

Palley, Thomas I.

Research Report

The contradictions of export-led growth

Public Policy Brief, No. 119

Provided in Cooperation with:

Levy Economics Institute of Bard College

Suggested Citation: Palley, Thomas I. (2011) : The contradictions of export-led growth, Public Policy Brief, No. 119, ISBN 978-1-936192-17-5, Levy Economics Institute of Bard College, Annandale-on-Hudson, NY

This Version is available at:

<https://hdl.handle.net/10419/54288>

Standard-Nutzungsbedingungen:

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

Terms of use:

Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.



Levy Economics Institute of Bard College

Public Policy Brief

No. 119, 2011

THE CONTRADICTIONS OF EXPORT-LED GROWTH

THOMAS I. PALLEY

Contents

3 Preface

Dimitri B. Papadimitriou

4 The Contradictions of Export-led Growth

Thomas I. Palley

12 About the Author

The Levy Economics Institute of Bard College, founded in 1986, is an autonomous research organization. It is nonpartisan, open to the examination of diverse points of view, and dedicated to public service.

The Institute is publishing this research with the conviction that it is a constructive and positive contribution to discussions and debates on relevant policy issues. Neither the Institute's Board of Governors nor its advisers necessarily endorse any proposal made by the authors.

The Institute believes in the potential for the study of economics to improve the human condition. Through scholarship and research it generates viable, effective public policy responses to important economic problems that profoundly affect the quality of life in the United States and abroad.

The present research agenda includes such issues as financial instability, poverty, employment, gender, problems associated with the distribution of income and wealth, and international trade and competitiveness. In all its endeavors, the Institute places heavy emphasis on the values of personal freedom and justice.

Editor: W. Ray Towle
Text Editor: Barbara Ross

The Public Policy Brief Series is a publication of the Levy Economics Institute of Bard College, Blithewood, PO Box 5000, Annandale-on-Hudson, NY 12504-5000.

For information about the Levy Institute, call 845-758-7700 or 202-887-8464 (in Washington, D.C.), e-mail info@levy.org, or visit www.levyinstitute.org.

The Public Policy Brief Series is produced by the Bard Publications Office.

Copyright © 2011 by the Levy Economics Institute. All rights reserved. No part of this publication may be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopying, recording, or any information-retrieval system, without permission in writing from the publisher.

ISSN 1063-5297
ISBN 978-1-936192-17-5

Preface

The export-led growth paradigm is a development strategy aimed at growing productive capacity by focusing on foreign markets. It rose to prominence in the late 1970s and became part of a new consensus among economists about the benefits of economic openness.

According to Thomas I. Palley, this paradigm is no longer relevant because of changed conditions in both emerging-market (EM) and developed economies. He outlines the stages of the export-led growth paradigm leading to its adoption worldwide, as well as the various critiques of this agenda that have become increasingly prescient. He concludes that we should reduce reliance on strategies aimed at attracting export-oriented foreign direct investment (FDI) and institute a new paradigm based on a domestic demand-led growth model. Otherwise, the global economy is likely to experience asymmetric stagnation and increased economic tensions between EM and industrialized economies.

Export-led growth was purported to generate a win-win outcome for developing and industrialized economies based on the principle of comparative advantage. Arguments about the benefits of trade and economic openness played an important role in propelling the new agenda of international economic integration because they dovetailed with the economic interests of large corporations—globalization. This alliance drove the expansion of the General Agreement on Tariffs and Trade and the establishment of the World Trade Organization.

The export-led growth model evolved to fit changing global circumstances and the conditions of individual countries. The various stages relied on undervalued exchange rates, the need for foreign technology, export-production platforms for foreign multinationals, the suppression of wages and social standards, and partnerships between countries and multinational corporations, as well as the managed undervaluation of exchange rates (capital controls), higher import tariffs, and joint ventures, in order to build an indigenous (national) technological base.

The North American Free Trade Agreement (NAFTA) created a free-trade production zone that unified developed and developing economies for the first time. However, its template damages the developed economies via deindustrialization, creates

international financial imbalances, and undermines the wage-productivity growth link. In effect, the NAFTA model has created a divided world, with consumers in the North and producers in the South.

The financial crash and accompanying Great Recession has created a global demand shortage and stagnation in the industrialized economies. Moreover, the positive factors related to export-led growth strategies are likely to prove increasingly ephemeral. There are several structural problems such as the debt saturation of US consumers and the fact that EM exports are sabotaging the recovery of the industrialized economies.

