TRADE & INDUSTRIALIZATIO

EDITED BY DEEPAK NAYYAR

HEMES

IN

CONOMICS

TRADE AND INDUSTRIALIZATION

Edited by

DEEPAK NAYYAR

DELHI
OXFORD UNIVERSITY PRESS
CALCUTTA CHENNAI MUMBAI
1997

Oxford University Press, Great Clarendon Street, Oxford OX2 6DP

Oxford New York
Athens Auckland Bangkok Calcutta
Cape Town Chennai Dar es Salaam Delhi
Florence Hong Kong Istanbul Karachi
Kuala Lumpur Madrid Melbourne Mexico City
Mumbai Nairobi Paris Singapore
Taipei Tokyo Toronto

and associates in

Berlin Ibadan

ISBN 0 19 563532 9

Typeset by Guru Typograph Technology, New Delhi 110 045
Printed at Pashupati Printers, New Delhi 110 032
and published by Manzar Khan, Oxford University Press
YMCA Library Building, Jai Singh Road, New Delhi 110 001

Note from the General Editors

As economics advances rapidly and becomes both more mathematical and statistically founded, the need arises to interpret its general principles in the context of specific economies. In India, students are taught the latest models but it is usually left to them or the rare teacher to relate the models to the Indian context. The present series is an attempt to rectify this lacuna. Each book in this series presents the latest developments in a field and enunciates these in the context of the Indian economy.

The series was conceived with senior undergraduate and postgraduate students in mind. The aim is to provide accurate and interesting books with contributions from leading economists. While each book has a volume editor, we—the general editors—work with the volume editors in order to try and maintain some common norms and standards for the series as a whole.

Initially there was a third general editor, the late Sukhamoy Chakravarty. He was actively involved in the planning of the first few books in this series; and was a great source of inspiration to us till the last days of his life.

Kaushik Basu
Prabhat Patnaik

Preface

The theme of trade, industrialization and development has aroused considerable interest for quite some time. There exists an extensive literature on the subject which has attempted to analyse and evaluate the industrialization experience of economies in Asia, Latin America and Africa during the second half of the twentieth century. It has also been the subject of a lively debate among economists. There have been two sets of contending views about the most appropriate strategy of development in countries that are latecomers to industrialization: those which emphasize the importance of limited openness and governmental intervention and those which stress the virtues of openness and markets. Over the past fifty years, the weight of opinion has shifted from the former to the latter. In spite of the dominant thinking, however, there have always been voices of dissent, just as there have been doses of eclecticism. The dissent, as also the eclecticism, has performed an important role in questioning conventional wisdom for doubt is as important as knowledge in the design of economic policy.

This volume brings together a collection of essays around the theme of trade and industrialization. It is different from the existing literature in some important respects. First, it examines the underlying economic theory to make explicit what is often implicit. Second, it explores interconnections between themes, which are sometimes lost in compartmentalized discussion associated with the selective appropriation of theory by different schools of thought. Third, it widens the canvas to consider the implications of globalization for trade and industrialization. Last but not least, it highlights the importance of dissent and eclecticism, by seeking to focus on problems from the perspective of developing countries.

The first essay, by Deepak Nayyar, serves as an introduction to the volume. It explores selected themes in trade and industrialization which have not received adequate attention in the literature on the subject and are also not a point of focus for the other essays in this book. It argues that the mainstream literature on trade and industrialization is narrow in its focus, just as it is selective in its use of theory and experience. It examines the neglected themes by situating trade in a macroeconomic perspective, recognizing the importance of the demand side and considering demand-supply linkages to highlight their significance. The essay, then, sketches the broad contours of globalization in the contemporary world economy, which has so changed the international context, to discuss what it means for trade and industrialization in the developing world. It finds that, at the present juncture, when the disillusionment with the State is so widespread, given the reality of globalization, the economic role of the State in the quest for industrialization and development is perhaps more critical than ever before. The conclusion is that the degree of openness *vis-à-vis* the world economy and the nature of State intervention in the market are strategic choices in the pursuit of industrialization, which cannot be defined, or prescribed, once-and-for-all because they depend upon the stage of development and must therefore change over time.

