Web Links

The United Nations Conference on Trade and Development can be found at *http://www.unctad.org* and the Group of 77 website at *http://www.g77.org*.

Visit the World Bank at *http://www.worldbank.org*.

You can also visit the regional development banks:

The African Development Bank: *http://www.afdb.org*.

The Inter-American Development Bank: *http://www.iadb.org*.

The Asian Development Bank: *http://www.adb.org*.

The WTO devotes a section of its site to developing countries and the international trade system: *http://www.wto.org/english/tratop_e/devel_e/devel_e.htm*.

The Electronic Development and Environment Information System (ELDIS), based at the Institute of Development Studies in Sussex, England, maintains a website with good links to information about development issues. This page can be found at *http://nt1.ids.ac.uk/eldis/eldis.htm*.

Suggestions for Further Reading

For a readable introduction to structuralism and development strategies more generally, see Ian Little, *Economic Development* (New York: Basic Books, 1982). For an in-depth look at Latin America, see Jeffry Frieden, Manuel Pastor, Jr., and Michael Tomz, eds., *Modern Political Economy and Latin America: Theory and Policy* (Boulder: Westview Press, 2000), and Victor Bulmer-Thomas, *The Economic History of Latin American since Independence* (Cambridge, Cambridge University Press, 2003).

For a detailed examination of the New International Economic Order, see Stephen Krasner, *Structural Conflict: the Third World against Global Liberalism* (Berkeley: University of California Press, 1985).

CHAPTER 7

Trade and Development II: Economic Reform

Whereas structuralism and import substitution industrialization shaped development strategies during the first 35 years of the postwar period, the last 20 years have been dominated by neoliberalism and export-oriented industrialization. In contrast to structuralism, with its skepticism of the market and faith in the state, **neoliberalism** is highly skeptical of the state's ability to allocate resources efficiently and places great faith in the market's ability to do so. And in contrast to structuralism's advocacy of protectionism and state intervention is neoliberalism's advocacy of the withdrawal of the state from the economy, the reduction (ideally, elimination) of trade barriers, and reliance on the market to generate industries that produce for the world market.

Like structuralism, neoliberalism has dramatically affected policy. Across the developing world, governments have reduced tariffs and removed other trade barriers, thereby opening their economies to imports. They have sold state-owned enterprises to private groups. They have deregulated domestic markets and allowed prices to reflect the underlying scarcity of resources. They have shifted their emphasis from producing for the domestic market to producing for the global market. Countries that had never joined the GATT sought membership in the WTO. Thus, the last 20 years have brought a complete reversal of the development strategies that most governments had adopted. Belief in the power of states has been replaced by belief in the efficacy of the market; skepticism about trade has been replaced by concerted efforts to integrate deeply into the world trade system. Neoliberalism has replaced structuralism as the guiding philosophy of economic development.

The shift from structuralism to neoliberalism emerged from the interplay between three developments in the global economy. First, by the early 1970s, import substitution industrialization was generating some serious economic imbalances. The emergence of these imbalances suggested that economic reform of some type was required, although it did not point to a specific solution. Second, at about the same time, it was becoming apparent that a small group of East Asian countries were outperforming all other developing countries. In only 30 years, these East Asian countries

transformed themselves from traditional agricultural societies into powerful industrialized economies capable of producing sophisticated products that were sold in Western markets. East Asian societies achieved this success through what many viewed as a neoliberal strategy: rather than insulate themselves from the global economy, they integrated deeply into world markets. The contrast between economic performance in East Asia and that in the rest of the developing world suggested, therefore, that a neoliberal strategy might deliver better results than import substitution could. Consequently, neoliberalism offered a compelling model upon which to base reforms. Third, a severe economic crisis in the early 1980s forced governments to finally embark on reform, and as they did, the International Monetary Fund and World Bank strongly encouraged them to base reform on the neoliberal model.

We examine each of these three developments. We look first at the factors that caused import substitution industrialization to generate economic imbalances. This examination allows us to understand the problems ISI created and the reasons that reform of some type was necessary. We then turn our attention to the East Asian countries. We briefly compare their performance with that of the rest of the developing world. We next examine two contrasting explanations for this remarkable performance, one that emphasizes the neoliberal elements of those countries' strategies, and one that emphasizes the role East Asian states played in the development process. We then turn to economic crisis and reform. We look at how the crisis pushed developing countries to the World Bank and IMF and at how these two institutions shaped the content of the reforms governments adopted. The chapter concludes by examining the challenges that developing countries now confront as active participants in the WTO.

Emerging Problems with Import Substitution Industrialization

By the late 1960s, import substitution industrialization was generating important economic imbalances, indicating that the approach might be nearing its limit as a useful development strategy. Two such imbalances were particularly important. The first lay in government budgets, in which ISI tended to generate persistent deficits because it prescribed heavy government involvement in the economy. Since governments believed that the private sector would not invest in industries that were important for the success of secondary ISI, governments themselves often made the investments, either in partnership with private-sector groups or alone by creating state-owned enterprises.

Yet, many of these state-owned enterprises never became profitable. By the late 1970s, state-owned enterprises in developing countries were running combined operating deficits that averaged 4 percent of GDP (Waterbury 1992, 190). Governments kept these enterprises afloat by using funds from the state budget. The combination of government investment and the subsequent need to cover the losses of state-owned enterprises contributed to large budget deficits throughout the developing world.

Domestic politics aggravated the budget deficits generated by ISI. For many governments, the urban residents employed in the nontraded-goods sector provided critical political support. Governments maintained this support by raising the standard of

living of urban residents through subsidies for essential items. Electricity, water and sewer, transportation, telephone service, and food were all made available to urban residents at prices well below the market price. This was possible only by using government revenues to cover the difference between the true cost and the price charged. In addition, many governments used state-owned enterprises and the civil service to provide jobs to urban dwellers. In Benin, for example, the civil service tripled in size between 1960 and 1980, not because the government needed so many civil servants, but because the government needed to find some way to employ urban residents. Governments used state-owned enterprises for similar purposes. However, such practices simply added to government expenditures while doing little to increase government revenues, thereby worsening the budget deficit.

Import substitution industrialization also generated a second important imbalance: persistent current-account deficits. The **current account** registers a country's imports and exports of both goods and services. A current-account deficit means that a country is importing more than it is exporting. Import substitution gave rise to current-account deficits because it generated a considerable demand for imports while simultaneously reducing the economy's ability to export. On the import side, ISI generated a steady demand for imported capital goods and inputs. Industrialization required countries to import the necessary machines, and once these machines were in place, production required the continued import of critical intermediate inputs that were not produced in the domestic economy. Somewhat ironically, therefore, import substitution industrialization became heavily dependent upon imports.

Exports declined for two reasons. First, the manufacturing industries created through import substitution were not competitive in international markets. Production in many of the heavy industries that governments targeted in secondary ISI is characterized by economies of scale. The domestic market in most developing countries, however, was too small to allow domestic producers to realize economies of scale. These inefficiencies were compounded by excess capacity—the creation of more production capacity than the domestic market could absorb. (See Little, Scitovsky, and Scott 1970, 98.) Consequently, the newly created manufacturing industries could not export to the world market.

Second, the policies that governments used to promote industrialization weakened export-oriented agriculture, thereby causing agricultural exports to fall. The decline in agricultural production was most severe in Sub-Saharan Africa, which, as a region, taxed farmers more heavily than did other developing countries (Schiff and Valdes 1992). Heavy tax burdens reduced farmers' incentives to produce, and as a result, the rate of growth of agriculture declined. In Ghana, for example, the real value of the payments that cocoa farmers received from the government marketing board fell by about two-thirds between 1960 and 1965. Falling prices gave cocoa farmers little incentive to invest in order to maintain, let alone increase, cocoa output (Killick 1978, 119). In addition, cocoa farmers smuggled much of what they did produce into the Ivory Coast, where they could sell cocoa at world prices (Herbst 1993, 40).

These microeconomic inefficiencies were reinforced by the tendency of most governments to maintain overvalued exchange rates. The exchange rate is the domestic currency price of foreign currencies. Ideally, a government should maintain an exchange rate that equalizes the prices of goods in the domestic and foreign markets.

However, under import substitution industrialization, many governments intentionally set the exchange rate higher than that, and as a result, foreign goods were cheaper in the home market than they should have been and domestic goods were more expensive in foreign markets than they should have been. Because foreign goods were underpriced in the domestic market, capital goods and intermediate inputs could be acquired from abroad at a lower cost than they could be produced at home. This difference in price created a strong incentive to import, rather than creating the capacity to produce the goods locally. The result was rising imports. Because domestic goods were overpriced in foreign markets, domestic producers, even when efficient, found it difficult to sell their products in those markets. The result was falling exports.