According to Palley, China is unlikely to become the global engine of growth because its export-growth model is that of an assembler who focuses on supplying consumers in industrialized countries. And because of its size, China is siphoning FDI and demand away from other EM economies. Thus, its entrance onto the global stage has introduced South-South competition to the traditional dynamic of North versus South. In addition, multinational corporations have created a “race to the bottom” dynamic where developing countries undermine one another to gain competitive advantage. As a result, Palley concludes, no single country or region can act as the global engine of growth, so all countries and regions must pull together.

A domestic demand-led strategy includes building social safety nets, raising and linking wages to productivity growth, increasing public infrastructure investment (as well as public goods such as health care and education), and rebalancing tax structures. In addition, the international economy needs to end undervalued exchange rates and adopt a system of managed rates aimed at avoiding global trade imbalances; implement labor, environmental, and social standards; and limit incentives to attract export-oriented FDI. However, agreement on such rules and standards is unlikely, says Palley, given the political and structural obstacles.

As always, I welcome your comments.

Dimitri B. Papadimitriou, *President*
August 2011

Introduction

For the past 30 years, development policy has been dominated by the paradigm of export-led growth. That paradigm is part of a consensus among economists about the benefits of economic openness, a consensus used to justify globalization.

The Great Recession has surfaced contradictions that were always inherent in export-led growth and globalization, and the global economy now confronts a troubling outlook of significant demand shortage. In developed economies, the shortage is explicit in high rates of unemployment and large output gaps. In emerging market (EM) economies, it is implicit in their reliance on export markets. EM economies differ from developing economies in that they are predominantly middle income (China and India are considered EM economies because they have attracted significant foreign direct investment), while the latter are low-income countries with limited industrialization.

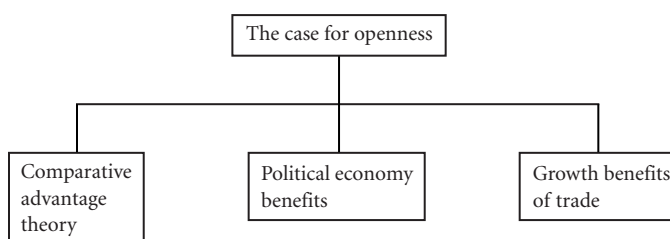
This paper argues that the case for trade openness and export-led growth was always oversimplified and oversold.¹ In part due to the widespread turn to openness and export-led growth, the global economy now confronts an extended period of asymmetric stagnation marked by slower growth in EM economies, stagnation in developed economies, and increased economic tensions between EM and developed economies.

The Rise of Export-led Growth

The export-led growth paradigm rose to prominence in the late 1970s, when it replaced the import-substitution paradigm that had dominated development policy thinking (especially in Latin America) after World War II. Export-led growth is a development strategy aimed at growing productive capacity by focusing on foreign markets. It is part of a new consensus among economists about the benefits of economic openness.

This new consensus rests on a fusion of three strains of argument, as illustrated in Figure 1. The first strain, based on the Heckscher–Ohlin–Samuelson comparative advantage theory, is about the gains from trade between economies with different capital-labor ratios (Ohlin 1933; Samuelson 1948; Dornbusch, Fischer, and Samuelson 1980). The second strain (political economy) concerns the benefits of openness for controlling rent seeking, a problem associated with import-substitution development that elicited strong criticism (Krueger 1974). The third strain, which developed later, is about the benefits of trade openness for growth. It claims that trade encourages technology diffusion and

Figure 1 Arguments Supporting the New Consensus on Openness



knowledge spillovers that contribute to faster productivity growth (Grossman and Helpman 1991).

Export-led growth represents a subsidiary branch within this new consensus that applies to developing countries. The argument is that self-conscious policy focused on external markets helps capture the economic benefits of openness (for developing countries) by encouraging best-practice adoption, promoting product development, and exposing firms to competition. The success of the four East Asian “tiger” economies (South Korea, Hong Kong, Singapore, and Taiwan) appeared to provide empirical support for this argument.

According to economists, export-led growth generates a win-win outcome for developing and industrialized economies. All benefit from the global application of the principle of comparative advantage, while developing countries realize added benefits, such as best-practice adoption, from an external focus. Moreover, industrialized economies supposedly benefit even if developing countries subsidize their exports in order to win additional export sales, because subsidized exports are essentially a gift to the countries receiving those exports. This claim, however, rests on two highly questionable assumptions: there is no long-term dynamic cost to industries displaced by such subsidies, and there is scarcity of resources owing to full employment (i.e., no Keynesian unemployment).

These arguments about the benefits of trade and economic openness played an important role in advancing the new agenda of international economic integration, since they dovetailed with the economic interests of large corporations looking to establish a new global economic structure (globalization). That created a corporate-elite opinion alliance, which drove expansion of the General Agreement on Tariffs and Trade (GATT) and the subsequent establishment of the World Trade Organization (WTO) in 1996. The International Monetary Fund (IMF) and World Bank

together played a special role in furthering the new agenda in developing countries—which needed financial assistance after the oil shocks of the 1970s—since access to these agencies’ funds was conditional on governments embracing the openness agenda.

