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THE INTERACTION BETWEEN MACROECONOMIC REFORM AND MICRO-LEVEL INDUSTRIAL ACTIVITIES

Short- and Long-Term Impact of Macroeconomic Reform and Liberalization on Development and Growth of Enterprises, Particularly SMEs

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CONTENTS

Executive Summary

The purpose of this study is to analyse the short- and long-term impacts of macroeconomic reform and liberalization on the development and growth of enterprises, particularly on SMEs, as requested by the Commission on Enterprise, Business Facilitation and Development at its first session. This study provides a framework for the analysis of the issue at the firm and activity levels. Reviewing the scarce available evidence, it reaches the following conclusions: first, the impact of macroeconomic reform and liberalization on the relative competitive position of SMEs is not uniform and cannot be *a priori* determined as it is, *inter alia*, country/activity specific. There is a need for field studies at the firm level. Second, to be successful macroeconomic reforms should be redesigned, and complemented by reforms at the firm level, and by the provision of infrastructural and institutional support for the operation of firms and markets and for the enhancement of government capacity.

A. Introduction

The immediate purpose of this study is to analyse the short- and long-term impact of macroeconomic reform and liberalization in a globalizing economy on the development and growth of enterprises, particularly SMEs, of developing countries in order to provide a conceptual framework for empirical field studies at the firm level. The ultimate goal is to contribute to the better understanding of the ways firms can take opportunities provided by liberalization, face its challenge, and remedy their possible weaknesses through microeconomic reform, restructuring and private sector development, with the support of government and other actors. Further, it aims to propose necessary changes in macroeconomic reforms.

The main argument of the study is that the impact of macroeconomic reform and liberalization on enterprises in developing countries depend mainly on: the type of countries, activities and firms; complementary policies (complementary to Structural Adjustment Programmes (SAPs)) adopted by the government; and the firms themselves. Macroeconomic reform and liberalization affect different countries differently; moreover, within each country they affect different sectors, activities, and firms differently. It will be shown also that various activities have, in their own turn, different influence on industrialization, export and general economic development of a country. In order to raise the chances of success of macroeconomic reform and liberalization, there is a need for these reforms to be complemented with reform at the micro-level for the development of the private sector. In the process of macro and micro reform one should envisage policies in favour of selected firms and activities which are important for industrialization, export expansion and general development in the long-run, but are negatively affected by macroeconomic reform and liberalization.

This study is confined to the conceptual aspects of short- and long-term impact of reforms mainly on the level of output and exports. Nevertheless, every now and then reference will be made to available empirical microeconomic evidence.

Sections B and C are devoted to clarification of various definitions and the philosophy and underlying assumption behind structural adjustment, stabilization programmes and trade liberalization. In Section D reference will be made to diversity of countries and activities - not appreciated in SAPs and SPs. In Sections E and F light will be shed on the way firms develop and the impact of SAPs and macroeconomic reform, in general, on the operation and growth of enterprises. Particular reference will be made to their impact on investment and productivity. In Sections G and H the impact of trade liberalization and devaluation are examined in more detail since they are more relevant to the work of UNCTAD.

B. Definitions

There are two kinds of attempts at macroeconomic reform and liberalization as far as their origins are concerned. They are initiated internally or accepted as a commitment to multilateral rules and/or multilateral institutions, or as commitments to bilateral donors. For example, reforms undertaken by the majority of Asian NICs and new-tier Asian NICs during the 1970s-1990s were most often until recently of the first category. Nevertheless, in the majority of developing countries in Africa, and some in Latin America, the design of the reform has been of the second type. These reform schemes include mainly stabilization programmes (SPs) of the IMF, structural adjustment programmes (SAPs) of the World Bank, and changes required in trade and investment policies as a result of ratification of the Uruguay Round Agreements.

Although both SPs and SAPs are short-term and medium-term policies which aim at adjusting some macroeconomic variables, they differ in scope and modalities. The main objectives of SPs are to achieve internal and external balances, (i.e. balances through controlling the demand side). Their main policy tools are expenditure switching, such as devaluation, and expenditure-reducing measures for the reduction of domestic consumption through fiscal and monetary policy (i.e. reduction in public expenditure, increase in taxes and control of the money supply). In practice, some other measure such as trade liberalization and fiscal reforms are also employed.

