CHAPTER 4:

EXPORT-ORIENTED INDUSTRIALIZATION STRATEGY

4.1. Export-Oriented Industrialization (EOI)

By the late 1960s, disillusionment with ISI and the impressive performance of a small group of East Asian countries consisting of South Korea, Taiwan, Hong Kong and Singapore, focused attention on export promotion, making a significant number of Asian, Mediterranean and Latin American countries begin to consider the EOI strategy (Wade, 1990; Jomo, 1993), based on a dominating theme of external liberalization (Huge, 1980; Krueger, 1990;).

External liberalization basically involves trade and investment reforms aimed at reducing protection for domestic sales and eliminating NTBs. However, so far, there is no definite definition of what external liberalization is. For Krueger (1978) and Bhagwati (1978), external liberalization was defined as more extensive use of the price mechanism, meaning replacement of NTBs with tariffs, that would reduce the anti-export bias of the trade regime. Later, according to Edwards (1989), external liberalization acquired a more drastic connotation, meaning an elimination of NTBs combined with a severe reduction of import tariffs to a uniform level of around 10%. Then, Sachs & Warner (1995) give the definition of liberalization as follows: “openness” was a decisive shift away from state-led industrialization with high levels of protection, which was the dominant development model adopted after World War II. An economy was classified as “closed” if it had any one of the following features: (i) non-tariff barriers covering 40% or more trade; (ii) average tariff rates of 40% or more; (iii) black market exchange rates more than 20%
below the official rate; (iv) a socialist economic system; (v) a state monopoly on major exports. More recently, external liberalization has been described as the process of drastic lowering or removal of long-standing barriers to almost all international transactions in accordance with the specific integration scheme of economic blocs. This wave has been the central feature of the non-industrialized world for the last 10-15 years (Taylor, 2000b).

To easily understand external liberalization, it is helpful to think in terms of the standard three-way breakdown of the balance of payments, or the sum of an economy’s transactions with the rest of the world\(^1\): (i) The “current account” consists of trade flows, which are the exports and imports of goods and services; and “factor service” payments, which include interest on outstanding foreign debt, profit repatriation, remittance from emigrant workers and so on; (ii) The “capital account” comprises of increases in foreign debt along with the net sales of foreign and domestic securities\(^2\); (iii) The sum of surpluses on the capital and current accounts equals the change in the third component, the economy’s “foreign exchange reserves” or foreign assets held by the central bank, which make up part of the money supply.

With such a notion of external liberalization, EOI has mainly used two important tools for export promotion, namely export subsidies and export processing zones. Export subsidies are justified as attempts to compensate for or to neutralize the effects of bias against exports. Moreover, it is argued that export subsidy is temporary assistance to firms selling goods in new markets, which face many difficulties and obstacle (Falvey & Gemmel, 1990). In these markets for such “experience goods”, exporters’ quality

\(^1\) Cash inflows counted as positive and outflows as negative.

\(^2\) An economy with a capital account surplus is borrowing and/or selling assets abroad in net terms.
reputations are created through a process of consumer “learning” analogous to that for production. Thus, temporary selective export subsidies can be used to exploit this consumer “learning” externality.

**Table 4.1: Types of Export Subsidies in Various Developing Countries**

<table>
<thead>
<tr>
<th>Input-Related Subsidies</th>
<th>Output-Related Subsidies</th>
<th>Externality-Related Subsidies</th>
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</thead>
<tbody>
<tr>
<td><strong>1. Intermediate input-related:</strong></td>
<td><strong>1. Direct:</strong></td>
<td><strong>1. Export quality inspection and incentives</strong></td>
</tr>
<tr>
<td>(a) Tariff and tax exemptions or rebates on imported inputs for exporters</td>
<td>(a) Production loans for exporters (preferential access/interest rate subsidy)</td>
<td>2. Monopoly rights granted in new export market.</td>
</tr>
<tr>
<td>(b) Import credits for exports</td>
<td>(b) Domestic indirect and direct tax exemptions or rebates</td>
<td></td>
</tr>
<tr>
<td>(c) Wastage allowance subsidies</td>
<td>(c) Import licenses linked to exports</td>
<td></td>
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<tr>
<td>(d) Reduced prices of public utility inputs.</td>
<td>(d) Export credits (preferential access or interest rate rebate)</td>
<td></td>
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<tr>
<td><strong>2. Primary input-related:</strong></td>
<td>(e) Foreign exchange deposits held by central banks for use by individual exporters</td>
<td></td>
</tr>
<tr>
<td>(a) Accelerated depreciation</td>
<td>(f) Foreign exchange loans (preferential access)</td>
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<tr>
<td>(b) Reduced interest rates for exporters</td>
<td>(g) Subsidized shipment insurance</td>
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<tr>
<td>(c) Investment loans (preferential access)</td>
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**Sources:** Alavi (1994); Falvey & Gemel (1990); and Yusuf & Peters (1985)
Export subsidies may be categorized as implicit or explicit according to whether they are inputs or outputs in the production process (Table 4.1). Many production incentives are implicit rather than direct subsidies to minimize the probability of retaliatory action (countervailing duties) on the part of (importing) trading partners. Moreover, countervailing duties are less likely if export subsidies fall within the GATT/WTO rules on subsidies\(^3\), according to which export subsidies on manufactured goods are prohibited for developed countries, but are permitted for developing countries, provided they do not cause serious prejudice to the trade or production of trading partners (Falvey & Gemmel, 1990: 111).

A second EOI instrument is the establishment of export processing zones (EPZs), which are special enclaves, outside a nation’s normal customs barriers, where investing (normally foreign) firms enjoy favored treatment in terms of absence of import tariffs on intermediate goods, company tax exemption, infrastructure provision, and freedom from industrial regulations applying elsewhere in the country. These privileges are subject to the condition that almost all of the output must be exported and that all imported intermediate goods are fully utilized within the zones or re-exported (Warr, 1990; Rajah, 1993). In this circumstance, EPZs will make the country’s export and economic growth increase and raise opportunities for unskilled employment. Moreover, EPZs also provide both opportunities for some export promotion to be realized without threatening existing manufacturing sector (as well as politically powerful manufacturing interests); and a quick and cheap solution in combating various distortions in the domestic economy. And

\(^3\) These rules distinguish between export and other subsidies, and also between export subsidies on primary and non-primary products. Other subsidies and export subsidies for primary products are permitted unless they are demonstrated to have adverse effects on the trade or production of trading partners.
more importantly, all these benefits can be attained without much strain on the
government's budget.

Stabilization and structural adjustment efforts in the industrializing economies
concentrated on fiscal and monetary restraints and realignment of exchange rates through
the mid-1980s. Then, in the late 1980s and early 1990s, came drastic reductions in trade
barriers in most countries. Apart from that, there were complementary policies including
restructuring of domestic financial markets, tax systems, and labor markets, tax rates were
lowered and made more uniform across income levels, and labor market rules and
regulations were cut back. These steps mark close to a 180-degree turn in the course of
development policy. It will take time before their full effects can be studied and
understood, but one should surely expect large consequences.

4.2. Debate on Liberalization Effects

Because of widespread domestic dissatisfaction with the previous import substitution
policy packages that developing countries had liberalization and outward orientation
effectively replaced ISI policies and became the norm rather than the exception among
developing countries (Rodrik, 1999: 8-9). The new policy package was supposed to
remedy the defects of ISI, as discussed in chapter 3, by generating visible increases in
economic efficiency and output growth. In this regard, the key question now being
debated by policy makers and scholars is how quickly developing countries should open
their economies to unrestricted flows of trade and investment in order to promote
economic growth. So far, there are the two main schools of liberalization as follows.
4.2.1. Arguments for External Liberalization

Many economists consider external liberalization an engine of growth. The theory of comparative advantage is widely accepted among economists, and external liberalization is a way of utilizing such advantages. The World Bank claims that among developing countries, the rates of GDP growth declined with greater inward-orientation (World Bank, 1987). There are some ways to explain why EOI and liberalization are likely to generate dynamic gains, leading to a virtuous cycle of growth.

1. The argument, in essence, is that by cutting back state intervention and implementing neo-liberal policies, resources could be allocated more efficiently in a changing world, leading to economic growth, growth of manufacturing exports and modernization of economic activity long suffocated by protectionist policies and bloated state. The social consequences of such measures in the short-term are the costs of long-range structural adjustment, whose long term objectives are to improve efficiency, achieve equity and increase the stock of physical and human capital. The opening rests on the fundamental supposition that the appropriate division of labor and the full use of a country’s comparative advantages are best obtained by the free play of the market in the sense of specialization and economies of scale (World Bank, 1987: 2-4).