The emergence of the twin imbalances of budget deficits and current-account deficits indicated that ISI was creating an economic structure that couldn't pay for itself. Many of the manufacturing industries created during secondary ISI could not sell their products at prices that covered their costs of production. Many developing countries could not export enough to pay for the imports demanded by the manufacturing industries they were creating. The system was therefore unsustainable. That is, the imbalances could not persist forever; some reform was clearly necessary.

Yet, the domestic political dynamics that had given rise to import substitution also made it exceedingly difficult for governments to implement the far-reaching reforms that were needed to remove the imbalances. On the one hand, most governments remained committed to rapid industrialization based on the logic of ISI. Far-reaching reforms would require them to reevaluate both this goal and the underlying strategy they were using to achieve it. And the only available alternative to ISI was a market-oriented development strategy (one we look at in detail in the next section). In the 1960s and 1970s, however, it was precisely this market-oriented strategy that the Group of 77 was fighting against in the UNCTAD and with the NIEO. Even moderate reforms held little appeal. Most governments were unwilling to scale back their industrialization strategies. Instead, they looked for a way to cover the twin deficits without having to scale back their ambitious plans.

Even if governments had been more willing to implement reforms, they would have faced considerable obstacles to doing so, because the political dynamics of ISI had created a vested interest in the continuation of the system. On the one hand, government intervention had established an environment conducive to **rent seeking** (Krueger 1974; Bhagwati 1982)—efforts by private actors to use the political system to achieve a higher-than-market return on an economic activity. Consider, for example, the consequences of government controls on imports. Governments controlled imports by requiring all residents who wanted to import something to first gain the permission of government authorities. Such import-licensing systems created an incentive for rent seeking. The restrictions themselves meant that imported goods were scarce. As a consequence, imports purchased at the world price could be sold at a much higher price in the domestic market. The difference between the world price and the domestic price provided a rent to the person who imported the good. A government license to import, therefore, was potentially very valuable. Consequently, people had incentives to pay government civil servants to acquire licenses, and government civil servants had incentives to sell them.

Such behavior was extraordinarily costly as people invested considerable time and energy pursuing licenses rather than engaging in productive behavior. It has been estimated, for example, that these forms of rent seeking cost India about 7 percent and Turkey about 15 percent of their national incomes during the 1960s (Krueger 1974, 294). Because so many people inside the government and in the economy were benefiting from the opportunities for rent seeking, they had a very strong incentive to resist any efforts by the government to dismantle the system.

The balance of power among domestic interest groups also greatly limited the ability of governments to embark on meaningful reform. Because governments depended so heavily upon urban residents for political support, they could not easily reduce benefits provided to that group (Waterbury 1992, 192). In 1971, for example, the Ghanaian prime minister devalued the exchange rate in an attempt to correct Ghana's current-account deficit. Concern that devaluation would raise the prices of many imported goods consumed by urban residents contributed to a coup against the government a few days later. Once in power, the new regime quickly restored the exchange rate to its previous overvalued level (Herbst 1993, 22–23). What message did that send to politicians who might be contemplating measures to address the economic imbalances they were facing?

More broadly, over time the "political support of special interests for import substitution grew. . . . Rather than changing policies when the consequences of further restrictiveness of the trade and payments regime became obvious, the political process in the short run resulted in increased support for it" (Krueger 1993b, 353). At the same time, those groups one might have expected to oppose the system—particularly the export-oriented producers—grew weaker as the incentives created by ISI caused them to exit export-oriented activities in favor of economic activities that were promoted and protected.

By the early 1970s, therefore, many developing countries faced growing budget and current-account deficits. Reform was constrained by governments' adherence to ISI and by resistance from the domestic groups that benefited greatly from that strategy. Facing economic imbalances, and unwilling and unable to adopt reforms, many developing-country governments kept the system running by relying heavily on foreign loans, which provided both the funds that governments needed to finance their current-account deficits and the funds required to finance investment in industry.

Yet, reliance on foreign loans could provide only a temporary solution; foreign lenders would eventually begin to question whether money they had lent could be repaid. When they concluded that it couldn't, they would be unwilling to advance additional loans, and governments would be forced to address the imbalances that ISI had created. That point was reached in the early 1980s and ushered in a period of crisis and reform. Before we can examine this period, however, we must look at economic developments in East Asia, as these developments played a critical role in shaping the content of the reforms adopted throughout the developing world after 1985.

The East Asian Model

While import substitution industrialization was generating imbalances in Latin America and Sub-Saharan Africa, a small number of East Asian countries were realizing dramatic gains on the basis of a very different development strategy. Four of these East

Table 7.1
Comparative Economic Performance, Selected Developing Countries (Average Annual Rates of Change)

	1965–1990	1985–1995
Growth of per Capita GNP		
East Asia and the Pacific	5.3	7.2
Sub-Saharan Africa	0.2	−1.1
South Asia	1.9	2.9
Latin America and the Caribbean	1.8	0.3
Growth of Manufacturing		
East Asia and the Pacific	10.3	15.0
Sub-Saharan Africa	n.a.*	0.2
South Asia	4.5	5.3
Latin America and the Caribbean	8.3	2.5
Growth of Exports		
East Asia and the Pacific	8.5	9.3
Sub-Saharan Africa	6.1	0.9
South Asia	1.8	6.6
Latin America and the Caribbean	−1.0	5.2

*n.a. = not available.
Source: World Bank, *World Development Report*, various issues.

Asian economies—Hong Kong, Singapore, South Korea, and Taiwan—consistently outperformed all other developing countries throughout the entire postwar period. This superior economic performance is evident in three simple economic indicators. (See Table 7.1.)

First, between 1965 and 1990, the rate of per capita income growth in these four East Asian economies was, on average, more than twice as high as the rate of income growth in Latin America and South Asia and more than 26 times the rate of per capita income growth in Sub-Saharan Africa.

Second, East Asian manufacturing output grew at a very rapid rate, averaging 10.3 percent per year between 1965 and 1990. While Latin America fared relatively well in comparison to East Asia for the early part of the postwar period, Latin American rates of growth were not sustained.

Third, East Asian exports grew rapidly, while exports from other developing countries grew hardly at all. The contrast with Latin America is perhaps most striking: whereas East Asian exports grew at an annual average rate of 8.5 percent between 1965 and 1990, Latin American exports in the same period shrank by an average of 1 percent per year. The contrast with Africa was also stark: while exports from Sub-Saharan Africa grew relatively rapidly between 1965 and 1980, by the mid-1980s this rate of growth had dropped sharply.

The consequences of these faster growth rates are illustrated in Tables 6.1, 6.2, and 7.2. The importance of manufacturing industries in the East Asian economies grew while the importance of agriculture diminished. Similarly, while agriculture's share of GNP shrank in both Africa and Latin America, but, in contrast to the situation

Table 7.2
GNP per Capita, Selected Developing Countries (1985 US Dollars)

	1960	1990	Percent Change
Hong Kong	2,247	14,849	561
Singapore	1,658	11,710	606
Taiwan	1,256	8,063	542
South Korea	904	6,673	638
Mexico	2,836	5,827	105
Malaysia	1,420	5,124	261
Argentina	4,462	4,706	5
Chile	2,885	4,338	50
Brazil	1,784	4,042	127
Thailand	943	3,580	280
Zaire/Congo	489	2,211	352
Indonesia	638	1,974	211
Pakistan	638	1,394	118
India	766	1,264	65
Nigeria	567	995	75
Kenya	659	911	38
Zambia	965	689	−29
Tanzania	319	534*	67

*Data for 1988.
Source: Penn World Tables.

in East Asia, manufacturing's share failed to grow. The increased importance of manufacturing in East Asia was translated into significant changes in the commodity composition of East Asia's exports. (See Table 6.2.) By the mid-1990s, manufactured goods accounted for more than 80 percent of East Asian exports. By contrast, only in Brazil, Mexico, India, and Pakistan did manufactured goods account for more than 50 percent of total exports by the 1990s, and most of these gains were realized after 1980. Finally, incomes (i.e., gross national product per capita) in East Asia soared above those in other developing countries (Table 7.2). In 1960, per capita incomes in East Asia were lower than per capita incomes in Latin America; by 1990, East Asian incomes were higher than—in some cases twice as large as—per capita incomes in Latin America.

