

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

TRADE AND DEVELOPMENT REPORT, 1996

Table of Contents and Overview

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OVERVIEW

Global trends

The economic recovery that began in 1993 after one of the deepest recessions in the postwar era continued throughout 1995. However, as foreseen in *TDR 1995*, the growth of world output for the year as a whole (2.4 per cent) was smaller than in the previous year (2.8 per cent). The recovery has been much weaker than after earlier recessions and output is below potential levels. Indeed, growth in both 1994 and 1995 disappointed the official expectations that the world economy was entering a new era of sustained market-driven growth in excess of 3 per cent which would allow unemployment in the North to be lowered and average per capita income in the South raised. Prospects for 1996 are for a continuation of this slower growth, with more rapid expansion in some regions and feeble growth in others.

The outlook for developing countries is once again brighter than for the developed world. Overall, expansion in the South continues to outpace that of the North, but rapid growth is highly concentrated in a small number of southern countries. Asia will again be the most rapidly expanding region, and China will continue to be one of the fastest-growing economies, although at a rate below the levels of previous years. Africa will outperform Latin America for the second consecutive year, and with growth exceeding 3 per cent may even succeed, for the first time in many years, in raising per capita incomes. In Latin America, on the other hand, the modest overall increase in the growth rate (to less than 2.5 per cent) will not result in any significant increase in per capita incomes. In the transition economies of Central and Eastern Europe 1996 may well be a turning point. Growth was robust in Central Europe, and the decline in output in the countries members of CIS has slowed.

Growth in *Africa* in 1995 was favoured by an improvement in many commodity prices, which accounted for much of the 10 per cent increase in export earnings, double that of 1994 and unprecedented for many years. But private capital inflows, including FDI, continued to fall. Although growth was broadly based throughout the region, some countries succeeded in achieving rates of over 5 per cent, while in others conditions continued to deteriorate, often due to political unrest and armed conflict. Moreover, drought was responsible for output declines in the Sahel countries and some other areas. Prospects for the region remain uncertain, and even under optimistic assumptions levels of wellbeing reached in the past will not be quickly restored: those countries that performed well in 1995-1996 will need to sustain their high rates of growth for more than a decade in order to bring real per capita incomes back to their levels of 20 years ago.

While the impact of the Mexican crisis of December 1994 on international financial markets was contained thanks to an international rescue operation, its effects on growth in *Latin America* were more severe than had been originally expected. The growth rate for the region fell from almost 5 per cent in 1994 to less than 1 per cent in 1995 as net capital inflows dried up. For the region as a whole, a trade

surplus and a net negative transfer reminiscent of the debt crisis of the 1980s reappeared. In the two economies most directly affected, Argentina and Mexico, swift external adjustments were made, but at considerable cost to economic growth, which fell sharply in 1995. Brazil (which ran a trade deficit for the first time in many years) and some other countries chose to slow down the economy rather than rely on capital inflows to finance mounting external deficits or resort to devaluation and risk reigniting inflation. The crisis has also laid bare the fragility of fiscal balances and the financial system in a number of countries. Few managed to avoid its adverse consequences. Chile, however, has continued to sustain, for the twelfth consecutive year, an annual growth rate matching that of East Asia, while maintaining budget and trade surpluses and keeping inflation to single-digit levels.

The fundamental question of how to maintain both price stability and a sustainable payments position, while achieving steady growth high enough to reduce poverty and catch up with more advanced countries, remains a challenge in much of the region. Until the Mexican crisis, capital flows appeared to provide a temporary solution, by enabling domestic investment to diverge from domestic savings and allowing time for the completion of structural reforms so as to close the savings gap. Prices were kept stable through use of the exchange rate instrument and trade liberalization, while capital inflows were more than sufficient to close the mounting external deficits associated with growth and currency appreciations. There is now much greater recognition, even in countries where there is once more a substantial net capital inflow, that this is not a viable solution in the long run. Consequently, external imbalances are being contained, but to bring deficits to sustainable levels and preserve price stability growth has been sacrificed for the time being. Maintaining stability depends on resuming growth, which in turn means raising domestic savings and investment and increasing export competitiveness. The Asian experience discussed in Part Two of this Report holds some useful lessons in these respects.