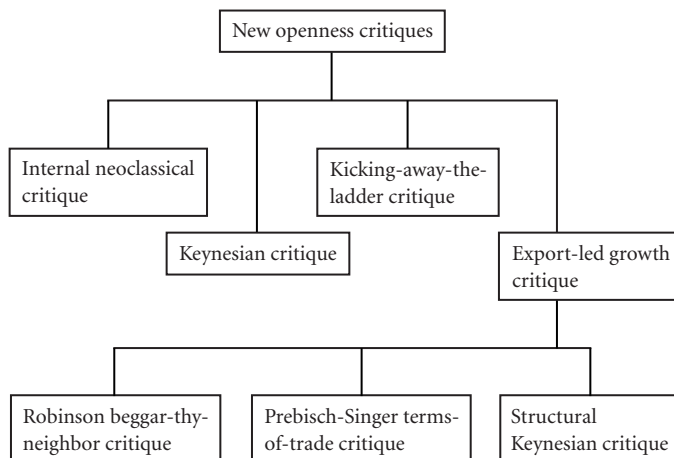
Critiques of the New Openness Agenda

Though the new “openness” agenda swept academic economics, there was always opposition and this opposition has become increasingly prescient. Figure 2 identifies four strains of critique regarding the openness paradigm. The first is the comparative-advantage (neoclassical) critique, which focuses on potential pathologies of trade liberalization. These pathologies include Harry Johnson’s (1954, 1955) terms-of-trade-deterioration critique; Jagdish Bhagwati’s (1958) immiserizing-growth critique, which extended Johnson’s work within a dynamic context; Wolfgang F. Stolper and Paul A. Samuelson’s (1941) critique of trade and income distribution; and critiques of the unintended negative effects of trade liberalization in a world of market imperfections (e.g., see Brewer 1985). However, this internal critique is a collection of rare pathologies and, in many regards, a confusing distraction, since, unlike more systemic critiques, it accepts rather than challenges the fundamental logic of neoclassical trade theory.²

The second strain—the Keynesian critique—has its roots in macroeconomics and Keynes’s rejection of comparative advantage (Milberg 2002; Prasch 1996). In a Keynesian world of demand shortage, trade can lower domestic demand and lead to reduced output, employment, and national welfare. An implicit corollary proposition in a Keynesian world is that export subsidies are not a gift but may instead poach demand and employment.

This critique also makes exchange rates a trade issue, since undervalued exchange rates impact demand by altering the relative price of imports and exports. Classical open-economy macroeconomics—the twin of neoclassical trade theory—asserts that any employment effects of undervalued exchange rates are at worst temporary, since monetary factors are supposedly neutral. Either the real exchange rate adjusts to offset the effects of money, or the money supply adjusts via the specie-flow mechanism in response to trade deficits. However, this logic falls apart if there are hysteresis effects related to patterns of demand and the organization of production (Palley 2003a). In that case, exchange rates are non-neutral in both the short and long run, and these non-neutralities make the benefits of trade contingent

Figure 2 Critiques of the New Openness Agenda



on appropriate exchange-rate arrangements. Absent such arrangements, trade can reduce economic welfare.

The Keynesian demand-shortage argument also carries over to situations with economies of scale, where measures that increase demand (including protection) can increase exports by lowering the average cost of producers. This provides a rationale for strategic trade policy that departs from free trade (Krugman 1984).

The third strain is labeled “kicking away the ladder,” after the book of the same name by Ha-Joon Chang (2002). This critique traces directly to the post–World War II import-substitution school of thought, arguing that trade protection, industrial policy, and the ability to conduct macroeconomic policy are necessary for successful development. According to Chang, no country has successfully industrialized without such policies. Whereas the Keynesian critique of openness is generic and holds for both developed and EM economies, the kicking-away-the-ladder critique applies only to EM economies.

The fourth strain is specifically about export-led growth, and it consists of three elements. The first is labeled the “Robinson beggar-thy-neighbor critique,” so named after Joan Robinson’s (1947) observations about macroeconomic mercantilism. Her Keynesian argument stems from the competitive devaluation experience of the 1930s. The logic is that countries trying to export their way out of a demand shortage implicitly harm their neighbors by poaching demand and employment. Applied to export-led development, the Robinson critique suggests a fallacy of composition, and that developing countries may crowd out one another’s exports (Blecker 2000; Palley 2003b; Blecker and Razmi 2010).

