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ASIAN EXPERIENCE IN TRADE AND INDUSTRIAL REFORM

Mohammad Sadli

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Asian Experience in Trade and Industrial Reform

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PREFACE

The International Center for Economic Growth is pleased to publish *Asian Experience in Trade and Industrial Reform* by Mohammad Sadli as the forty-seventh in our series of Occasional Papers, which present reflections on broad policy issues by noted scholars and policy makers.

This paper was originally submitted to the General Session of the Fifth Asian Development Bank Round Table on Development Strategies, held in Manila on March 8, 1993. A panel discussed the paper under the general theme of "Economic Reforms for Sustainable Development."

Mohammad Sadli looks at the experience of the Asian developing countries in achieving trade and industrial reforms, particularly drawing on his intimate knowledge of Indonesia. He first takes a look at the history of the countries after they achieved independence and at the domestic and international factors that caused reforms to gain momentum in the 1980s.

Turning then to the issues surrounding trade and industrial policy reforms, the author examines both the problems and successes of such questions as removing trade barriers, controlling domestic trade, and reforming industrial policy. Whether trade should be oriented toward internal or external markets, what the role of foreign direct investments should be, how technology can be transferred, and how governments support industrialization are only a few of the issues discussed in depth. The author concludes that Asian developing countries must increasingly open their economies and establish sound macroeconomic environments.

Mohammad Sadli speaks from a unique perspective as a former chairman of the Board of Investments of Indonesia, a former minister

of manpower, and former minister of mines and petroleum. He is also an emeritus professor of economics of the University of Indonesia and has been active in the Indonesian Chamber of Commerce.

As the developing Asian countries strive to achieve reforms and find a place in a global economy, the observations in this paper should be quite useful to economists and policy makers with an interest in the region.

Nicolás Ardito-Barletta
General Director
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Panama City, Panama
November 1993

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MOHAMMAD SADLI

Asian Experience in Trade and Industrial Reform

Reasons for Reform: Domestic and International Factors

In the 1980s economic reforms gained momentum in the developing Asian countries, motivated by a combination of domestic and international factors. Which of the two was more influential is difficult to prove and may differ from country to country, from period to period, and from reform to reform.

Reform measures do not come overnight, triggered, for example, by an economic crisis. Often there have been preludes or previous timid attempts. The Indian reforms and deregulation, for example, are often attributed to the present government under Prime Minister Narasimha Rao, dating only from 1991. However, preludes could be heard at the time Prime Minister Indira Gandhi was in power, in response to the oil crises. Prime Minister Rajiv Gandhi then tried to promote exports and encourage foreign investments but could not push effectively because of political distractions.

In Indonesia the reforms gathered momentum in the middle 1980s, but the economic technocrats in government and academia had been exposed to the teachings and preachings of World Bank officials much earlier. Every year the World Bank and the International Monetary Fund (IMF) send missions to prepare reports on the state of the economy for the annual conference of Indonesia's international aid consortium, the Consultative Group on Indonesia (CGI). Such reports are civil exercises in policy dialogue. The Indonesian government, how-

ever, likes being given credit for acting independently, before international policy advises become pressing or near conditional. Its economic ministers have cultivated good relations and mutual understanding with officials of the Bank and Fund for much of the past twenty-five years. There has never been domestic political resistance against this relationship, perhaps because the stabilization and structural adjustment policies have borne fruit within a relatively short period and the supply responses were rather quick. Economic aid and capital inflows were also adequate. Economic reforms have come in a series since the beginning of the present Suharto government some twenty-five years ago. They certainly were not a one-time, big-bang affair.

Ideological factors. During the early days of independence many developing countries oriented economic policy around the role of the government as the guiding power to organize and reorganize the economy. The planning idea behind European socialism had greater appeal than capitalistic laissez-faire paradigms because of the first promised reforms of a colonial economy, enabled by the political power of the newly independent state, that is, the power of government. In the eyes of the new power holders and their followers, there were many things wrong in an economy left behind by a colonial regime; it served mainly the interests of the far-away metropolitan center, and it was controlled by aliens.