Most *Asian developing countries*, including those in South Asia, continued to grow rapidly in 1995. Despite measures to cool the economy, expansion in China exceeded 10 per cent, and there was none the less a large trade surplus. In most other East and South Asian countries, however, fast growth was associated with a widening current account deficit and a moderate acceleration of inflation. The balance of payments has been a matter of concern, particularly in some South-East Asian countries, where debt servicing and profit remittances associated with FDI came on top of trade deficits which had been widening as a result of a slowdown in exports. The payments gap was financed by continued inflows of FDI and liquid funds attracted by relatively high domestic interest rates.

A virtuous circle, involving trade and investment, has continued to underpin rapid industrialization and growth in East Asia, the region which has continued to provide the most dynamic impetus to world trade. The share of Asian developing countries in world trade now exceeds that of either the United States, the European Union or Japan. The trade of the United States, as of the European Union and of Japan, with the Asian developing countries is greater than trade among those developed countries themselves. Trade among Asian developing countries is also growing much faster than trade among developed countries, which is one of the major reasons why world trade has risen faster than world output.

Growth experiences in *Central and Eastern Europe* in 1995 were varied. In Central Europe recovery is now well under way. Output rose on average by 5.3 per cent in 1995 and inflation has been brought down in most countries. However, even though exports rose rapidly, external deficits widened considerably, financed by massive inflows of capital. Following extensive trade liberalization, industry has apparently been unable so far to generate sufficient export earnings to finance the surge in imports associated with accelerated growth. In some respects, these countries face difficulties similar to those faced by many Latin American economies.

In the rest of Central and Eastern Europe, comprising mainly the CIS members, output continued to decline in 1995, but at a slower pace. In the Russian Federation, some progress was made in economic stabilization, supported by a sizeable standby loan from IMF, and there was also a large increase in the current account surplus. Although there is some evidence that the declines in output in these countries may be bottoming out, the outlook is still uncertain.

The current recovery in the developed world has been slower than during the previous two cyclical expansions, with growth falling from 2.8 per cent in 1994 to 2.0 per cent in 1995. The deflationary gap has consequently widened further and unemployment has risen by almost one third since the beginning of the decade, reaching a level (some 34 million in mid-1996) reminiscent of the interwar years. Even for the employed, real earnings have not been rising for several years. No real improvement is in sight for 1996, when growth in these countries is expected to fall on average to below 2 per cent.

The United States continues to enjoy its third longest cycle of postwar expansion, although the economy slowed down considerably in 1995, with growth falling to 2.0 per cent from 3.5 per cent in 1994. This overall performance is markedly better than that of Japan, which has been confronted with the challenge of adjustment to shifts in international competitiveness while still suffering from debt deflation. It is also better than that of the European Union, where measures taken to restore fiscal balance and reduce public debt so as to attain greater macroeconomic stability and also to meet the conditions for monetary union, have been an important restraint on growth.

As discussed extensively in past issues of *TDR*, in recent years the Japanese economy has encountered a number of serious difficulties caused by, *inter alia*, currency appreciations, heightened foreign competition, external pressures to reduce the trade surplus and debt deflation. The trade surplus has been diminishing rapidly as a result of a slowdown in exports and a surge in imports, partly reflecting the relocation of production abroad to low-cost countries. While this contributed much to the dynamism of trade and investment in East Asia as part of the “flying geese” process (described in Part Two of this Report), and more generally to growth and industrialization in the developing countries of the region, it has been at the cost of domestic investment, production and exports. The challenge for Japan is how to make the structural adjustment required to avoid further rises in unemployment while shifting from the present dependence on external demand to dependence on demand from the home market as its economy matures. Success will require switching from investment in manufacturing to investment in infrastructure and technology-intensive services, and allowing wages to rise relative to profits so as to stimulate consumption. Recently the Government has taken measures in this direction by introducing a major new fiscal package.

Fiscal stances in other developed economies have been contractionary. In the United States current plans will lead to the elimination of the budget deficit by the year 2002. In Western Europe, fiscal retrenchment has put downward pressure on employment and growth. Low growth itself has enlarged cyclical budget deficits, but these are not allowed to act as automatic stabilizers. Instead, expenditure cuts are being made in order to meet the convergence conditions for the third stage of monetary union. Consequently, recourse to monetary policy will be necessary to offset the effects on aggregate demand of these budgetary reductions and ensure that monetary union is not at the cost of low or zero growth.

