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**Working Paper — Digitized Version**

## Export liberalization and the outward oriented trade regime

Kiel Working Paper, No. 241

**Provided in Cooperation with:**

Kiel Institute for the World Economy – Leibniz Center for Research on Global Economic Challenges

*Suggested Citation:* Donges, Juergen B.; Hiemenz, Ulrich (1985) : Export liberalization and the outward oriented trade regime, Kiel Working Paper, No. 241, Kiel Institute of World Economics (IfW), Kiel

This Version is available at:

<https://hdl.handle.net/10419/46725>

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# Kieler Arbeitspapiere Kiel Working Papers

Kiel Working Paper No. 241

EXPORT LIBERALIZATION AND THE  
OUTWARD-ORIENTED TRADE REGIME

by

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ISSN 0342 - 0787

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## I. Introduction

There is a voluminous theoretical and empirical literature about the implications of alternative trade regimes for economic development, which on balance points out that export-oriented strategies provide the most appropriate framework of economic incentives conducive to sustained and rapid growth along with an efficient use of available resources including indigenous labour [see, for instance, the surveys by Balassa, 1980a; Donges, 1983; and Krueger, 1984a]. Accordingly, an increasing number of developing countries have linked, to varying degrees, their economies to world production on the basis of comparative advantage and, by doing so, they were transformed into the now "newly industrializing countries" (NICs). South Korea is one of the outstanding cases in point, and Dr. Jae-Ik Kim, in whose memory the present essay is written, shared firmly the notion of international specialization, adhering to it also when the world economic environment sharply deteriorated during the seventies.

Yet, many governments of developing countries (and some influential academic economists as well) remained sceptical to-

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\* Prepared for a book in memory of Jae-Ik Kim (The Liberalization Process in Economic Development, ed. by Lawrence Krause and Kihwan Kim).

wards the implementation of outward-oriented trade regimes. The standard argument is that, after a long-lasting inward-oriented economic development, based on import substitution policies for industrialization, trade liberalization would cause excessively high adjustment costs while the potential benefits from such a liberalization could only be small, if not negligible, in an unfavourable international economic environment as the present one. That some South American countries which embarked upon liberalization experiments during the seventies fell into deep economic recessions, often accompanied by social and political upheavals, provide convenient support to such anxieties, despite pervasive evidence to the contrary in Asian countries. There are also instances, again mainly in Latin America, in which governments, faced with pressing foreign exchange needs to service foreign debt, undid prior shifts to relatively outward-oriented trade regimes and readopted import-substitution strategies.

The purpose of this essay is to re-assess the case of outward-oriented trade regimes in the process of economic development. The nature of outward-orientation is briefly explained in the next section. As developing countries usually start their industrialization through import substitution strategies, the shift from an inward- to an outward-oriented trade regime raises questions concerning the set of economic policies to be reshaped, the timing of the policy reform, and the feasibility of such changes, which all are discussed in the third section. The fourth section provides evidence on successful as well as on unsuccessful liberalization attempts undertaken in the seventies and traces the

causes for success or failure by relating the country experiences to the policy framework for export liberalization outlined in the previous section. In the fifth section, the revival of export pessimism is evaluated.

## II. Essence of an Outward-looking Strategy

Export promotion and outward-oriented trade regimes have frequently been misinterpreted to be policies which deliberately promote exports over other economic activities and beyond the level attainable under free trade conditions [see, for instance, Streeten, 1982]. The crucial point to be made is that government incentives to industrialization should be compatible with an optimal allocation of resources to the largest extent possible [as elaborated in the rejoinders to Streeten by Henderson, 1982, and Balassa, 1983].

This is not the case when the trade regime is biased towards import substitution on the basis of a variety of trade barriers ranging from high tariffs and restrictive quotas to outright import bans. Too many resources are then attracted by the protected industries. Moreover, as the process of import substitution goes on, encompassing the production of intermediate and investment goods, the incremental capital-output ratio will rise, which is likely to affect adversely the rate of economic growth and thereby to lead to a vicious circle of generally lower saving and investment paths and weakening productivity and development

trends. Export activities are, in the absence of corrective measures, discriminated against. On the one hand, exporters have to pay higher prices for protected locally produced or imported inputs, which they cannot pass on to potential customers on the world market unless they have a monopoly power (which is unlikely for most developing countries); on the other hand, the exchange rate tends to be over-valued due to protection, which is a self-inflicted export obstacle par excellence.

The allocation of resources would be more efficient and economic growth more sustainable if there is a framework of incentives which frees producers of exportables from cost disadvantages vis-à-vis foreign producers. As long as some import protection is granted on the grounds of non-pecuniary dynamic externalities, exporters have to be compensated by some forms of subsidies and by duty-free import allowances, as will be discussed below. Subsidies constitute a drain on government budgets which provides a stimulus to policy makers to refrain from excessive export promotion, to maintain a realistic exchange rate as an alternative to public subsidies, and to keep import protection at moderate levels. By contrast, import substitution strategies have revealed built-in tendencies towards reinforcing the inward bias of the incentive system [Bhagwati, 1978; Donges, 1983:280-282; Krueger, 1983a:32-33]. Import-substituting industries replace less imports than additionally required as intermediate inputs or for investment purposes, thus aggravating existing or giving rise to new balance-of-payments problems. Growing current account deficits as well as the exhaustion of narrow domestic markets by

the newly established industries put pressure on governments to implement additional trade restrictions and to intervene in foreign exchange, capital and labour markets, thereby further penalizing export activities.

Disregarding externalities, an optimal allocation of resources requires that the domestic rate of transformation equals the international rate of transformation. Taking international prices as given (small country assumption), the ratio of relative domestic prices of importables and exportables over the respective world market prices must be unity [Krueger, 1978]. Then, the system of incentives is neutral with respect to sales in domestic or in world markets. It is in this sense, and only in this, that the export promotion strategy is differentiated from an import-substitution strategy. Export promotion strategies provide incentives to exports sufficient to compensate for the discrimination of export production inherent in import protection; they provide a uniform incentive to both import-substitution and exports and thus to saving and earning foreign exchange per unit of domestic resources used; but they do not aim at boosting exports beyond free trade levels. The emphasis is on specialization based on comparative advantage, not on export expansion per se.

In cases in which the private costs of export production are higher than the social costs and this positive externality is higher than the corresponding externalities associated with import substitution, a bias of the incentive system in favour of exports could be justified on economic grounds [Mayer, 1984]. The



general problem with the "infant-industry" argument is, however, that it may turn out to be very difficult in practice to accurately demonstrate the existence of significant externalities and, if this was possible, to discontinue the extra-subsidies to exporting (or the protection of import substitutes) later on when the assisted activities have become mature.