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4 Wade (1990: 14-24) presents a synthesis of neo-classical arguments, citing works by Balassa, Lal and Krueger. His reading is opposite to that presented in the *World Development Report* of 1987, chapter 5, on the economic performance of forty one countries broken down into the strongly externally oriented, the moderately externally oriented, the moderately internally oriented, and the strongly internally oriented. He draws the conclusion that countries moderately internally oriented obtained better results than those moderately externally oriented, and that countries judged strongly externally oriented were all in Southeast Asia, but all of them pursued managed trade and industrial policies rather than the application of the free
In addition, the World Bank offers other possible reasons for liberalization as follows:

(a) Export orientation is generally accompanied by high savings due to the following reasons: (i) marginal propensity to save (MPS) in EOI countries exceeds the average propensity to save (APS). As a result, as incomes rise with the expansion of exports, average savings rise; (ii) the MPS out of export income is high; (iii) export orientation is associated with less distorted capital markets, and a positive real interest rate acts as an incentive for savings.

(b) Exports generate foreign exchange and facilitate imports of raw materials and capital goods.

(c) Exporting firms often benefit foreign know-how and hence boost innovation.

(d) Exporting firms must keep up with up-to-date technology and bring managerial skills up to international standards to improve and thus maintain their market.

2. According to neo-classical theorists, the appropriate policy recommendation was that trade restrictions should be relaxed, and greater attention should be paid to the correct price signals (Kirpatrick, 1984: 198). Neo-classical theories assume that the country should obtain static gains, which result from more efficient allocation of resources, thanks to liberalization. But, in reality, resources are not efficiently allocated in most countries, and this limits their ability to respond to external liberalization. Liberalization is supposed to make a country produce what is more profitable (exportable) market (liberalization) or neo-classical model (Wade, 1990: p.17-18).
and import what is cheaper. Thus, liberalization expands the set of feasible consumption possibilities by providing technology for transforming domestic resources into goods and services that yield current and future utility for the consumers (Chowdhury, 1993: 82).

Thus, it is argued that liberalization will generate welfare gains by (as discussed in 3.3.):

- preventing the emergence of welfare-reducing domestic monopolies,
- preventing rent-seeking activity and directly unproductive activities,
- inducing domestic producers to improve the quality of products and to reduce production costs,
- allowing economies of scale to be reaped by expanding the size of the market (Tullock, 1967; Krueger, 1974; Bhagwati, 1980).

3. Based on these arguments on the advantages of EOI, external liberalization and the role of the market, a series of policies was recommended, now known as the Washington Consensus (Williamson, 1990; Meller 1992-93), emphasizing the following:

a. Public sector reform including:

- Reduction of the fiscal deficit by between 1 and 2 per cent of GDP by cutting public spending. Implementation of tax reform to broaden the tax base with low marginal rates.
- Privatization of public enterprises because a private sector producer is supposedly much more efficient than public sector. Besides, cutting the number of public enterprises reduces transfers from the central government in the form of subsidies, which have a positive effect on public spending.

b. Liberalization and deregulation reforms are to encourage competition in the domestic market. Among them:
➤ Liberalization of the domestic capital market, which implies floating interest rates. Interest rates ought to be moderately positive.

➤ Trade liberalization, by replacing quantitative restrictions with low tariffs.

➤ Labor market flexibilization to encourage.

➤ Positive treatment for foreign capital to promote the entrance of new capital, technology and know-how.

c. An elevated and stable real exchange rate to increase international competitiveness and promote exports5 (Williamson, 1990; Meller 1992-93).

The Washington Consensus view, whose the term was coined by John Williamson, is that deregulated markets will lead to better economic performance, at least in the medium to long run. Even if there are adverse transitional impacts, they can be cushioned by social policies, and in any case, after some time, they will be outweighed by more rapid income growth. Like all recent mainstream economic discourse, these conclusions rest on supply-side economic arguments. The purpose of trade reform is to switch production from non-tradable goods and inefficient import-substitutes to exportable goods in which poor countries should have a comparative advantage. Postulated full employment of all resources is supposed to allow this realignment of production to take place without significant dislocation costs. Opening the capital account is assumed to ensure financial inflows that will stimulate investment and productivity growth (more in Baker, Epstein & Pollin, 1998).

4. Contrary to those who all think that the benefits of openness (liberalization) policies revolve around the importance of exports and FDI, Rodrik (1999) argues that

5 John Williamson (1990) offers a neo-classical critique while Jose Maria Fanelli (1990) provides a neo-structural critique of Williamson.
these are the wrong reasons for maintaining an open economy. The benefits of liberalization lie on the import side, rather than on the export side. The theory of comparative advantage emphasizes that exports are important only insofar as they pay for imports. Exports are the price an economy pays for having access to imports. They are a means, not an end. There are four types of imports that liberalization enables countries to purchase: ideas, goods and services, capital and institutions:

(a) Importing ideas: According to Paul Romer (1993), ideas on organizing the process of production, manufacturing new products, and (most fundamentally) identifying commodities with latent demand are central to economic growth. And the advantage of backward economies is that they can borrow (import) ideas from rich countries. Successful importation of ideas requires individual skills and organizational capacity in importing countries (Landes, 1998).

(b) Importing goods and services: There are two channels through which importing goods and services can have significant positive effects on long-term economic performance in developing countries, namely imports of capital (investment) goods and imports of intermediate goods (critical to long-run economic growth), which would be too expensive to produce locally. Trade protection raises the relative prices of capital and intermediate goods, reduces the level of real investment attainable for any level of savings, as well as has adverse effects on the productivity of domestic manufacturing firms (Long & Summers, 1991; Temple, 1998).

(c) Importing capital: In principle, the ability to borrow from (and sometimes, to lend to) international capital markets is an important source of gain for
developing countries that are capital poor, but where the rate of return to capital is higher than elsewhere. Thus, the flow of capital to developing countries can foster investment and growth. Moreover, borrowing allows smoothing consumption in response to temporary shocks that often buffet poor economies. Apart from that, borrowing from international capital markets allows households to diversify their portfolios and achieve a better mix of risk and return.  

(d) Importing institutions: International integration, apart from entailing price arbitrage, often entails arbitrage among national institutions (institutional convergence). This is because of deliberate policy actions to harmonize a country's economic and social institutions with those of its partners. The way that governments can employ institutional arbitrage to good effect is by using it to enhance the credibility of domestic institutions.  

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6 In practice, foreign borrowing has been a mixed blessing at best. For one thing, there is little evidence that capital inflows will crowd in additional domestic investment. For another thing, in international financial markets, market failures - arising from asymmetric information, incompleteness of contingent markets, bounded rationality, and occasion irrationality - are endemic. Such problems are particularly severe where short-term capital flows (of maturity of less than a year) are concerned (Bosworth & Collins, 1998). The Mexican peso crisis of 1994 and the Asian financial crisis of 1997 are the most recent examples of danger of international capital markets to an individual economy.

7 For example, membership in the WTO requires the adoption of certain sets of institutional norms: nondiscrimination in trade and industrial policies, transparency in the publication of trade rules and patent and copyright protection, among others.

8 However, imported institutions can also turn out to be ill suited or counterproductive (e.g. environmental and labor standards and regulations on intellectual property right).
4.2.2 Critiques of External Liberalization

Lewis, Singer, Prebisch, Nurkse, Myrdal and Emmanuel have criticized the neo-liberal model from various viewpoints ever since the 1950s. The central critique is that the model's suppositions do not reflect real world conditions\(^9\) (Hunt 1989: 320-7). And the EOI strategy relying on external liberalization has been criticized for various reasons as follows:

1. In industrialized countries outside Europe that did not follow the way of the free market, meaning that these countries do not leave market forces to determine the prices of production factors and rates of interest, investment and savings, governments still maintain public subsidies and control foreign investments. This implies that governments still play important roles in process of industrialization for all the countries (Wade, 1990; Penrose, 1992; Amsden, 1992-93). For instance of East Asian economies: there is no agreement regarding the contribution of liberalization policies to their success, since their

\(^9\) According to Prebisch and Emmanuel, the model fails to consider the implications of union strength in collective bargaining, or the capacity of advanced countries to set oligopolistic prices and to thus retain improvements in productivity, rather than transfer them through international commerce in the form of lower prices for manufactured goods (Hunt, 1989). And in the opinion of Lewis and Emmanuel, it ignores the incapacity of developing countries to retain the gains from productivity increases in primary production due to the depressive effects on wages of the excess supply of labor (Hunt, 1989). Even the Heckscher-Ohlin's version of the theory of comparative advantage is critiqued for its presumption that all goods are technologically specific, since there is no the case for all raw materials or for simple manufactures. This argument undermines the Heckscher-Ohlin version because other technologies could render economies lacking their own raw materials more competitive, while the initial theory assumes that possessing raw materials is a prerequisite for trade specialization for such economies.
governments have promoted exports while maintaining restrictions on imports. In other words, the distinction of the EOI strategy of East Asia is that outward focus consisted of opening to export competition while retaining protection of domestic industries, so that such industries could link up to international markets without allowing international prices to become determinant domestically (Sachs, 1987 in Edwards and Larrain, 1989; Ugarteche, 2000: 105-11).