Restructuring then meant the promotion of the new national interest. Various means were resorted to in order to advance ownership of property into national hands, to control international payments, to license entry into an industry, and to give preference to nationals. Many developing countries did not institute a command economy with an all-encompassing public sector; those economies remain mixed, with a private sector of varying strength continuing to exist. Governments did, however, engage in "planning," meaning resource allocation through a government mechanism. Almost everywhere there is a planning agency and a minister for planning. The allocation of the capital budget of the government was the easiest to control. Investment in the private sector to a certain extent was directed by a licensing system, whereas imports were controlled by another licensing system.

Moreover, the state enterprise sector became an extension of the control mechanism of the government.

As many of those newly developing countries still had inadequate national savings, financing economic development was dependent upon foreign aid. Foreign aid, however, is a government-to-government affair, hence reinforcing public sector planning. Some countries, such as Indonesia, enjoyed oil booms in the 1970s with revenues accruing to the governments, which then were used to buttress their capital budgets and the priority sector lending operation of government banks.

Price controls. Price controls were rampant, partly as a consequence of the prevailing ideology, but also because of a perceived necessity to protect the society, that is, consumers, against the hazards of inflation. The newly independent states after World War II emulated the wartime economic controls practiced by the industrial countries, deeming such controls legitimate.

That price controls could not be exercised for too long without penalty was not realized. Of course a government hypothetically could practice extensive price controls without damaging the long-term growth of the economy if such a system politically and administratively could be neutral between the interests of consumers and producers, between consumption and investments. In practice, however, the interests of consumers prevailed because governments tend to appease the mass of the society whereas producers often are still afflicted by the colonial stigma. Moreover, state enterprises are not set up for their own growth but to serve the public good first of all.

Economic reforms aimed at fuller play of market forces eventually have to phase out most price controls, but such a process cannot be completed in a short period, if at all. Administrative price and rate setting is practiced with respect to public utilities and monopolies or cartels. Such market structures abound in developing countries because of the small size of the market. In Indonesia many commodities deemed "vital" or "strategic" (such terms date from World War II years) to the interest of the society remained subject to price controls, such as rice and wheat flour (basic foodstuffs), fertilizers (vital for the farmers), hydrocarbon fuels (production and distribution controlled by

a state enterprise), and cement and steel (strategic). The adjustment of administratively controlled prices to continuing inflation at times becomes a very difficult political process, and the policy of deregulation still has to cope further with this problem.

International factors. The breakdown of the economic system of the European socialist countries made easier the liberalization of economies in many developing countries. It punctured the perceived superiority of the control system to support economic development. The greater success of East Asian countries in managing growth made more attractive a market-oriented model and an open economy fully interacting with the world. Apart from this counter-ideological influence, the drastic reduction of Soviet economic aid and guaranteed trade became a compelling reason for a number of countries to reorient their economic policies and emulate the more market-oriented systems of East Asian countries in order to have greater access to new markets and sources of financing.

Oil producing and exporting countries had to restructure their economies in the 1980s to lessen the dependence on oil revenues and promote non-oil exports. This change required a major reorientation of policies, away from an overvaluation of their currencies and toward providing incentives to new growth sectors through the price mechanism and macroeconomic policies. Oil importing countries had to restructure and reorient their economies to cope with higher-priced oil and increasing current account deficits. That is why Thailand started reforms earlier in the 1980s as a result of the second oil crisis.

Reform: A Political Process

These external shocks or influences and internal needs for adjustment have not produced clean and straightforward processes of reform. This is because reform is basically a political exercise. The old system, however deficient, always has its merits and beneficiaries. The mass of the people, being consumers, will get a shock when the prices of their daily necessities go up to a new equilibrium. They will not easily understand the macroeconomic needs for economic reform, the bene-

fits of which will come only later. In a number of countries price and rate adjustments have sent people into the streets, protesting and demonstrating. In other countries, with different political regimes, the government seemingly could get away unscathed. Indonesia is probably one example of the latter.