### III. The Framework for Export Liberalization

#### III-1. Economic Objectives

The outward oriented trade regime aims at promoting sustained economic development and a rapid process of industrialization by exposing the domestic economy to international competition. The objectives are to improve the allocative efficiency of the economy as a whole by bringing, at each instant, the structure of production in line with the country's comparative advantage and to reap irreversible external benefits from the exploitation of economies of scale through exports, the stabilization of export earnings through export diversification into manufactured goods, the increase of savings for investment through raising real incomes, and the acceleration of technological innovation and human capital formation through competition from, and contacts with, abroad. Such gains are foregone in an inward-oriented trade regime since import protection and the whole system of market regulations do not only discriminate against exports, distort the structure of production and make it rigid, but also cause losses in efficiency through cartelization,

rent seeking behaviour, the formation of a labour aristocracy and the expansion of bureaucracy.

Export liberalization entails the two tasks of substituting price signals for administrative controls and of adjusting domestic relative prices to international relative prices, either by gradual measures or shock treatment. Liberalization does not necessarily mean the implementation of free trade and non-intervention in all other markets; it rather means a reform of economic policies, so that the price mechanism can work more effectively and competition is less distorted<sup>1</sup>. Government measures to remove market failures are perfectly justified, provided that such market imperfections are real (non-pecuniary externalities, publicness in goods or services, natural monopolies, and the like) and not the result of excessive encroachment of public authorities into the market process [as it so often happens, see Krueger, 1983:Chapter 7]. A liberalization reform requires ad hoc measures to be replaced by a stable and foreseeable policy framework, uniform rather than selective interventions, and a return to price flexibility which allows for a proper response to market changes. What does this mean in detail? The answer will differ between countries, depending much on the nature of the inward-oriented trade regime which has been in force so far. The common characteristics of an inward-oriented trade regime may therefore provide an appropriate starting point for a discussion of essential elements of a reform package.

<sup>1</sup> The economically successful Asian NICs, which have not abstained from a substantial degree of government intervention in their development process, may serve as illustration.

### III-2. Inadequacies of the Inward-oriented Policy Regime

Once a country embarks on an import-substitution strategy there seems to be a logic to the evolution of direct government controls on prices and quantities over time [Bhagwati, 1978]. Initial tariff protection for "infant industries" soon proves to be insufficient as non-protected domestic as well as discriminated export sectors vehemently complain about unfair treatment and as protection creates an incentive to evade the regime via smuggling, over- and underinvoicing, or black market transactions. The public authorities tend to react by moving from tariff protection to quantitative controls and import licencing procedures, effected with ever-increasing product coverage and ever-finer selectivity, yielding to political pressures of (often disparate) sectional interest groups. When easy import substitution possibilities have been exhausted, but the inward-looking policy approach is maintained, a complex control network is likely to evolve encompassing direct import allocation by category of commodity, by type of domestic uses, and by source of foreign exchange.

Despite proliferating import controls, import substitution regimes will generally not come to grips with the balance-of-payments difficulties, which typically afflict developing countries. As industrialization proceeds, the demand for imported intermediates and capital goods, which are complementary to domestic production, continues to grow at high rates, while the policy-induced over-valuation of the national currency retards or

impedes export expansion. Rising trade deficits and subsequent shortages of foreign exchange make interventions in foreign exchange markets inevitable and the resort to external credits a pressing need. Hence, import controls are supplemented by a direct allocation of foreign exchange to domestic uses and, also, complemented by an administrative credit rationing.

Capital market interventions usually emerge from two sources. Firstly, import substitution policies, making for unlimited vertical diversification of the industrialization process, favour production of relatively capital-intensive products, the application of capital-intensive technologies (because of relatively low barriers to imports of capital goods), and an inefficient use of capital (due to the lack of competition in domestic markets). High incremental capital-output ratios would soon slow down industrialization and economic growth unless access to financial capital at reasonable rates of interest can be maintained. To sustain the momentum of import substitution, governments will, therefore, impose interest rate ceilings on both deposits and loans and/or provide preferential treatment for selected economic activities - as it actually occurred time and again. As these interventions usually are administered in a discretionary way, they create uncertainty among investors; and as they tend to be guided by public preferences rather than by comparative advantages, investment patterns are likely to be distorted. In addition, interest rate and other subsidies to capital formation become an increasing burden to the public budget.

Secondly, interest rate ceilings on bank deposits discourage domestic private savings and encourage - together with the over-valued exchange rate - capital flight, both augmenting demand for external funds. Reflecting donor rules or preferences for securing external financing by government guaranties, loans from abroad might largely be channeled through public institutions, which reinforces the heavy hand of the government in the allocation of credit. Foreign borrowing is, however, not an unlimited source for financing public budget deficits. Government which are not able (or not willing) to reduce the deficits may be tempted to turn the screw of the inflation tax by accelerating the rate of growth of money supply. To collect the inflation tax the banking sector has to be exposed to tighter supervision of the central bank. High non-interest-bearing reserve requirements on bank deposits, forced lending to public sector enterprises and, ultimately, nationalization of private banks are tools to make sure that the inflation tax accrues to the government, but these tools further weaken the functioning of the capital market.

Import protection and the availability of credit at subsidized interest rates promote expansion of capital-intensive lines of production and, thereby, boost labour productivity at the expense of creating sufficient employment opportunities to absorb a rapidly growing labour force. The distorted structure of production paves the way to nominal wage levels in excess of equilibrium wages in the formal sector of the economy with the well-known consequences for labour migration and informal labour markets. The situation worsens if governments pursuing inward-

oriented development strategies do keep wages above their equilibrium levels by minimum wage legislation and if they artificially increase labour costs to employers further by excessively rigid labour codes and generous social policies. Such interventions in fact occurred in many developing countries [Squire, 1981; Berry, Sabot, 1984]. They were meant to secure the political support of the - in most cases well organized - urban labour force for the development strategy applied by the government. For this reason, governments also sought to shelter the urban labour force from the costs derived from high inflation through price controls for essential consumer goods, publicly decreed wage increases and/or formal indexation of wages. Thus, labour markets become subject to a significant degree of government regulations and controls as inward oriented economic development progresses over time, and comparative advantages based on a relatively elastic supply of labour are not exploited.

It is against such a background, i.e. an economic environment characterized by manifold interrelated and distorting government interventions in the economy, that export liberalization has to be contemplated. Attempts to liberalize the economy have to take into account the nature of controls and regulations as well as the interactions between them. Welfare theory suggests that in a case of multiple distortions removal of one distortion may make things even worse. Export liberalization will, therefore, require a reform package which includes some degree of policy change vis-à-vis all major markets.