2. Amsden suggests that Gerschenkron’s belief that backward countries should leap to the forefront of world technologies in the most dynamic sectors is now obsolete since international competitiveness no longer depends only on product, innovation and wages, but also on organizational structure (Amsden, 1992-93). Moreover, the potential for the technological leaps suggested by Gerschenkon requires externalities that do not necessarily obtain in developing countries (Ugarteche, 2000: 105-11).

3. According to the theory of comparative advantage, productivity within a given industry differs from country to country, but the exchange rate can be managed to offer low-wage countries’ advantages in labor-intensive goods. However, Amsden argues that in reality, this is limited by the effects of the costs of imported goods on the costs of exported goods, and by the social impact of devaluation and resultant inflation (Amsden, 1992-93).

4. Amsden also argues that it is not correct when conventional price theory presumes that in all countries, all companies in a given industry operate with the same production function. Besides, in the dynamic industries of advanced countries using world-class modern technologies, international competition has forced the adoption of liberalization strategies, which raise barriers to accessing the technologies (Amsden, 1992-93: 161-2).
5. Meller synthesizes the critiques of Helleiner (1986) and Sachs (1986), and indicates that reforms based on internal and external liberalization, deregulation and privatization in an imperfect “next-to-optimum” world cannot show empirical evidence and the theoretical basis of achievement.

6. There is little evidence supporting the ideas of the World Bank that everything related to public enterprises and public administration is inefficient and corrupt, and that everything related to private sector is efficient and honest, e.g. in Latin America, where the real situation is much more complex (Ugarteche, 2000: 107). As a result, it is argued that the World Bank’s structural adjustment programs towards liberalization, which by nature interferes with a country’s development strategy, with its management of economic policy and its distributive and re-distributive consequences, were unacceptable at least up to the end of the 1980s (Feinberg, 1986; Meller, 1991).

7. In fact, international economic integration into the world economy in the name of liberalization is supported by advanced countries, but the international economy is not particularly liberal because very powerful private multinational corporations with lion’s shares of trade in raw materials, high-tech industrial goods and most service industries in international markets can manipulate consumers’ and market demands. They are horizontally and vertically integrated, both functionally and geographically, across national borders, and they base their operations on R&D backed by the immense real and financial resources at their disposal. These companies are the dynamic forces of modern capitalism. In this world, the prices of commodities are determined internally by multinational corporations and such prices are not the results of free market mechanisms. The entrance of new independent producers is complicated and not ensured by any means (Penrose 1992, Amsden, 1992-93).
8. While there is often a lot of talk about liberalization and free movement of the factors of production, no one mentions the free movement of labor from the South to the North, which the North has managed to block. If labor cannot migrate to where there are high wages and foreign investment can migrate, there must be some protection offered to foreign investments so that high wages can be created in the developing countries. But if FDI cannot be attracted, the liberalization could well be counterproductive.\(^{10}\)

9. The viewpoint of dependency theory is that development in East Asia was not achieved by free-market policies without state intervention. On the contrary, ISI policies laid the basis for later achievements. The question is what would happen with markets and raw materials if all countries all over the world applied the same external policies (Dutt, 1992). If all developing countries promoted their manufacturing sectors, they would face a new wave of protectionism from the industrialized countries (Streeten, 1982 in Hunt, 1989: 321).

Using a three-region model (the North, the NICs and the South), Dutt examines growth in the South as a result of the application of NICs strategies to the South.\(^{11}\) The

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\(^{10}\) Paraphrasing Joan Robinson and Oscar Wilde, Penrose says the misery of being exploited by capitalist is better than the misery of not being exploited at all.

\(^{11}\) With the three-region model, Dutt concludes that the NIEs increased the gap between the industrialized and developing countries. The more the gap widens, the more difficult the catch up process will be. This does not means that new NIEs can not emerge in the South, but they will do so only if they can attract a portion of world spending away from other Southern countries, thus tending to make the gap between the rest of the South and the North ever wider. As a result, a corollary, Dutt says, is that the longer it takes countries of the South to develop, the more likely NICs will become like northern countries, producing capital goods and an ever greater quantity of consumer goods at the expense of other Southern economies. He says that attempts to raise investment rates, hold down wages or improve technology will be neutralized.
conclusion is that in order to advance by means of EOI policies, technological change, and increasing savings rates, South countries will have to modify their relations with global trade and their dependent status. This model demonstrates a pattern of dependency: the North produces capital goods and growth in the North is determined by Northern parameters, while growth in every other region depends on internal and external factors. Dutt calls the production of capital goods in the South a “long term change”, and he suggests that it could best be achieved by protecting industries both from NICs and the North, and by promoting careful competition among producers in the South (Dutt 1992: 1168-9).

10. At the same time, Magdoff (1992) presents other critiques of EOI policies and liberalization from the viewpoint of dependency theory. He argues that 50% of world trade is regulated; and that NTBs are still on the rise. FDI from countries other than the US, particularly of Japan and Germany, which have been broadening, have transformed the structure of international property from being mostly controlled by US multinational corporations to being controlled by multinational corporations of other countries as well. In addition, FDI is increasingly being deployed within advanced countries (see Table 4.2). Moreover, so far, the internationalization of capital has been a feature of modern liberalization\textsuperscript{12}. All these things do not create a new integrated and ordered world, but rather a more chaotic world. At the same time, while southern countries’ share of manufacturing exports compared to the rest of the world, excluding countries in Southeast

by deterioration in the terms of trade. Individual export success is possible, but will come at the cost of other developing countries (the prisoner’s dilemma).

\textsuperscript{12} Nowadays, the annual volume of goods and services in world trade is estimated at between US$ 2.5 trillion and US$ 3.5 trillion, while daily transactions of world foreign exchange markets is worth US$ 3.5 trillion causing instability within an unstable world the monetary system (Khor, 2000: 3).
Asia, fell by 30% between 1966 and 1986, trade competition among advanced countries is tending towards the formation of the blocs and away from the MFN principle of multilateral trade. Consequently, Magdoff concludes that today’s centrifugal tendencies are an echo of the past, of the period between the great crisis of the nineteenth century’s end and the beginning of the First World War, and of the period between the Depression of the 1930s and the Second World War (Magdoff, 1992).

**Table 4.2: Accumulated FDI in Developed and Developing Countries, 1967-2000 (%).**

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<tbody>
<tr>
<td>Developed countries</td>
<td>69.4</td>
<td>73.9</td>
<td>79.0</td>
<td>80.8</td>
<td>82.1</td>
<td>80.8</td>
</tr>
<tr>
<td>Developing countries</td>
<td>30.6</td>
<td>26.1</td>
<td>22.0</td>
<td>19.2</td>
<td>17.9</td>
<td>19.2</td>
</tr>
<tr>
<td>Total</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
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**Note:** The brunt of the world FDI decline in 2001 was borne by developed countries, a drop of 59% from US$1,000 billion in 2000 to US$503 billion in 2001. Developing countries experienced a relatively small drop of 14%, from US$238 billion to US$205 billion *Business New Straits Times* (Malaysia), 18 Sep. 2002.

11. Another critique from the structuralists’ viewpoint emphasizes the need for significant changes in the economic structure including land redistribution, income distribution, and greater national control as the appropriate policy reforms. Income distribution policy, according to Fajnzylber, is very important because it allows economies to broaden the domestic markets, and therefore, attain a better competitive

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13 From the viewpoint of neo-classical theory, poverty is related to the economic assets. In this way, factor remuneration will be the direct result of allocation of assets in the economy.
position for manufactures. A more equitable income distribution policy creates high rates of savings, a better pattern of demand, greater innovation in production and therefore, more growth (Fajnzylber, 1986 and 1990). Adelman & Morris suggest, that social equity should be considered fundamental for justice, democracy and development, which are outside of neo-classical theory (Adelman & Morris, 1973). Adelman (1984) considers that during international recessions, internal demand, which is directly related to the distribution of land and income, and not external demand, will stimulate growth. At the same time, Nixson presumes that since the failure of ISI was fundamentally due to its reliance upon existing internal market demands, greater state intervention through centralized industrial planning was seen as essential to create more internal demand, to guarantee successful ISI implementation (Nixson, 1981).