The second element is labeled the “Prebisch–Singer critique.” It focuses on the supply and price effects of export-led growth, in contrast to the Robinson critique that focuses on the demand and quantity effects. Sixty years ago, Raul Prebisch (1950) and Hans Singer (1950) identified a problem of declining terms of trade for commodity-exporting countries. Today, the problem has shifted from commodities to manufactured goods. Countries that engage in export-led growth may exacerbate the problem by increasing the global supply of such goods (Sarkar and Singer 1991; Kaplinsky 1993; Sapsford and Singer 1998).

The third element is labeled the “structural Keynesian critique” (Palley 2002, 2004). The argument here is that export-led growth promotes economic structures that deliver low-quality growth and prevent the development of deep prosperity. Development that is externally focused has shallow roots—a phenomenon exemplified by export processing zones such as Mexico’s maquiladoras. Internationally, export-led growth promotes a race to the bottom, as countries try to gain competitive advantage by any means. That results in wage suppression; disregard for labor and environmental standards, and workplace conditions; and weak regulation aimed at pleasing capital.

A Brief History of Export-led Growth

The last 30 years have seen tremendous spread of the export-led growth paradigm. The model has evolved to fit changing global circumstances and the conditions of individual countries. This evolution involved four stages. Stage I was kicked off by Germany and Japan, and ran from 1945 to 1970. Both countries had an indigenous industrial base and export growth was driven by an undervalued exchange rate. Growth also benefitted from US aid for postwar reconstruction and in response to the Cold War.

Stage II ran from 1970 to 1985 and applies to the four East Asian “tiger” economies. Once again, during this stage countries relied on an undervalued exchange rate but now there was need for acquisition of foreign technology via strategic planning.

Stage III holds for countries in South East Asia (Thailand, Malaysia, and Indonesia) as well as Latin America (Mexico) in the 1980s and 1990s. The major change from stage II is that these countries turned themselves into export-production platforms for foreign multinationals rather than developing their own indigenous industrial capacity. This new strategy was made feasible by the increased mobility of technology and capital. Its key elements included integration into the global economy, an

undervalued exchange rate, and the suppression of wages and social standards. The goal was to enhance international competitiveness and attract multinational corporations (MNCs) as a site for foreign direct investment (FDI) that was export oriented. The benefits, however, have been elusive.

The third stage represents the beginning of the modern era of corporate globalization, where export-led growth is no longer a purely national strategy but a partnership between developing countries, MNCs, and developed countries. Governments and MNCs promoted the new system using the traditional language of free trade, claiming that their goal was to create a global marketplace. The real goal, however, was not to promote traditional trade but to create a global production zone where corporations could establish export-production platforms for markets in developed countries.

Mexico’s engagement with export-led growth epitomizes this stage. Trade liberalization began in 1986, and it set the country on the path toward creation of the North American Free Trade Agreement (NAFTA) in 1994. The inauguration of NAFTA was marked by a massive devaluation of the peso vis-à-vis the US dollar, and thus provided Mexico with an undervalued currency. NAFTA is the template for the new model, and it is significant from a historical standpoint. By unifying the United States, Canada, and Mexico, NAFTA created a free-trade production zone that unified developed and developing economies for the first time. This template was then extended globally via the establishment of the WTO in 1996, followed by the organization’s admission of China in 2001.

There are three important features of the NAFTA–corporate globalization model. First, it promotes trade, but not in the classical sense of balanced exports and imports. Second, it promotes a new type of export-led growth based on relocating existing production and diverting new investment, which benefits EM economies by creating jobs, transferring technology, and relieving balance-of-payment constraints on growth; these economies, however, do not own the industrialization process like those in stages I and II. And third, this model does considerable damage to developed economies via deindustrialization and the creation of international financial imbalances, as well as undermining the wage–productivity growth link—which, in turn, undermines the coherence of the domestic income and demand generation process.

Stage IV extends and augments the stage III model, as exemplified by China, making three major adjustments to Mexico’s NAFTA model. First, it is characterized by asymmetric global

Table 1 Chinese Exports and Imports by Firm Ownership, 2005 (in percent)

	All Firms	State-owned	Private Domestic	Joint Ventures	Foreign-owned
Exports	100	10.3	13.1	26.3	50.4
Imports	100	21.7	7.1	24.1	47.2

Source: Manova and Zhang 2008

Table 2 Relative Growth of Mexico (Stage III) and China (Stage IV) (in percent)

	GDP		Labor Productivity		Total Factor Productivity		
	1950–1980	1980–2008	1950–1980	1980–2008	1960–1980	1980–1989	1990–2004
Mexico	6.4	2.6	3.1	-0.1	1.6	-2.4	-0.6
China	4.9	8.5	2.0	6.7	0.6	4.2	4.7

Source: Palma 2010

engagement, with China maintaining greater tariffs on imports. Second, there is managed undervaluation of the exchange rate, which is maintained with capital controls. Third, there is a strategy for building an indigenous (national) technological base via forced technology sharing, joint ventures (where MNCs may be minority shareholders), and technology theft. Prime examples of this new approach to technology transfer are China’s banking and automobile sectors.