SAPs' main stated objective is to achieve efficiency in the allocation of resources and to enhance production capacity in order to encourage growth. Efficiency is to be achieved through the removal of market imperfections. The removal of market imperfections is supposed to take place, according to SAPs, by state withdrawal from the market. By contrast, the Latin American structuralists favour the removal of imperfections through state intervention (P. Mosley, 1991, p. 223). The counter argument is that while state intervention may remove some imperfection, it may also introduce other distortions.

Although the term SAPs is used in the context of supply side policies which contribute to enhancing production capacity, in practice it excludes investment policies - at least at the sectoral level. Often the SPs and SAPs are complementary, or a SP precedes a SAP, since macroeconomic stability is regarded as a precondition for medium-term and long-term growth.

Elements of SAPS

SAPs entail various elements, the coverage, extent and sequence of which may vary from one country to another. Generally speaking, however, they include the following:

- trade liberalization by removing, or reducing, tariff and non-tariff restrictions converting non-tariff measures to tariffs and making them uniform;
- devaluation of the exchange rate to compensate for reduction in tariff rates, or to improve international competitiveness in cases where the currency is believed to be overvalued;
- liberalization of the allocation of credit and increase in the interest rates to the level that represents the scarcity of capital;
- rationalization of fiscal policy by increasing the efficiency of public expenditure, including reduction and "rationalization" of subsidies, restructuring of the tax system in favour of VAT and other indirect taxes;
- privatization and improved management of public enterprises;
- liberalization of the labour market and removal of wage and interest rate subsidies;
- liberalization of the capital market and FDI;
- removal of "price distortions" such as those caused by fixed and underpriced food items and the removal of subsidies paid to agricultural inputs, food produce and other agricultural products and the abolition of marketing boards.

Judged by the conditionalities attached to structural adjustment lending since the early 1980s, trade liberalization, exchange rate policy, public expenditure, agricultural policy, including price policy, fiscal policy, public enterprise policy and financial policy, have been the most important elements of SAPs (Greenway and Morrissey 1995 - Table 1).

Trade liberalization is also undertaken by the member countries of WTO as a result of their adherence to the UR agreements. The major difference between liberalization in this case as compared with the liberalization under SAPs, is that in the former case all member countries attempt to liberalize. As a result, a liberalizing developing country also enjoys better access to other markets for its exports (the same applies to liberalization under regional trade agreements). By contrast, trade liberalization under SAPs is undertaken unilaterally by a developing country, so there is no consequential change in its access to markets for its export products.

C. Philosophy and underlying assumptions

The main philosophy behind SAPs is that markets perform efficiently, so what is needed is "to get price signals right". This in turn will contribute to the efficient allocation of resources and long-term growth. Hence, the government should refrain from all intervention in the economy, except functional interventions for providing infrastructure, education, etc.

SAPs have three main characteristics. The first is that although specific elements of SAPs may vary from one country to another, the same principle applies to all countries irrespective of their level of development, industrialization and the capabilities of their firms. The second characteristic is

uniformity: all sectors and activities should be treated the same way, (i.e. be governed by market forces or be given the same incentives). The neutrality of the incentive structure would correct the incentive structure (which had been biased against exports in many developing countries due to pursuance of traditional import substitution policies) in favour of export activities, thus leading to export and output expansion in areas where the country has comparative advantages. The neutrality of the incentive structure will also lead to development of efficient activities and efficient firms and to the disappearance of inefficient ones. Third, in order to have credibility, the reform should be carried out rapidly and on all fronts (see e.g. World Bank, 1987). It should be mentioned however, that a slow pace of reform is recommended in some cases, depending on political situations; nevertheless, it is still maintained that "more rapid reforms … are likely to be preferable to slower ones because the benefits of adjustment will tend to be realized faster" (Husain and Faruguce, 1994 p. 432).

The theoretical foundation of stabilization, SAPs and trade liberalization through the WTO, is the general equilibrium theory and the static version of the doctrine of comparative advantage. These theories are based on a number of assumptions, the most important of which are: passivity and smallness of firms, (i.e. absence of market power); constant return to scale; free entry and exit to markets; the lack of uncertainty and risk for the firms including newcomers to the market; homogeneity of goods and factors of production; perfect information and absence of marketing and transaction costs; existence of a well developed market and the necessary supporting institutions for the operation of the market; the absence of contractual arrangement among firms and the absence of externalities. One strong implicit assumption behind SAPs is that countries are at the same level of development in terms of their experience in industrialization, the capabilities of their firms and the experience of the private sector since, according to its underlying theory, experience does not play a role in industrialization.