12. Moreover, structuralists believe that there may be supply-side benefits from trade and capital market reforms, one should not overlook aggregate demand, its potentially unfavorable interactions with distribution, and the impact of capital inflows on macro prices. Import substitution basically relies on expansion of internal markets, with rising real wages as part of the strategy. However, liberalization controls wage costs to keep traded good prices low. So long as there is enough productivity growth and no substantial displacement of workers, wage restraint need not be a problem because output expansion could create space for real income growth. But if wage levels are seriously reduced and/or workers with high consumption propensities lose their jobs, domestic demand contraction could cut labor income in sectors that produce for the local market. Income inequality could rise if displaced unskilled workers end up in informal service activities for which there is declining demand (Taylor, 1987: 1407-35; 2000b).

13. Structuralists also argue that liberalization can push macro prices in
unfavorable directions. An upward shift in the supply of foreign exchange due to rising capital inflows (bigger capital account surpluses) tends to lead to real exchange rate appreciation (a stronger local currency), eliminating liberalization's incentives for export production and putting downward pressure on real wages to keep domestic suppliers competitive. Through financial markets, real appreciation of the local currency is usually linked to high real interest rates (the simple reason is that investors will not want to hold securities valued in an expensive local currency unless they receive especially high returns), which add to production costs, penalize capital formation, and increase the current account deficit (imports generally exceed exports).

Simultaneously, higher interest rates may also draw in more external capital, setting off a high interest rate-strong exchange rate spiral. Via the banking system, capital flows feed into international reserves and expansion of supply of domestic money and credit. On the positive side, additional credit may stimulate aggregate spending through increased investment. However, it can also trigger a consumption boom (with purchases heavily weighted toward imports due to cheap imports) or speculative price bubble (typically in equity and/or real estate). The import-fed demand spurt may prove to be short-lived if the consequent widening of the external balance is unsustainable or if capital flees the economy when the bubble begins to deflate. Rolling back prudential financial regulation makes the latter outcome all the more likely (Taylor, 1987: 1407-35; 2000b).

14. From his empirical studies, Rodrik argues that openness by itself is not a reliable mechanism to generate sustained economic growth. There is no evidence that exports and FDI per se generate economic growth or that they produce significant positive spillovers. Furthermore, the belief that exports can increase the overall level of
employment in an economy over the longer term is mercantilist fallacy. Openness likely exerts pressures that widen income and wealth disparities within the country (Rodrik, 1997). He recommends that:

"Developing countries need to create an environment that is conducive to private investment...They need to improve their institutions of conflict management - legally guaranteed civil liberties and political freedoms, social partnerships, and social insurance - so that they can maintain macro-economic stability and adjust to rapid changes in external circumstances. In the absence of these complements to a strategy of external liberalization, openness will not yield much. At worst, it will cause instability, widening inequalities and social conflict" (Rodrik, 1999: 137).

In his opinion, the fundamental determinants of economic growth are the accumulation of physical and human capital and technological development. Openness can contribute to these determinants in a way by making cheap capital goods available for investment, or by allowing the transmission of ideas from developed countries, for example. But these potential linkages are contingent ones, requiring other pieces of the puzzle to fall into place.

Apart from that, openness will also leave countries vulnerable to external shocks that can trigger domestic conflicts and social upheavals. These consequences are damaging, not only in their own right, but also serve to prolong and magnify the effects of external shocks\textsuperscript{14}. As the Asian financial crisis that began in 1997 demonstrates, no matter

\textsuperscript{14} The developing world has been buffeted by a series of external shocks since 1970s, arising from rapid changes in the terms of trade, spikes in world interest rates, and sudden reversals in capital flows. The protracted debt crisis of the 1980s in Latin America was a poignant demonstration of the consequences of the inability to handle shocks.
what its trade orientation or the qualities of its economic policies, it is not entirely
immune from the shocks. As a result, it is a warning that a strategy of economic
development that relies too much on encouraging exports and FDI, without emphasizing
complementary policies and institutions, risks disappointment and failure.

15. Apart from economic viewpoints, the neo-classical model has also been
criticized from a political standpoint, according to which this model leads to concentration
of income and consumption, leading to (i) explosions of social unrest (Chiapas, 1994;
Cordoba, 1994; Bolivia, 1995); (ii) erosion of corporative mechanisms in solving
problems; (iii) worsening labor conflicts15 (Roxborough, 1992: 427). Moreover, it is
argued that successful economic operations do not mean that the political system (for
distribution of economic benefits) will operate well too. The political apparatus might
eventually even undermine the operation of the model itself.

Generally speaking, many major development economists have been pessimistic
about EOI opportunities. Some argue that the era of export-oriented growth is over, and
that EOI can no longer be expected to be an engine of growth. They have argued, in
varying ways, that EOI opportunities have become so restricted that development
strategies have become increasingly inward-looking, import-substitution oriented and so
on (Bhagwati & Srinivisan, 1984: 23-28). It has also been observed that the rate of
economic growth over time will depend on factors such as the MPS, APS and the rate of
technological progress, none of which are directly related to the trade regime in an
obvious way (Findlay, 1984: 23-42).

15 The model’s direct beneficiaries are people who possess significant assets in the economies and the
middle classes, while the rest of society is lost. Therefore, social conflicts are difficult to avoid.
In fact, external orientation had already started in the 1960s in a group of a few East Asian economies such as Hong Kong, Taiwan, South Korea, and Singapore, which geared their development strategies towards EOI. Then, other countries in Europe, Southeast Asia and Latin America followed the examples of this group in the 1970s (OECD, 1979). Later, in the 1980s, EOI further spread to the socialist economies in Asia and Europe, and to African economies. This policy spread further to South Asia, the Middle East, and the rest of Africa in the 1990s. However, economic performance and industrialization in these countries under EOI policies have been differed from country to country\(^{16}\) (can be referred to Table 3.1, 3.2) that resulted in two different effects of EOI and liberalization.

\subsection*{4.3.1 Evidence of Liberalization and EOI}

The Krueger-Bhagwati NBER project dealt with 10 countries, namely Brazil, Chile, Colombia, Egypt, Ghana, India, Israel, Philippines, South Korea and Turkey during the period 1950-1972. Krueger (1978) found that real effective exchange rates played a significant role in determining exports, and that higher exports were associated with higher GNP. Bhagwati (1978) analyzed, in detail, the static gains from liberalization. He

\footnote{\textit{Liberalization is not, of course, the only factor affecting economic performance in each economy. Moreover, countries vary in their resource endowments, initial levels of development, export capacities, initial degrees of openness, other policy stances, as well as in the timing and pace of their liberalization. Consequently, measuring the impact of liberalization is not easy. An approach sometimes used is to construct a measure of the degree of openness as an indicator of the degree of liberalization and to relate it to economic performance (Kirkpatrick and Weiss, 1994).}}
argued that pre-reform data on REPs and DRCs clearly suggest that liberalization in these countries generated important static gains in the form of efficiency improvements, but did not generate any dynamic gains.

Balassa (1982) summarized a large World Bank project of 11 countries, including Argentina, Brazil, Chile, Colombia, Mexico, Israel, Yugoslavia, India, South Korea, Singapore and Taiwan for the period 1960-73. In the first stage of the analysis, he examines whether export incentives fostered export growth by using two proxies for quantifying export incentives, namely (i) the rate of growth of manufacturing exports; and (ii) the change in the export-output ratio in manufacturing. In the second stage, he investigated the effects of export and output growth, and found that these variables were consistently higher in those countries that had sustained export promotion policies.

More impressive export performances after the introduction of export promotion policies was the case in the ASEAN countries including Malaysia, Thailand, Indonesia, the Philippines, Singapore and Brunei in the period 1962-1982 (Ariff and Hill, 1982). In the Philippines as well as in Thailand, the share of manufactures rose about 10-fold, while in Singapore, it almost doubled from an already substantial base. In Malaysia, the share of manufactures began to rise sharply in the 1970s, coinciding with the first sustained attempts to promote manufactured exports. However, the significant increase in manufactured exports in these countries consisted of labor-intensive products, mainly electronics, electrical appliances, textiles and clothes produced in EPZs. It implies that exports were not generated from previously IS industries (Alavi, 1994). Wade (1990: 14-24) presents a synthesis of neo-classical arguments, citing works by Balassa, Lal and Krueger. His reading is opposite to that presented in the World Development Report of 1987 (chapter 5) on the economic performance of forty one countries broken down into
those that are strongly externally oriented, moderately externally oriented, moderately internally oriented, and strongly internally oriented. He draws the conclusion that countries moderately internally oriented obtained better results than those moderately externally oriented, and that countries judged strongly externally oriented are all in Southeast Asia, but all of them pursue managed trade and industrial policies, rather than the application of the free market (liberalization) or neo-classical model (Wade, 1990: 17-18).