### III-3. What Policy Reform Package?

From a theoretical point of view, export liberalization would best be achieved by an instantaneous removal of all controls and regulations which distort the allocation of resources and contribute to an underutilization of available capacity. Such a first best solution is, however, likely not to be feasible in the context of a highly regulated economy since adjustment costs may become excessively high and even disrupt the political system as such. A more cautious approach to liberalization raises a number of questions such as which are the key markets to be liberalized, which degree of deregulation is both necessary and feasible, and which timing and sequencing of policy changes should be envisaged.

Under a fixed exchange rate system, import liberalization can reduce the bias of trade policies in favour of import substitution and may have a beneficial effect on inflation rates. It may, yet, fail to achieve the desired export expansion as long as capital- and labour markets remain under tight control. Export prices do not change because of the fixed exchange rate. Although intermediate input costs decline as a result of import liberalization, labour costs remain high, and artificially low capital costs due to interest rate ceilings provide little incentive to redirect investment flows toward export activities which usually yield a higher capital productivity than import substitution. A devaluation of the currency would appear to be more promising than import liberalization with respect to export expansion,

since, even with quantitative import controls persisting, the relative domestic price of exportables would increase. This result depends, however, very much on how the necessary exchange-rate adjustment is effected. In the presence of high rates of inflation, the authorities may underestimate the difference between domestic and international inflation and thus cause a real appreciation of the exchange rate rather than a depreciation. But even a freely floating exchange rate and a liberalization of the foreign exchange market can have its draw-backs unless domestic financial markets are simultaneously liberalized. For, in the presence of controlled (and usually negative) interest rates, full liberalization of the exchange regime for both current and capital account and a floating exchange rate would surely result in capital outflows and rapid depreciation of the currency in excess of the rate of inflation. In countries with high and persistent inflation, a complete deregulation of financial markets will, however, hardly be feasible (at least not in the short run) since the tightly controlled banking sector has lost the capability to collect and allocate financial resources efficiently.

Obviously, there are no cookbook recipes for initiating the transition from an inward to an outward oriented trade regime. Level of development, size of the country, resource endowment, and relative importance of controls in individual markets will have to be taken into account when designing an effective and feasible reform package. However, empirical evidence strongly suggests that trade interventions have been a major, if not the biggest single source of distortion [Krueger, 1984b:417].



For this reason, it is a safe proposition that any policy reform will have to focus on the removal of obstacles to an expansion of exports in the first place. Depending on the nature and degree of protection, a combination of the following three elements of an import liberalization strategy will have to be applied to accomplish this task: a transformation of quantitative trade interventions into tariffs, harmonization of tariff protection across sectors, and a reduction of the average level of protection. As to the first aspect, tariffs are preferable to quantitative restrictions not only because the latter tend to veil the actual degree of protection but also because the competition for import licenses diverts productive resources from more efficient use elsewhere in the economy, apart from encouraging corruption in the bureaucracy<sup>1</sup>. Secondly, remolding the (new) tariff structure towards a uniform tariff system serves the purpose to eliminate or at least reduce escalation and de-escalation effects of selective nominal tariff protection on effective rates of protection. A more uniform effective rate of protection across sectors lowers artificial advantages for import-substituting activities through, for instance, duty-free imports of capital goods, and leaves the choice of efficient import substitution possibilities to market forces rather than to bureaucrats. Thirdly, a more uniform tariff system in itself usually entails a lower overall degree of import protection to domestic industries, since those sectors which were granted low protection in the past will now exert pressures on the government to treat the other

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<sup>1</sup> The beneficial effects of phasing out quantitative restrictions on imports have recently been shown in Turkey [Gönensay, 1984].

activities equally. Obstacles to the expansion of exports are thus mitigated. However, additional efforts will be required if the general level of protection is to be lowered further<sup>1</sup>.

As long as some degree of import protection prevails, export activities remain discriminated against both directly through higher prices for imported intermediate and capital goods and indirectly through the effects of protection on the general level of product and factor prices. Direct cost disadvantages of export activities can be remedied by one or all of the following measures, which have been applied in a wide range of developing countries: duty-free importation of inputs for export production, draw-back schemes for import tariffs, and the establishment of free export-processing zones. From the point of view of administrative ease, duty-free importation and export-processing zones are clearly superior to draw-back schemes while free zones - if appropriately established - may offer additional net benefits in terms of employment creation and strengthened linkages to the domestic economy [Spinanger, 1984].

A closer vertical integration of the economy is also promoted by measures compensating export activities for indirect cost disadvantages. Such measures include income or sales tax rebates, special depreciation allowances, preferential credits

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<sup>1</sup> Chile, where the government removed quotas and reduced tariffs from an average level of 90 per cent in 1974 to a uniform rate of 10 per cent in 1979, following a pre-announced time schedule, is the most recent case in point proving that a trade liberalization policy is feasible despite the opposition of vested interests [Sjaastad, 1983].

and straightforward subsidies [for details see de Wulf, 1978]. These various kinds of subsidies on either output or factor use can be compared to a partial, export related devaluation of the currency which may be necessary to balance the incentive system with respect to sales in domestic and foreign markets. However, this approach bears some risks: Firstly, it is almost impossible to determine the subsidy rate required to compensate for disadvantages accruing from import protection which may lead to an undesirable overshooting. Secondly, the subsidies, typically related to the amount of investment, tend to encourage the use of capital over labour and, thus, may be detrimental to a satisfactory rate of employment growth. And thirdly, export subsidies can provoke retaliation from industrialized countries which tend to ignore the compensatory nature of these subsidies, regarding them as price dumping. For these reasons, the emphasis of trade policy reform should be on import liberalization rather than on the implementation of export subsidies.

With import liberalization, the compensation of indirect cost disadvantages can be achieved by a more rational exchange rate policy which increases the prices of exportables without inflating import prices. In the medium and long term, exchange rate policy has to neutralize differences between domestic and foreign rates of inflation to shelter domestic suppliers from inflation-induced cost disadvantages vis-à-vis foreign competitors. This goal cannot be achieved if the exchange rate is used as a policy instrument to influence other macro-economic variables as well, such as the rate of inflation itself. If the exchange rate is

used to break the inflation mentality, as was done for instance in Chile in 1979-81, this is at best a short-term policy the success of which depends on the credibility of the governments' effort to contain inflation and on the ability of the export sector to cope with the temporary discrimination implied by the real appreciation of the currency. The choices for an appropriate medium-term exchange rate policy are ad hoc devaluations in an otherwise fixed exchange rate system, the implementation of a sliding peg or a pre-announced devaluation schedule, or a freely floating exchange rate. The first alternative can be dismissed as impracticable both on theoretical and empirical grounds. In a fixed exchange rate system, the external value of the currency is adjusted ex post to inflation differences. This in itself contributes to permanently fluctuating real exchange rates which discourages export orientation of domestic firms, is detrimental to long range investment planning, and induces destabilizing speculation. These negative effects are aggravated if necessary devaluations are delayed on account of ill-fated national prestige considerations, as frequently occurs, so that further uncertainty is caused.