The theory has four main implications for enterprise development. First, since firms play no active role, comparative advantage is achieved at the level of the national economy and as firms react to markets, they cannot influence the market. Hence, current market-determined factor costs (i.e. wages, interest rates, raw materials) are the only sources of competitiveness. Second, the exchange rate is influential in attaining international competitiveness since it translates internal prices into international ones. Third, neither productivity (in H-O version) nor non-price factors play any role in international competitiveness. Finally, economies of scale have no role to play in competitiveness - except Marshalian external economies of scale (i.e. scale of the manufacturing sector as a whole), which could be compatible with perfect competition. Reference will be made to their implications in other sections of this study. First, some light will be shed on the importance of diversity of countries and activities.

D. Diversity of countries and activities

The impact of economic reform on a firm depends on the country in which the firm is located. A firm in country A is different from a firm in country B because the environment in which it operates is different (M. Porter, 1990). For example, an electronics firm in Tanzania may face many obstacles to its growth because of structural limitations and the macro-policy environment of the country which is different from those of another country. Moreover, SAPs and liberalization

measures have different impacts on different countries mainly because their initial conditions are not the same.

Developing countries are different in terms of the level of industrialization, market and institutional development and the size of their modern sector. Taking *per capita* income as a rough indicator of the level of development of a country, Table 1 would indicate that in the mid-1980s, when most SAPs started, only 10 per cent of developing countries (excluding oil exporters) showed, in 1986, per capita income of more than US$ 5,000 which is the minimum level of per capita income for the group of developed countries. By contrast, over half of them show per capita income of less than US$ 1,000 and over one-fifth of them, located mostly in Africa show per capita income of less than US$ 200. In this group in particular, the formal market for products and factors of production hardly exists; neither do the necessary institutional set-up and infrastructure. According to the same table, in the mid-1980s, the manufacturing sector accounted for more than 20 per cent of GDP in only 23, out of 141, developing countries. The majority of developing countries had little, or no, experience, in industrialization; the manufacturing/GDP ratio was less than 10 per cent in over half of developing countries, out of which 26 countries showed a ratio of less than 5 per cent. In terms of export of manufactured goods, the experience of developing countries is even more diverse. Manufactured goods accounted for more than 50 per cent of exports only in 17, out of 108 developing countries for which data are available. By contrast, almost a third of developing countries and territories relied almost entirely on other products for their export earnings. (In 1986 export - and re-export - of manufactured goods exceeded US$ 75 million in only around 60 developing countries).

Experience in both industrialization and the export of manufactured goods are crucially important because of the dynamic economies involved. At the sectoral and country levels the experience gained in the process of production, distribution and marketing in each firm and/or activity in each period not only benefits the same activity, or firm, but also involves some benefits to other firms, or activities in the future, in terms of lower cost of the activities concerned. In technical terms, dynamic external economies, or external economies of time, would prevail (Corden 1974, chap. 9.II). As a result, as time passes, the cost of production of all firms in an industry (Marshalian external economies), or in the manufacturing sector as a whole (List's external economies) will decline - at least up to a point. In other words, the longer the experience, other things being equal, the lower the production cost, and the wider the industrial base the more probable is the existence of dynamic external economies. It should be emphasized that the external economies created by various firms, or activities, should not necessarily be equal.

There are a number of sources for external economies of time which exist not only in production but also in distribution, marketing, after-sale services, etc., both for sale in the domestic market and for exportation. They include, labour training, learning by doing, diffusion of technical, managerial, and marketing knowledge and information, the creation of a favourable atmosphere and industrial culture and the creation of goodwill and reputation. Another important source of external economies is production linkages: for example, experience in the production of a product by industry A, which is an input to industry B, provides benefits to industry B in terms of lower current production cost.

There is usually a direct relationship between the size of the industrial sector, in relation to GDP, and experience in industrialization. The larger the manufacturing/GDP ratio, the longer the experience in industrialization.

Developing countries are also diverse in terms of the degree of development of a modern private sector, development of factor and product markets, supporting market institutions and infrastructure which contribute to the well functioning of the market and to the level of transaction cost in the country. These institutions include, for example, credit facilities, marketing networks, training establishments, transport and communications, etc.