Why did East Asian countries outperform other developing countries by such a large margin? Most who study East Asian development agree that the countries in the region distinguished themselves from other developing countries by pursuing an export-oriented strategy of development. In an **export-oriented strategy,** emphasis is placed on producing manufactured goods that can be sold in international markets. Such an approach contrasts sharply with the emphasis on producing for the domestic market, a central tenet of ISI. Where scholars disagree is on the relative importance of the market versus the state in creating these export-oriented industries. One position, the neoliberal interpretation, is articulated most forcefully by the International Monetary Fund and the World Bank. This thesis argues that East Asia's success was a product of market-friendly development strategies. Another position, the state-oriented

interpretation, is advanced by many scholars specializing in East Asian political economy. This viewpoint argues that East Asia's success is due in large part to state-led industrial policies.

The IMF and the World Bank contend that East Asia's economic success derived from their adoption of a neoliberal approach to development. In particular, this interpretation places primary emphasis on East Asia's embrace of international markets and ability to maintain a stable macroeconomic environment. (See World Bank 1989, 1991, 1993; Little 1982; Lal 1983; for critiques, see Toye 1994 and Rodrik 1999.) Most East Asian governments adopted ISI strategies in the immediate postwar period. Unlike governments in Latin America and Africa, however, East Asian governments shifted to export-oriented strategies once they had exhausted the gains from easy ISI. Thus, whereas Latin American and African governments followed easy ISI with secondary ISI, both of which emphasized production for the domestic market, the East Asian governments followed easy ISI by encouraging the manufacturing industries they had created under easy ISI to export to the advanced industrialized countries.

In Taiwan, for example, the government shifted in 1958 from production for the domestic market to a strategy that emphasized production for export markets. South Korea adopted similar reforms in the early 1960s. A second wave of newly industrializing countries (NICs)—a group that includes Indonesia, Malaysia, and Thailand—adopted similar reforms beginning in the late 1960s (World Bank 1993). The emphasis on exports forced Asian manufacturing firms to worry about international competitiveness. This approach stood in great contrast to that of Latin American firms, which produced for domestic markets sheltered from foreign competition. As a result, the World Bank and IMF argue, Asian societies invested their resources in domestic industries that were profitable in world markets, while Latin American and African governments did not.

The shift to export-oriented strategies was followed by selective import liberalization. Asian governments did not engage in wholesale import liberalization. The Taiwanese and South Korean governments continued to rely heavily on tariff and nontariff barriers to protect domestic markets. In Taiwan, for example, approximately two-thirds of imports were subject to some form of tariff or nontariff barrier greater than 30 percent, and as late as 1980 more than 40 percent of imports faced protection greater than 30 percent (World Bank 1993, 297). A similar pattern appeared in South Korea, where, as late as 1983, "most sectors were still protected by some combination of tariffs and nontariff barriers" (World Bank 1993, 297). However, selective liberalization helped promote exports by reducing the cost of critical inputs. By reducing tariffs on key intermediate goods, such as looms and yarn in the textile industry, domestic producers were able to acquire inputs at world prices. This kept exports competitive in international markets. The export orientation thus promoted investments in sectors that exploited an underlying comparative advantage, while import liberalization helped ensure that these sectors' advantages were not eliminated by high input prices.

East Asian governments also maintained stable macroeconomic environments. Three elements of the macroeconomic environment were particularly important. First, inflation was much lower in East Asia than in other developing countries. Between 1961 and 1991, East Asian economies experienced an average rate of inflation of only 7.5 percent over the period. By contrast, annual inflation rates in the rest of the developing world averaged 62 percent over the same period (World Bank 1993, 110). Second, because inflation was kept under control, East Asian governments were able to maintain appropriately valued exchange rates. In many developing countries, high inflation caused the domestic currency to rise in value against foreign currencies, making things difficult for exporters. In the East Asian countries, by contrast, governments were able to maintain exchange rates that allowed domestic firms to remain competitive in foreign markets. (We will explore exchange-rate issues in greater detail in Chapter 14.) Third, East Asian governments pursued relatively conservative fiscal policies. They borrowed little, and when they did borrow, they tapped domestic savings rather than turning to international financial markets. This approach was in stark contrast to that of Latin American governments, which accumulated large public-sector deficits financed with foreign capital. More conservative fiscal policies allowed East Asian governments to minimize the growth of foreign debt.

This stable macroeconomic environment had beneficial consequences for Asian economic performance. Low inflation promoted high rates of saving and investment (World Bank 1993, 12). Savings rates in the Asian NICs averaged more than 20 percent of GDP per year, almost twice the level attained in other developing countries, while investment rates were 7 percentage points of GDP higher, on average, than in other developing countries (World Bank 1993, 16, 221). A stable macroeconomic environment also made it easier to open the economy to international trade. Because inflation was low and exchange rates were maintained at appropriate levels, trade liberalization did not generate large current-account deficits that forced the government to reimpose trade barriers. Finally, the ability to maintain relatively stable and appropriately valued **real exchange rates** encouraged private actors to invest in export-oriented industries.

The interaction among the export orientation, the relatively liberal import policy, and the stable macroeconomic environment promoted economic development. As Doner and Hawes (1995, 150) put it, the

> pattern of limited government intervention in the market, coupled with cheap labor and an open economy, [has] guaranteed the private sector stability and predictability, the means to achieve competitiveness on a global scale, and access to the international market so that entrepreneurs could actually discover areas where they have comparative advantage. In shorthand, the model is often reduced to "getting the prices right" and letting market-based prices determine resource allocation. Doing so results in export growth that is in turn positively correlated with broader economic growth.

According to the World Bank and IMF, East Asia succeeded because markets played a large role, and states played a small role, in allocating resources.

Other scholars have argued that East Asia's successful pursuit of an export-oriented development strategy had less to do with allowing markets to work and much more to do with well-designed government industrial policies. (See Wade 1990; Amsden 1989; Haggard 1990). In what has come to be called the **East Asian model of development,** economic development is conceptualized as a series of distinct stages of industrialization. Government intervention at each stage is aimed at identifying and promoting specific industries that are likely to be profitable in the face of international competition. In the first stage, industrial policy promotes labor-intensive light industry, such as textiles and

other consumer durables. In the second stage, industrial policy emphasizes heavy industries such as steel, shipbuilding, petrochemicals, and synthetic fibers. In the third stage, governments target skill- and research-and-development-intensive consumer durables and industrial machinery, such as machine tools, semiconductors, computers, telecommunications equipment, robotics, and biotechnology. Governments design policies and organizations to promote the transition from one stage to the other (Wade 1994, 70).

These three stages of industrialization are evident in Taiwan and South Korea. (See Table 7.3.) In Taiwan, industrialization focused initially on light manufacturing, textiles in particular. By the mid-1950s, textiles were Taiwan's most important export. The government also encouraged the domestic production of simple consumer durable goods such as television sets. In the late 1950s, the Taiwanese government began to emphasize the heavy industries characteristic of the second stage of ISI. A joint venture between several Taiwanese firms and an American firm was formed in 1954 to produce synthetic fibers (Wade 1990, 80). In 1957, a plant to produce polyvinyl chloride was constructed under government supervision and then handed to a private entrepreneur, Y.C. Wang (Wade 1990, 79). The government created state-owned enterprises in the steel, shipbuilding, and petrochemical industries. During the 1970s, government emphasis shifted to skill- and R&D-intensive industries, with particular emphasis on machine tools, semiconductors, computers, telecommunications, robotics, and biotechnology (Wade 1990, 94). By the mid-1980s, electrical and electronic goods had replaced textiles as Taiwan's largest export (Wade 1990, 93).

The South Korean government adopted similar policies (Amsden 1989). In the 1950s, the government emphasized textile production, and textiles became South Korea's first important manufacturing export. During the late 1960s, emphasis shifted to the second stage of ISI, as the South Korean state initiated the development of the chemical and heavy-machinery industries. In 1968, the government created the Pohang Iron and Steel Company, known as POSCO, which subsequently became one of the world's leading steel producers. The government also provided extensive support to Hyundai Heavy Industry, a shipbuilder formed in the early 1970s and that subsequently became a world leader in this industry. During the late 1970s, the South Korean government began to give priority to skill- and R&D-intensive sectors, and it is during this period that the South Korean electronics and automobile industries began to emerge (Amsden 1989).