In recent years, monetary policy in the major industrial countries has generally paid relatively little attention either to unemployment, except when it was falling, or to growth, except when it was accelerating. Such an approach was perhaps initially justified, in view of the then prevailing rate of inflation, but price stability has now become the norm and inflation has settled at its lowest level for over 30 years. None the less, the tendency to dampen upturns quickly while leaving downturns to work themselves out has continued.

The experience of the United States in the past two years illustrates the difficulties that have emerged in balancing considerations of inflation and growth. Monetary policy was tightened in early 1994 in order to pre-empt the inflation that was feared in view of tight labour market conditions. But unemployment subsequently fell by at least 1 percentage point, to below the level then considered compatible with stable inflation, and over 3 million jobs were created. Still, inflation has remained subdued as unit labour costs were kept down. This experience suggests that the rate of unemployment compatible with price stability may be well below that generally assumed by monetary authorities.

At about 11.5 per cent, current unemployment in Europe is certainly far above the rate that could be safely considered compatible with stable inflation. With inflation under 2 per cent in both Germany and France, there is scope to lower interest rates.

Financial markets are often said to limit monetary expansion. However, monetary policy itself exerts a major influence on the behaviour of these markets. Bond prices tend to fall when employment prospects improve, not so much because markets themselves anticipate inflationary pressures as because they believe that the monetary authorities will do so and hence push up interest rates. Because of the greater integration of financial markets, rising interest rates in expanding economies tend to be transmitted even to countries that lag behind, making it very difficult for them to initiate recovery, as has already twice been the case in the 1990s.

The risk of deflation is real if monetary policy continues to focus on combating inflation while attempts are made to improve fiscal balances. Without sufficient growth the adjustment to shifts in dynamic competitive forces associated with greater integration of markets and rapidly changing technology is much more difficult, and thereby also the pursuit of the process of globalization and the freeing of trade and payments.

External financing and debt

There continue to be great disparities in the experience of developing countries and transition economies regarding the availability of external financing from the international capital markets. A minority of countries raise significant sums in the forms of equity and various types of debt from this source, while the remainder - the great majority - continue to depend more heavily on official financing, including export credits.

For the major recipients of funds from the international capital markets 1995 was marked by the sequel to the Mexican financial crisis at the beginning of the year. But, even for Latin American countries, the consequences of the crisis for bank loans and issues of debt instruments were short-lived. Financing for Argentina and Brazil began to revive as early as the second quarter, while Mexico re-entered the international securities markets in the second half of the year. The crisis had more lasting effects in the markets for internationally issued equities of developing countries of all regions. After their recent expansion, such issues remained at a level similar to 1995. However, internationally issued equities by developing countries are increasingly dwarfed by institutional investors' direct purchases of domestically issued equities in emerging financial markets.

In recent months some countries experienced surges in capital inflows which, as earlier in the 1990s, have posed problems for macroeconomic policy. The countries affected were not only from Asia and Latin America but also, for the first time, from Central Europe.

Economies without access to international financial markets continued to fare less well in 1995. International bank lending to Africa contracted again. Moreover, the revival of export credits during 1994 was not sustained into 1995. For the majority of developing countries and transition economies the official insurance cover associated with export credits continues to be available only on restrictive conditions or remains completely unavailable. These limitations not only lead to higher transaction costs in trade but also indicate low creditworthiness for the countries concerned.

Recent episodes of international financial instability such as the disruption of the EU Exchange Rate Mechanism and the Mexican crisis have led to widespread reconsideration of appropriate policies for fostering more orderly financial markets and handling crises due to volatile capital movements.

One school of thought believes that convergence of macroeconomic policies, particularly as regards inflation, interest rates and fiscal deficits, would by and large suffice to produce stability. However, seeking to attain particular targets for such variables would generally be regarded as too deflationary by some countries and too inflationary by others. Moreover, the concepts underlying advocacy of policy convergence, which link the determination of exchange rates to such economic fundamentals, have only a tenuous connection to indicators widely used to guide the day-to-day decisions of traders in the currency markets.