MNCs have also changed their strategy by engaging in joint ventures, as well as licensing and sourcing from foreign producers instead of owning facilities. This is the price of entry into China, where corporations hope to be paid back by future profits stemming from its large market. Licensing and joint ventures also benefit corporations by reducing their capital investment. However, the basic structure of dependence on multinationals for exports remains intact, making stage IV distinct from stages I and II. This dependence is illustrated in Table 1, which decomposes Chinese exports and imports in terms of firm ownership. Foreign-owned firms accounted for 50.4 percent of Chinese exports in 2005, and the proportion rises to 76.7 percent when joint ventures are included along with the foreign-owned firms.

The Fall of Export-led Growth

Export-led growth has been a relatively successful development strategy for the past several decades, but there have also been clear signs of fraying. Though China has done well, stage III participants (like Mexico) have been less successful. Table 2 shows that China has had rapid growth in terms of GDP, labor productivity (due to rapid capital accumulation), and total factor productivity (TFP), reflecting a dynamic economy characterized by technological advance. In contrast, Mexico has not recovered its strong economic performance of the 1960–80 period. GDP growth has been sluggish, labor productivity is unchanged, and TFP growth has been negative.

Going Forward

So far, this analysis has looked backward. In this section, we peer into the future.

There are reasons to believe that the export-led growth strategy is exhausted because of changed conditions in both developing and developed economies. The financial crash of 2008 and the accompanying Great Recession represent a watershed event that has created an overarching structural condition of global demand shortage. The US economy is debt saturated, Europe is constrained by fiscal austerity and wedded to export-led growth via Germany, and Japan continues to suffer from weak internal demand and an aging population, while remaining hooked on export-oriented growth. This combination augurs for stagnation in the industrialized economies.

EM economies continue to grow on the back of export-led growth strategies, but the positive factors are likely to prove increasingly ephemeral. They have benefitted significantly from the global recovery following the collapse of trade in 2009, higher commodity prices (further strengthened by the view of commodities as a speculative hedge against inflation), and interest-rate compression produced by the crisis. Although this last benefit will likely be permanent, the trade bounce is a one-off, and the prospect of stagnation will likely take the inflation premium out of commodity prices. EM economies as a group face structural impediments that make collective export-led growth impossible.

Problem number one is the debt saturation of US consumers. The export-led growth model relies on robust consumer markets in developed economies (particularly the United States) to buy exports and justify FDI. These markets were artificially strong for 25 years, fueled by rising debt and asset-price inflation.

Table 3 The Changing Composition of Global GDP
(in billions of 2011 dollars)

	1980	1990	2000	2008
World	12,961	26,988	45,205	77,109
Developed Economies (in percent)	7,896 (60.9)	16,242 (60.2)	26,071 (57.7)	37,900 (49.2)
Developing and EM Economies (in percent)	5,064 (39.1)	10,746 (39.8)	19,133 (42.3)	39,210 (50.8)

Sources: International Monetary Fund, World Economic Outlook Database, October 2007; and author's calculations

Table 4 The Changing Composition of World Trade
(in percent)

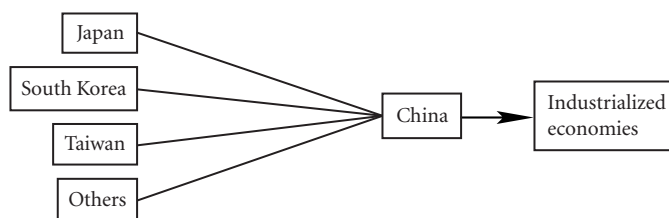
	1995	2000	2005	2008	
Exports	G7	48.9	46.4	40.1	36.4
	OECD	74.9	72.2	66.9	63.6
	Non-OECD	25.1	27.8	33.1	36.4
Imports	G7	48.7	50.0	45.0	40.1
	OECD	73.8	75.0	71.1	66.8
	Non-OECD	26.2	25.0	28.9	33.2

Source: OECD Economic Outlook S7 Database, June 2010

This pattern was unsustainable and is now over, leaving a hole in the model's logic.