In the East Asian model, therefore, government policy drives industrialization from initial low-skilled, labor-intensive production to capital-intensive forms of production and from there to industries that rely on high-skilled labor and research and development. Each stage is associated with particular types of government policies, and as each stage reaches the limits of rapid growth, emphasis shifts to the next stage in the sequence (Wade 1994, 71). Moreover, at each stage, governments stress the need to develop internationally competitive industries.

East Asian governments implemented industrial policies in pursuit of four broad objectives: reducing the cost of investment funds in the selected industries, creating incentives to export, protecting infant industries, and promoting the acquisition and application of skills. Taiwan and South Korea created incentives to invest in industries that state officials identified as critical to development. To do so, governments in both countries provided firms investing in these industries with preferential access to low-cost credit. In South Korea, the government nationalized the banks in the early

Table 7.3
Stages of Industrialization in Taiwan and South Korea, 1880–1970

	Commodity Exports 1880–1930	Primary ISI 1930–1955	Primary Export-oriented Industries 1955–1968
Main Industries	Taiwan: Sugar, rice South Korea: Rice, beans	Taiwan and South Korea: Food, beverages, tobacco, textiles, clothing, cement, light manufactures (wood, leather, rubber, and paper products)	Taiwan and South Korea: Textiles and apparel, electronics, plywood, plastics (Taiwan), wigs (South Korea), intermediate goods (chemicals, petroleum, paper, and steel products)
Major Economic Actors	Taiwan and Korea: Local producers (colonial Japan)	Taiwan and South Korea: Private national firms	National private firms, multinational corporations, state-owned enterprises
Orientation of the Economy	External markets	Internal market	External markets

Source: Gereffi 1990, 19.

1960s and in the ensuing years fully controlled investment capital. Control of the banks allowed the government to provide targeted sectors with access to long-term investment capital at below market rates of interest (Haggard 1990, 132). While the banking sector was not nationalized in Taiwan, the government did influence banks' lending decisions. During the 1960s, banks were provided with government-formulated lists of industries that were to receive preferential access to bank loans. During the 1970s, the banks themselves were required to select five or six industries to target in the coming year. As a result, about 75 percent of investment capital was channeled to the government's targeted industries (Wade 1990, 166).

Asian governments also implemented policies that encouraged exports. One method was to link preferential access to investment capital to export performance. In Taiwan, for example, firms that exported paid interest rates of only 6–12 percent, while other borrowers paid 20–22 percent (Haggard 1990, 94). In South Korea, short-term loans were extended "without limit" to firms with confirmed export orders (Haggard 1990, 65). Credit was also made available to exporters' input suppliers and to these suppliers' suppliers (Haggard 1990, 65–66). In addition, "deliberately undervalued exchange rates" improved the competitiveness of exports in international markets (World Bank 1993, 125). Finally, a variety of measures were used to ensure that domestic firms could purchase their intermediate inputs at world prices. These measures often entailed the creation of free-trade zones and export-processing zones—areas of the country into which intermediate goods could be imported duty free as long as the finished goods were exported. Export-processing zones allowed domestic producers to avoid paying tariff duties that would raise the final cost of the goods they produced.

The Taiwanese and South Korean governments also protected infant industries at each stage. In some instances, the measures they used were straightforward forms of protection. The South Korean government, for example, enacted legislation in 1983 that "prohibited the import of most microcomputers, some minicomputers, and selected models of disk drives," in order to protect domestic producers in the computer industry (Amsden 1989, 82). POSCO initially produced steel behind high import barriers. In other instances, protection was less transparent. Hyundai Heavy Industry, for instance, was protected in part through a government policy that required Korean crude-oil imports to be carried in ships operated by a merchant marine that Hyundai Heavy Industry had itself created (Amsden 1989, 273). Similar policies were adopted in Taiwan, where, for example, the China Steel Corporation, a state-owned enterprise, has been able to exclude imports of the types of steel it produces (Wade 1990, 131). In these ways, new firms were protected against imports (Wade 1990, 132).

Finally, the Taiwanese and South Korean governments put in place policies that raised skill levels. These policies were of particular importance in the transition from second-stage heavy industry to third-stage skill- and research-intensive industries. Investments in education were made to improve labor skills. In Taiwan, enrollment in secondary schools had reached 75 percent of the eligible age group by 1980. Enrollment increases were accompanied by rising expenditures on education; per pupil expenditures increased eightfold in primary schools, threefold in secondary schools, and twofold at the university level between the early 1960s and 1980s (Liu 1992, 369). Similar patterns are evident in South Korea, where enrollment in secondary schools increased from 35 percent in 1965 to 88 percent in 1987 and "real expenditures per pupil at the primary level rose by 355 percent" (World Bank 1993, 43, 45).

Governments also invested in their countries' scientific infrastructure, to facilitate the application of skills to research-and-development activities. In Taiwan, the Industrial Technology Research Institute was formed in 1973, and nonprofit organizations were created during the 1970s to perform research and disseminate the results to firms in the private sector. A science-based industrial park designed to realize agglomeration effects was created in 1980 (Haggard 1990, 142). In South Korea, tax incentives were used to induce *chaebols*, the large South Korean firms, to create laboratories for research-and-development purposes. An industrial estate for computer and semiconductor production was created, and the Electronics and Telecommunications Research Institute, a government-funded institute oriented toward product development was formed in the industrial estate (Amsden 1989, 82). These policies raised skill levels and created an infrastructure that allowed the more highly skilled labor force to work to its full potential. This skill upgrading was critical to the transition to the third stage of the industrialization process.

The two explanations discussed thus present different arguments for East Asia's success. One suggests that East Asia succeeded because governments allowed markets to work. The other suggests that East Asia succeeded because governments used industrial policy to promote economic outcomes that the market could not produce. Which argument is correct? While we lack definitive answers, we may conclude that both explanations have value. By "getting prices right," the export orientation and the stable macroeconomic environment encouraged investments in industries in which East Asian countries had or could develop comparative advantage. By targeting sectors where comparative advantage could be created, by reducing the costs of firms operating in those sectors, by encouraging firms to export, and by upgrading skills, industrial policy encouraged investments in areas that could yield high returns. As Stephan Haggard (1990, 67) has summarized, macroeconomic "and trade policies established a permissive framework for the realization of comparative advantage, and more targeted policies pushed firms to exploit it."

While the relative importance of the state and the market in accounting for East Asia's success remains in dispute, what is clear is that the experience of the East Asian NICs was vastly different from the experience of Latin America and Sub-Saharan Africa. East Asian governments adopted development strategies that emphasized exports rather than the domestic market, and they realized substantial improvements in per capita income. The development strategies adopted by Latin American and sub-Saharan African governments emphasized the domestic market over exports and led to large economic imbalances and only modest improvements in per capita incomes. Consequently, when economic crises forced governments to adopt reforms, the East Asian example provided a powerful guide for the kind of reforms that would be implemented.

Structural Adjustment and the Politics of Reform

While the imbalances generated by ISI created the need for reform, and while East Asia's success based on a different approach provided an attractive alternative model, governments began to implement reforms only under the pressure created by a severe economic crisis. We will examine this crisis in detail in Chapter 14; here, we need to

say a few words about it in order to understand how it contributed to the adoption of neoliberal reforms throughout the developing world.

Economic crises emerged in the early 1980s in large part as a consequence of governments' decision to cover their budget and current-account deficits with foreign loans. Using foreign loans to finance budget and current-account deficits is not an inherently poor choice. But two factors made this decision a particularly bad one for developing countries in the 1970s. First, many of the funds that governments borrowed were used to pay for large infrastructure projects or domestic consumption, neither of which generated the export revenues needed to repay the loans. As a result, the amount that developing countries owed to foreign lenders rose, but their ability to repay the debt did not.

Second, between 1973 and 1982, developing countries were buffeted by three international shocks: an increase in the price of oil, a reduction in the terms of trade between primary commodities and manufactured goods, and higher interest rates on the foreign debt those countries had accumulated. These shocks increased the amount of foreign debt that developing countries owed to foreign banks, raised the cost of paying that debt, and greatly reduced export earnings. By the early 1980s, a number of developing countries were unable to make the scheduled payments on their foreign debt.

Many turned to the International Monetary Fund (IMF) and the World Bank for financial assistance. These agencies offered financial assistance, but it was explicitly linked to the implementation of a package of neoliberal reforms. The World Bank and IMF encouraged governments to adopt such reforms under the banner of **structural adjustment programs**—policy reforms designed and promoted by the World Bank and IMF that strive to reduce the role of the state and increase the role of the market in the economy. The specific content of the reforms that the IMF and World Bank advocated were shaped by their belief that East Asia's economic success had resulted from export-oriented and market-based development strategies. (See World Bank 1991, 1993.) In the World Bank's own words, "the approach to development that seems to have worked most reliably, and which seems to offer most promise, suggests a reappraisal of the respective roles for the market and the state. Put simply, governments need to do less in those areas where markets work, or can be made to work, reasonably well" (1991, 9).