Ideas put forward in this context have also included international lender-of-last-resort facilities and steps other than policy convergence for reducing international financial instability. So far, initiatives in IMF have addressed an expansion of financing under the General Arrangements to Borrow and improvements in available information regarding countries borrowing from international financial markets. International debate has also focused on monetary union, better arrangements for handling countries' debt problems as they emerge (to prevent their becoming full-blown financial crises), improved prudential supervision of banks and securities firms, tax and tax-like measures to restrain currency speculation, and new methods of official intervention in foreign-exchange markets. Progress has been made on some of these fronts, but proposals such as a tax on currency transactions or on profits from currency trading would require the solution of difficult technical problems and the attainment of international consensus. The difficulties associated with various proposed measures none the less need to be seen in conjunction with the likely costs of failing to deal adequately with present policy lacunae: continuing recurrences of international financial instability can be prejudicial to orderly trading relations and, more generally, to coherence in global economic policy making.

* * *

The debt situation of many heavily indebted poor countries (HIPCs) - the majority of which are LDCs - continues to be extremely difficult. Concern over their plight has led to substantial cancellation of ODA debts by some donors and increasingly concessional rescheduling by Paris Club creditors. However, studies on the impact of the Naples terms, which were adopted in December 1994, indicate that for a significant number of countries the debt situation would remain unsustainable even with the full implementation of those terms, mainly on account of the sheer burden of their multilateral debt as well as of non-Paris Club bilateral debt. Progress toward a solution concerning non-Paris Club bilateral debt is advancing only slowly and still lacks a coherent framework. Debt owed to multilateral financial institutions (MFIs) now accounts for an important and rising portion of total indebtedness and an even larger share of total debt service in HIPCs. While MFIs have adopted schemes to alleviate the debt burden of poor countries, their scope has been limited, given the severity of the problem, and pressure has been growing for these institutions to take stronger action.

The solution to the debt problems of HIPCs requires bolder measures. For these countries, approaches involving only part of the total debt have clearly not worked satisfactorily. An effective debt strategy needs to be comprehensive, covering all components of debt, and should involve equitable burden sharing among all creditors. The framework for action to resolve the debt problems of HIPCs, which was recently proposed by IMF and the World Bank, constitutes the first official recognition of the need for a comprehensive debt strategy and represents a commitment to act decisively to ease the burden of multilateral debt. It offers hope for debt-distressed LDCs as well as other poor countries with proven track records of economic reform and structural adjustment to attain debt sustainability.

The endorsement of the framework by both the Development Committee and the Interim Committee at their spring 1996 meetings, as well as by the G-7 during the Lyons Summit, augurs well for the

success of this initiative. Appropriate flexibility in the application of certain conditions determining country eligibility, as well as in the timing of enhanced multilateral action, would contribute to ensuring a lasting and rapid solution to the debt crisis. The differences that have arisen concerning the contributions to be made by various creditors also need to be ironed out, so as to arrive at an equitable burden-sharing arrangement that is acceptable to all. Of vital importance in this respect is the extent of enhanced relief to be extended by Paris Club creditors. The assessment of contributions from all creditors should be based on additionality of resources, so as to prevent diversion of scarce development funds for debt relief. For MFIs, any proposal regarding the use of their resources must ensure that the financial integrity of the institutions is preserved and that their credit rating is unharmed. Among proposals put forward which would meet these criteria are the sale of a portion of IMF gold stock and the use of part of the reserves of the World Bank. It will be important to define clearly the modalities of the various contributions to be made, taking into account the difficulties that some MFIs might experience in meeting their financial contributions, and how coordination among all the parties concerned could best take place. The severity of the situation faced by a number of HIPC, in particular the LDCs, calls for additional efforts from all concerned. For eligible debtors, continued strong commitment to reform would be required, not only to safeguard against moral hazard but also, and above all, to enable them to create the right conditions for sustained growth, thus ensuring the successful resolution of the debt crisis. It is urgent to formulate a workable plan of action for decision at the Annual Meetings of IMF and the World Bank in October 1996.

Export-oriented growth and industrialization in East Asia

The past three decades have witnessed an unprecedented pace of growth and industrialization in a small group of East Asian countries, comprising the Republic of Korea, Taiwan Province of China, Hong Kong and Singapore. Per capita income in these first-tier newly industrializing economies (NIEs) rose at an average rate of almost 7 per cent per annum during that period. A second tier of NIEs has now emerged (Indonesia, Malaysia and Thailand) for which average annual growth in the past decade has been 6 per cent. A third tier is now emerging, including notably China, where high growth rates have been sustained over a number of years.

