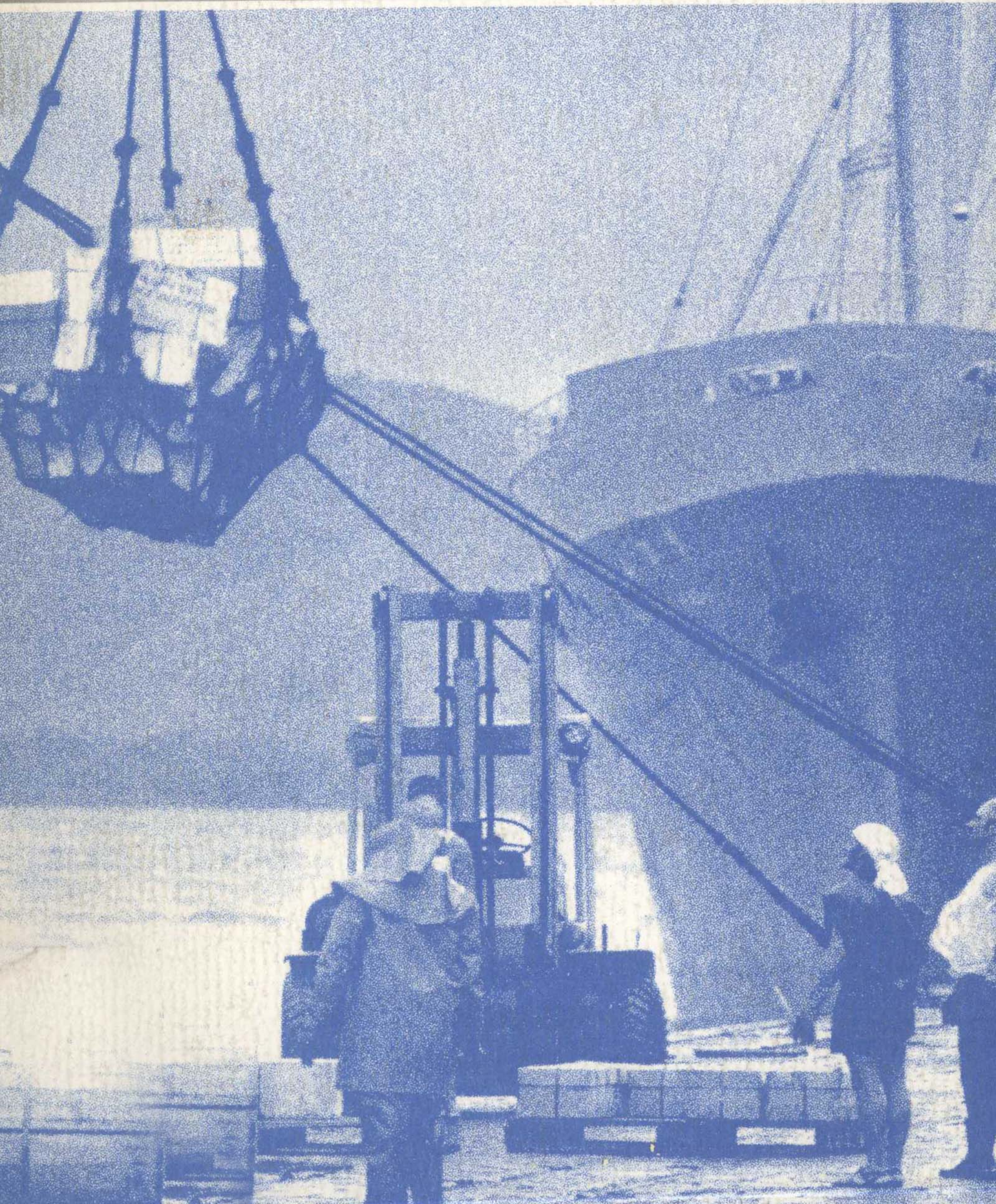
Trade and Employment Policies for Industrial Development



Trade and Employment Policies for Industrial Development

The World Bank

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SUMMARY

In the last decade, the developing countries have proved that they can compete internationally in exporting manufactured goods, as well as primary products and services. Their exports of manufactures grew by some 13 percent a year in real terms during the 1970s. Countries at all levels of development have participated in the explosion of trade, and those that have done so have grown more rapidly overall and survived the vicissitudes of the 1970s better than those that did not.