To this end, structural adjustment emphasized changing those aspects of developing economies which were most unlike conditions in Asia. Governments were encouraged to create a stable macroeconomic environment, to liberalize trade, and to privatize state-owned enterprises (Williamson 1990; 1994). Macroeconomic stability was to be achieved by transforming government budget deficits into budget surpluses. This change would reduce the demand for imports, thereby reducing developing countries' current-account deficits. Governments also were encouraged to liberalize imports, by dismantling import-licensing systems, shifting from quota-based forms of protection to tariffs, simplifying complex tariff structures, and reducing tariffs and opening their economies to imports.

The IMF and the World Bank also encouraged the **privatization** of state-owned enterprises—that is, selling such enterprises to private individuals and groups. The IMF and World Bank argued that reducing government involvement in the economy would foster competition and that greater competition would in turn help create a more efficient private sector that could drive economic development. Through structural adjustment, therefore, governments were encouraged to scale back the role of the state in economic development and enhance the role played by the market.

Table 7.4
Countries Adopting Trade and Domestic Policy Reforms, 1980–1996

Africa		Latin America	
Benin	Malawi	Argentina	Honduras
Burkina Faso	Mali	Barbados	Mexico
Burundi	Mauritania	Bahamas	Nicaragua
Cameroon	Mauritius	Belize	Panama
Central African Republic	Mozambique	Bolivia	Paraguay
Chad	Niger	Brazil	Peru
Congo	Nigeria	Chile	Suriname
Cote d'Ivoire	Rwanda	Colombia	Trinidad and Tobago
Ethiopia	Senegal	Costa Rica	Uruguay
Gabon	Sierra Leone	Dominican Republic	Venezuela
The Gambia	Tanzania	Ecuador	
Ghana	Togo	El Salvador	
Guinea	Uganda	Guatemala	
Guinea-Bissau	Zambia	Guyana	
Kenya	Zimbabwe	Haiti	
Madagascar			

Source: World Bank 1994a; Thorp 1999.

Many governments undertook structural adjustment between 1983 and 1995. (See Table 7.4.) Tariffs throughout the developing world fell substantially beginning in the mid-1980s. (See Figure 7.1.) While average tariffs still remain higher in developing countries than in the advanced industrialized countries, they have been cut in half, on average, since the early 1980s. Many governments have also substantially reduced their reliance upon nontariff barriers to trade. In Latin America, average tariffs fell from 41.6 percent prior to the crisis to 13.7 percent by 1990 (Inter-American Development Bank 1997, 42). While it is hard to get accurate measures of the coverage of nontariff barriers, Table 7.5 provides some evidence on the scope of such measures in a number of developing countries. A general trend toward the elimination of these obstacles to trade is evident.

Privatization became a priority objective in the late 1980s. In Latin America, "more than 2,000 publicly owned firms, including public utilities, banks, and insurance companies, highways, ports, airlines, and retail shops, were privatized" between 1985 and 1992 (Edwards 1995, 170; see also Corbo 2000). In general, African governments have moved less rapidly than Latin American governments to carry out structural adjustment reforms. (See World Bank 1994a, 1994b.) Many African governments have in fact begun to liberalize trade, shifting away from quotas and lowering tariffs, but progress has been slow. Privatization has moved even more slowly, with less than one-fifth of state-owned enterprises having been privatized by the mid-1990s. As governments

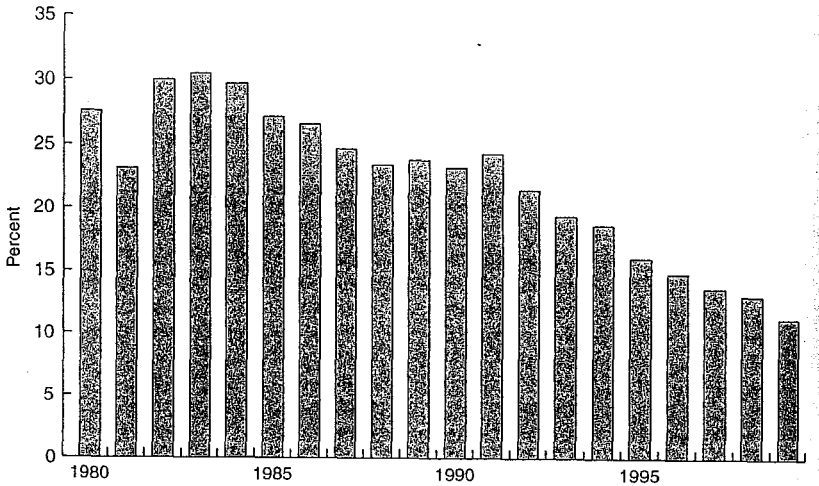

Figure 7.1 Average Tariffs, Developing Countries.
Source: World Bank.

Table 7.5
Nontariff Barriers in Developing Countries (as a Percent of All Industry Categories)

	1989–1994	1995–1998
Hong Kong, China	2.1	2.1
Indonesia	53.6	31.3
Korea	50.0	25.0
Malaysia	56.3	19.6
Singapore	1.0	2.1
Thailand	36.5	17.5
India	99.0	93.8
Nigeria	14.4	11.5
South Africa	36.5	8.3
Morocco	58.3	13.4
Turkey	5.2	19.8
Argentina	3.1	2.1
Brazil	16.5	21.6
Chile	5.2	5.2
Colombia	55.2	10.3
Mexico	27.8	13.4
Uruguay	32.3	0.0

Source: World Bank.

liberalized their economies, they gradually became more deeply integrated into the world trade system.

The structural adjustment programs were expected to reduce average incomes and redistribute income across groups in the short run and generate faster growth and higher average incomes in the long run. Most developing countries did experience a sharp fall in per capita income as they began to implement reforms. In Latin American countries, national incomes fell by about 8 percent between 1981 and 1984, while in African countries, incomes fell, on average, by about 1.2 percent per year throughout the 1980s (Thorp 1999, 220; World Bank 1993).

Structural adjustment also redistributed income from industry and the urban nontraded goods sector to agriculture and other export-oriented industries. In Guinea, for example, reform yielded a threefold increase in the price coffee producers received for their crops (Arulpragasam and Sahn 1994, 73–76). In The Gambia, producer prices on groundnuts tripled as a consequence of structural adjustment policies (Jabara 1994, 309). These policies hurt producers based in the import-competing sector, as well as those employed in the nontraded-goods sector. In The Gambia, for example, the government raised the price of petroleum products, public transportation, water, electricity, and telecommunications in connection with structural adjustment (Jabara 1994, 309). In Guinea, the elimination of government rice subsidies doubled the price that households paid for rice, an important staple in their diets (Arulpragasam and Sahn 1994, 79).

Privatization usually resulted in large job losses in these import-competing manufacturing industries, while scaling back the size of the civil service eliminated jobs in the nontraded-goods sector. In Guinea, the civil service was reduced in size from 104,000 in 1985 to 71,000 in 1989 (Arulpragasam and Sahn 1994, 91). In The Gambia, government employees were reduced by 25 percent in 1985–1986, and wages and salaries of those retained in the government sector were frozen (Jabara 1994, 312, 318). In pursuing structural adjustment, therefore, governments redistributed income: export-oriented producers benefited from the successful implementation of these policies, while people employed in the import competing and nontraded goods sectors saw their incomes fall.

These short-run economic consequences of structural adjustment drove the domestic politics of reform. (See Nelson 1990; Remmer 1986; Haggard and Kaufman, 1992, Oatley 2004). Groups that would lose from structural adjustment attempted to block the reforms, while those who stood to gain attempted to promote reform. Governments were forced to mediate between them, and in many countries governments were heavily dependent upon political support from the import-competing and nontraded-goods sectors. Thus, reforms were hard to implement.