A common feature of all these economies has been a strong growth of exports of manufactures. Indeed, trade has been an integral part of the industrialization process. East Asian experience holds useful lessons in three areas. First, it points to the need for, and the ways and means of, establishing a dynamic interaction between exports and investment in the industrialization process. Second, it shows how it is possible to mobilize and make full use of natural resource endowments and abundant unskilled labour. Third, it demonstrates the need for industrial upgrading and moving up the technological ladder in order to raise productivity and per capita incomes and shows how this can be done.

The experience of the first-tier NIEs is relevant in all three respects, though less so with respect to natural resources in view of their poor endowments. That of the second-tier NIEs is relevant with respect to the first two, and in particular has important lessons for LDCs that are rich in natural resources. The second-tier NIEs, which have not yet completely acquired the skills and technology needed to move to a more advanced stage of industrialization, can also learn from the experience of the first tier in upgrading. Moreover, the diversity of experience in East Asia demonstrates the range of options available to other developing countries in pursuing outward-oriented strategies.

Although some interpretations of this East Asian experience have highlighted the benefits of rapid liberalization of foreign trade and finance and deregulation of domestic markets, to the detriment of the role of the State, the reality is much more complex. As discussed extensively in *TDR 1994*, in most countries the State provided a necessary complement to, and sometimes corrective influence on, the market, particularly by promoting a rapid pace of capital accumulation and technological progress that was linked to exports.

No doubt competition in foreign markets has exerted an important discipline over enterprises, thereby promoting efficiency. However, the principal rationale for the strategy of export-oriented industrialization that these countries pursued has been different. Initially they had no significant capital goods sector and produced mainly consumer goods. Exports, together with some limitation of imports of consumer goods, allowed domestic industry to expand without a corresponding growth in domestic consumption, thereby helping to raise domestic savings. They also provided the foreign exchange needed for capital goods imports and access to advanced foreign technology as part of the strategy of catching up based on imitating technology leaders.

While success in raising savings and investment depended crucially on export growth, export expansion in turn required new investment. Thus, rapid growth required mutually reinforcing dynamic interactions among savings, investment and exports. That all the East Asian NIEs have been successful in bringing about such a growth nexus is evidenced by their sustained and rapid increases in savings and investment and in exports, in both absolute and relative terms.

But successful export orientation in East Asia has not been confined to the macroeconomic level. It has been accompanied by structural changes, from resource-based to labour-intensive, and subsequently to technology-intensive, production and exports, and by increased penetration of northern markets, particularly the fastest-growing ones. Not only have the East Asian NIEs succeeded in expanding their manufacturing exports to the North much faster than other developing countries, but also they have experienced a much smaller decline in their manufacturing terms of trade than Latin America and the LDCs.

The first-tier NIEs quickly moved out of resource-based production and exports and into low-skill-intensive manufactures, employing active investment and export promotion policies, whereas the second-tier NIEs relied much longer and more heavily on exports of primary commodities. However, in the latter countries, too, export expansion has gone hand-in-hand with the growth of savings and investment. Consequently, they have been much more successful than other resource-rich developing countries in diversification and processing in the primary sector. From almost complete dependence on raw material exports in the mid-1960s, they have reached a position where such exports account for only one third of total export earnings, compared with closer to two thirds in Latin America.

The development of labour-intensive manufacturing was very rapid in the first-tier NIEs. By contrast, in part due to their greater natural resource endowment, the shift to manufacturing has been slower in the second tier. From an early date, the first-tier NIEs also started building technology- and scale-intensive industries, in anticipation of the difficulties they would encounter in competing in international markets for labour-intensive products because of increases in domestic wages and/or the emergence of low-cost producers in other countries. Thus, rather than seeking to maintain competitiveness by keeping down wage costs, they chose to upgrade rapidly as a way of raising productivity, exports and incomes.

The challenge for policy was considerably stronger as production became more scale- and technology-intensive and the investment climate more uncertain, necessitating new forms of intervention to support infant industries, including subsidies and protection from foreign competition, industrial and technology policies, and measures to accelerate investment in both human and physical capital. Simultaneously, support for older-established industries was withdrawn as they matured and became competitive in world markets, earning the foreign exchange necessary to build the next generation of infant

industries. Import substitution and export promotion were thus integral parts of a comprehensive long-term strategy of industrialization.