The most successful countries adopted outward-oriented strategies. Manufacturing for export, as well as for domestic consumption, encouraged efficient allocation of resources, permitted the exploitation of economies of scale, generated technological improvements in response to competition from abroad, and contributed to increased employment. Furthermore, the strong growth and balance-of-payments positions these countries attained by promoting exports enabled them to borrow abroad to supplement domestic savings.

It is now being suggested that there may be limits to the extent to which new exporters can benefit from outward-oriented strategies. Chapter 1 examines three sets of issues. The first is whether good export performance is attributable to special characteristics of the most successful countries or whether their success can be readily replicated in other countries. The evidence shows that, although four East Asian countries still account for nearly 50 percent of all exports of manufactures from developing countries, the balance comes from a rapidly growing group of countries that differ in size, resource endowment, geographical location, extent of industrialization, and other factors.

Entrepreneurship, organization, and hard work are not unique to East Asia. The key to good performance is to avoid

inappropriate policies that suppress these characteristics and to make full use of whatever comparative advantages a country possesses. The common elements in the strategies of developing countries that are successful industrial exporters are:

- maintenance of realistic foreign-exchange rates;
- provision of easy, duty-free access to imported inputs for exporters;
- competitive wage and labor policies;
- encouragement of foreign investment and other forms of cooperation with foreign companies;
- moderate and relatively uniform protection for domestic, import-substituting industries; and
- perceptive political leadership and constructive government intervention in the development process.

There are, of course, other important complementary factors required for industrial development, including easy access to foreign technology, favorable treatment of innovation, and adequate financial and physical infrastructure. But their presence does not appear to distinguish good export performers from the less successful.

The second issue is whether the penetration of the markets of industrial countries has reached, or will soon reach, a limit. These fears are shown to be greatly exaggerated. In 1980, products from developing countries accounted for less than 3.5 percent of consumption in the industrial countries. If their market penetration were to continue to rise in the 1980s at the rate it did in the 1970s, the developing countries' share would reach only about 5 percent. In clothing, textiles, and other industries with high market penetration, that share might rise to 15 percent. Even so, the production of these goods in the industrial countries would still increase at a projected average annual rate of 2 percent. Furthermore, several studies have shown that levels of employment in the industrial countries are positively affected by an expansion of trade between industrial and developing countries. Despite increasing protectionist pressures, the process of global liberalization of trade continued throughout the decade.

The third issue is whether trade in manufactures among the developing countries can expand further. This trade grew

more rapidly during the second half of the 1970s than did exports to industrial countries; in 1980, it represented about a third of the manufactured exports of the developing countries. Petroleum-exporting countries have been particularly important markets. Continued expansion can be expected as developing countries industrialize further. Outward-looking policies that stimulate trade in all directions hold out better prospects for expansion than do trade-diverting policies that take the form of economic integration schemes among developing countries alone. Such schemes have not generated sustained growth because of their biases against exports to countries outside the integrated group and the limited scale of the group's markets.

Outward-oriented strategies not only raise income but, equally important, provide more jobs. Korea, Malaysia, Mauritius, Singapore, and Thailand, for example, have followed such strategies. They have generated higher rates and levels of labor absorption in industry than have most other countries in their income groups. The effect of exports on employment has been high, in part because the products they exported were mostly labor-intensive: clothing, textiles, footwear, electronic components, and other light consumer goods. However, outward-oriented policies also have beneficial effects on the level of employment in industries catering primarily to the domestic market by raising the economywide rates of savings and investment.

Three areas of employment policy are examined in greater detail in Chapter 2. The first consists of policies affecting the relative prices of capital and labor. Countries that increased employment rapidly were able either to prevent undue wage/capital price distortions or to remove those that had occurred. Positive rates of "real" interest were established. Realistic exchange rates were generally maintained. Accelerated depreciation allowances were excluded from their investment incentive systems. Flexible labor policies encouraged wage negotiation at the enterprise level. Real wages rose in response to growth in productivity which was enhanced by an emphasis on training.

In regard to technology, several studies reveal considerable opportunity to vary proportions of capital to labor in a wide

range of industries and products. It is estimated that the general adoption of more appropriate technology, already in use in some factories, would significantly raise both the value added and the employment in manufacturing in developing countries.