Trade and investment liberalization was an integral part of the first generation of economic reforms implemented by transitional economies in the Central and Eastern European (CEE) and Newly Independent States (NIS) after the fall of the communist system (Kalinova, 1998). The opening of their economies to the outside world was considered critical to overcome the legacies of central planning, notably a distorted administered price system, lagging productivity and technological backwardness. But such liberalization must occur concurrently with state intervention in wide-ranging structural transformation in order to sustain and build on progress as it occurs. Privatization and competition policy are key, as they facilitate the entry of new firms and discourage market concentration that might allow protectionist alliances among major producers to emerge. Labor market policies also support liberalization by encouraging work force mobility, especially from inefficient to internationally competitive sector and firms. Structural improvements in the banking system and capital markets in general also facilitate liberalization, since poorly functioning banks reduce the efficiency of foreign trade operations and make the financing of modernization requirements difficult and expensive. Moreover, the state's role, expressed in working out a solid foundation with clear and predictable regulations, is another prerequisite, as legal uncertainty and
inadequate enforcement of contracts discourages firms from investing and modernizing their production facilities.

*Source:* World Bank, 1996: 28

*Figure 4.1:* Liberalization and GDP Growth
The 1996 *World Development Report* of the World Bank surveys the impacts of liberalization and EOI policies on the economies of Central and Eastern European (CEE) and Newly Independent States. According to this survey, such liberalization has been positively associated with growth. In countries where liberalization has been stronger (as
measured by average liberalization scores\textsuperscript{17}, output losses have, on average been, smaller (Figure 4.1). And the difference increases over time: relatively stronger liberalization boosted average growth during 1989-95, but boosted average growth in 1994-5 by even more\textsuperscript{18}. It is worth noting that typically, all countries have returned to growth only after three years of sustained liberalization. Countries of groups 1 and 2, where liberalization has been more rapid and comprehensive, experienced earlier output decline, but also earlier and stronger recovery. Output in countries in other groups (3,4)\textsuperscript{19} was still falling

\textsuperscript{17} The liberalization score is a weighted average of estimates of liberalization of domestic transactions (price liberalization and abolition of state trading monopolies), external transactions (elimination of export controls and taxes, substitution of low to moderate import duties for import quotas and high tariffs, current account convertibility), and entry of new firms (privatization and private sector, or non-state, development). The weights on these components are 0.3, 0.3 and 0.4 respectively. Initial estimates for the three components were based on comparative information in World Bank and other reports. These were revised following consultation with country specialists as well as experts with a comparative perspective across a number of countries. For the 25 countries in CEE and NIS, the transition indicators and accompanying text in EBRD 1994 and 1995 provide a further basis for calibration (World Bank, 1996: 13-5).

\textsuperscript{18} Apart from the liberalization factor, two other factors have had a strong impact on recent growth, namely (i) output has tended to increase further since 1989 (or declined less) in poorer, more agricultural countries with more overbuilt industrial sectors; (ii) each year a country has been adversely affected by regional tensions has added 6.5% of GDP, on average, to the annual decline in output since 1989.

\textsuperscript{19} According to liberalization scores, World Bank (1996) classifies 26 CEE and NIS into four groups. Countries in group 1 have the highest degree of liberalization, while countries in group 4 have the lowest degree of liberalization. The countries of group 1 are Poland, Slovenia, Hungary, Croatia, Macedonia, Czech Republic, and Slovak Republic. Group 2 consists of Estonia, Lithuania, Bulgaria, Latvia, Albania, Romania, and Mongolia. Group 3 includes Kyrgyz Republic, Russia, Moldavia, Armenia, Georgia, and Kazakhstan. Countries in group 4 are Uzbekistan, Ukraine, Belarus, Azerbaijan, Tajikistan, and Turkmenistan.
in 1994-5, but recent reforms have brought a number of them to the threshold of recovery (Figure 4.2). However, it is believed that the success of some economies in economic performance is due the combination between liberalization programs and selective state intervention in these economies.

4.3.2 Evidence against Liberalization and EOI

In contrast, according to many economists, the apparent correlation of economic growth with export growth does not imply causation. The Grauger-Sims causality test finds very weak causality running from exports to economic growth was found (Jung & Marshall, 1985: 1-12). Combining Jung & Marshall’s F-statistics with World Bank findings, Dodaro found very little support for the export promotion hypothesis. He concluded that some degree of economic development and efficiency is necessary before a country can make any significant inroads in the world market, particularly in manufactures (Dodaro, 1991: 1154). Similarly, Daraf finds no evidence of causality between export growth and economic growth for Hong Kong, Korea and Singapore. On the other hand, in the case of Taiwan, he reports that economic growth did not cause export growth (Darat, 1986: 695-700).

Contrary to the engine of growth hypothesis, export expansion in the nineteen century did not differentiate successful from unsuccessful countries. It concluded that external demand may be helpful, but is neither a necessary nor a sufficient condition for growth (Kravis, 1970: 850-72). In Riedel’s opinion, supply side rather than demand factors principally determined less developed countries’ export performance in manufactures (Riedel, 1984: 57-73).
Table 4.3: Indicators of Economic Performance in African LDCs
Classified by Degree of Liberalization, 1980s

<table>
<thead>
<tr>
<th>Country group</th>
<th>Annual average growth of output and exports (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Real GDP</td>
</tr>
<tr>
<td>High liberalizer (6)</td>
<td>3.9</td>
</tr>
<tr>
<td>Medium liberalizer (4)</td>
<td>5.0</td>
</tr>
<tr>
<td>Low liberalizer (14)</td>
<td>1.6</td>
</tr>
</tbody>
</table>


Note: The figures in brackets are the number of countries to be examined.
High liberalizers are Benin, Burkina Faso, Chad, Gambia, Guinea, and Malawi.
Medium liberalizers are Botswana, Burundi, Central African Republic, and Lesotho.
Low liberalizers are Djibouti, Ethiopia, Madagascar, Mali, Mauritania, Niger, Sudan, Rwanda, Sierra Leone, Somalia, Togo, Uganda, Zaire and Zambia.

Surveying the impacts of liberalization on economic performance in African countries, Shafaeddin (1994) uses three proxy measures to assess the degree of liberalization in an economy in a given period: (i) the ratio of imports to GDP; (ii) the share of revenue from import tariffs to total government revenue; and (iii) the average foreign exchange premium on the black market. On this basis, he classifies African countries into high, medium, and low liberalizers. Table 4.3 shows three indicators of

20 In some African countries (e.g. Burundi, Guinea, Guinea Bissau, Madagascar, Malawi, Niger, Togo and Zaire) liberalization was initiated already in the early 1980s, while in others it began around the mid-1980s or later. By 1987, mean tariffs for manufactures that were below the average level (23.4%) prevailing for the same year in South Korea, where there already prevailed a relatively liberal trade regime. Since 1987, most of these countries have undertaken further liberalization measures, including binding of tariffs. In a number of early liberalizers there are now few barriers to trade (Shafaeddin, 1994).
economic performance over the 1980s for each group, namely annual real GDP growth, manufactured value-added (MVA) and exports. The Table shows that in general, high and medium liberalizers tended to perform better than low liberalizers. However, medium liberalizers performed better than high liberalizers in respect of all indicators (Shafaeeddin, 1994: 5-6). A similar pattern was revealed when the exercise was repeated only for the second half of the 1980s (Kirkpatrick and Weiss, 1994).

Feenstra & Hasson (1996), Wood (1997), and Pissarides (1997) use evidence from developing countries to indicate that rising inequality has been experienced in many Latin American countries that have opened up their economies during the last two decades. Two recent research projects have investigated the impacts of full-scale liberalization on the current account and capital account, through the use of quantified narrative histories for a number of countries. They analyzed changes over time in effective demand, productivity growth, employment, and income distribution across producing sectors (agriculture, industry, services and so on) and forms of payment flows (wages by different skill levels, profits, interest, and so on). One project concentrated on countries in Latin America and the Caribbean, with the other adding details on the effectiveness of social policies in dealing with the impacts of liberalization in Argentina, Colombia, Cuba, India, South Korea, Mexico, Russia, Turkey, and Zimbabwe (Ganuza, Taylor & Vos, 2000 and Taylor 2000a). The results are sobering. Liberalization packages generated modest improvements in economic growth and distributional equity at their best, but the best cases were infrequent. At their worst, they have been associated with increasing income inequality and slower growth, even in the presence of rising capital inflows (Taylor, 2000b) (see in Table 4.4).
### Table 4.4: Growth and Distributional Changes under Liberalization

<table>
<thead>
<tr>
<th>Growth effect</th>
<th>Distributional Impacts</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Favorable</td>
</tr>
<tr>
<td>Positive</td>
<td>Chile (post 1990)</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
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<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Neutral</td>
<td>Costa Rica</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Negative</td>
<td></td>
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</tr>
</tbody>
</table>

**Source:** Taylor, 2000b.

An immediate conclusion from Table 4.4, which presents changes in growth rates and the primary income distribution for countries included in the two projects, is that the effects of liberalization have not been uniformly favorable. The general impression given by the Table is of slower growth and deterioration in the primary income distribution. Just two countries had a clear distributional improvement, and only Chile after 1990 managed to combine high growth with decreasing inequality.\(^2^1\) Stable or more rapid growth on a

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\(^{21}\) Liberalization began in Chile shortly after the fall of the Allende government in 1973. The economy grew steadily after the mid-1980s, but inequality increased markedly over almost 20 years until the early 1990s.
sustained basis was observed in a few small, open economies that benefited from capital inflows and a somewhat illiberal policy orientation. Two-thirds of the countries had rising inequality, while five, to a greater or lesser extent, were "disasters".