The choice between administered stepwise devaluations and freely floating exchange rates is a much more difficult one because the potential effects on resource allocation of either policy depends on monetary and credit policies pursued simultaneously. A controlled sliding peg has the advantage of levelling exchange rate fluctuations and, hence, reduces exchange rate risks for exporters and local as well as foreign investors. Coun-

tries such as Brazil, Colombia and South Korea have successfully applied such a policy in the late 1960s and early 1970s [Donges, Müller-Ohlsen, 1978:112]. Problems have been encountered, however, with pre-announced stepwise devaluations ("tablita") in some Latin American countries with high and increasing rates of inflation such as Argentina and Uruguay [for details, see Barletta, Blejer, Landau, 1984]. In these countries, the "tablita" has repeatedly failed to bring about the desired devaluation of the currency in real terms in the second half of the 1970s and early 1980s, since governments usually underestimated future rates of inflation. The result was a real appreciation of the currency since nominal devaluation rates fell short of international inflation differences. The lesson is that a "tablita" policy will only help to restore foreign exchange equilibrium if governments simultaneously pursue a strict anti-inflationary monetary policy which usually implies incisive cuts of public deficits [Sjaastad, 1983; Fischer, Hiemenz, Trapp, 1985]. In order to alleviate short-term adjustment costs as much as possible, anti-inflationary policies will have to be accompanied by financial policies designed to enhance the restructuring of the economy according to comparative advantages, a topic to which we will return shortly.

The other alternative, the transition from a fixed over-valued to a freely floating exchange rate will usually imply a large initial devaluation with a similar rise in the price level which is difficult to contain by import liberalization measures, at least in the short term. Moreover, with low or negative real

rates of interest in local capital markets, devaluation expectations are likely to give rise to an uncontrollable capital outflow, which would further reduce <sup>the</sup> ~~to~~ capacity of the economy to adjust to new relative prices. Yet, a freely floating exchange rate may be the only feasible policy alternative as long as high inflation has not abated, since governments lack the foresight to predict future price increases correctly in an inflationary environment.

It thus seems clear that appropriate trade policies have to be combined with fiscal and monetary policies designed to curb inflation, and with a deregulation of capital markets as well, if the shift to an outward-oriented trade regime is to succeed. The deregulation of capital markets gains particular significance once the adjustment process is considered. With greater reliance on market forces and increased competition from abroad, parts of the installed capacity will be rendered obsolete, while expansion into new profitable activities creates demand for credit to finance the necessary investment. The ease and the speed of the adjustment process will heavily depend on whether this demand for fresh funds can be met. Therefore, efforts have to be undertaken to mobilize domestic savings and to attract capital from abroad. In both respects it is imperative to let interest rates reflect the true scarcity of financial capital, i.e. to allow for a positive real rate of interest, and to strengthen the ability of the banking sector to attract and allocate funds efficiently by re-

moving excessive banking regulation<sup>1</sup>. In some countries it may also be necessary to revamp investment legislation so that existing "red tape" is reduced and foreign investors get guaranteed their property rights, which is much more important than the provision of generous financial incentives by the host government, as all available evidence indicates.

Efficient capital market policies are crucial, since the social acceptability of liberalization hinges on swift achievements in terms of output growth and employment creation. It need not be stressed that such achievements do not only depend on consistency between trade, monetary, and credit policies, as pointed out earlier; it is of equal importance that governments do not erode the potentially beneficial effects of the new incentive system by countervailing policy action such as, in particular, controls of prices, profits and dividends or interventions into labour markets. The positive welfare effects of liberalization arise from a reallocation of resources following a shift in relative prices including the wage rate. Any attempt to maintain a privileged income position of workers in the hitherto protected sector of the economy endangers the establishment and growth of internationally competitive activities and prevents the creation of additional productive jobs. Governments may find it difficult to resist the claim of organized labour to secure, if not in-

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<sup>1</sup> A relaxation of banking regulations requires, of course, to adopt anti-inflationary policies lowering the government's dependence on the inflation tax. This interrelationship highlights, again, the crucial interdependence of trade, monetary, and credit policies.

crease, real wages, but this political pressure will relax only when the employment and income effects of liberalization materialize; and this will happen the sooner real wages are allowed to decline temporarily until productivity gains accruing from a better resource allocation permit further wage increases.

#### III-4. Timing and Sequencing of Liberalization

An abrupt liberalization would be the least painful way of proceeding if the following conditions are given: Firstly, with the new system of incentives firmly in place, adjustment will proceed rapidly without being hampered by resource misallocation during the transition. Secondly, instantaneous adjustment will prevent political opposition to the policy change from diluting it. And thirdly, an immediate transformation of the economic environment will reduce uncertainty about the credibility of the policy initiative which could delay the response of economic agents to new incentives. If these considerations are overriding, the issues of timing and sequencing do not arise.

There is a wide-spread belief, however, that instantaneous liberalization of an economy hitherto subjected to exchange control, import licencing, negative real interest rates, indexed real wages, and so on, will completely disrupt economic activities and cause high adjustment costs in terms of declining output and increasing unemployment. It is then suggested to remove controls gradually so as to give economic agents time to prepare for



adjustment (timing) and to deregulate individual markets in a stepwise fashion depending on the ease with which adjustment can be accomplished in these markets (sequencing).

Some of these problems have already been discussed above with respect to import liberalization and exchange rate policy. Analytically, an optimal liberalization program depends on the degree of prevailing interventions, on the intensity of linkages between individual markets (i.e. the level of economic development) and on expectations which have been built up on the basis of past experience with economic policy making [Lächler, 1985]. Although all these factors do matter, very little is known concerning their precise relationship to the time schedule of a reform program. Therefore, the basis for any proposal remains largely judgmental. The advantages of graduation in import liberalization have been emphasized on the grounds that losses of capital and jobs, inevitable as they are in the process of moving towards a new production structure, would be minimized<sup>1</sup>. Whether this can be achieved depends on the success of exchange rate policy in shifting relative prices in favour of exportables without propelling domestic inflation.