In his essay, Sanjaya Lall suggests that the growing dominance of the neo-liberal 'rules of the game' is based on a particular view of development and industrialization policy: that markets are basically efficient, governments are basically inefficient, resource allocation is optimized by responses to free markets, and the best industrialization policy is to remove all interventions in the functioning of markets. This paradigm combines simple economic theory with certain empirical assumptions about how economies and governments function, what drives growth and structural transformation, and what 'good' development policy consists of. There is increasing concern about some of the underlying assumptions and values of the new paradigm: about market efficiency, government inefficiency, the links from static optimization to dynamic growth, and the role of government interventions in explaining recent industrial success. Lall argues that the neo-liberal approach is based on a misunderstanding of how industrial enterprises actually become efficient and competitive, and that the difficult and unpredictable learning process involved can suffer from a variety of market failures. These failures call for both selective and functional government interventions, and the pattern for success among the newly industrializing economies in Asia reflects the nature of their interventions. However, these interventions have to be carefully designed to overcome market failures rather than promoting wholesale import substitution. Case studies of the less successful industrializing countries like India and Mexico illustrate how interventions can 'go wrong' if they are not integrated across product and factor markets and not disciplined by export-orientation. The case for selective government interventions also applies to policy reform: what is required is to remove inefficient interventions and not efficient ones.

The essay by Abhijit Sen is about the paradigmatic shift that has taken place in recent years in the way development economists look at the link between industrialization and the extent of economic openness. The development consensus which ruled in the first thirty years after World War II is contrasted with the Washington Consensus now current, and possible reasons for this shift from the one to the other are examined. It argued that the shift in consensus cannot really be attributed to any new insight from economic theory about either trade or industry. The state intervention and deviations from free trade envisaged in the old consensus were justified by pointing to certain external benefits of the industrialization process, and based on the idea that these externalities were essentially dynamic in nature. Recent developments in theory vindicate these ideas, and their theoretical basis is much better understood today than when these were originally formulated. On the other hand, actual development policy was based less on these dynamic arguments than on the 'structural' argument that developing countries faced chronic balance of payments problems and suffered from domestic rigidities. The resulting emphasis on import substitution was not entirely successful however, and compared unfavourably with the more export oriented economies of East and South East Asia. The central message from the Washington Consensus, that openness to international trade and finance is good, is usually backed by this observation. But, the problem with this is that the exact notion of 'openness' varies from one perspective to another. And, empirical evidence does not provide support for the change in the worldview from 'structuralist economics' to 'structural adjustment'. The lesson seems to be that the actual results of interventions in the sphere of trade and industrialization depend not merely on whether these are theoretically desirable. Of equal importance is the question whether the existing balance of forces (both domestic and international) allow desired interventions to be implemented without causing unintended losses larger than the gains theoretically possible.

In the next essay, Nirmal Chandra considers trade and industrialization together with technology and development as related themes. In doing so, he analyses the Indian experience. The essay seeks to restate the case for planning based on theory and experience in a large developing country. To start with, it sets out the rationale for planning in the context of developments in the world economy. It goes on to explore the Mahalanobis strategy and evaluate the orthodox critique of import substitution in India. Recent developments in trade theory, which build a case for protection of high technology sectors in the industrialized countries, are then examined to suggest a strong parallel with the core of the Mahalanobis strategy. The prospects of technology transfer from the rich to the poor countries are examined. The author argues that more R&D work is likely to be undertaken in developing countries, but these countries will have little control over the technologies so created. On the other hand, it is shown that India has an enormous potential in generating its own know-how in many modern industries, of which only a small part has been realized. Such questions about technology have acquired a new significance in the debate on trade in the industrialized countries: for example, are cheap imports of manufactured goods from developing countries responsible for the massive unemployment in Europe and North America? These issues are discussed. The conclusion drawn by Chandra is that rich countries may need to protect some of their labour-intensive sectors as much as developing countries may need to protect some of their technology-intensive sectors, for a 'balanced' pattern of global development, so that free trade is not the appropriate guiding principle for international economic transactions.

