIENTATION

There has been growing disillusionment in the past two decades with the notion of promoting development by domestic planning efforts assisted by foreign aid. This disillusionment was experienced on both sides, in the developing countries as well as in the aid-giving countries. It certainly has to do with the fact that the whole array of factors influencing what is commonly called economic development is not always open to planning. It also has to do with the fact that the state as the planning authority is expected to know everything producers and consumers want. The lessons from the process currently going on in Eastern Europe are clear: economic performance is one thing and economic planning another.

What does this mean for public policy? What does this mean for the role of the government in economic development? The economy has its own laws, namely economic laws governing the behaviour of economic agents i.e of producers and consumers. The art of public policy is to implement policies given that producers and consumers will behave in a certain manner. If producers and consumers react to these policies the way the government expects it, then the government was right and the policies were good.

Studies of development strategies of both successful and unsuccessful developing countries, for instance those carried out at the Kiel Institute, Federal Republic of Germany, and at the World Bank, have shown the role played by the structure of incentives or the set of prices and laws resulting from public policies in economic development. They have made clear that wrong incentives are responsible for poor performance. Neither the producer, nor the consumer are to be blamed for poor performance. They just react to the existing structure of incentives which is a child of public policies.

It is also true that especially developing countries are often exposed to external shocks. However, some LDCs manage to cope with external shocks much better than others. Why is this so? For example, what happened after the first oil crisis in 1973? Most LDCs had to restrict energy consumption and imports; some LDCs resorted to foreign debt in order to be able to pay the bill for some months. Only a few countries, notably Asian NICs, which were obliged to increase their oil consumption due to high growth rates, managed well by letting the economy absorb the shock by its own. Similarly, when in the early eighties highly indebted Asian NICs faced a rapid increase in interest rates in the international capital markets, the reaction was to expand their exports, in order to be able to pay the higher debt services bill. In contrast, what happened in Latin America during the oil and debt crises? These countries were severely hit. Their general reaction was to constrain imports and to pay less debt service. They are still trying to cope with those shocks in the late eighties. This applies even to Brazil, the only Latin American NIC.

This story tells us that the economic regime or development strategy chosen by a country determines to a great extent its capability to manage serious external shocks. Economic history shows that there are three possible development strategies:

- outward oriented,
- inward oriented, and
- world-market oriented.

What do we mean by these orientations? An outward-oriented regime presents a structure of incentives which is leaning towards exports. The government offers strong export promotion measures to entrepreneurs and the latter are expected to orient their activities to the external market. The domestic

market does not matter at all; profits of the available resources (capital, skilled labour, natural resources) are channelled to export production.

The inward-oriented strategy is virtually symmetric to the outward-oriented strategy: the existing structure of economic incentives is biased towards the domestic market. Entrepreneurs are offered incentives in order to induce them to supply goods and services only for the local market where the profits are. The external market does not matter at all, resources are channelled to the production of import substitutes.

Finally, within the context of a world-market oriented strategy entrepreneurs face a structure of incentives which is unbiased. The incentives are such that it is up to the entrepreneur, if he/she serves the local market, the external market or both. Incentives are set in such a way as to make and keep economic activity in that country profitable. Instead of the government, market forces will select those activities which will be inward oriented and those which will be export oriented. However, the implementation of a world market oriented regime does not mean that the government is redundant. On the contrary, there is a justified scope for public policy, say, in the form of export promotion if export experience is considered to be poor or if the international competitiveness of firms might be improved by specific monetary, fiscal and exchange rate policies.

Many LDCs which set out to change their economic structure for instance, to industrialize rapidly, resorted to an inward-oriented strategy. To achieve this, they decided to change the prevailing structure of economic incentives which, in many cases, favoured the primary sector, agriculture or mining. The aim was to free the production factors working in the primary sector and to allocate them to industry. The overall objective was to give the country a push for a take-off, i.e. to increase its per capita income.

Since every change in the economic structure of a country needs to be brought about by changes in the price structure, a series of policies were implemented which distorted the prices of goods and factors. I am saying "distorted" and not "changed", because by doing so, real scarcities were delinked from prices in an artificial manner: For example since new industries need capital investment, the logic of changing the incentives called for a lower price of capital in order to promote capital investment. Similar policies in other fields of public policy led to other distortions: in many countries a multiple system of exchange rates was introduced. This system allowed to set a lower

exchange rate for goods or services that were considered indispensable and higher rate for unwanted goods, and for exports.