For the purpose of analysis, developing countries can be classified into three groups according to their level of development, industrialization and capacity to export of manufactured goods in the mid-1980s. Examples of these countries are shown in table A.1. The first group includes countries with a low level of development, little or no industrial capacity, and thus no or little capacity to export manufactured goods. This category includes many African and other least developed countries. The burning issue for this group is to develop their supply capacity. The second group includes countries which had already developed some industrial capacity through import substitution, and had some experience in the export of manufactured goods. Many Latin American, most Middle Eastern, and a number of Asian countries are among this group. The main issue facing this group is to make their industrial structure efficient to be able to compete in the internal and international markets. The third group consisted of countries which had established considerable industrial and export capacities. Nevertheless, they need to diversify and upgrade their export capabilities. Most East Asian countries figure in this category.

The market size of developing countries, which depends mainly on population and per capita income, is also different. As far as population is concerned, Table 1 indicates that only 40 countries show populations of more than 10 million and 43 countries less than 1 million. Most highly populated countries show low per capita incomes. Nevertheless, their markets are huge due to the size of population. Large domestic markets provide the opportunity to enjoy economies of scale before the country gains experience in the export markets.

In a given country, different industrial activities and firms may be at different levels of development in terms of learning and experience. Moreover, the characteristics of various industries may be different, not only in terms of the externalities they provide to the industrial sector and the economy as a whole, but also in other respects. For some activities, for example, economies of scale may be important. Some may be more import intensive than others as will be shown in Section H.

E. Factors in enterprise development

To study the impact of trade liberalization and other economic reform on enterprise growth and development one should shed some light on the way firms operate and grow. Subsequently, one could analyse whether SAPs and macroeconomic reforms *per se* could facilitate operation and growth of enterprises, particularly SMEs.

(a) Growth of firms

There are different approaches to causes, and obstacles to the growth of firms and the way they should be tackled. Some regard the lack of entrepreneurship and management (factors internal to the firms) as the main obstacle to the establishment and growth of firms. Others regard external factors, (e.g. access to resources as a main constraint on growth of firms, see Schmitz, 1982 for a survey), while Odagiro (1992) considers human resources as a main constraint. Another school of thought regards actions taken by large firms inimical to the growth of SMEs. Others regard "clustering" of firms as a means to the growth and development of firms (Schmitz, 1995).

To study enterprise development, a comprehensive approach to the way firms operate is needed. The starting point is that firms are cultural units with learning capabilities (Penrose 1959). For its operation and learning a firm relies on its internal factors and interacts with agents/factors/environment outside the firm. Internal factors include the internal organization of a firm, its capabilities and its strategy. External agents/factors may facilitate and/or limit the operations of a firm and its development. These agents/factors include the market, government, other firms and consumers. Moreover, for its operation a firm relies on infrastructure and institutions either directly or though the operation of markets. The interrelations between an enterprise and other agents/factors is shown in figure (1). Firms draw on the market for factors of production and inputs. Further, they supply these products to the market. In their operations markets require supporting infrastructure and institutions. For example, the market for finance and credit cannot operate without supporting credit institutions. Governments influence the operation of firms though their macro, sectoral and enterprise strategies and policies. They can provide incentives to firms and/or impose pressure on them.

A firm also interacts with other firms which provide it with sources of supply, demand or marketing channels for its products. Moreover, a firm may be competing and/or collaborating with other firms in its operations. For example, firm A may be collaborating on R & D with another firm, which produces the same products, and competes with it in the market for its final products.

It goes without saying that apart from its internal structure and characteristics, and the activity in which it is involved, the operation of a firm depends to a large extent on specific characteristics of a country. For example, the degree of market and institutional development varies from one country to another. Thus market efficiency may vary depending on the country in which a firm operates. Similarly, the degree by which a firm is exposed to competition depends on the internal market structure of the country, as well as the extent of the openness of the country, both of which are in turn affected by government policies.

(b) Country-specific aspects of enterprise development

Having such characteristics of a specific country in mind, the type of issues firms and the Government of the country need to focus on for enterprise development would depend on the stage of development of the country. For the first group of developing countries, where the main concern is the creation of supply capacity, enterprise development requires focus on the acceleration of

production capacities. In this case, theories of acceleration of growth and investment are applicable to the development of enterprises. In addition to availability of finance and foreign exchange, acceleration of investment is limited by the availability of skill, physical (infrastructure) and institutional obstacles to the establishment and growth of enterprises. In other words, the burning issues to be tackled for enterprise development in these countries are finance, foreign exchange, training, and the development of infrastructural and institutional support for the operation of the market and expansion of supply capacity.