Over time, however, the economic crisis triggered a realignment of interests, discrediting those groups associated with the old regime and the old policies and giving greater influence to groups that proposed an alternative approach (Krueger 1993a). The economic crisis thus forged a new political consensus asserting that the old order had failed and that a new strategy was required. By weakening key interest groups and by forcing many to redefine their interests, the crisis gradually eroded many of the political obstacles to far-reaching reform. Yet, this process took time, as reforms could

A Closer Look

Structural Adjustment in Mexico

The Mexican government embarked on structural adjustment in the mid-1980s. Between 1985 and 1990, the policies adopted in connection with structural adjustment radically shifted the direction of Mexico's economy. (See Lustig 1998; Córdoba 1994.) In part, the changes reflected pressures exerted by the World Bank, from which Mexico borrowed $2.3 billion in 1986 and 1987. The scope of the reforms, however, suggested that the Mexican government was doing more than responding reluctantly to external pressure. Trade liberalization, one of the centerpieces of reform, began in earnest in 1985, and its initiation was heralded by the announcement that Mexico had applied to join GATT. At that time, Mexico was one of the most heavily protected economies in the world. More than 90 percent of the domestic economy was protected by import licenses, in some industries tariffs were as high as 100 percent, and the average tariff stood at 23.5 percent. Trade liberalization occurred in three stages between 1985 and 1993. First, the government reduced the coverage of the import-licensing system, so that, by 1990, only 20 percent of imports were subject to explicit government approval, and the accompanying requirements were restricted to a limited number of sensitive sectors, including natural gas, petroleum refining, automobiles, and agriculture. Next, the government simplified the tariff structure, shifting from a system with ten tariff rates to a system with only five rates and capping the highest rate at 20 percent. From this base, the government then gradually reduced tariffs, which fell from an average of 23.5 in 1985 to an average of only 12.5 by 1990. Finally, in 1990, the Mexican government initiated negotiations with the United States and Canada that culminated in the creation of NAFTA.

Trade liberalization was accompanied by the liberalization of foreign direct investment. Until the mid-1980s, the operation of foreign firms in the Mexican economy was tightly restricted. Foreigners were completely excluded from many sectors of the Mexican economy, and they could hold only a minority share of firms in all other sectors. In February 1984, the government relaxed some of these restrictions by allowing majority ownership by foreign firms in 33 selected industries. The restrictions were further relaxed in 1989 by an expansion of the sectors in which foreign firms could control as much as 100 percent of a Mexican firm. Thus, in addition to opening the Mexican economy to imports, the government opened the economy to investments by multinational corporations.

The government also dismantled its industrial policy, which had been a central component of Mexico's ISI strategy. Mexican industrial policy used financial incentives and import controls to promote specific industries. More than 700 programs had been put in place between 1965 and 1970, and 1,200 more had been established during the 1970s. The government began to dismantle these programs in the early 1980s as the crisis first hit. The programs were reduced in number and oriented toward critical industries, particularly automobiles, pharmaceuticals, capital goods, and petrochemicals. But even these last remnants of ISI were dismantled in the late 1980s. The government eliminated many of the financial incentives it had previously used to encourage investment, eliminated rules governing domestic content for foreign firms operating in these industries, and relaxed the rules restricting foreign direct investment.

Continued

The government also began reducing its role in the Mexican economy in other ways. In 1983, privatization was undertaken with a change to the Mexican constitution that limited the sectors in which the government could maintain state-run monopolies. Then, between 1985 and 1990, the government either sold to private investors or liquidated 875 of the 1,155 state-owned enterprises that had been in existence in 1982. Also greatly reduced was the degree to which the government directly controlled prices. Between 1950 and 1980, the government had used price controls to ensure that domestic industry could acquire its most important inputs at relatively low and stable prices. In the early 1990s, Mexico began to dismantle this system. It shortened the list of items subject to price controls, reduced the difference between the controlled price and the international price, and attempted to inject greater flexibility into the price-setting mechanism. The government liberalized many primary-commodity sectors, eliminating regulations governing the production and marketing of cacao beans and cacao products, coffee, and sugar, among others. It relaxed restrictions on fishing, allowing private individuals, corporations, and foreigners to fish in Mexican waters. These and other deregulations created greater competition within the industries concerned and allowed market-based processes, rather than state actors, to play the more important role in determining the outcome of the competition.

All of the reforms just described had a dramatic impact on Mexican incomes. Overall, economic growth between 1982 and 1987 averaged −0.4 percent, and per capita income fell from $3,500 in 1981 to $3,024 in 1988. As a result, the percentage of the population living in poverty increased from about 42 percent in the early 1980s to about 48 percent in 1989. The sharp drop in incomes stabilized in the late 1980s, however, when positive growth resumed. The Mexican economy has grown at an average rate of 3.5 percent per year since 1989, and per capita incomes have risen to $3,600 by 1999. Reform also affected the relative positions of groups in the Mexican economy (Lustig 1998; Damian 2000). Hardest hit were those who had benefited most from ISI. Government employees saw their incomes fall by an average of 12 percent per year during the second half of the 1980s. Manufacturing workers were also hit hard, experiencing average income losses of 6.2 percent per year in the same period. People employed in agriculture and in export-oriented manufacturing industries fared better. Incomes in these sectors fell, too, but much less than incomes in other sectors. Agricultural wages fell an average of only 3.8 percent per year. Workers employed in the export-oriented maquiladora industries fared substantially better than other manufacturing workers, as they saw wages fall by only 0.2 percent in 1986–1987.

be implemented only after new governments responsive to new interests had replaced the governments that presided over import substitution industrialization.

Because the political battle over reforms involved an intense distributive struggle, governments implemented reforms unevenly, in fits and starts, and, in many instances, only partially. As a result, it is difficult to evaluate the extent to which the wrenching short-run consequences have been offset by stronger economic growth and higher average per capita incomes over the long run. As Table 7.6 indicates, some countries pushed through the low growth that characterized the period of crisis and reform during the 1980s and

Table 7.6
Trade Openness and Growth, 1980–2002

	Trade as a Percent of GDP		Average Annual Growth of GDP (%)	
	1990	2002	1980–1990	1990–2002
Argentina	11.6	33.7	−0.7	2.7
Bolivia	33.1	39.5	−0.2	3.6
Brazil	11.7	24.3	2.7	2.7
Chile	53.1	55.2	4.2	5.9
Costa Rica	60.2	73.8	3.0	4.9
Mexico	32.1	52.4	1.1	3.0
Peru	22.3	26.9	−0.1	4.1
Latin America	23.1	41.2	1.7	2.9
Benin	30.0	37.8	2.5	4.9
Cameroon	30.5	38.6	3.4	2.4
The Gambia	69.1	67.3	3.6	3.3
Ghana	35.7	75.3	3.0	4.3
Kenya	38.1	43.6	4.2	1.9
Uganda	10.2	36.2	2.9	6.9
Sub-Saharan Africa	40.8	55.3	1.6	2.6

Source: World Bank 2004. World Development Indicators Online, *http://www.worldbank.org/data/wdi2004/index.htm.*

resumed more rapid growth beginning in the 1990s. In the crisis-and reform-decade, most Latin American countries grew sluggishly, if at all. Average growth rates have been substantially higher since the early 1990s, however, and in 2004 Latin American growth rose to 5.5 percent. The picture in Africa is a bit more mixed, as African governments have struggled with structural adjustment. Moreover, efforts to implement economic reform have been overtaken by civil and international conflict. Even so, average economic growth during the last 12 years has been higher than the average during the 1980s.

Comparing average growth rates across decades is misleading, however, because such comparisons fail to recognize that some governments have reformed much more than others. Thus, to get a better appreciation of the impact of reforms on long-run growth, we need to control for the variation in reform across countries. Figure 7.2 depicts the relationship between progress on reform and the gain in economic growth between the 1980s and the 1990s. Progress on reform is measured as the change in an index of structural adjustment developed by researchers at the Inter-American Development Bank. This index summarizes the extent to which national economies are characterized by stable macroeconomic conditions, liberal trade, privatized industries, and flexible labor markets. The higher the score on the index (which ranges from 0 to 1), the closer the country approximates the "neoliberal ideal." I calculated the change in this index between 1985 and 1995 for each country, to measure the extent to which each has moved from ISI toward a neoliberal framework. I then plotted this measure of structural change against the difference between average growth in the 1990s and average growth in the 1980s. Neoliberalism leads us to expect a strong positive rela-