First-tier NIEs have also succeeded in combining industrial upgrading with market dynamics by penetrating the fastest-growing OECD markets. Although in the early 1960s they were no better placed than other developing countries in respect of producing goods that were to prove to be the most dynamic in international trade, by the early 1990s high-skill, high-technology goods accounted for well over half of total export earnings in the Republic of Korea, Taiwan Province of China and Singapore, which was over twice the proportion for most other major exporters of manufactures.

Although infant industry programmes in larger first-tier NIEs have concentrated on building domestic capital and intermediate goods industries, it would not have been possible for them to gain access to the requisite technology without establishing close links with foreign firms, which have taken a variety of forms. In most cases a selective approach to FDI complemented efforts to strengthen domestic capabilities. In Singapore a more open-door policy toward FDI has been followed, using various incentives to guide investment to higher-level activities. Hong Kong stands out as an economy attracting FDI within a more *laissez faire* policy framework. It has also been less successful in upgrading its industrial base. While its unique location compensates for these deficiencies, enabling it to go on to the stage of providing a wide range of modern services, its very uniqueness makes it doubtful whether Hong Kong is a model for most other developing countries.

The second-tier NIEs appear to have moved into technology-intensive products rather more rapidly and with heavier reliance on FDI. Exports of such products, however, have a considerably larger import content than those of the first-tier NIEs, and consequently a much lower domestic value added content. This evolution of industrial output and exports in the second-tier NIEs is currently raising concerns over insufficient technological and supply linkages between TNC-dominated export sectors and the rest of the economy. Appropriate policies to fill this industrial hiatus need to be found. In this respect, the second-tier NIEs, like many other middle-income developing countries, have much to learn from the experience of the first-tier ones.

Large current account deficits that are of more immediate concern in the second-tier countries are related to the same phenomenon. Dependence on extensive reinvestment of profits of TNCs when there are large external deficits is a potential threat to payments stability; without upgrading and strong linkages with domestic suppliers so as to raise the domestic value added content of exports in industries dominated by foreign firms, FDI will tend to remain footloose. In consequence, the economy will be highly vulnerable to interruptions in the reinvestment of TNC profits, as competition increases from low-cost locations elsewhere.

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The fact that so many rapidly growing economies are concentrated in East Asia gives strong grounds for suggesting a regional dynamic may be at work. This dynamic is associated with a regional pattern of industrialization which has not only proceeded in waves, but also involved a constantly shifting regional division of labour whereby the upgrading of economic activity from resource-based and labour-intensive industries to increasingly sophisticated manufactures by the lead economies has opened up opportunities for less developed countries to participate in the regional division of labour. This “flying geese” pattern of industrialization has involved both regional trade and regional investment as vehicles for transferring new goods and technology among countries. Indeed, close to one third of total exports to countries in developing East Asia originate from elsewhere in the region, and the figure is closer to one half if Japan is included. Similarly, over half of the stock of FDI in four ASEAN countries originated from elsewhere in East Asia, and the proportion is much higher for China.

Regional dynamics were less important for industrialization in the first-tier NIEs than in the second tier. Japan did not constitute an important market for the labour-intensive products of these countries in their earlier stages of development, largely because it had not yet phased out many of its labour-intensive industries. Nor did it play an important role in the industrialization of these countries, partly because it was not at that time a major international investor in manufacturing, and partly because of the policy choices of the first-tier NIEs themselves.

The mid-1980s were a turning point in the strengthening of regional dynamics, with Japan playing an increasing role, both in trade and FDI, vis-à-vis the second-tier NIEs. Japan's emergence as a major international investor was initially reflected in a large increase in flows to the first-tier NIEs, but attention quickly switched to the second tier in the late 1980s, and to China in the early 1990s. Export promotion measures, including a more liberal approach to hosting FDI in the second tier, coincided with strong wage and exchange rate pressures in Japan and in the first tier, which made the second-tier countries attractive locations for Japanese firms facing increased competition on world markets. Similarly, there has been an upsurge in Japanese imports of labour-intensive and electronic goods from East Asia. Recent trends suggest that Japan will become an increasingly important market for the output of all the East Asian NIEs. Indeed, in 1994 China ran a small trade surplus in manufactures with Japan.