Ajit Singh addresses the relatively unexplored theme of stockmarkets, which has acquired a new significance in the context of openness and industrialization. Today, stockmarkets play a much more important role in mobilizing financial resources than at any other point in the history of modern capitalism. Economic theorizing has followed their growth to stress the efficacy of stockmarkets as mechanisms for resource mobilization and as a source of discipline for firms operating within imperfect market structures. There is, however, considerable scepticism in the literature on both these counts. The essay provides a critical review of the debate on stockmarkets and examines how contending theoretical paradigms have viewed their role in economic development. It goes on to analyse the role of Indian stockmarkets in the growth of manufacturing firms in India. The author, then, puts together theory and experience to analyse the implications of using stockmarkets as the main mechanism for financing industrialization. Singh argues that the phenomenal growth of stockmarkets across the world is policy induced and must be situated in the wider context of a worldwide tendency towards deregulation of the financial sector. But the evidence presented suggests that stockmarkets do not necessarily improve the efficiency of corporate sector investment or increase the level of saving and investment in an economy. On the contrary, it would seem that economies in which stockmarkets play a central role in mobilizing financial resources find themselves at a competitive disadvantage relative to economies where banks, as opposed to stockmarkets, play this role.

The focus of the essay by C.P. Chandrasekhar is on the trade–investment nexus in the current, yet evolving, phase of globalization. It explores the links between economic openness, through international investment and international trade, and industrialization in the developing world, to provide an assessment based on the Asian experience. In particular, the author examines the argument that the wave of liberalization in the developing world has created conditions for correcting global inequalities in the distribution of industrial production. This argument is based on the contention that transnational firms with globally networked operations, are constantly in search of new international sites for world market-oriented production as part of their competitive strategy. Trade liberalization now not only provides such sites, but also demands that all capacity installed in developing countries is internationally competitive, and therefore capable of targeting the world market. In the event, there develops a virtuous nexus between trade and foreign investment which creates conditions for the global proliferation of industrial capacity. The evidence, however, suggests that while liberalization is a generalized phenomenon, the flow of world market-oriented foreign direct investment is concentrated in an extremely small number of countries. Some of them are locations, which in terms of conventional explanations of choice of investment sites, are no more attractive. Chandrasekhar suggests that the relocation of industrial capacity is driven less by the pull from attractive sites and more by strategies of developed countries and transnational firms which target a few chosen locations as bases to be used in the growing rivalry between different sections of international capital. As a result, the hope that liberalization would automatically attract world market-oriented investment is belied in a number of developing countries.

The essays in this book endeavour to provide a critical survey of the literature in the areas of focus. In doing so, the authors clarify the complexities and the nuances of the debate on the subject. The exposition is juxtaposed with their own perspectives. The contribution of the volume lies not in original research but in critical synthesis. I hope that this book would contribute to an understanding of problems, even if it cannot provide definitive answers to complex questions. For it is clear that we have not reached the end of the debate on trade and industrialization. There are unexplored themes and unsettled issues. And our understanding of the industrialization process would benefit from further research which draws upon theory and experience.