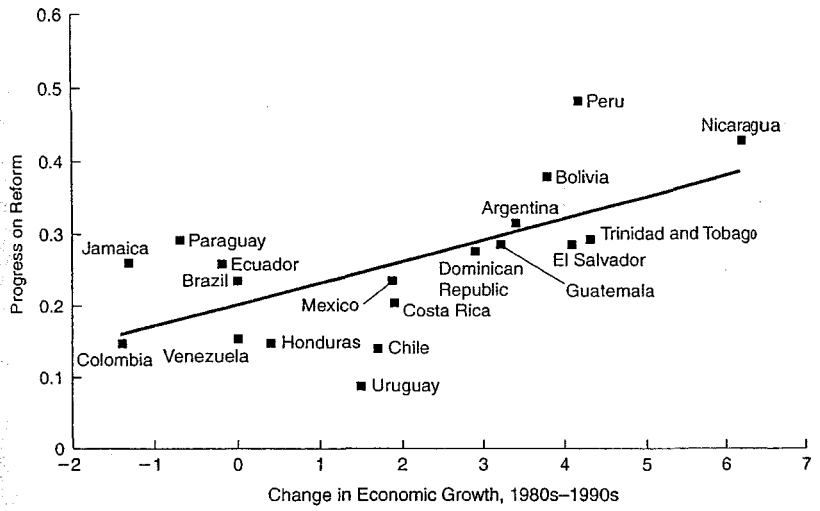

Figure 7.2 Reform and Growth in Latin America.
Source: Reform Index from IADB 1997, 96; Growth Rates from World Bank World Development Indicators.

tionship between progress on reform and change in growth: countries that have reformed the most should see large improvements in growth, while countries that have reformed less should see small growth gains. That expectation finds some support in this simple graph. The overall relationship is positive, indicating that countries which have progressed furthest along the trajectory of reforms have experienced larger gains in growth. Countries that have reformed less have realized smaller, and in some cases, negative, changes in growth.

Even this more nuanced evaluation is misleading, however, because it compares the wrong growth rates. To fully understand reform's impact on long-run growth, we really need to compare growth rates after reform with growth rates that would have occurred had governments never implemented reform. That is, suppose Latin American governments continued along the path they were on in the early 1970s. What rate of economic growth would they then have realized during the 1980s and 1990s? We can compare these growth rates with growth rates following reform to see reform's impact on long-run growth. This comparison is obviously difficult to make, because we can't replay history to see what would have happened if governments had not adopted reforms. The best we can do is estimate what growth rates would have been for Latin American countries had they not adopted reforms. A number of such analyses have been conducted, and they suggest that Latin American growth in the postreform period has been between 1.9 and 2.2 percentage points higher than it would have been had governments not implemented reforms. (See Easterly, Loayza, and Montiel 1997; Montiel Fernández-Arias 2002; Lora and Barrera 1997; and the useful summary in IADB 1997, 54.)

On balance, then, available evidence suggests that the short-run adjustment costs of structural adjustment have been followed by stronger growth than would have occurred in the absence of reform. This is not to suggest that the resumption of growth has eliminated poverty in Latin America or sub-Saharan Africa. It hasn't. In fact, during much of the last 20 years, poverty rates have remained stubbornly high and national income has remained very unevenly distributed. Even the staunchest supporters of neoliberalism don't claim that this approach guarantees that poverty will be eliminated. Instead, they argue that neoliberalism offers the surest path to that goal. As David Dollar and Aart Kraay, two researchers at the World Bank, argue, growth through trade is good for the poor. (See Dollar and Kraay 2004, 2002.) Over time, the short-run pains brought about by structural adjustment should be rewarded with falling poverty and a narrowing of the income gap between the advanced industrialized countries and the developing world. It remains to be seen whether this optimistic perspective will be realized.

Developing Countries and the WTO

Developments in the WTO will play an important role in determining whether the neoliberal optimism mentioned in the previous section is warranted. For, as developing countries have embraced neoliberalism, economic progress has come to depend heavily upon gaining access to world markets. In part, gaining such access involves maintaining a domestic economic climate that encourages the creation of competitive industries. Equally important, however, is the willingness of the advanced industrialized nations to open their markets to the competitive products being produced in the developing world. Success on this dimension hinges critically upon developments within the WTO. In particular, can developing countries use the WTO to begin to dismantle the barriers that the advanced industrialized countries maintain against their imports?

The central challenge that developing countries face in the WTO arises from the political economy of trade in the advanced industrialized countries. Trade politics in those countries generates barriers to imports in many of the industries in which developing countries hold a comparative advantage. Agriculture, on the one hand, and textiles and apparel, on the other, are the two sectors in which the bias against developing countries' exports is perhaps greatest. Many developing countries have a comparative advantage in agriculture. Yet, three aspects of advanced industrialized country policies make it difficult for developing countries to capitalize on this advantage.

Tariffs pose the most obvious obstacle to the ability of developing countries to export agricultural products to the United States, Western Europe, and Japan. In addition to tariffs, however, governments in the advanced industrialized countries subsidize agricultural production heavily. In the year 2000 alone, the advanced industrialized countries provided a total of $327 billion of financial assistance to domestic farmers. These subsidies increase agricultural production in the advanced industrialized countries, reducing the demand for imports from developing countries. In addition, governments in the advanced industrialized countries subsidize exports, thereby displacing other countries' farm products from world markets and driving down the world price of these commodities. EU price supports, for example, caused EU wheat production to increase by 2.5 percent per year between 1970 and 1998. As a consequence, whereas the EU was a net importer of wheat in the early 1960s, by the early 1970s it had become a net exporter of wheat.

Finally, **tariff escalation**—the practice of imposing higher tariffs on goods whose production involves relatively more processing—makes it difficult for developing countries to export processed food to the industrialized countries. Unprocessed agricultural commodities face the lowest tariffs, semiprocessed goods face higher tariffs, and fully processed goods face still higher tariffs. Such a structure of protection in the advanced industrialized countries makes it difficult for developing countries to move into the higher value-added segments of the food industry.

Developing countries also have a comparative advantage in labor-intensive manufactures. Yet, many domestic labor-intensive manufacturing industries remain heavily protected by the advanced industrialized countries. Protection has been particularly prominent in the textile and apparel industries. As part of the Uruguay Round, the advanced industrialized countries agreed to dismantle the quota-based regime governing world trade in textiles and apparel, called the **multifiber arrangement.** Quotas limiting imports are to be replaced by tariff-based protection, and these tariffs are to then be liberalized. The advanced industrialized countries were allowed to defer most liberalization until the end of the ten-year phase-in, however, and most have taken advantage of this opportunity. As a result, the liberalization that has occurred thus far has done little to expand export opportunities for developing countries' producers. And even when quotas have finally been eliminated, this sector will remain heavily protected: about half of the advanced industrialized country textile imports face tariffs above 10 percent. Moreover, in the fall of 2004, the United States began threatening to raise tariffs on Chinese apparel imports under the WTO safeguards clause. This episode suggests that governments in the advanced industrialized countries may find innovative ways to protect domestic producers once the quota regime is fully dismantled.

Protection of textiles and apparel producers highlights the broader pattern of protection of manufacturing industries in the advanced industrialized countries. Manufactured goods exported from the developing world face tariffs that are four times higher than the tariffs applied to exports from other advanced industrialized countries. The discrepancy arises solely from the commodity composition of exports in the two regions. Developing countries produce and export goods that compete with import-competing sectors in the advanced industrialized world, and industries in these sectors have been successful at maintaining protection. Advanced industrialized countries export goods that compete with the export-oriented sector in other advanced industrialized markets, and while the average tariff that the advanced industrialized countries apply to manufactured goods is quite low (only 3.4 percent), labor-intensive goods often confront **tariff peaks,** which are tariff rates above 15 percent. And it isn't only the advanced industrialized countries that are the culprits: developing countries face higher tariffs when they export manufactured goods to developing countries (an average of 12.8 percent) than when they export to the advanced industrialized world. (See Hertel and Martin 2000.) Thus, the ability of developing countries to export manufactured goods into world markets will require them to engage in meaningful reciprocal trade liberalization.

The gains that developing countries could realize from the elimination of trade barriers are substantial. A number of studies have estimated the impact that trade

liberalization would have on incomes in the developing world. The size of the income gain obviously depends in part on the extent of liberalization. The most widely reported estimate was based on an analysis performed by the World Bank in the period leading up to the launch of the Doha Round (World Bank 2001b). According to this analysis, eliminating existing barriers to developing countries' exports could yield as much as $500 billion in additional income to developing countries over a ten-year period. This amount represents a full 5 percent increase in national incomes for developing countries (World Bank 2001b, 168), a figure that is substantially more than total foreign aid flows to the developing world.