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<sup>1</sup> Similarly, gradualism has been advocated with respect to stabilization policy [Stein, 1980]. The main argument here is that unwinding inflation in smaller steps can avoid a head-on-collision between monetary policy and price and wage determination which would result in a major economic recession. However, in a high inflation environment, any fine tuning of monetary policies may be impossible and gradual stabilization may be insufficient to break the inflation mentality. The experience of Germany in the early 1920s and that of Austria, Hungary and Poland in the late 1940s show furthermore that a shock treatment can achieve stabilization quickly and at low cost in terms of unemployment [Sargent, 1982].

Concerning the proper sequence of liberalization steps Jakob Frenkel [1984] has argued that domestic distortions in the goods and asset markets should be removed before links with the rest of the world are liberalized. In addition, restrictions on capital flows should only be lifted after free trade has been introduced because asset markets are adjusting more quickly to new policy regimes than goods markets. The latter proposal also emerges from several studies of unsuccessful liberalization attempts in Chile, Uruguay, and Argentina [McKinnon, 1982; Dornbusch, 1984; Edwards, 1984; Sjaastad, 1984]. They all conclude that liberalization of the capital account should be postponed because capital flows would either - under a freely floating exchange rate - push the value of the domestic currency to a level which impedes the structural transition of the real sector, or - under a "tablita" or fixed exchange rate regime - require extremely high real rates of interest in domestic capital markets to maintain the chosen parity<sup>1</sup>.

Both effects are clearly undesirable but we would argue that they have rather resulted from an inconsistent mix of exchange rate and domestic economic policies than from the liberalization of the capital account as such. In particular, the attempt to use the exchange rate as an anti-inflationary device while distortions of domestic capital and goods markets remained in place, has caused the severe economic recessions which each time marked

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<sup>1</sup> For similar reasons the Bretton Woods Agreement of 1944 focused on trade liberalization and did not envisage the elimination of restrictions on capital flows.

the end of so-called economic liberalization in Latin America. Even if controls on capital flows had been maintained the exchange rate regime managed by the government would still have induced an appreciation of the real exchange rate. The resulting decline in the international competitiveness of the tradeables sector which was enforced by incompatible domestic policies such as wage indexation (Chile) or persistent monetary expansion (Argentina), would have been sufficient to prevent the necessary adjustment of the real sector of the economy and, thus, to provoke a new balance-of-payments crisis. Most likely, the risks associated with the choice of a "wrong" exchange rate are by no means smaller than those stemming from destabilizing capital flows.

This assessment suggests that appropriate liberalization policies for concrete cases can only be proposed after a careful economic analysis of the country concerned was undertaken. With this qualification in mind, the history of successful liberalization in Asian countries and less successful liberalization attempts in Latin America's Southern Cone (to which we shall return in detail later) would at least suggest the following policy guidelines. Gradualism tends to be self-defeating with respect to stabilization and exchange rate policies, while import and capital markets may be better candidates for a more cautious removal of controls. It has to be stressed, however, that at least a partial deregulation of the capital market is an urgent task since capital markets have to play a key role in providing the funds needed for rapid and successful economic adjustment to a

more outward oriented trade regime. To facilitate financial flows, it may also be advisable in many countries not to postpone the liberalization of the capital account until the real sector of the economy has adjusted, even if there are some risks concerning an unwarranted appreciation of the currency. If the government abstains from interventions into the foreign exchange market, i.e. does not buy up the foreign exchange inflow, a revaluation of the currency is unlikely. A steady course of the Central Bank with respect to monetary policies can prevent an inflationary increase of domestic money supply, while import liberalization will help to mitigate the revaluatory effect of capital inflows. The government should be prepared to accept a temporary deficit in the current account (j-curve effect) to accelerate productive investment based on imported capital goods and to limit the inflow of speculative capital. Once new investments go into operation and export growth is accelerating, the current account deficit will automatically be eliminated.

### III-5. The Political Economy of Export Liberalization

Despite some open questions, the switch from an inward to an outward oriented trade regime has hardly been hampered by a lack of knowledge concerning the economic management of transition; it was rather impeded by a lack of political will to change the direction of economic development. The major problem with liberalization is that government officials, politicians and the informed public can readily foresee those interests that are likely

to be damaged in the short run by any liberalization effort. The damage accrues primarily to those benefitting most from controls and regulations, and it is in the logic of the system that the main beneficiaries of the regime such as import-substituting industries, the labour aristocracy and bureaucrats issuing power through controls also tend to be well organized in political pressure groups. For them, it pays to invest into the continuity of the inward oriented trade regime. Those, on the other hand, who have to foot the bill for excessive regulations in terms of income and employment foregone, such as consumers, informal labour, export industries and agriculture, often do not realize the price they are paying and, hence, have little incentive to organize themselves in special interest groups. They usually find it difficult as well to perceive the medium and long term benefits that export liberalization holds out to them. For these reasons, there has always been a lot of opposition against and little support for a change of the trade regime.

Yet, not just the so-called "Gang of Four" in Asia (Hong Kong, Singapore, South Korea and Taiwan) but also quite a number of other developing countries have adopted export promotion strategies in the 1960s and 1970s. This raises the question which political conditions may be conducive to liberalization. Bhagwati [1985:Chapter 1] has hypothesized that authoritarian regimes can more easily choose appropriate policies than democratic governments. His main argument is that the import-substitution strategy confers more political power than the export promotion strategy since it provides politicians with greater patronage; hence where

politicians take power directly by authoritarian means, they have no necessity to use the economic system to generate and exercise power, thus freeing themselves to embrace economic liberalization. Though analytically appealing, Bhagwati's hypothesis does not carry very far in the light of empirical evidence. There are military dictatorships in some Latin American countries clinging to populist policies while politicians in fairly democratic countries such as Malaysia or Thailand have taken the initiative to liberalize their economies in the 1970s.

So far, we do in fact know very little about the political-economic background of economic decision-making in developing countries and on the constellation of power groups which provide governments with enough independence to implement appropriate policies for sustained economic development. Much more research is needed in this area. All that can be said at this stage is that standard arguments against the political feasibility of export liberalization did not stand a test. The attempt to preserve national independence through a diversified domestic industrial sector, largely de-linked from the world economy, has increased dependence on imported intermediate and capital goods and has contributed to the currently intractable foreign indebtedness. Trade unions were not pacified by maintaining the course of import-substitution strategies; the political pressure exerted by organized labour against the government was as strong under inward-oriented trade regimes as when liberalization was attempted. And finally, persistent reliance on import-substitution strategies for fear of political and social upheavals in case of a

policy change has not protected many countries in Africa and Latin America from plunging into economic crises and civil disorder with a subsequent change of government. The new government, often a military one, then had little choice but to implement some liberalization measures to remedy the economic crisis.