No government, however, is totally immune to popular sentiments, and no government can completely break away from the past. The old system always has its strong advocates, or at least supporters of certain features, such as relative price stability thanks to price controls. Old teachings also die hard. Hence a process of zigzagging, or moving forward with occasional backtracking or moving sideways, has been more the order of the day.

Even in Indonesia, with a very strong government, economic pundits often complain that deregulation of the economy has proceeded too slowly, by fits and starts. Approaching the time of the meeting of the Consultative Group on Indonesia, there is usually a burst of new deregulation measures. Indonesian economic ministers, and even President Suharto, like to repeat their commitment to further deregulation. They mean what they say, but because of the inherent political process those ministers cannot always be on top of things.

The role of the government. There is a school of thinking that deregulation should proceed gradually, in stages, and that governments should not overreact or go overboard. Deregulation is practically a never-ending process and is a regular part of the functions of a government adjusting itself to changing needs and requirements. At the heart of this belief is a philosophy of the role of government. Deregulation should not be interpreted as abandoning the role of government in favor of a laissez-faire stance. Deregulation is a reinterpretation of the functions of government. Governments in developing countries remain proactive agents, guiding the development of the economy and society. In this process, however, they should now let market forces play a greater role in the allocation of resources and should not go against the market.

It is often said today that governments "should get the prices right." That may be good advice, but it gives no definition of what "right" means. Prices in the market are not always right because of

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market distortions. On the other hand, we have seen a lot of government interventions inimical to economic growth as well as equity. Hence the debate about the role of governments in setting prices right is a never-ending one, perhaps even, in retrospect, like the debate among western economists about the role of government in Korea in relation to its growth success.

Monopolies arise more easily in developing countries because of the size of the market. Governments in the past have even often created or supported such monopolies. Monopolies should be phased out when the market can support a greater number of suppliers without loss of efficiency. Periodically, old monopolies should be reviewed in the light of present-day market realities and efficiency options. Hence government has a distinct function to make the market mechanism work better by certain interventions. Such interventions should be based on transparent rules and mechanisms.

Is it possible for developing countries to have a "smart" government, or bureaucracy, handling control mechanisms? What does "smart" mean? If the ministers and their staff have doctorates in economics, would that be an assurance? If the government follows IMF and World Bank advises, would that be another assurance? In Indonesia we have a technocratic system (professional rather than influenced by party politics and ideology), but the decisions have not always been smart. Inflation control, stability, and transparency of policies still can be improved.

For one thing, political influences play a part, such as the tug-of-war between consumers' and producers' interests, between development impatience and macroeconomic prudence. For another thing, information for decision making is often not adequately and timely available. If the government or bureaucracy establishes close relations with the business community and its organizations for better feedback of information, as is often perceived to be the case in Japan, would that produce better decisions? Perhaps, but those decisions may be tilted toward the interests of such business organizations. That may be legitimate if one can assume that what is good for the chamber of commerce is also good for the country. Many economists may doubt the merits of such a proposition, because the national chamber could represent a lobby of business monopolies and other interest groups that

may be tilted toward protection. On the other hand, if a system is inclined more toward the interests of consumers than producers, such a system may be less sustainable in an inflationary environment. The trouble is that abandonment of the price control system in such an environment is often politically unacceptable.

Macroeconomic stability and low inflation. If a government wants to abandon the price control system, it must be able to deliver price stability through proper macroeconomic policy measures over a sustained period. This is the latest proposition in Indonesia, where the government recently announced a 5 percent inflation rate target for fiscal 1993–94, and probably beyond. Its track record has been closer to 10 percent per annum, but the instability that high inflation brings with it and the political costs of making the adjustments are in the end deemed not worth the while because these efforts are sapping the strength, the credibility, and the goodwill of the government.