Developing countries also face a new challenge from more recent efforts by the United States to bring core labor standards into the WTO. Developing countries have strenuously resisted this initiative. India, Egypt, Indonesia, China, and Pakistan have been vocal opponents of these linkages, as has the Third World Network (TWN), a group of intellectuals based in research institutes in developing countries. The problem is not that all developing countries are unwilling to protect workers' rights (although some of them are). Instead, developing countries oppose the linkage between trade and labor standards for two reasons. First, many governments from developing countries believe that the push to include labor standards into the WTO is driven by import-competing interests as a new form of protectionism. As Murasoli Maran, India's minister of commerce and industry, told the Indian parliament shortly after the 1999 Seattle WTO Summit, the attempt to bring labor standards into the WTO represents a "pernicious way of robbing our comparative advantage. Many developing countries consider it as a maneuver by wealthy nations to force our wages up, to undermine our competitiveness" (*New York Times* December 17, 1999, C4). Second, developing countries face a power imbalance in the WTO. The TWN argues that, because the advanced industrialized countries dominate the WTO, any labor standards incorporated in that organization "would only be used as a weapon by developed countries against developing countries" (O'Brien et al. 2000, 87). For these reasons, many governments from the developing world argue that it would be better to keep labor standards separate from trade considerations.

Will developing countries be able to use the WTO to remove the obstacles they face? Some signs are encouraging. The Doha Round agenda emphasizes the need to address the concerns of developing countries and highlights the positive contribution that trade can make to economic development. In addition, developing countries have thus far been able to keep labor standards out of the WTO. Other signs are less encouraging. The European Union remains reluctant to implement far-reaching reforms of the Common Agriculture Policy, and liberalization of world trade in agriculture will make little progress as long as the union maintains this position. Moreover, labor-intensive industries in the advanced industrialized countries are turning to administered forms of protection—antidumping and countervailing-duty investigations, as well as safeguard actions—with growing frequency. Current American pressure on China regarding trade in textiles and apparel is only one example of this dynamic. Thus, even if tariff peaks in these industries are eliminated, the threat of new trade barriers remains. Only time will tell whether developing countries can gain the expanded access to markets in the advanced industrialized countries upon which the success of the new export-oriented development strategies so many of them have adopted depends.

Policy Analysis and Debate

Core Labor Standards and the WTO

Question

Should the WTO require developing countries to strengthen their labor standards?

Overview

Working conditions in many developing countries are very poor. A number of objectionable practices have been documented: long hours, very low wages, physical and psychological harassment, exposure to toxic chemicals, and dangerous machinery without safety equipment. Such practices appear to be most prevalent in locally owned firms producing apparel, footwear, toys, and sporting goods under contract for Western firms.

Growing awareness of such practices led the United States to try to use WTO negotiations to establish rules that linked market access to the implementation of specific labor standards. These "Core Labor Standards," developed by the International Labor Organization during the 1990s, include freedom of association and collective bargaining, the elimination of forced and compulsory labor, the abolition of child labor, and the elimination of discrimination in the workplace. Some have suggested that two further standards—pay and workplace conditions—be added. By bringing labor standards into the WTO, governments could use the dispute settlement mechanism to enforce compliance. Governments that refused to adopt higher standards would face higher trade barriers.

Developing countries have resisted the linkage between trade and labor standards, because they see it as a new form of protectionism. Martin Khor, the director of the Third World Network (and a prominent critic of many other aspects of globalization), argued, "developing countries fear that . . . they want to protect jobs in the North by reducing the low-cost incentive that attracts global corporations to the developing countries" (Khor 1999). Many economists have also questioned the link, arguing that developing countries' comparative advantage lies in low-cost labor. Higher standards would diminish this advantage. Should developing countries be forced to strengthen their labor standards?

Policy Options

- Negotiate enforceable WTO rules that require developing countries to adopt labor standards equivalent to those in the West.
- Allow developing countries to regulate their national labor markets as they see fit.

Policy Analysis

- Why are labor standards low in developing countries?
- Will bringing core labor standards into the WTO necessarily raise the cost of labor in developing countries? Could this linkage hurt developing countries' exports in other ways?
- In the absence of the linkage, will developing countries' labor standards ever improve?

Take a Position

- Which option do you prefer? Justify your choice.
- What criticisms of your position should you anticipate? How would you defend your recommendation against these criticisms?

Continued

Resources

Online: Search for the National Labor Committee report on conditions in Central America. Other reports are also available online. Search also for the Scholars against Sweatshop Labor (SASL) and for the "Third World Intellectuals and NGOs Statement against Linkage." You might also visit the ILO and read the core labor standards.

In Print: John Miller, "Why Economists are Wrong about the Antisweatshop Movement," *Challenge* 46 (January–February 2003): 93–122. Kimberly Ann Elliott, *Can Labor Standards Improve under Globalization?* (Washington, DC: Institute for International Economics, 2003).

Conclusion

Neoliberalism supplanted structuralism as the guiding philosophy of economic development as a result of the interplay among three factors in the global economy. Import substitution generated severe economic imbalances that created pressure for reform of some type. The success of East Asian countries that adopted an export-oriented development strategy provided an alternative model for development. Finally, the emergence of a severe economic crisis in the early 1980s, a crisis that resulted in part from the imbalances generated by ISI and in part from developments in the global economy, pushed governments to launch reforms under the supervision of the IMF and World Bank. By the mid-1980s, most governments were implementing reforms that reduced the role of the state and increased the role of the market in economic development.

The implementation of these reforms has been neither quick nor painless. The depth of the reforms brought substantial short-run costs as average incomes fell and as this smaller income was redistributed among groups. The proponents of neoliberal reforms argue that the short-run costs are worth paying, however, for they establish the framework for strong and sustainable growth far into the future. Achieving that outcome will require developing societies to consolidate and build upon the reforms already implemented. In addition, it will require the advanced industrialized countries to accept short-run adjustment costs of their own in order to meet the legitimate demands that developing countries now make about market access.

The adoption of neoliberal reforms in the developing world is also transforming the global economy. For the first time since the early 20th century, the developing world has integrated itself into that economy. In doing so, developing countries have altered the dynamics of global economic exchange. Standard trade theory tells us to expect trade between capital-abundant and labor-abundant societies. Yet, trade barriers have greatly limited such trade for most of the postwar era. As these barriers have fallen during the last 20 years, trade between countries with different factor endowments has become increasingly important. Businesses are increasingly locating their activities in those parts of the world where they can be performed most efficiently. Labor-intensive aspects of production are being shifted to developing societies, while the capital-intensive aspects of production remain in the advanced industrialized countries. The expansion of North–South trade is thus creating a new global division of labor.

Key Terms

Current Account
East Asian Model of Development
Export-oriented Industrialization
Export-oriented Strategy
Multifiber Arrangement
Neoliberalism
Privatization
Real Exchange Rates
Rent Seeking
Structural Adjustment
Tariff Escalation
Tariff Peaks

Web Links

The United Nations Conference on Trade and Development website can be found at *http://www.unctad.org* and the Group of 77 website at *http://www.g77.org*.

Visit the World Bank at *http://www.worldbank.org*.

You can also visit the regional development banks:

The African Development Bank: *http://www.afdb.org*.

The Inter-American Development Bank: *http://www.iadb.org*.

The Asian Development Bank: *http://www.adb.org*.

The WTO devotes a section of its site to developing countries and the international trade system: *http://www.wto.org/english/tratop_e/devel_e/devel_e.htm*.

The Electronic Development and Environment Information System (ELDIS), based at the Institute of Development Studies in Sussex, England, maintains a website with good links to information about development issues. The site is found at *http://nt1.ids.ac.uk/eldis/eldis.htm*.

Suggestions for Further Reading

On the Asian Model, see Robert Wade, *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization* (Princeton: Princeton University Press, 1990), and Stephan Haggard, *Pathways from the Periphery: The Politics of Growth in the Newly Industrializing Countries* (Ithaca, NY: Cornell University Press, 1990). For a concise summary of the World Bank view, see World Bank, *The East Asian Miracle: Economic Growth and Public Policy* (Washington, DC: World Bank, 1994).

On structural adjustment, see Tony Killick, *Aid and the Political Economy of Policy Change* (London: Routledge, 1998), and World Bank, *Adjustment in Africa: Lessons from Country Case Studies* (Washington, DC: World Bank, 1998). On the politics of reform, a useful place to start is Stephan Haggard and Robert Kaufman, eds., *The Politics of Economic Adjustment: International Constraints, Distributive Conflicts, and the State* (Princeton: Princeton University Press, 1992), and John Williamson, ed., *The Political Economy of Policy Reform* (Washington, DC: Institute for International Economics, 1994). For a more recent work, see Anne O. Krueger, *Economic Policy Reform* (Chicago: University of Chicago Press, 2000).