New Delhi DEEPAK NAYYAR
February 1997

Contributors

DEEPAK NAYYAR
Jawaharlal Nehru University, New Delhi

SANJAYA LALL
University of Oxford, UK

ABHIJIT SEN
Jawaharlal Nehru University, New Delhi

NIRMAL KUMAR CHANDRA
Indian Institute of Management, Calcutta

AJIT SINGH
University of Cambridge, UK

C.P. CHANDRASEKHAR
Jawaharlal Nehru University, New Delhi

Contents

List of Tables and Figures

TABLES

FIGURES

Themes in Trade and Industrialization*

DEEPAK NAYYAR

1. INTRODUCTION

In the post-colonial era, which began soon after the end of the second world war, most underdeveloped countries adopted strategies of development that provided a sharp contrast with their past during the first half of the twentieth century. For one, there was a conscious attempt to limit the degree of openness and of integration with the world economy, in pursuit of a more autonomous, if not self-reliant, development. For another, the State was assigned a strategic role in development because the market, by itself, was not perceived as sufficient to meet the aspirations of latecomers to industrialization. Both represented points of departure from the colonial era which was characterized by open economies and unregulated markets. But this approach also represented a consensus in thinking about the most appropriate strategy for industrialization. It was, in fact, the development consensus at the time.

It is almost fifty years since then. And it would seem that, in terms of perceptions about development, we have arrived at the polar opposite. Most countries in the developing world, as also in the erstwhile socialist bloc, are reshaping their domestic economic policies so as to integrate much more with the world economy and to enlarge the role of the market *vis-à-vis* the State. This is partly a consequence of internal crisis situations in economy, polity or society. It is also significantly influenced by the profound transformation in the world economic and political situation. The widespread acceptance of this approach represents a new consensus in thinking about development. It has come to be known as the Washington Consensus.

This dramatic change in thinking is significant enough to be characterized as a shift of paradigm. The change, however, is not confined to the domain of thinking. It extends to reality. For the process of globalization is changing the character of the world economy. Yet, the theme of trade

*I am indebted to Amit Bhaduri for helpful discussion. I would also like to thank Satish Jain, Mrituinjoy Mohanty, Anjan Mukherji and Abhijit Sen for useful suggestions.

and industrialization has remained central to the debate throughout this period. It was then. It is now.

The conventional editorial introduction attempts a synthesis of the contributions if not a survey of the literature. But I have decided to depart from this practice. It would be repetitive to summarize the essays. And there are already too many surveys of the literature. Instead, this essay seeks to explore themes in trade and industrialization which have not received sufficient attention in mainstream literature and are also not a point of focus for the other essays in this volume. The discussion, therefore, is selective rather than exhaustive. It does, however, widen the canvas to consider the implications of globalization for trade and industrialization.

Section 2 begins with the underlying economic theory. It sets out the logic of the free trade argument and explains the rationale of exceptions to this rule. Section 3 examines the evolution of thinking about the degree of openness (in the sphere of trade) and the degree of intervention (by the State in the market) in the process of industrialization, to provide a critical assessment of the consensus: old and new. Section 4 explores the neglected themes in the literature on the subject. It situates trade in a macroeconomic perspective, highlights the importance of the demand side, outlines the implications of demand–supply linkages and states the problems associated with missing out on the technology factor. Section 5 sketches the broad contours of globalization in the contemporary world economy, which has changed the international context, to discuss what it means for trade and industrialization in the developing world. Section 6 analyses the role of the State in countries that are latecomers to industrialization. In particular, it attempts to redefine the role of the State *vis-à-vis* the market, with reference to the present conjuncture, when globalization has increased the degree of openness of economies but reduced the degrees of freedom for nation states.

2. ECONOMIC THEORY AND THE FREE TRADE DOCTRINE

It is necessary, as also appropriate, to begin by outlining the logic of the free trade doctrine, which has received so much emphasis in economic theory, and by explaining the rationale of departures from free trade, which have been central to the debate on trade and industrialization over the past two centuries.[1]

[1] For a detailed discussion, see Nayyar (1996a).