#### IV. Evaluation of the Evidence

##### IV-1. Export Performance

The proposition that an open trading environment promotes an efficient use of available resources has received impressive support from the experience of an increasing number of old and new NICs which gradually opened their markets during the 1960s and 1970s. Export liberalization has caused manufactured exports from the Third World to expand spectacularly, outpacing both world trade expansion and domestic industrial output growth. As Table 1 shows, manufactured exports of developing countries grew on average at an annual rate of roughly 14 per cent in real terms in the period 1965-1982, i.e. about twice as fast as world trade. Export expansion was predominantly carried by the 19 countries listed in Table 1 which accounted for 79 per cent of total Third World manufactured exports in 1982. With rapid domestic industrialization, the export portfolio of these countries significantly shifted towards manufactured goods as shown by the shares of these goods in total exports which increased from 7.2 per cent in 1965 to 44.8 per cent in 1982.

Table 1 - Manufactured Exports<sup>a</sup> of Newly Industrializing Countries (NICs), 1965-1982

Countries	Value in Mill. US \$			Share in total exports (p.c.)		Annual real rates of growth (p.c.) <sup>b</sup>	
	1965	1973	1982	1965	1982	1965-73	1973-82
<b>First Generation NICs</b>	<b>2 645.4</b>	<b>16 796.7</b>	<b>77 735.1</b>	<b>33.1</b>	<b>58.2</b>	<b>19.4</b>	<b>9.6</b>
Argentina	83.9	735.4	1 846.4	5.6	24.2	24.4	2.4
Brazil	124.3	1 216.9	7 720.9	7.8	38.3	26.1	13.5
Hong Kong <sup>c</sup>	819.7	3 649.5	13 161.0	93.2	96.3	14.3	6.6
India	812.8	1 560.7	5 000.0 <sup>d</sup>	48.3	55.5 <sup>d</sup>	2.9	5.3 <sup>e</sup>
Israel	276.3	1 108.8	4 243.2	64.3	80.4	12.8	7.3
Mexico	165.9	1 129.9	2 012.9	14.5	9.6	20.5	-1.4
Singapore <sup>c</sup>	72.1	1 004.0	5 034.3	52.1	37.0	31.8	10.6
South Korea	103.8	2 717.2	19 121.3 <sup>d</sup>	59.3	90.0 <sup>d</sup>	42.6	16.2 <sup>e</sup>
Taiwan	186.6	3 674.3	19 595.3	41.5	88.8	37.6	11.3
<b>Second Generation NICs</b>	<b>230.1</b>	<b>1 500.6</b>	<b>10 326.2</b>	<b>0.7</b>	<b>20.5</b>	<b>20.6</b>	<b>14.6</b>
Chile	15.0	44.5	780.0 <sup>d</sup>	2.4	20.8 <sup>d</sup>	8.6	30.2 <sup>e</sup>
Colombia	33.8	307.3	745.5	6.3	24.3	24.9	2.0
Indonesia	-	60.6	808.1	-	3.6	-	23.3
Malaysia	64.3	346.5	2 734.9	6.4	22.7	17.0	16.3
Morocco	23.1	129.9	706.0	5.4	34.3	24.1	11.6
Peru	4.1	28.6	377.3	0.6	13.7	20.7	23.1
Philippines	65.8	219.6	1 145.7	8.3	22.9	10.2	11.1
Thailand	12.1	255.4	1 871.8	2.0	21.9	38.8	15.4
Tunisia	11.6	83.9	833.7 <sup>d</sup>	9.9	33.3 <sup>d</sup>	21.1	21.3 <sup>e</sup>
Uruguay	-	24.4	323.2	-	31.6	-	23.2
<b>Total</b>	<b>2 875.5</b>	<b>18 297.2</b>	<b>88 061.3</b>	<b>7.2</b>	<b>44.8</b>	<b>19.5</b>	<b>10.1</b>
in p.c. of developing countries' exports	68.3	79.0	79.0	-	-	-	-
in p.c. of world exports	2.8	5.3	8.5	-	-	-	-
<b>Manufactured exports of</b>							
Developing countries	4 212	23 148	111 519	-	-	17.3	10.1
World	102 137	346 851	1 042 052	-	-	10.5	4.5

<sup>a</sup>SITC 5+6+7+8-68. - <sup>b</sup>Export values deflated by unit value indices for manufactured exports of industrialized countries. - <sup>c</sup>Excluding re-exports. - <sup>d</sup>1981. - <sup>e</sup>1973-1981.

Sources: UN, Yearbook of International Trade Statistics, Department of International Economic and Social Affairs, New York, various issues. - UN, Commodity Trade Statistics, Department of International Economic and Social Affairs, Statistical Papers, New York, various issues. - UN, Monthly Bulletin of Statistics, Department of International Economic and Social Affairs, Statistical Office, New York, various issues. - UNCTAD, Handbook of International Trade and Development Statistics, New York 1983; Supplement 1984. - Estadísticas de Exportación hasta 1969, Banco Industrial del Perú, División de Comercio Exterior, Lima 1971. - Analisis Estadístico, Importación - Exportación, Centro de Estadísticas Nacionales y Comercio Internacional Edición no. 17, Montevideo 1973. - Economic Survey of Singapore 1983, Ministry of Trade and Industry, Republic of Singapore. - Yearbook of Statistics Singapore 1979/80, Chief Statistician Department of Statistics, Singapore. - The Trade of China (Taiwan District) 1982, Compiled and published by the Statistical Department Inspectorate General of Customs, Taipei, Taiwan, The Republic of China, Chinese Maritime Customs, Statistical Series No. 1, 1983. - Economic Survey 1982-83, Government of India, printed by the Manager, Govt. of India Press, New Delhi 1984.



The 19 countries in Table 1 are quite diverse as there are some - the first generation NICs - which had established a substantial industrial base already in 1965, while others - the second generation NICs - were latecomers which began to promote industrialization and exports of manufactures only in the 1970s. The interesting point to make is that this happens in spite of successive oil shocks, economic recession in industrialized countries, high interest rates and new protectionism during the last decade. The unfavourable external environment did not prevent these countries from penetrating markets of industrialized countries further and from intensifying trade within the Third World. The real rate of manufactured export growth of 10.1 per cent for all countries taken together, which has to be compared to a rate of 4.5 per cent for world trade in manufactures, indicates the continuity of export success in the period 1973-82. In this difficult period, the second generation NICs were even more successful than their forerunners as shown by rates of export expansion of 14.6 and 9.6 per cent respectively.