Chapter 2 concludes with a discussion of the contribution of small enterprises to the creation of employment and the alleviation of poverty. Experience with small enterprises has been disappointing in many developing countries over the past fifteen years. This disappointment is attributed to two basic causes. Small firms are either left to their own devices and are unable to realize their full potential because markets are distorted or overregulated, or help is extended to them by governments in ways that are largely ineffective or that may even hinder their growth. Significantly, small-scale enterprises have flourished in those countries where governments have pursued consistent, relatively unbiased policies that allow markets to operate with considerable freedom. In such an environment, competing firms vie for markets on a more equal footing. Just as important, in this environment, firms in different fields form complementary, mutually beneficial relationships. Development programs focused specifically on small enterprises can then concentrate on strengthening and supplementing private-sector initiatives.

In sum, the body of empirical research on the economic "success stories" of the post-World War II era points, with remarkable unanimity, toward the efficacy of such policies in bringing about industrial growth and labor absorption. Although the role played by governments in this process has varied greatly from country to country, it has also been marked by common elements. Apart from adopting policies that provide adequate incentives for efficient performance, governments have assisted enterprises in exploiting the opportunities thus opened up, particularly in export markets. The research indicates that even the most fleet-footed and imaginative intervention by government is not a sufficient condition; a policy mix that gives appropriate signals and rewards is the indispensable base. The diversity of conditions in developing countries means, of course, that the policy mix must be adapted to individual circumstances, particularly in

the least industrialized countries. Nevertheless, the general policy orientation most likely to be useful in realizing the goals set by the developing countries for industrialization is clear.

CHAPTER 1. TRADE AND STRUCTURAL CHANGE

Proving their ability to compete in international markets, the developing countries boosted their sales of manufactures to the industrial countries and to other developing countries during the 1970s at an average of 13 percent a year in real terms (see Table 1). Countries that participated in this trade boom came from all levels of development and enjoyed more rapid growth than those that did not participate.

Table 1. Exports of Manufactures from Developing Countries

	All developing countries	Low-income developing countries	Middle-income developing countries
Value of exports, 1980 (1978 US$ billion)	97.4	6.0	91.4
Annual growth of exports, 1970-80 (%)	12.9	6.9	13.4
Destination, 1977 (%)	n.a.	100.0	100.0
Industrial countries	n.a.	51.0	58.0
Developing countries	n.a.	27.0	30.0
Centrally planned economies	n.a.	12.0	6.0
Capital-surplus oil exporters	n.a.	10.0	6.0

Note: n.a. = not available
Source: *World Development Report 1981* (New York: Oxford University Press, 1981).

Though some of the successful countries tried to develop domestic production to replace imports at early stages of industrialization, they quickly moved away from an import-

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substitution policy toward what is often called an outward orientation. The policies of the successful countries have been generally supportive of industrialization and commerce but have avoided directing that support toward any particular sector. Decisions about the activities and processes that could be built up profitably have been left to individual firms, which succeed or fail as their decisions prove to be correct or incorrect.

What Are the Advantages?

Outward-looking strategies have been shown to raise income. Major studies undertaken by the Organisation for Economic Co-operation and Development (OECD) and the National Bureau of Economic Research in the early 1970s analyzed the foreign-trade regimes of twenty countries in the post-World War II period and revealed the superior performance of those that encouraged exports compared with those that were biased toward import-substitution.[1] A subsequent World Bank study contrasted the experience of ten developing countries. It estimated that the 1966-73 increase in per capita incomes in Chile, India, and Mexico, for example—which all favored inward-looking policies—would have been 21 percent, 22 percent, and 17 percent higher, respectively, if those countries had reached the average export growth of the sample. In contrast, per capita income in Korea—which took an outward orientation—would have been 43 percent lower than it actually was if Korea's exports had only matched the average for the same sample.[2] Later research has found similar relationships between exports and growth of gross domestic product (GDP) in a larger group of countries.[3] The most recent

[1]See Jagdish N. Bhagwati and T. N. Srinivasan, "Trade Policy and Development" in Rudigar Dornbusch and Jacob A. Frenkel, eds., *International Economic Policy: Theory and Evidence* (Baltimore and London: The Johns Hopkins University Press, 1978).

[2]See Bela Balassa, "Exports and Economic Growth: Further Evidence," *Journal of Development Economics*, vol. 5 (1978), pp. 181-89.