The underlying concept is that the infant industry should be protected by a series of policies, also by commercial policies, in order to grow. Unfortunately, LDCs with a long experience with inward-oriented development strategies never achieved the aim of self-sustained economic growth and higher per capita incomes, unless they switched to a different strategy in time. Good examples for this pattern are Peru and South Korea, the latter representing a typical success story (with switch) and the former a typical case of policy failure (without switch).

Like many other Latin American countries, Peru subscribed to the philosophy that a country can by itself change its economic structure just by intervening in the goods and services markets. Policy makers believed that a further expansion of Peru's primary sector (mining) was incompatible with sustained growth, full employment and a more equitable income distribution. Thus, in the 1950s Peru switched from an outward-oriented to an inward-oriented strategy based on domestic demand growth and foreign savings. The incentives for rapid industrialization introduced primarily entailed a commitment of the government to an expansionary fiscal policy and an active income policy, supplemented by an accommodating monetary policy. Value added derived from domestic production of manufactures (only for the local market) was artificially increased through credit and other subsidies, and particularly so by tariff and non-tariff barriers to international trade. Ceilings for the nominal interest rate were set at convenient levels in order to foster investment in physical capital. Firms adopting capital-intensive lines of production could import capital goods and intermediate products at a preferential (overvalued) exchange rate. These measures were taken in the context of a repressed financial system (negative real interest, credit rationing) and strict foreign exchange controls.

In spite of some occasional minor changes in policy, the overall package outlined above with its overt bias towards the domestic market, has been maintained in Peru even in the eighties. What was the impact of this regime on Peru's economic performance? After almost 30 years of inwardness in this country, it can safely be said that this strategy contributed to less and not to more development: growth in per capita terms has been negative for a long time, with the usual consequences for employment and income distribution. Other

consequences are the accumulation of a huge foreign debt (huge compared to the country's ability to service its debt as indicated by foreign exchange receipts from exports), and the realisation that the Peruvian economy reached the stage of total distortion. Finally, a three-digit rate of inflation per annum, indicating that this country is currently on the verge of hyperinflation, along with the worst recession in the country's history leave no room for recovery within the context of an inward-oriented strategy.

A quite different story has been written by South Korea. This country first embarked on an inward-oriented industrialisation strategy, but very soon South Korea's policy makers realised that the domestic market of a developing country does not create the demand needed by local industry. In order to exploit scale economies and benefit from learning by doing products, embodying foreign technology, industrial firms must be able to sell in many markets, and particularly in high income markets. Also, foreign capital goods and disembodied foreign know-how can only be paid for with foreign exchange receipts from exports. On the other hand, it was realized that Korean firms could only be competitive in the world markets if domestic economic conditions matched the conditions prevailing in the high income markets. Therefore Korea opened the domestic market to foreign competition. At the same time the government promoted exports and introduced regulations adapting local technical standards to international standards.

In contrast with Peru, South Korea belongs nowadays to the small group of LDCs which achieved 2-digit rates of economic growth in the 1970s and 1980s. Since such a rate of growth by far exceeds the rate of population growth, per capita income in Korea has been continuously increasing. In the 1980s, Korea began to displace some industrialized countries in the world markets.

III. THE STRUCTURE OF ECONOMIC INCENTIVES

Given the trade orientation, there are several public policies which may be used to determine the structure of economic incentives. The most important ones are:

- commercial policy
- income policy

1. Commercial Policy

The national instrument of commercial policy (tariffs, non-tariff barriers, state trading monopolies, free economic zones, export promotion, etc.) embrace instruments with a negative impact on trade and instruments with a positive impact on trade. Tariffs, non-tariff barriers and state monopolies belong to the former and free economic zones as well as export promotion to the latter. Growth-oriented developing countries need instruments with a positive impact on trade, because growth follows from investment and investment from imports of capital goods and foreign technology both of which have to be paid for with foreign exchange receipts from exports. Thus, measures interfering with trade might also interfere with growth and development.

Similarly, the international instruments of commercial policy (bilateral trade agreements, multilateral trade agreements, regional integration schemes, counter trade, etc.) can also be classified according to their overall impact on trade, although it is certainly easier to identify non-tariff barriers as trade distorting than to establish the net impact of, say, regional integration schemes. A case in point is, for instance, counter trade, a controversial instrument of trade policy.