Problem number two is the relative size of the EM economies. They now constitute such a large share of the global economy that their exports are sabotaging the recovery of the industrialized economies, as shown in Tables 3 and 4. Table 3 shows the evolution of developed-economy and developing- and EM-economy shares of global GDP. The latter share rose from 39.1 percent in 1980 to 50.8 percent in 2008, making it difficult for the group to continue to rely on export-led growth. Table 4 shows the changing composition of world trade. Non-OECD country exports rose from 25.1 percent in 1995 to 36.4 percent in 2008, while imports climbed more slowly—from 26.2 percent to 33.2 percent. As a bloc, these countries run trade surpluses and are still significantly dependent on exports for growth, despite their larger size.³

Figure 3 Stylized Representation of the New China-centric Global Supply Chain



In effect, the NAFTA globalization model has created a divided world where consumers are in the North and producers are in the South. In the era of globalization, expanding productive capacity is relatively easy, owing to technological innovations that have increased the mobility of capital and managerial expertise. The structural Keynesian challenge is to create an income and demand generation process that supports productive capacity (Palley 2006). Furthermore, China is unlikely to become the engine of growth, since its model is that of an assembler focused on supplying the consumers of industrialized countries. Figure 3 shows a stylized representation of the new China-centric global supply chain, wherein East Asian countries export to China and China exports to the industrialized economies.

This trade pattern is supported by Table 5, which shows the changing composition of East Asian exports. The share of East Asian exports to China has been rising, reflecting China's role as an assembler rather than a manufacturer. However, the share of Chinese exports to East Asia has been falling, reflecting China's reliance on consumers in industrialized economies.

The third problem is the declining relative price of manufactured goods. The widespread adoption of export-led growth is contributing to a new Prebisch–Singer declining terms-of-trade problem similar to the one that afflicted commodity-producing developing countries in the first half of the 20th century. During that period, the relative price of primary commodities fell as the supply increased. Now the problem is the increased supply of low-technology manufactured goods (Sarkar and Singer 1991).

Problem number four is what globalization critics term “the global race to the bottom.” Because it is easy for MNCs to shift production between countries, they have created a “race to the bottom” dynamic in which developing countries undermine one another in an attempt to gain competitive advantage by suppressing wages, labor, and business regulations; minimizing environmental and social standards; shifting the tax burden from

Table 5 The Changing Pattern of East Asian Trade (in percent)

Exporter	East Asia		China	
	1990–1994	2000–2004	1990–1994	2000–2004
East Asia	44.1	49.0	6.4	11.1
China	60.5	45.3	N/A	N/A

Source: M. Haddad, “Trade Integration in East Asia: The Role of China and Production Networks,” World Bank Policy Research Working Paper 4160, March 2007

capital income to labor income; creating extrajudicial export processing zones; and promoting competitive devaluations that create financial instability. But since all countries do it, no one gains significant competitive advantage. Instead, this (destructive) dynamic undermines standards, institutions, and income equality, as well as the wage growth needed for deeply rooted economic development. The only beneficiaries are the MNCs, which gain from higher profit margins.

The fifth and final problem is China’s adoption of an export-led growth strategy. Because its labor force is so large, its wages so low, and the prospect of producing for its large domestic market so commercially attractive, China is siphoning FDI and demand away from other EM economies and undermining their industrialization and development. China poses two problems for other developing and EM economies: its size blocks the access of newcomers to the traditional development ladder, and its entrance onto the global stage has introduced South–South competition to the global marketplace. That explains why the benefits of export-led growth have been so limited for stage III countries like Mexico.

One benefit for developing economies is that urbanization in China is likely to create persistent upward pressure on commodity prices. Urbanization requires energy resources for power and transportation, as well as using commodities such as iron ore, copper, and lumber in construction. This is a mixed blessing, however. First, it will only benefit EM and developing economies that have these resources. Second, it stands to create the “Dutch disease” by appreciating exchange rates—something that is already clearly visible in Brazil and Chile. This undermines industrialization and development, and could re-create an inter-

national division of labor paralleling that created by British industrialization in the 19th century.

The Case for Domestic Demand-led Growth

The implication of the above arguments is that the export-led growth paradigm is exhausted for developing countries and risks doing serious harm to the global economy. This means there needs to be a shift toward domestic demand-led growth while maintaining exports, which are always needed to pay for imported inputs and finished goods that are not produced domestically. It also means reducing reliance on strategies aimed at attracting export-oriented FDI.

The imperatives for successful domestic demand-led growth are clear (Palley 2002):

- (a) Build social safety nets that diminish the need for precautionary saving.
- (b) Raise and link wages to productivity growth by implementing a minimum wage, improving labor protections, and increasing collective bargaining via unions.
- (c) Increase public infrastructure investment and fill the backlog resulting from 25 years of neglect imposed by the neoliberal Washington Consensus development model.
- (d) Increase the provision of public goods such as health care and education.
- (e) Rebalance tax structures by increasing taxes on higher-income groups and decreasing taxes on lower-income groups.