[3]See Michael Michaely, "Exports and Growth: An Empirical Investigation," *Journal of Development Economics*, vol. 4 (1977), pp. 49- 54; Anne O. Krueger, *Foreign Trade Regimes and Economic Development* (Cambridge, Mass.: Ballinger, 1978); and William G. Tyler, "Growth and Export Expansion in Developing Countries: Some Empirical Evidence," *Journal of Development Economics*, vol. 9 (August 1981), pp. 121-30.

study examined the performance of fifty-five developing countries between 1960 and 1977. It found a significant positive relationship between the growth of manufactured exports and economic growth.[4]

Manufacturing for export as well as for domestic consumption encourages efficient allocation of resources, permits the exploitation of economies of scale, generates technological improvements in response to competition abroad, and, in labor-surplus countries, contributes to increased employment. Furthermore, the strong growth and balance-of-payments positions that countries can attain by promoting exports enable them to borrow abroad to supplement domestic savings. By contrast, once the "easy" stage of import substitution is completed (for products in which local producers have advantages over foreign producers in the domestic market), substituting domestic production for imports entails rising costs because of the loss of economies of scale in small national markets. In short, trade has proved a more effective instrument for promoting efficient structural change than has economic autarky.

It is now being argued that there are limits to the extent to which new exporters can benefit from outward-oriented strategies. There are three sets of issues, which will be examined here. The first is whether good export performance is attributable to special characteristics of the most successful countries or whether their success can be readily replicated in other countries. The second is whether the penetration of the markets of industrial countries has reached or will soon reach a limit. The third is whether trade in manufactures among the developing countries can continue to expand.

Replicability of Successful Performance

Initially, a large percentage of manufactured exports from developing countries came from a handful of countries. The principal East Asian exporters still account for nearly 50

[4]Pearson and Spearman rank correlation coefficients of 0.55 and 0.50, respectively, were reported for the non-OPEC developing countries covered. See Tyler, "Growth and Export Expansion."

percent of all exports of manufactures.[5] This creates the impression that the characteristics of these countries—relatively resource-poor economies with energetic entrepreneurs and a disciplined, hard-working labor force and with special ties to the main importing countries—are the main factors behind their export performance. But the suppliers of the balance of manufactured exports include a wide range of countries. The number of developing countries that realized more than $500 million in exports of manufactures (in constant 1975 U.S. dollars) rose from seven in 1965 to fifteen in 1975. Those with exports exceeding $50 million went up from twenty-seven in 1975 to fifty-eight in 1978.[6]

These countries differ in size, resource endowment, geographical location, extent of industrialization, and other factors. After examining the characteristics of twenty-eight countries that achieved an average annual growth of manufactured exports of between 8 percent and 36 percent from 1965 to 1975, a World Bank study grouped the countries into four broad categories:[7]

1. Countries that specialized relatively early in export of manufactures and have followed generally outward-looking policies. This group includes Hong Kong, Singapore, Korea, Israel, Portugal, and Greece. They are all characterized by limited natural resources, relatively educated labor, and the need to export manufactures (or services) in order to develop.

[5]See Donald B. Keesing, "World Trade and Output of Manufactures: Structural Trends and Developing Countries' Exports," World Bank Staff Working Paper No. 316 (Washington, D.C.: World Bank, January 1979). It has been pointed out that this figure overstates the export share of these countries as it includes considerable reexports.

[6]See Hollis B. Chenery and Donald B. Keesing, "The Changing Composition of Developing Country Exports," World Bank Staff Working Paper No. 314 (Washington, D.C.: World Bank, January 1979); and *World Development Report 1981* (New York: Oxford University Press, 1981), table 12. This list includes twelve countries in the low-income group and eleven from Africa. It should also be noted that although the most successful exporters are mainly middle-income countries, some began their export drive at low income levels and with few natural resources. Per capita income in Korea, for example, was well below the average for Africa in 1950 and was only 41 percent of the level in Ghana in that year. See David Morawetz, *Twenty-five Years of Economic Development, 1950 to 1975* (Baltimore and London: The Johns Hopkins University Press, 1977).

[7]See Chenery and Keesing, "Changing Composition of Exports."

With local variations, their exports initially were built around labor-intensive, technologically stable products, such as textiles, clothing, footwear, assembled electronic components, and toys. In recent years they have begun to diversify their exports into more sophisticated, skill-intensive products, such as ships.

2. Large semi-industrial countries that have achieved considerable success in industrialization based mainly upon the home market, and in recent years have also tried to promote exports of manufactures. Among those on this list are Brazil, Mexico, and Turkey. Most of these countries began to expand manufactured exports as a remedy for shortages of foreign exchange. These countries have managed to develop export markets for their capital goods, chemicals, and other intermediate goods for which their domestic markets, augmented by exports, provided sufficient economies of scale.