Several very different types of commercial transactions are commonly associated with the term counter trade. This term is used to cover counterpurchase, compensation, barter, switch and offset transactions. Since there are no internationally recognized standards in this matter, counter trade involves a wide range of activities, among others:

- an obligation by foreign suppliers to purchase products in the buying country, or
- a buy-back arrangement obliging the supplier of capital goods to take a certain amount of the production made possible by these capital goods, or
- selling domestic goods to an international trading company which will pay a foreign supplier, often through another trading company which buys the goods from the first trading company, or
- a direct exchange of goods or services between two principals without the use of currencies, mostly accomplished from government to government through a bilateral clearing arrangement, or

- military sales from private supplier to the government with counter-purchase of domestic goods by the foreign supplier or a correspondent trading company.

What economic benefits can we expect from counter trade? Governments and firms in many LDCs and centrally-planned economies of Eastern Europe expect (i) hard currency savings and (ii) to find an outlet for non-traditional exports. Evidence collected hitherto shows that neither of these objectives have been achieved on a country level. Trading companies might have benefited, however. Why does counter trade not allow countries to reap the gains from trade? Counter trade could be a short-term relief if it is used to increase the import capacity of a country suffering from severe balance of payments problems. It could help to import some indispensable goods (food, oil) and, at the same time to sell non-competitive goods abroad. In the long term, though, the economy will be harmed, because counter trade

- is not trade in the traditional sense; it constitutes an exchange of goods without considering prices or qualities. Only quantities matter;
- reduce the set of possible choices; importers are denied the opportunity to select the cheapest and otherwise best supplier. They are required to adjust their demand to the list of products agreed on a bilateral basis;
- reduces the pressure to maintain and eventually increase the international competitiveness of domestic production;
- reduces the scope for an international division of labour based on national specialization following dynamic comparative advantage;
- reduces the chances of countries with a foreign exchange bottleneck to expand exports which are not conditional on imports from a certain source, by committing exportable quantities of goods to counter trade;
- reduces the rate of growth by reducing the chances to earn foreign exchange and thus reducing the capacity to import capital goods embodying modern technology (which are generally not available for counter trade).

Therefore, all in all counter trade does not save foreign exchange, but rather costs foreign exchange.

2. Monetary, Fiscal and Exchange Rate Policy

Price stability is a basic condition for economic activity. Price stability can only be achieved in an open economy if a consistent set of monetary, fiscal and exchange rate policies is implemented. We know from economic theory that in an open economy the money supply can be controlled only partially, namely through domestic money creation and the level of accumulated reserves. In developing countries, central bank credit to the government usually is the most important source of domestic money creation. This money is channelled to finance the budget deficit in absence of a domestic capital market and/or of capital inflows from abroad. Therefore, under such circumstances, budget deficits tend to be inflationary. The first best policy to cope with inflation in this context would be to cut public expenditure and to raise tax income in order to reduce the budget deficit. At the same time, a devaluation of the domestic currency vis-a-vis the currencies of the major trading partners at a rate matching the difference between the domestic and the world rate of inflation would keep the real exchange rate constant and thus neutralize the impact of domestic inflation on the international competitiveness of domestic products. High rates of inflation, particularly those on the verge of hyperinflation should always be avoided, due to their adverse effects on the distribution of domestic income, the allocation of capital in the domestic economy, and the international competitiveness of domestic products.

3. Incomes Policy

Inflation can also result from an incomes policy aiming at a high level of real wages. A wage level which is totally delinked from labour productivity and accommodated by monetary policy contributes to cost inflation. Only an incomes policy subject to real productivity growth does not need to be financed by the inflation tax. In many developing countries public employees and other privileged parts of the labour force are able to push for a high real wage. To the extent that such changes in the level of labour compensation take place without considering the performance of the economy, they favour capital intensive investments. The latter are not consistent with the natural comparative advantage of many developing countries, namely the availability of relatively cheap unskilled labour, and thus reduce the international competitiveness of products using the dear labour as directed or indirect input.

IV. CONCLUSIONS

The trade regime determines the structure of economic incentives. To the extent that firms are able to adjust to the prevailing system of incentives, available factors of production are allocated either to activities related to import substitution or to production for export, or to both. Policy makers may thus alternatively choose an inward oriented, an outward oriented or a world-market oriented development strategy. The international position of any country can be maintained or improved if a set of consistent policies is implemented. Departures from simple consistency rules have to be paid for with losses in competitiveness, reduced market shares and lower income.

Low income countries have a greater growth (catching-up) potential than rich countries. This income gap could be narrowed if low income countries would create economy-wide incentives for growth. In choosing the appropriate trade regime and a consistent set of economic policies, a country can compete as a potential location for domestic and foreign capital. Only those locations will succeed in attracting the most profitable ventures which offer a good business climate. The latter not only depends on economic policies but also on long-run political stability.