Equally noteworthy is the fact that the early export drive of old NICs has not clogged the markets of industrialized countries, leaving hardly any room for latecomers, as it often asserted. Most of the new NICs started industrialization based on a relatively open trade regime in the 1970s and were able to compete successfully with old NICs and with suppliers from industrialized countries. All second generation NICs except Colombia (which had abandoned outward orientation by then) have achieved rates of manufactured export expansion in excess of the group of

old NICs [for further details, see Havrylyshyn, Alikhani, 1982]. An analysis of ASEAN countries [Hiemenz, 1984] even suggests that the take-off to export oriented industrialization may have been easier for the latecomers since the experience of the old NICs served as an indication for choosing an appropriate product mix, tapping the right markets and exploiting established trade links.

A great number of country studies show that exports, which expanded so rapidly under outward-oriented trade regimes, have been the major driving force of economic growth and employment creation, exceeding any performance observed in countries pursuing import-substitution strategies [Donges, 1983, and the references given there; Ram, 1984]. The domestic saving rate increased rapidly and so did the proportion of investment in GDP, both behind remarkable rises in the export-to-GDP ratios (Table 2). What in most NICs appears as an "export-led type" of economic development, in fact meant a continuous strengthening of the supply potential of the economy and a steady increase in productivity. Relatively low real wages provided the inducement to build up manufacturing production capacities using labour-intensive technologies to a large extent, which allowed the absorption of surplus labour. When later on labour became scarcer during the industrialization process and consequently real wages increased more rapidly, particularly in the leading NICs, the economies had gained sufficient flexibility on the supply side to gradually shift the production structure towards more physical-capital and skill-intensive activities and to be internationally competitive with the new undertakings. Direct foreign investment has contrib-

Table 2 - Indicators of Export-oriented Development

Countries	Percentage Share in Gross Domestic Product of						Annual Rates of			
	Exports		Savings		Investment		Real Manufac- turing Output		Real GDP	
	1965	1983	1965	1983	1965	1983	(in per cent)			
							1965-73	1973-83	1965-73	1973-83
<b>First Generation NICs</b>										
Argentina	8	13	22	18	19	13	4.6	-1.8	4.3	0.4
Brazil	8	8 <sup>a</sup>	27	21 <sup>a</sup>	25	21 <sup>a</sup>	11.2	4.2	9.8	4.8
Hong Kong	71	95	29	25	36	27	.	.	7.9	9.3
India	4	6	16	22 <sup>a</sup>	18	25 <sup>a</sup>	4.0	4.2	3.9	4.0
Israel	19	33	15	9	29	22	.	.	9.6	3.2
Mexico	9	20	21	28	22	17	9.9	5.5	7.9	5.6
Singapore	123	176	10	42	22	45	19.5	7.9	13.0	8.2
South Korea	9	37	8	26	15	27	21.1	11.8	10.0	7.3
Taiwan	19	58	20	32	23	25	15.4	8.4	10.4	7.2
<b>Second Generation NICs</b>										
Chile	14	24	16	11	15	8	4.1	0.5	3.4	2.9
Colombia	11	10	17	15	16	19	8.8	1.9	6.4	3.9
Indonesia	5	25	6	20	7	24	9.0	12.6	8.1	7.0
Malaysia	44	54	23	29	18	34	.	8.5	6.7	7.3
Morocco	18	23	12	11	10	21	6.1	4.0	5.7	4.7
Peru	16	21	19	14	21	13	4.4	0.4	3.5	1.8
Philippines	17	20	21	21	21	27	8.5	5.0	5.4	5.4
Thailand	18	22	19	20	20	25	11.4	8.9	7.8	6.9
Tunisia	19	35	14	20	28	29	10.3	11.1	7.3	6.0
Uruguay	19	24	18	14	11	10	.	.	1.3	2.5
<b>For comparison:</b>										
Middle Income Countries	18	24	21	21	21	22	9.3	4.9	7.1	4.7
Upper Middle-Income Countries	19	25	24	23	23	22	.	.	7.4	4.9
Lower Middle-Income Countries	17	21	16	17	17	22	8.5	5.4	6.6	4.1
Industrialized Countries	12	18	23	20	23	20	3.8	1.1	4.7	2.4
<sup>a</sup> 1982										

Sources: World Bank, World Development Report 1985, Washington D.C. 1985; Asian Development Bank, Key Indicators of Developing Member Countries of ADB, Vol. 15, April 1984.

uted to the success of export orientation and diversification, mainly by providing technical knowledge and marketing expertise and by upgrading skills of domestic workers as well; but with the exception of Singapore the significance of (totally or partly) foreign-owned firms, in terms of investment, production, export or employment shares, was much more modest than commonly believed.

The empirical evidence also confirms that these encouraging results have been brought about by improvements of trade and trade-related policies along the lines discussed in Section III. A corrected and more sensible import-tariff and export-subsidy policy, combined with more realistically valued real exchange rates, more rational factor pricing, and less intervention in goods markets have constituted the pillars of outward-orientated trade regimes. State intervention remained important in all NICs (with the exception of Hong Kong which always has come very close to a "laissez-faire" economy), but the readiness of governments to consider comparative-cost criteria, to modify plans when circumstances changed and to learn from past mistakes was much greater than elsewhere in the Third World. When export liberalization involved some kind of resource misallocation, for instance because the governments promoted exports which were bearing high marginal domestic resource costs per unit of foreign-exchange earnings, the country's industrialization process did not come up against a balance-of-payments constraint, as it almost inevitably would under an inward-oriented regime; those

exports at least provided foreign-exchange revenues. It should also be noted that the transition from an inward-oriented to an outward-oriented trade regime did nowhere cause traumatic dislocations in production and employment. On the contrary, the more or less gradual approach adopted by the governments in reforming policies facilitated the needed adaptation greatly. Even many of the inefficient producers which so comfortably lived under the previous protectionist environment, demonstrated that they were actually quite able to reduce costs through process innovations and to develop new markets through product innovations, once the increased competitive pressures made such efforts imperative for survival.

#### IV-2. External Shocks and Foreign Indebtedness

One frequently raised objection against export liberalization concerns the dependence of outward-oriented economies on conditions in world markets. It is argued that open economies are vulnerable to external shocks while less trade orientation provides a protective shield against disruptive external demand or price changes. The experience of the 1970s and 1980s, when all developing countries were suddenly confronted with the need to overcome increasing balance-of-payments pressures in order to preserve the momentum of their development process, reveals the opposite. Outward oriented economies commanded enough flexibility both at the macro and micro level to meet the challenge of deteriorating world market conditions without falling into the debt

trap, while inward oriented economies suffered from severe economic depression and - in many cases - mounting foreign indebtedness. Balassa [1984] has shown that outward-oriented economies relied largely on output-increasing policies of export promotion and import substitution to offset the balance-of-payments effects of external shocks in the 1974-76 and the 1979-81 periods and accepted a temporary decline in the rate of economic growth in order to limit their external indebtedness. In turn, inward-oriented economies failed to apply output-increasing policies of adjustment; they financed the balance-of-payments effects of external shocks by foreign borrowing in the 1974-76 period and had to take deflationary measures in 1979-81 as their increased indebtedness limited the possibilities for further borrowing. The policies applied led to economic growth rates substantially higher in outward-oriented than in inward-oriented economies, with the differences in growth rates offsetting the differences in the size of external shocks several times.