Apart from years of overt crisis, most countries achieved moderate growth GDP rates in the 1990s. As already observed, Russia and, not quite so disastrously Jamaica, Paraguay, Argentina (late in the decade), and Zimbabwe were the main losers. Except in Argentina before 1997-98, Chile, the Dominican Republic, India, and Korea prior to its crisis, rates of household per capita income growth in other countries were negative or modestly positive. Towards the end of the decade, growth had tapered off in many countries due to emerging domestic financial crises (Paraguay, Colombia, Ecuador) or external events. Adverse foreign shocks included the impacts of the Asian crisis on capital flows to Russia and Brazil (with spillover effects on Argentina), and falling export earnings for most primary exporting economies due to plummeting commodity prices.

Inequality in primary incomes increased in most countries. Virtually without exception, wage differentials between skilled and unskilled workers rose with liberalization, reflecting reallocation of workers from relatively well-paid jobs in traded goods sectors to more precarious employment in non-traded (often "informal") activities. Relative to the economically active population (following the standard definition), the unemployment rate was stable or tended to rise. Except in Turkey, the unemployed as a proportion of the economically active went up as well, especially after crises and/or later in the decade. Excess labor was absorbed in the non-traded, informal and services sectors (Bolivia, Colombia, Ecuador, India, Peru, and Russia) or where traditional

---

22 Given the modest GDP growth noted previously, lackluster employment performance with liberalization is scarcely surprising.
agriculture served as a sponge for the labor market (Costa Rica, Guatemala, Mexico).

As already observed in 4.2.2.13, real exchange rate appreciation has been a central characteristic of the post-liberalization period in most countries. But trade expansion and diversification stimulated growth only where depreciation occurred or the currency was kept weak (Bolivia, Chile, Colombia 1990-92, Korea and Russia post-1998, Mexico post-1995, Uruguay 1986-90). Similar observations hold for small Latin American countries with credible incentive systems for non-traditional exports (Dominican Republic, Chile, Costa Rica, El Salvador, and Uruguay via MERCOSUR)23 (Taylor, 2000b).

4.4. Economic Performance and Industrialization in the East Asian Newly Industrializing Economies

In the East Asian newly industrializing economies (EANIEs), growth of national income and manufacturing output since 1960 has been high by most standards, whether in relation to historical rates in these countries before 1960, or in relation to rates currently achieved by developed economies, or in relation to the growth performance of developed economies at earlier stages of their industrialization, or in relation to the growth performance of other NIEs (see Table 3.1, 3.2, 4.5). Empirical studies have shown that

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23 These observations are of interest because one of the principal justifications for external liberalization was its anticipated effect on trade performance. Due to efficiency gains induced by freer trade, "export-led" growth was supposed to be an immediate consequence. It did not happen, at least in terms of effective demand generation, in most countries. As the detailed studies demonstrate, exports did tend to rise with liberalization, but imports rose more strongly, especially when the local currency appreciated in real terms. Trade therefore held back or added weakly to effective demand. Growth stimulus was present, but far less visibly than predicted by advocates of liberalization.
Japan, South Korea, Hong Kong, Singapore, Taiwan and later Malaysia, Thailand, Indonesia, China have achieved unprecedented economic growth rate of 7 to 10% until 1997. Along with GDP growth, manufacturing's shares of GDP and exports are expected to increase over time\(^{24}\). The World Bank (1993) hailed them as the "East Asian Miracle".

**Table 4.5: Real Annual Average Growth Rates of GDP in Latecomer Industrializing Countries, 1965-2000.**

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>4.7</td>
<td>2.2</td>
<td>11.6</td>
<td>4.4</td>
<td>8.6</td>
<td>-3.9</td>
<td>-3.1</td>
<td>-1.7</td>
</tr>
<tr>
<td>Brazil</td>
<td>9.4</td>
<td>5.0</td>
<td>25.2</td>
<td>2.9</td>
<td>3.2</td>
<td>0.1</td>
<td>1.0</td>
<td>4.0</td>
</tr>
<tr>
<td>Chile</td>
<td>7.9</td>
<td>5.5</td>
<td>10.4</td>
<td>7.4</td>
<td>7.4</td>
<td>3.9</td>
<td>-1.1</td>
<td>5.6</td>
</tr>
<tr>
<td>Mexico</td>
<td>7.7</td>
<td>1.6</td>
<td>8.4</td>
<td>5.2</td>
<td>6.8</td>
<td>4.6</td>
<td>3.5</td>
<td>6.5</td>
</tr>
<tr>
<td>China</td>
<td>4.3</td>
<td>8.1</td>
<td>12.7</td>
<td>9.7</td>
<td>8.8</td>
<td>7.8</td>
<td>7.1</td>
<td>8.0</td>
</tr>
<tr>
<td>Japan</td>
<td>7.2</td>
<td>4.1</td>
<td>0.9</td>
<td>5.0</td>
<td>1.4</td>
<td>-2.8</td>
<td>1.0</td>
<td>1.2</td>
</tr>
<tr>
<td>South Korea</td>
<td>9.6</td>
<td>9.3</td>
<td>7.7</td>
<td>7.1</td>
<td>5.0</td>
<td>-5.8</td>
<td>6.5</td>
<td>8.8</td>
</tr>
<tr>
<td>Taiwan</td>
<td>9.8</td>
<td>7.8</td>
<td>6.2</td>
<td>5.7</td>
<td>6.8</td>
<td>4.9</td>
<td>5.0</td>
<td>6.5</td>
</tr>
<tr>
<td>Singapore</td>
<td>10.1</td>
<td>6.5</td>
<td>9.7</td>
<td>7.5</td>
<td>9.0</td>
<td>0.3</td>
<td>4.5</td>
<td>7.9</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>8.6</td>
<td>6.4</td>
<td>5.1</td>
<td>4.6</td>
<td>5.3</td>
<td>-5.1</td>
<td>1.2</td>
<td>8.0</td>
</tr>
<tr>
<td>Malaysia</td>
<td>7.3</td>
<td>6.0</td>
<td>8.8</td>
<td>10.6</td>
<td>7.5</td>
<td>-7.5</td>
<td>5.8</td>
<td>8.5</td>
</tr>
<tr>
<td>Thailand</td>
<td>8.2</td>
<td>8.1</td>
<td>8.5</td>
<td>5.5</td>
<td>-1.3</td>
<td>-9.4</td>
<td>4.0</td>
<td>5.0</td>
</tr>
<tr>
<td>Indonesia</td>
<td>6.1</td>
<td>7.5</td>
<td>7.6</td>
<td>8.0</td>
<td>4.1</td>
<td>-13.7</td>
<td>-0.8</td>
<td>4.0</td>
</tr>
</tbody>
</table>


\(^{24}\) It has been proven that there is an intimate and close relationship between GDP growth rate and the manufacturing shares of GDP and exports.
However, Krugman (1994) contested the "miracle" by pointing out that the high growth performance of EANIEs was not due to productivity growth, but due to an increase in factor inputs; if the supply of labor and capital were to cease to increase eventually, EANIEs' growth would stop. His conclusion was based on empirical studies of productivity growth in the manufacturing sector in some EANIEs (see Table 4.6). But although total factor productivity for manufacturing has not grown remarkably, the sector still enjoyed high productivity, and productivity growth was sustained by an incessant flow of factors from low productivity sectors to high productivity sectors (EPA, 1998).