Of course, it is much easier to set a low-inflation target than to execute it. Moreover, if low inflation is not hard to achieve, why the past record? Why are Singapore, Malaysia, Brunei, and Thailand low-inflation countries whereas Indonesia and the Philippines are not known as such? The answer must lie in the governmental and political sphere, including institutions (such as the independence of the central bank and the role of the bureaucracy) and traditions. If a country does not have a tradition of monetary stability, it is not easy to establish a new one.

Early Industrialization Policies and the Need for Reform

Having discussed several of the factors leading to economic reform, we come now to the problem of trade and industrial policy reforms. Why is it that the Asian countries needed them so badly? In the early days of independence, or immediately after World War II, the developing countries wanted to modernize their economies and create greater prosperity. The leading strategy was industrialization. For industrialization one needs markets. Foreign markets look forbidding for the uninitiated. The domestic market in many countries looks to be the

easiest way to serve. Small countries, such as the newly industrializing economies (NIEs), found out early that they did not have such options for too long and went out the hard way to sell abroad. In many developing countries, however, the size of the domestic market spawned the doctrine of import substitution industrialization, with an important footnote, that is, under high protection.

This led first of all to control of imports for the sake of protection. Control of imports had another, equally strong, motivation: conservation of scarce foreign exchange. Of course one could do the same through a more open market system, by not overvaluing the currency and by setting high tariffs for unessential goods without resorting to quantitative restrictions. Overvalued exchange rates are difficult to correct timely in countries with a tradition of high domestic inflation. Hence import controls are usually resorted to through the imposition of high tariffs, quantitative restrictions, and a licensing system. Such systems, however, work against the interest of exports as these become less profitable propositions.

Sooner or later these developing countries faced a balance of payments crisis and were forced to abandon such regimes in favor of systems favoring exports. They had to decontrol the foreign trade and exchange regime and adjust industrial policy to give greater incentives to exports. Most of this happened in the 1980s, apart from the NIEs that had embarked upon export-oriented industrialization much earlier by force of circumstance.

Trade and industrial policy reforms are two sides of one coin. The Asian Development Bank (ADB) publication *Asian Development Outlook 1991* says: "Under any long-term structural reform program, trade and industrial policies need to be closely coordinated. Liberalization of an economy's external trade sector, if not accompanied by reforms in the industrial policy, is bound to fail."[1]

Conceptually, this is right. But in practice it is never a black-or-white proposition. There are a lot of variations and sequences that form different shades of gray. Trade policy reform reducing quantitative restrictions could be a response to a balance of payments crisis starting with a devaluation. The reduction or removal of quantitative restrictions is sometimes a fiscal device to improve government revenue collection from foreign trade. With import quantitative restrictions and

a licensing system, the importers and traders are pocketing the economic rent, not the government.

Trade policy reforms, however, can be undertaken without an immediate need to reform industrial policy. If the Association of South East Asian Nations (ASEAN) wants to start economic cooperation through a trade preferential system, the individual member countries can cut tariff rates without intending to change their industrial policy much. Of course, the state of industrial policy will influence the boldness of the tariff reductions. If in the end ASEAN produces a consolidated list of items for tariff reduction as compared to individual countries offering reductions (perhaps with a great number of exclusions), then in the end trade policy reforms, for whatever initial reasons, will affect the state of domestic competition and in turn impact on industrial policies.

Trade Policy Reforms

Trade policy reforms are usually started in the international trade sector. Such reforms consist of lowering tariff rates, narrowing the range of tariffs, and removing trade barriers such as import quotas and bans, the import licensing system, assigned channels for the exclusive importation of certain commodities, and other administrative, legal, or institutional restrictions.

Many developing countries have erected high tariff walls to protect domestic industries and to control imports of unessential goods to preserve scarce foreign exchange. Apart from high tariffs, they also have instituted nontariff barriers (NTBs). The question is, What are the imperatives for these countries to lower such barriers, and at what times?