3. Countries now shifting away from specialization in primary exports to diversify their exports and accelerate development. Such countries include Malaysia, Colombia, Ivory Coast, Morocco, Tunisia, the Philippines, and Thailand. The optimal timing of such a shift into manufactured exports depends in part on the prospects of (and effects on) primary exports. It has proved difficult for resource-rich countries, whose current exchange rates are based on specialization, to accomplish this shift through the market. Conversely, countries in this group that still have relatively low wage levels (for example, Thailand) find this shift easier.

4. Large poor countries that have achieved a significant volume of manufactured exports. All countries in this group had income levels below $300 per capita in 1975; examples include Egypt and Pakistan. This is a heterogeneous group with a diverse industrial background and structure.

It is clear from the export success of this wide variety of countries that entrepreneurship, organization, and hard work are not unique to East Asia. The key to good performance is to avoid adopting inappropriate policies that suppress these characteristics and to make full use of whatever comparative advantages a country possesses. But which policies work best?

The diversity of national endowments and situations means that a single policy prescription would not be useful. Each

country is unique, and policies should be adapted to the particular circumstances of each. Nevertheless, it would be equally wrong to imply that no general lessons can be drawn from past experiences. There are some common elements in the strategies of developing countries that have been most successful in promoting industrial exports.[8]

Realistic Foreign Exchange Rates

Exchange-rate policy plays a crucial role. The extent to which exports of all kinds are promoted depends above all on the relationship between the exchange rate effectively applied to exports and domestic prices and costs. If, in real terms, people are well rewarded for producing exports, they will be encouraged to produce more; if not, they will turn their attention in other directions. The exchange rate also determines the rewards for saving foreign exchange by producing goods or services that will compete with imports. Import substitution is rewarded when the real rate of exchange is shifted so that imports are made more expensive. Local production is discouraged when imports are made cheap.

It is not easy to determine the optimal exchange rate. A resource-rich economy may build up a strong balance-of-payments position by exporting a simple primary (nonrenewable) commodity. This may make importing too easy, in effect, and block the development of a wide range of activities, notably in manufacturing, that compete with imports and have the potential to promote exports. Here the key seems to be to tax the main exports, while sustaining a unified exchange rate that is favorable to export production and import substitution in other sectors.

It is also recognized that an equilibrium exchange rate cannot be defined without roughly specifying how fast the economy is to grow. More inputs, including foreign exchange, are required to make an economy grow faster. Crucial growth-related activities, such as capital investment and tech-

[8]The following section draws upon John Cody, Helen Hughes, and David Wall, eds., *Policies for Industrial Progress in Developing Countries* (New York: Oxford University Press, 1980); and Donald Keesing, "Trade Policy for Developing Countries," World Bank Staff Working Paper No. 353 (Washington, D.C.: World Bank, August 1979).

nology transfer, use foreign exchange intensively, and much learning-by-doing in industry depends on imported inputs. Furthermore, foreign exchange plays a special role in overcoming shortages, not only in energy, food, or construction, but also in skilled manpower and technical know-how. In order to earn enough foreign exchange for these purposes, a rapidly growing economy needs to maintain its exchange rate at a level that makes its products and services competitive in foreign markets.

There are limits, of course, to the extent to which economic growth can be stimulated by adjustments to the exchange rate. Devaluation or other exchange policies will have the desired effects when there are underutilized factors of production—underemployed labor, idle capital equipment, and so forth—that can be brought into the production of tradable goods. Otherwise devaluation may lead to inflation, which will negate its initially favorable effect on the balance of payments. Inflation is especially likely if wages rise to compensate for the higher domestic prices of tradables. Experience has shown that exchange-rate policies cannot be used in isolation. They must be combined with other tools of economic management.

Easy, Duty-free Access to Imported Inputs

Exporters will not be able to survive in a competitive world market if they are forced to depend for their inputs on suppliers that are isolated from such competition. In what are called the footloose export industries, such as clothing or electronics, nearly all exports from developing countries come from those countries where imported inputs are given what amounts to a free-trade regime.

Because these exports generally involve modest capital requirements, low labor costs, and low profit margins, the bulk of the cost of the final product (60 percent to 70 percent at world prices) goes for raw materials and intermediate inputs. Any significant tax on these inputs, or even unusually high transport and handling costs, can knock a country out of the running in export markets. Quality defects in raw materials or parts are equally fatal.

In several countries, export processing zones have proved to be a useful means of avoiding the bureaucratic entangle-

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