**Table 4.6: Sources of Growth in EANIEs, 1960-94 (annual average, %)**

<table>
<thead>
<tr>
<th>Country</th>
<th>Growth of output per worker</th>
<th>Contribution of Physical capital</th>
<th>Education</th>
<th>Total Productivity (TFP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>South Korea</td>
<td>5.7</td>
<td>3.3</td>
<td>0.8</td>
<td>1.5</td>
</tr>
<tr>
<td>Taiwan</td>
<td>5.8</td>
<td>3.1</td>
<td>0.6</td>
<td>2.0</td>
</tr>
<tr>
<td>Singapore</td>
<td>5.4</td>
<td>3.4</td>
<td>0.4</td>
<td>1.5</td>
</tr>
</tbody>
</table>

*Source: Collins & Bosworth (1996)*

Thus, while the EANIEs have been very successful in industrialization, but there are different ways to explain EANIEs' successes. Dependency theorists have been largely dismissive of the rapid industrialization of the EANIEs which have adopted EOI programs. They have portrayed the EANIEs' industrialization as externally derived and qualitatively inferior to that experienced by the advanced capitalist countries in their early stages of development. On the other hand, neo-classical economists cite South Korea, Taiwan, Singapore and Hong Kong not only as proof of genuine industrialization in the
Third World, but also of the success of free market (strong liberalization) policies in generating rapid industrialization (OECD, 1999). The rational choice theory supporters argue that the EANIEs represent a triumph for economic rationality over political interference, and show what can be achieved when domestic policies are conducted on a sound basis. Yet another view of the EANIEs maintains that far from epitomizing laissez-faire development, their industrialization is a product of state-directed initiatives. In view of such divergent claims, it seems that close empirical and theoretical examination of the genuine reasons for the EANIEs successes are urgently required for all developing countries, particularly transitional ones like Vietnam which are integrating into regional and global economy. Differing from the above arguments, the achievements of EANIEs should be attributed to both objective and subjective conditions as follows:

(a) Objective Conditions:

There are three objective conditions. First is that the post-war economic boom of the 1950s and 1960s involved a tremendous expansion in international trade, creating tremendous opportunities for export-led growth. The internationalization and liberalization of manufacturing production processes from the 1960s created new opportunities for industrialization. GATT also served to create an international environment conducive to such trade expansion and industrialization: Eight rounds of GATT multilateral trade negotiations succeeded in lowering the average (trade weighted) MFN tariff rates\(^{25}\) (see Table 4.7); Under the Generalized System of Preferences (GSP),

\(^{25}\) For OECD countries, trade-weighted average tariffs reduced from a high rate of 40% at the end of the World War II to around 5% at the end of the Uruguay Round. However, tariff reductions have not been
developing countries that found favor with the North were exempted from import duties

**Table 4.7: Tariffs Before and After Liberalization**

*(Pre and Post-Uruguay Round (%))*

<table>
<thead>
<tr>
<th>Country</th>
<th>Trade-weighted Average Tariffs</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Pre-Uruguay Round</td>
</tr>
<tr>
<td>USA</td>
<td>5.4</td>
</tr>
<tr>
<td>Japan</td>
<td>3.9</td>
</tr>
<tr>
<td>European Union</td>
<td>5.7</td>
</tr>
<tr>
<td>South Korea</td>
<td>18.0</td>
</tr>
<tr>
<td>Malaysia</td>
<td>10.0</td>
</tr>
<tr>
<td>Thailand</td>
<td>37.3</td>
</tr>
<tr>
<td>Indonesia</td>
<td>20.4</td>
</tr>
<tr>
<td>India</td>
<td>71.4</td>
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<tr>
<td>Turkey</td>
<td>25.1</td>
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<tr>
<td>Argentina</td>
<td>38.2</td>
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<tr>
<td>Brazil</td>
<td>40.7</td>
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<tr>
<td>Chile</td>
<td>34.9</td>
</tr>
<tr>
<td>Mexico</td>
<td>46.1</td>
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</tbody>
</table>

**Source:** GATT secretariat (1994), appendix tables 5 and 6, as cited in Hoda (1994).

**Note:** The pre-Uruguay Round duties refer to 1994 bound duties or, for unbound tariff lines, to duties applicable as of September 1986. The post-Uruguay Round duties refer to the concessions listed in the schedules annexed to the Uruguay Round Protocol to the GATT (1994). As import statistics refer in general to 1988, trade-weighted duties using post-Uruguay Round import data may be slightly different. The data are preliminary and may be revised to reflect the final schedules annexes to the Final Act of the Uruguay Round. Although as of April 1999, no changes were registered, except for Thailand. The changes for Thailand appear above.
and other restrictions on exporting to the USA and other developed countries. Although many would maintain that economic growth has been retarded since the 1970s, and especially in the 1980s, global conditions have remained generally favorable to late industrialization (Jomo, 1993: 294). The second is that EANIEs have common objective conditions favoring export-oriented industrialization such as all of them were colonies of imperialism before 1960s (Jomo, 1993: 290). The third condition for the rapid growth of the EANIEs has been cultural. Except for Malaysia, it is claimed that Confucianism has provided an important cultural advantage over other cultural traditions because of its supposed emphasis on diligence, loyalty and respect for authority (Jomo, 1993: 296).

(b) Subjective Conditions:

What have been the subjective conditions? Yamazawa (2000) and others argue that there are at least two groups of subjective fundamentals for the EANIEs’ achievement, namely

- Expansion of physical capital thanks to the accumulation of private and public savings, and their transformation into fixed assets (investments). Their saving ratios (savings/GDP) averaged over 30%, compared with 26.1% in other developing countries and 20.4 % in industrialized economies. Their investment ratios (gross capital formation/GDP) were even higher, achieving rates of 38.3% on average compared with about 20 % for Latin American economies26 (IDE, 1999). This

26 Asian countries, almost without exception, experienced investment ratios of over 20% between 1965 and 1973, over 24% between 1980 and 1985, jumping over 30% for most of them in 1990s, while Latin American countries had this indicator of 13-20% between 1965 and 1973, and between 17-20% during
provided the material base for structural change in industrial capacity.

- Hard-working habits of EANIEs' people and their traditional emphasis on education helped to enhance the level of qualified and skilled labor and active entrepreneurship, strengthening local responses to EOI. An un-precedented quantitative and qualitative expansion of human capital has been complementing the material components of the "growth engine". Therefore, the EANIEs have been known for prudent macro-economic management, and until recently, this had kept their public debt and current account deficits at a minimum.

But, these two sources of development of EANIEs were clearly derived from sound government policies under which savings have been mobilized and hard-working habits and educational traditions have been stimulated. It is believed that the state's role has been crucial for industrialization in each EANIE, including Japan and China. Observers such as Amsden (1989), Wade (1990), Jomo (1993, 1997, 2000), Rodrik (1995, 1999), and many others have argued that the economic reforms went considerably beyond giving market and comparative advantage free rein. According to these authors, the governments of EANIEs had clear industrial priorities, and did not hesitate to intervene (through instruments such as subsidies, trade restrictions, administrative guidance, public enterprises, credit allocation, exchange rate depreciation, duty free treatment of inputs for export production) to reshape comparative advantage in the desired direction (Rodrik, 1999: 48-58). Governments also intervened in business and production activities in accordance with desired goals, providing favorable arrangements, where necessary, to remedy market failure. The governments of EANIEs were thus able to improve market

1980s and 1990s. Overall, then, the investment ratio in EANIEs was twice higher than that in Latin American countries over the last thirty years. The same is true of savings ratio (Ugarteche, 2000: 42-48).
outcomes and to accelerate growth by deliberately distorting prices and incentives.

It is also increasingly clear that there has been considerable variation in the role, nature and extent of state intervention over time. It is now well known that the EANIEs are all examples of state-led development. Whereas state interventions in either South Korea or Taiwan have tried to consolidate strong domestic industrial capitalists, with more than a little help from their respective governments, the industrialization paths of Malaysia, Thailand, Indonesia and China are closer to Singapore's experience. Insofar as they have relied heavily on foreign capital (particularly FDI), policy-makers seem to be quite happy to develop their economies as more sophisticated export platforms for transnationals attracted by relatively cheap and skilled labor, good infrastructure and favorable investment climates (Jomo, 1993: 229; OECD, 1999). The ASEAN-4 and China have collectively become among the most important destinations for FDI outside the OECD.

Moreover, firms and bureaucrats in the EANIEs have promoted exports without dismantling import barriers. The emphasis on export competitiveness has given businessmen and bureaucrats a transparent and objective system to gauge the desirability of specific actions. But the most important thing that distinguishes the EANIEs from other countries is that policy makers in these economies strongly believed that both export and import substitution can be better promoted by export subsidies with tariffs and NTBs (World Bank, 1992).