If such countries start an export promotion drive, is it inherently necessary to liberalize the import regime? The theory is that a restricted import regime will produce a high costs economy that will be counterproductive to an export drive. On the other hand, if the import regime is liberalized, imports may increase faster than exports, and the balance of payments will risk high and unsustainable current account deficits. Imports will certainly increase because of additional require-

ments for raw materials, capital goods, and other inputs to enable new exports. Those requirements are self-financing, but the society may also embark upon a buying spree of consumer goods and durables, perhaps as a result of pent-up demand. How should the country deal with such a problem?

First, the macroeconomic stability should be upheld. Exchange rates should not be, or become, overvalued, because this will encourage imports and work against exports. Second, demand management should be the basis of inflation control. Beyond such measures, however, there is no inherent logic that prescribes a developing country to liberalize its import regime to protect its export drive. Countries such as Japan, Korea, and Taiwan are known as examples of mercantilist regimes where a very successful export performance can go together with a not-so-open import and domestic trading regime. The 1991 United Nations Conference on Trade and Development (UNCTAD) *Trade and Development Report* concludes: "Taken as a whole, the results indicate that rapid export growth was critical to economic performance in the past decade, but there is no simple link between protection and export success. It is not trade policies in general, but rather how specific countries manage them that really determines economic performance."[2]

Should Hong Kong and Singapore always be the preferred model or could late starters like Indonesia, Thailand, and the Philippines not also engage in this "dual-track strategy"? Of course it should be an intelligent system. The high-cost elements burdening exports should be removed or compensation made. For instance, Indonesia has institutionalized an effective draw-back system to reimburse duties paid on imports of inputs for exported goods. The rupiah is protected from overvaluation through a gradual depreciation of the value over the year in line with domestic inflation. Exports of manufactured goods have been going up by 20 percent or more on an annual basis. There are critics, however, who claim that the fast growth of exports of Southeast Asian countries was because of the international relocation of labor-intensive industries from the NIEs and Japan, and hence it was supply driven. That may be true, but why have exports of the Philippines and South Asia not advanced with the same speed?

Liberalization of the import regime is based upon the following

argument. Tariffs and NTBs are for the protection of domestic industries. The protection function should be based on an effective infant industry policy; it should be phased down and out over a specific time. The level of tariff protection should also not facilitate domestic producers setting near-monopoly prices because of the ineffectiveness of import competition. Tariffs also have a fiscal function. Thailand, for instance, has relied on such revenues. Hence there is a connection between trade reform and fiscal reform.

Although in the past such reforms have been difficult to implement, the present conditions are different. We live now in an environment where industries must be made export competitive and import substitution industrialization has lost its appeal. Within this new policy environment it should be more feasible to phase out protection of domestic industries from external competition. High tariffs will create producers' rent and induce prolongation of protection; it is better to have lower and more efficient protection. The fiscal function of tariffs also rejects high tariffs because revenues may be less than optimal. As industrialization progresses, import tariffs should be transformed into general sales taxes applying to both imports and domestic production, therefore having a more neutral effect. This trend is already visible in Indonesia, where revenues from import duties are becoming much less important than revenues from the value added (sales) tax (VAT). The 10 percent VAT has to be paid on all import goods. Moreover, developing countries should progressively collect more income taxes for equity reasons.

How have NTBs crept into the system? NTBs have no fiscal function. Why then impose import quotas and outright bans rather than rely on tariff protection? The argument often given is that high tariffs encourage smuggling and dumping, as well as underinvoicing and bribing of custom officials. Once the merchandise is inside the custom boundary, it is hard to remove from the market, adds to the supply, and pulls prices down. Domestic industry then complains about unfair and even cutthroat competition. It lobbies for an outright ban because if imported merchandise is spotted in the market it is easier to remove it. Such an argument may not be very sound but has nevertheless been effective for the spread of NTBs. In short, high tariffs are counterproductive for optimal revenue collection and over time induce the spread

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