In the international economy, there is the need to:

- (a) End undervalued exchange rates and adopt a system of managed rates aimed at avoiding global trade imbalances.
- (b) Abandon policies of international labor competition by implementing global labor standards.
- (c) Implement global environmental and social standards that block international competition based on environmental degradation and social exploitation.
- (d) Limit incentives to attract export-oriented FDI.

Though it is clear what is needed, there are tremendous political obstacles to change. EM economies are unwilling to give up a strategy that has worked so well, and paying transition costs now in order to avoid hypothetically higher costs later is not politically compelling. There is also resentment that EM economies are

asked to change in spite of having much lower per capita income than the advanced economies. Furthermore, no individual country has an incentive to abandon export-led growth and adopt the policy measures of a domestic demand-led strategy for fear of being the only country to do so. In effect, there is a collective-action problem: the only way to ensure a global shift toward a new demand-led growth model is to establish and enforce multilateral rules on exchange rates, as well as acceptable standards on labor, tax, and environmental competition. Agreement on such rules and standards, however, is unlikely.

In addition to political obstacles to change, there are structural obstacles. Once countries embark on export-led growth, it seems to be very difficult to change strategies. Germany and Japan still focus on exports and consistently run large trade surpluses 50 years after adopting the export-led model and long after they became top-tier, high-income countries. One possible explanation is that export-oriented industries gain political control after acquiring dominance, while the institutions and political interests supporting domestic demand-led growth remain weak.

Conclusions and Predictions

The above analysis suggests four conclusions, which support three predictions. The first conclusion is that the export-led growth paradigm is exhausted because of changed conditions in both EM and developed economies. The second is that EM economies are mistaken in their belief that they can continue to grow collectively on the basis of export-led growth; rather, this policy will impede economic recovery in the developed countries. The third conclusion sees a need for a major recalibration of the global economy, whereby export-led growth is replaced by a new paradigm: domestic demand-led growth. The final conclusion is that no single country or region can act as the locomotive of global growth because globalization has diversified economic activity to the extent that all countries and regions must pull together.

These conclusions support the following three predictions. For political reasons, it is highly unlikely that EM countries will shift away from export-led growth, nor will the international community agree on the arrangements needed to make the domestic demand-led growth paradigm work. Once a country has adopted an export-led growth model, it appears that it is nearly impossible to abandon it. The second prediction is that failure to recalibrate the global economy is likely to produce a political backlash in the industrialized countries; in particular, the United States,

where the public has lost its political patience because trade and exchange-rate adjustments by China have been delayed too long. The third prediction is that the global economy is likely to experience asymmetric stagnation marked by slower growth in EM economies, stagnation in developed economies, and increased economic tensions between EM and industrialized economies.

Notes

1. This brief is based on Working Paper no. 675.
2. Progressive activists sometimes appeal to arguments such as the Stolper-Samuelson (1941) theorem to criticize free trade. This is a dangerous tactic, since it implicitly accepts the logic of neoclassical trade theory and its claims about the benefits of trade from applying the principle of comparative advantage.
3. In Table 4, “non-OECD” is a proxy for EM and developing economies. However, Mexico, South Korea, and Turkey are members of the OECD. If their exports and imports were subtracted from the OECD and added to the non-OECD list, the trade share of developing economies would increase further.

References

- Bhagwati, J. 1958. “Immiserizing Growth: A Geometrical Note.” *The Review of Economic Studies* 25, no. 3 (June): 201–05.
- Blecker, R. A. 2000. “The Diminishing Returns to Export-led Growth.” Prepared for the Council of Foreign Relations Working Group on Development, New York.
- Blecker, R. A., and A. Razmi. 2010. “Export-led Growth, Real Exchange Rates, and the Fallacy of Composition.” In M. Setterfield, ed. *Handbook of Alternative Theories of Economic Growth*. Cheltenham (UK): Edward Elgar Publishing.
- Brewer, A. 1985. “Trade with Fixed Real Wages and Mobile Capital.” *Journal of International Economics* 18, nos. 1–2 (February): 177–86.
- Chang, H.-J. 2002. *Kicking Away the Ladder: Development Strategy in Historical Perspective*. London: Anthem Press.
- Dornbusch, R., S. Fischer, and P. A. Samuelson. 1980. “Heckscher-Ohlin Trade Theory with a Continuum of Goods.” *Quarterly Journal of Economics* 95, no. 2 (September): 203–24.