#### IV-3. Aborted Liberalization Attempts in Latin America

The liberalization attempts in Uruguay, Chile and Argentina, initiated in the mid-1970s [for details see the country papers in Barletta, Blejer, Landau, 1984], seem to run counter the arguments presented in previous sections. True, all three economies experienced initial success in reducing inflation and accelerating the rate of economic growth. But the positive

developments ended abruptly, as each country encountered a sudden economic downturn, large increases in external indebtedness, and internal financial crises.

Closer examination of the experience of these countries underlines the extreme importance of internal consistency in the policy package implemented to liberalize the economy. In particular, a fixed exchange rate system pegged against an appreciative currency (the US dollar) turned out to be incompatible with fiscal, monetary and wage policies. In the Chilean economy, the momentum of economic development achieved by trade liberalization and anti-inflationary budget policies broke down when the exchange rate was fixed against the US dollar in 1979. A sharply appreciating real exchange rate in 1980-81 combined with a considerable rise in real wages (due to wage indexation to past, and higher, inflation rates) and with persistently high interest rates (due to bank regulations causing substantial arbitrage costs) could not but erode the international competitiveness of the tradables sector and provide strong incentives for speculative investment (mostly in construction activities). A lack of consistency between exchange rate policy and trade policies as well as fiscal policies has also caused the failure of economic liberalization in Argentina. In this country, a "tablita" was implemented with a concomitant opening of the capital account while protectionist trade interventions remained untouched and large fiscal deficits continued to fuel domestic inflation. This combination of contradictory policies has put the trade sector under untenable pressure - as in the case of Chile - and gave

rise to an unprecedented outflow of domestic capital. Both countries accumulated staggering levels of foreign debt within a relatively short period of time as a result of unresolved balance-of-payments problems.

These partial deregulation attempts can clearly not be used as examples against export liberalization based on a package of stabilization-cum-restructuring policies as suggested in Section II and applied in most of the second generation NICs. However, they do provide lessons with respect to the crucial link between exchange rate, interest rate, and wages, and with respect to the disastrous consequences of step-by-step approaches to liberalization. Sjaastad [1983:19] made the point unequivocally: "..., the fatal flaw is not to be found in the liberalisation programme per se, but rather in policy inconsistencies. Policy inconsistencies are of minor importance when markets are heavily regulated. Free markets, however, require a high degree of policy coherence."

#### V. World Market Conditions - Obstacle to Export Liberalization?

The previous analysis has stressed that the main factors determining the success of outward-oriented economic development are to be found on the supply side of the economy. To be sure, world market conditions also matter and when they are as favourable as they were in the 1950s and 1960s, the chances for accomplishing a successful transition to an open trade regime are particularly good. But even a buoyant external demand can only be



transformed into an impetus to economic development if there is an adequate export potential. Nevertheless, scepticism holds on and fuels new variants of export pessimism which rest on the assumption that the revival of protectionism will further restrict access to markets of industrialized countries, that these markets cannot absorb expanding exports from a large number of developing countries, and that world demand will remain sluggish due to a weak economic performance of industrialized countries.

Though "new protectionism" in industrial countries has not completely eroded the gains from earlier rounds of trade liberalization [Hughes, Waelbroeck, 1981:131] and has not prevented export-oriented economies (in particular the East Asian NICs) from penetrating foreign markets, the danger is that it generate additional uncertainty among investors in developing countries concerning engagement in export-oriented activities. Investors may then turn to presumably "safe" investment opportunities geared towards production for local markets, and political forces favouring an import-substitution type of economic development may succeed in forestalling or at least slowing down any attempt to liberalize the system of economic incentives. In this sense, protectionists in the industrial countries play into the hands of protectionists in developing countries.

As to the proposition, that it will be impossible for all developing countries to emulate success stories, because the resulting surge of manufactured exports to Western markets would

cause a glut on these markets and provoke further protectionist tendencies [Cline, 1982; Spraos, 1983:140], it reflects a fallacy-of-composition. When moving in the direction of market liberalization, it takes a longer time for large, natural resource-rich countries, e.g. in Latin America, starting from a higher level of distortions, to arrive at the same manufactured export share in GDP than for small, labour-abundant countries of the Asian type. It would be even more likely that manufactured export shares in the former group would always fall behind those in the latter group, even at the same population and income levels. Nor would all developing countries export the same products, given differences in resource endowments and skills. Even in the labour-intensive segment of the product range, there is a wide variety of manufactures developing countries can specialize in, and for most of these products market penetration is rather marginal in industrialized countries. Moreover, the implementation of an outward-oriented trade regime would provide for some degree of import liberalization. This offers the chance to expand South-South trade along with South-North trade, in particular with labour-intensive and standardized capital-intensive products. And finally, should too many developing countries specialize in the same products for exporting, their terms of trade would deteriorate (other things being equal). But this can be only a temporary effect because it is unreasonable to assume that investors and exporters do not learn. Most likely, they will react to declining prices by changing the product mix.

As to export pessimism derived from slow economic growth in developed countries, it should be emphasized that for industrializing developing countries there is not a stringent and invariable link between the rate of expansion of world demand and that of exports [Riedel, 1984]. The composition of output changes and so does the structure of exports. In fact, the changing composition of exports was the major reason behind rapid export expansion of developing countries over the past 25 years. Third World manufactured exports grew twice as fast as real GDP in industrialized countries in the 1960s and more than four times faster after 1973 when industrialized countries experienced successive economic recessions.

## VI. Conclusion

This essay has reviewed the arguments and the empirical evidence for the superiority of an outward-oriented trade regime in promoting industrialization and accelerating economic development. Trade policies which do not discriminate between local and foreign sales improve allocative efficiency and provide dynamic gains from economies of scale, an enhanced transfer of technology, and better access to international financial markets. Beyond outward-oriented trade policies, internal liberalization of markets increase the flexibility of the economy, which is one necessary condition for successful economic development. These advantages accrue even in an international economic environment less favourable than that of the 1960s and early 1970s. It is, how-

ever, of crucial importance that a high degree of coherence between trade liberalization and related policies is achieved, that the policies are credible, and that they are implemented rigorously.

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