More important, the strengthening of regional dynamics has been associated with increased trade and investment among the developing countries of East Asia. Following Japan, the first-tier NIEs began investing in the second tier and for much the same reasons. Moreover, in some cases they have become not only more important investors in other developing countries of East Asia, but also more important trading partners. In 1994, the first-tier NIEs absorbed twice as much in manufacturing exports from the ASEAN countries as Japan.

However, the position of the second-tier NIEs in this regional dynamic is far from certain. The recent upsurge of FDI from Japan appears to represent a one-off adjustment to an abrupt shift in competitiveness, and with the growing economic presence of China and the emergence of new locations such as India and Viet Nam, their position may become more precarious if they do not find the right policy response.

Government policies have played an important role in fostering East Asian regional integration, which could be characterized as a recycling of comparative advantage. The experience of East Asia suggests that - with proper policies - South-South cooperation could play a decisive role in fostering outward-oriented development through closer trade and investment links. Indeed, such cooperation may become increasingly important in the light of broader developments in the global economy.

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It is possible to detect a creeping pessimism among policymakers looking for lessons from East Asia. Indeed, on some accounts the experience is already of more archaeological interest than contemporary relevance, at odds with a globalizing and liberalizing world. For some, export-led growth no longer holds out the dynamic prospects it did earlier because of the heightened competitiveness in the world economy. Indeed, on some accounts a simultaneous export push by a large number of developing countries could flood the market and significantly reduce world prices. This "fallacy of composition", familiar to exporters of primary products, provides the backdrop for pessimism over prospects for manufactured exports. A second argument against replicability of East Asian export success is more straightforward and relates to diminished national policy autonomy after the Uruguay Round.

But these concerns, while meriting careful consideration, tend to equate replication with cloning. Indeed, the East Asian countries have differed among themselves in terms of export dependence as well as the pace of export promotion, and it would be foolish to suggest that India or China, for example, must achieve the same per capita exports or imports as the first-tier NIEs. The replication of East

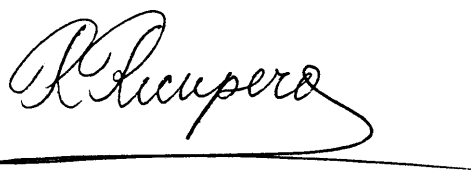
Asian industrialization implies different degrees of export orientation in manufactures for different levels of per capita income, industrialization and resource endowments and varying sizes of population.

Moreover, the very rise of East Asia has itself profoundly altered the question of replication. The East Asian NIEs not only provide new markets for other developing countries, but are also a source of capital goods and technology. More generally, although the markets in the South are still smaller than the North, many are growing much faster. There is thus considerable scope for increased trade and FDI among developing countries.

In the light of these developments, the fallacy of composition in manufactured exports should not be seen as an immediate constraint on export promotion. Indeed, taking a traditional export good such as clothing, if the commitments made in the Uruguay Round are duly implemented, the scope for export expansion in the South will be considerable; a tripling of southern clothing exports over the next decade is far from unrealistic, giving ample scope for a new generation of NIEs to expand their exports without adverse effects on their terms of trade.

However, exploiting the opportunities provided by the Uruguay Round depends in part upon the existing generation of NIEs' diversifying into new export lines and, in part, on preventing the imposition of any new protectionist measures against exports from developing countries. Thus, replicability of the East Asian experience in this sense depends very much on the success of industrial policies in the South in upgrading and diversifying, and on the success of macroeconomic policies in the North in accelerating growth and reducing unemployment. There is enough uncertainty on both these scores to suggest that developing countries might benefit from international assistance in formulating export strategies which, when taken together, minimize the risk of fallacy of composition.

The conclusion of the Uruguay Round has clearly opened up new export opportunities and improved security of market access compared to the situation when the East Asian NIEs began to industrialize. In this regard, it has encouraged outward-oriented strategies. At the same time, it has closed or narrowed some policy options pursued by the East Asian NIEs. Certainly, the scope for lengthy periods of protection, resort to extensive trade-related subsidies and performance standards and lax enforcement of intellectual property rights has been reduced. However, in many areas critical to the East Asian experience, such as investment and savings, research and development, and regional policies, there remains ample room for active policy measures that needs to be fully utilized. In any case, it is necessary to avoid exaggerated claims regarding either opportunities or limitations and to stress the need for objective analysis of the options which remain open to developing countries when seeking to emulate the experience of the East Asian economies.



Rubens Ricupero
Secretary-General of UNCTAD