The EANIEs' openness and outward-orientation have not been based on dogmatic adherence to free trade. In the EANIEs, governments actively intervened, both in the promotion of exports and in selectively fostering import substitution. These interventions, along with several other factors, helped to explain the superior growth performance of
these economies. The government’s effectiveness in formulating and implementing appropriate policies has been an indispensable ingredient in the success of the EANIEs. The EOI policies have generally sought to correct market failures, improve the x-efficiency of industries and enhance the bargaining strength and competitiveness of domestic firms viz-a-viz their foreign counterparts. The government has intervened in trade and investment to promote certain sectors, raise government revenue, reduce foreign exchange deficits and strengthen inter-state alliances. Hence, the volume and composition of imports have not simply reflected domestic demand in relation to international prices, and exports have been promoted by both price and non-price means. The trade regime has been dualistic: export-related production has enjoyed near free trade status, while domestic market-related production has been protected\(^\text{27}\). In other words, high effective rates of protection on import substitutes were given to domestic producers, on condition that export targets were fulfilled (Little, 1979; Scott, 1979; Hamilton, 1986; Leudde-Neurath, 1986; Pack & Westphal, 1986; Liang, 1992; Jomo, 1993; OECD, 1994, 1996, 1998). Thus, it can be concluded that the success of the EANIEs has been thanks to the EANIEs’ governments pursuing both EOI and IS. As a result, industrialization strategies of EANIEs have been termed “export-oriented import substitution” (Suh, 1975); or “import restriction as export promotion”; (Krugman, 1984); or “government-led development” (Wade, 1990) or “market-friendly” (World Bank, 1993). World Bank (1997) recognizes role of government in explanation of the income gap between EANIEs

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\(^{27}\) Liang argues that even though the 1987 World Development Report classified Argentina as “strongly inward-oriented”, and South Korea as “strongly outward-oriented”, South Korea actually provided more import protection than Argentina in 1978. This is because “what distinguishes South Korea from Argentina is not the absence of import substitution measures, but the presence of strong export promotion incentives” (Liang, 1992: 462).
and African economies (see illustration in Figure 4.3).


Figure 4.3: Good Government Helps Explain the Income Gap between EANIEs and Africa

While the East Asian "miracle" supported arguments of successful state intervention, the Asian financial crisis of 1997 happened. The crisis disrupted the region’s trade and investment and abruptly halted its economic growth (see Table 4.5). One big question from the crisis is whether government-led development strategy of the EANIEs
caused the crisis. Stiglitz (1998) and Radelet & Sachs (1998) argue against the official view of the IMF (1998) - that the main determinants of the crisis were financial, and that macroeconomic and industrial policies were, at most, secondary factors. They also argue that structural aspects of East Asian model were not at the root of the crisis. This is not to say that these economies did not have structural weaknesses, in particular an over-reliance on governmental steering of the economy that had probably outlived its usefulness. But as Stiglitz points out, financial crises break out with some regularity in economies ranging from Scandinavia to the United States, regardless of form of economic management and standards of transparency.

Moreover, it is argued that the government-led development strategy did not collapse because the economic structures of the EANIEs, which had guaranteed high growth rates for more than 30 years, had not changed enough with the new international economic situation. Although attacked by monetary speculators, the currencies of Hong

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28 Many argue that this strategy collapsed because it resulted in the situation that banks and corporations were linked closely with governments in webs of implicit guarantees that led to excessive risk-taking, over-investment and insufficient attention to credit and exchange risks. In addition, weak corporate governance practices led firms to emphasize size rather than creating shareholder value. Overall, this led to excess capacities in heavy industry, many bad loans and consequent banking sector difficulties (OECD, 1999).

29 Many EANIEs successfully expanded their production and export of labor-intensive products in a relatively short period. However, their production relied heavily on imported parts and materials, which in turn made these economies vulnerable to currency instability and frequent current account deficits. Therefore, they made significant progress in upgrading their industrialization in order to substitute these imports. Thus, the main issue is not lack of funds, but the lack of capacity for absorbing technology, and the lack of skilled personnel. This structural deficiency is now recognized by the EANIEs' governments, and as a result, will be remedied to catch up with new tendency of the world economy towards a "knowledge based economy".
Kong, Taiwan and Singapore were not depreciated as much as expected; Indonesia, Thailand, and South Korea sought relief from the IMF, and had to follow IMF prescriptions for liberalization and structural reform. Indonesia strongly followed the IMF prescriptions for liberalization, resulting in economic and politic chaos, while Thailand and South Korea combined their own policies with IMF prescriptions to recover more quickly. Malaysia has followed its own way to economic recovery (see Table 4.5).

Moreover, so far, the governments still have important role in mobilizing, stimulating and maintaining the economic fundamentals in terms of enacting the policies toward high savings and investment ratios, hard working habits and patriotism and active entrepreneurship, which has supported rapid growth. The governments have been implementing a variety of structural reforms mostly aimed at strengthening their domestic financial system, encouraging the disposal of non-performing loans (even through provision of public money and allowing non-bank financial corporations to go bankrupt). They have also implemented various institutional reforms to improve their competitiveness. The governments of Malaysia and South Korea are pushing hard for the merger of smaller banks into a few competitive groups. The government of Korea has gone further in streamlining the corporate governance of its chaebol business groups. The Chinese government has also tackled the rationalization of its ineffective state-owned enterprises (SOE).

Some economists think that owing to the adverse social effects of crisis on poverty, education, health, and social infrastructure, it will take the EANIEs a longer time to return to the former growth path (e.g. from Alburu, 1999). But, in fact, signs of recovery of the real economies were 1999, as Krugman expected in late 1997. All the crisis economies improved their growth rates from negative in 1998 to positive in 1999
(see table 4.5). Industrial production has resumed once more and imports of industrial materials have been increasing. Foreign (both direct and portfolio) investments are rapidly returning to the region. All these results clearly stemmed from state interventions, and the governments' sound policies.

From the Asian crisis, three lessons can be drawn. The first lesson is that international capital markets do a poor job of discriminating between good and bad risks. Its implication is that relying excessively on short-term capital is dangerous strategy. The second is that trade orientation per se has little to do with the propensity to be hit with severe liquidity problems. The Asian economies most affected by the reversal in capital flows were among the most outward oriented in the world. The last lesson is that domestic institutions of conflict management are critical in containing the adverse economic consequences of shocks. It seems that authoritarian governments would have a better chance of preventing the social explosions that the crisis might create, while messy democracies would suffer more.

4.5 Conclusion

Although there are some arguments and evidence supporting the ideas that openness could lead to economic success in the various EANIE economies, it cannot be denied that there are also arguments and evidence showing that liberalization of trade and investment in themselves may not have created any economic growth. Then, what are the sources for economic development? According to the experiences of most EANIEs, their governments have played important role in economic development and industrialization. Their governments have sought to maximize efficiencies putatively resulting from
market-based resource allocation. The neo-classical economists argue that the EANIEs
governments did not intervene much in market allocation or progressively liberalized their
economies prior to rapid economic growth associated with EOI, or that state induced
market distortions have been kept to a minimum, allowing markets to operate more
efficiently. In the 1983 World Development Report, the World Bank argued that there was
an inverse relationship between price distortions and economic growth (Edwards, 1993:
303). But, contrary to the neoclassical view, Wade argued that, at the aggregate level,
EANIEs’ governments successfully balanced domestic protection with export promotion
policies. The overall effect has been “neutralization” of one set of state induced market

Moreover, according to Appelbaum, it is no coincidence that the principal
counterweight to neoclassical arguments about the supposedly pivotal role of free markets
in EANIEs has come from those who argue, in fact, that there are a variety of free market
economies, and that for some of them, “free” is very much a relative term. While the
EANIEs may indeed have quite small public sectors, and while their domestic economies
may be intensively competitive, this does not mean that the role of the state with regard to
economic transformation has been minimal. On the contrary, late industrialization -
EANIEs are the best examples so far - demands a decisive role for the state in setting and
implementing national goals for economic growth (Appelbaum, 1992: 14)

In his two empirical analyses, Rodrik reveals that there is no evidence to back the
claims of many that integration into the global economy in and of itself will improve
economic performance. Indeed, according to Rodrik’s analysis, there is no convincing
evidence that openness (or liberalization), in the sense of low barriers to trade and capital
flows, systematically produces economic growth. In practice, the links between openness
and economic growth tend to be weak, and contingent on the presence of complementary policies and institutions (Rodrik, 1992a: 23-42; Rodrik, 1999: 136-52). It implies that openness will not work efficiently in the absence of an effective participatory domestic development strategy worked out by government. It requires a complementary set of domestic policies and institutions.

The OECD also came to the same conclusion as Rodrik that trade and investment liberalization policies have been beneficial for development only when accompanied by a coherent set of growth-oriented macro-economic and structural policies, capacity-building, adequate social policy and good governance, i.e. by building strong policies and institutions for well-functioning market economies (OECD, 1999). In other words, it widely believed that the successful countries in economic development and industrialization must successfully combine policies of trade and investment liberalization with sound industrial and social policies.