- Grossman, G. M., and E. Helpman. 1991. "Trade, Knowledge Spillovers, and Growth." *European Economic Review* 35, nos. 2–3 (May): 517–26.
- Haddad, M. 2007. "Trade Integration in East Asia: The Role of China and Production Networks." World Bank Policy Research Working Paper 4160. March.
- Johnson, H. 1954. "Increasing Productivity, Income-price Trends, and Trade Balance." *Economic Journal* 64 (September): 462–85.
- . 1955. "Economic Expansion and International Trade." *Manchester School of Economic and Social Studies* 23, no. 2 (May): 95–112.
- Kaplinsky, R. 1993. "Export Processing Zones in the Dominican Republic: Transforming Manufactures into Commodities." *World Development* 21, no. 11 (November): 1851–65.
- Krueger, A.O. 1974. "The Political Economy of Rent-seeking Society." *American Economic Review* 64, no. 3 (June): 291–303.
- Krugman, P. 1984. "Import Protection as Export Promotion: International Competition in the Presence of Oligopoly and Economies of Scale." In H. Kierzkowski, ed. *Monopolistic Competition in International Trade*. Oxford: Oxford University Press, 180–93.
- Manova, K., and Z. Zhang. 2008. "China's Exporters and Importers: Firms, Products, and Trade Partners." Unpublished manuscript. Department of Economics, Stanford University.
- Milberg, W. 2002. "Say's Law in the Open Economy: Keynes' Rejection of the Theory of Comparative Advantage." In S. Dow and J. Hillard, eds. *Beyond Keynes*. Aldershot (UK): Edward Elgar Publishing.
- Ohlin, B. 1933. *Interregional and International Trade*. Cambridge, Mass.: Harvard University Press.
- Palley, T. I. 2002. "Domestic Demand-led Growth: A New Paradigm for Development." In J. Weaver, D. Jacobs, and J. Baker, eds. *After Neo-Liberalism: Economic Policies That Work for the Poor*. Washington, D.C.: New Rules for Global Finance Coalition. Also published as "A New Development Paradigm: Domestic Demand-led Growth." *Foreign Policy in Focus* (September).
- . 2003a. "International Trade, Macroeconomics, and Exchange Rates: Re-examining the Foundations of Trade Policy." Presented at a conference on Globalization and the Myths of Free Trade held at the New School for Social Research, New York, April 18.
- . 2003b. "Export-led Growth: Evidence of Developing Country Crowding-Out?" in P. Arestis et al., eds. *Globalization, Regionalism, and Economic Activity*. Cheltenham (UK): Edward Elgar Publishing.
- . 2004. "The Economic Case for International Labor Standards." *Cambridge Journal of Economics*, 28, January. 21–36.
- . 2006. "Great Controversies: Developing the Domestic Market." *Challenge* 49, no. 6 (November–December): 20–34.
- Palma, G. 2010. "Why Has Productivity Growth Stagnated in Most Latin American Countries Since Neoliberal Reforms?" Cambridge Working Papers in Economics No. 1030. Department of Applied Economics, Cambridge University. July.
- Prasch, R. E. 1996. "Reassessing the Theory of Comparative Advantage." *Review of Political Economy* 8(1): 37–54.
- Prebisch, R. 1950. *The Economic Development of Latin America and its Principle Problem*. Santiago (Chile): UNECLA.
- Robinson, J. 1947. *Essays in the Theory of Employment*. 2nd ed. Oxford: Basil Blackwell. First published in 1937.
- Samuelson, P. A. 1948. "International Trade and Equalisation of Factor Prices." *Economic Journal* 58, no. 230 (June): 163–84.
- Sapsford, D., and H. Singer. 1998. "The IMF, the World Bank, and Commodity Prices: A Case of Shifting Sands?" *World Development* 26(9): 1653–60.
- Sarkar, P., and H. Singer. 1991. "Manufactured Exports of Developing Countries and Their Terms of Trade since 1965." *World Development* 19(4): 333–40.
- Singer, H. 1950. "The Distribution of Gains between Investing and Borrowing Countries." *American Economic Review: Papers and Proceedings* 40(2): 473–85.
- Stolper, W. F., and P. A. Samuelson. 1941. "Protection and Real Wages." *Review of Economic Studies* 9, no. 1 (November): 58–73.

About the Author

THOMAS I. PALLEY is an economist living in Washington, D.C. He was formerly chief economist with the U.S.-China Economic and Security Review Commission. Prior to joining the commission, Palley was director of the Open Society Institute's Globalization Reform Project and assistant director of public policy at the AFL-CIO. He is the founder of Economics for Democratic and Open Societies, which seeks to stimulate public discussion about the kinds of economic arrangements and conditions needed to promote democracy and open societies.

Palley has published in numerous journals, including the *Atlantic Monthly*, *American Prospect*, and *Nation* magazines. He is the author of *Plenty of Nothing: The Downsizing of the American Dream and the Case for Structural Keynesianism* (1998) and *Post Keynesian Economics* (1996). He holds a BA degree in modern history and economics from Oxford University and an MA in international relations and Ph.D. in economics from Yale University.