The analytical foundations of the orthodox theory of international trade, as it now exists, were laid in the era of classical political economy by Adam Smith, David Ricardo and John Stuart Mill. Smith(1776) enunciated the principle of absolute advantage to demonstrate that there were gains from trade, by extending his concept of the division of labour between men to a division of labour between countries. Ricardo (1812) formulated the theory of comparative advantage to develop an explicit argument against protection and an implicit argument for free trade. At the same time, Smith and Ricardo endeavoured to provide a rationale, as also to analyse the conditions, for a transition from the prevalent feudalism to a prospective capitalism. Thus, for Adam Smith, free trade was simply one dimension of the case for *laissez faire* which confirmed his belief in the magic of the invisible hand. Similarly, for David Ricardo, the formulation of comparative advantage was not simply about the pattern of trade or the gains from trade, as contemporary textbooks would have us believe. It was as much, if not more, about the impact of international trade on income distribution, capital accumulation and economic growth. The repeal of the Corn Laws and the adoption of free trade was advocated by Ricardo in the belief that it would redistribute incomes away from the reactionary landed gentry, who would at worst not save and at best invest in agriculture which promised diminishing returns, in favour of a progressive industrial capitalist class, who would earn more profits (given a lower corn wage) through cheap imports of wheat, and invest in manufacturing which promised increasing returns. The moral of the story was that, consequent upon the removal of restrictions on trade, an increase in profits would lead to an increase in the rate of accumulation which in turn would lead to a growth in employment, income and wealth.

Subsequent economic theorizing about international trade, beginning in the late nineteenth century, became much narrower in perspective.[2] The neoclassical paradigm, as it emerged, emphasized the gains from trade. The economic logic underlying the proposition was indeed simple. In the most elementary sense, there are gains to be derived from trade if it is cheaper for an economy to import a good than to produce it at home, in terms of domestic resources used, and pay for it by exporting another. The gains are attributable in part to international exchange when costs or prices differ among countries before trade is introduced, and in part to international specialization in production after trade commences. In a world

[2] This process started with Alfred Marshall and Francis Edgeworth in the late nineteenth century. It was taken to its logical conclusion by Eli Heckscher (1919), Bertil Ohlin (1933) and Paul Samuelson (1939) during the first half of the twentieth century.

where countries enter into international trade on a voluntary basis, each partner must derive some benefit to be in the game. The very existence of trade, then, becomes proof of its mutual benefit, irrespective of how the gains from trade are distributed between countries. Orthodox theory combined the economic logic of the gains from trade proposition with the assumption of perfect competition to establish that free trade will enable an economy to operate with technical efficiency in production, in terms of resource allocation, and to optimize consumption through trade, in terms of utility maximization. The neat conclusion derived from this theorizing is that free trade ensures efficiency for a country and for the world as a whole.

The belief in free trade is almost a sacred tenet in the world of orthodox economics. Yet, from time to time, the profession of economics has recognized that there are reasons—orthodox and unorthodox—which may justify departures from free trade.[3] Economic theory has analysed these exceptions to the rule, mostly in response to developments in the real world which have questioned the free trade doctrine.

In the era of classical political economy, even before the doctrine gained widespread acceptance, it was recognized that there are two critical assumptions underlying the strong prescription of free trade: first, that market prices reflect social costs and, second, that a country's trade in a good is not large enough to influence world prices. If these assumptions do not hold, free trade cannot ensure an efficient outcome. Market failure provides the basis of the infant industry argument, recognizing that free trade may prevent an economy from realizing its comparative advantage in manufacturing activities. Monopoly power provides the basis of the optimum tariff argument recognizing that restricting the volume of trade may enable an economy to increase its real income at the expense of the rest of the world. These arguments were accepted as valid exceptions to the rule by Mill (1848), thus providing the analytical foundation for legitimate departures from free trade. It must be recognized that this thinking was prompted largely by the concerns of late industrializers such as the United States and Germany who wished to follow in the footsteps of England and France.[4] It was also motivated by the pursuit of economic interests rather than economic efficiency on the part of nation states.

[3] The challenges to free trade are discussed, at some length, by Irwin (1991) and Bhagwati (1994). See also Nayyar (1996a).

[4] The origin of the infant industry argument is associated with Alexander Hamilton whose *Report on Manufactures* was published in the United States in 1791 and Friedrich List whose *Das Nationale System der Politischen Okonomie* was published in Germany in 1841.