In the case of the second group, where the main concern is to penetrate international markets, theories of competition and capacity management, that is, managing the existing capacity more efficiently, is more relevant. Competition in the modern world takes place not only on price but more importantly on the non-price attributes of a product: quality, product differentiation, in-time delivery, etc., as will be explained shortly. Such competition requires physical infrastructure and an institutional set-up, (e.g. information, international marketing channels, distribution, etc.). Moreover, it needs changes in the internal structure and organization of the firm. For the third group, theories of technological innovation (frontier-technology) is more applicable to the development of enterprises.

One common feature of enterprise development in all groups is that the provision of incentives and pricing policy alone is not sufficient. In the case of the first group the market is not enough to accelerate investment beyond a point, and it fails to provide skills, institutional and infrastructural support rapidly. The acceleration of investment is often constrained by financial resources including foreign exchange. Even when financial resources are available physical and institutional constraints impose limits on the expansion of production capacity. Physical resources include skills and infrastructure. Expansion can be limited by supply determined activities such as natural resources, food production and utilities. The supply of physical resources does not easily and rapidly respond to price signals because of the lack of necessary institutions and the nature of the activity. For example, skill development requires training facilities which will not often be provided by the private sector because the benefits of training will go beyond the firms which undertake the training. The development of infrastructure requires heavy investment, which often is not undertaken by the private sector because of the risks involved. Agricultural development is limited by the lack of credit institutions, distribution networks, and in some cases the ownership structure, etc. As a result, in all these cases government intervention is required to supplement and develop markets and market institutions.

In the second case also, market forces alone fail to achieve the related objectives since price signals cannot take care of non-price factors in improving efficiency and competitiveness. In other words, even when prices provide incentives for the expansion of exports, non-price factors could limit penetration into international markets. Such factors include, for example, market information, marketing channels, trade financing and transportation systems. Unless price incentives are supplemented by such non-price factors, export expansion would not be easily and rapidly feasible. In the case of the third group, technological development is not only time-consuming, but also is costly and involves risk which requires to be compensated for by the Government. In both developed and particularly developing countries, there has been some bias against SMEs. In other words, while

the market has a role to play in all cases, at the same time the Government has also a role to play to supplement and develop the market and its institutional support. Nevertheless, the degree of market failure and inadequacy vary from one case to another as does the nature of market failure. Accordingly, the type and degree of government intervention also varies from one case to another.

(c) Bias against SMEs

SMEs in developing countries suffer from two categories of problems. The first is related to the general problems of enterprise development in developing countries, as compared with developed countries, and concerns the stage of development of the country in which they operate. The second category is related to the question of size. SMEs suffer from two kinds of biases: market bias and policy bias. Generally speaking, SMEs are more subject to market failure than large firms. Such failure is more evident in the case of SMEs having access to credits, training, technological development, etc. One may refer to the imperfections in the capital market as an important example of market failure, since such imperfection is also an obstacle to the financing of training and technological development.

Capital markets are imperfect not only in developing countries but also in developed countries, due to problems of adverse selection, moral hazard and contract enforcement.[i] Nevertheless, imperfection in the capital market prevails more significantly in developing countries because of the institutional and organizational weaknesses in these countries (Stiglitz, 1989, Myint, 1985). The capital market failure prevails on both supply and demand sides. The lack of perfect information and foresight, and the lack of a market for insuring against risk, are two main common causes of imperfection in the capital market on both supply and demand sides in developing countries. Moreover, each involves further specific imperfections.

On the supply side, the well functioning of the market requires availability of funds and readiness on the part of financial institutions to finance requests made for all socially desirable investment. The sources of financing any new investment are, in theory, the equity market, the credit market, and internal financing (i.e. reserves available to a firm). In practice, in many developing countries the equity market is non-existent or underdeveloped. This is also the case with the credit market because of underdevelopment of the organized financial market (i.e. the banking system and other financial institutions).

SMEs suffer more than large firms from imperfections in the capital markets. For a given availability of sources of finance, the readiness to lend might be affected by a bias against small enterprises, particularly new ones. This is so not only because of risks involved in investment decisions (i.e. borrower's risk), but also because of the existence of lender's risk. The borrower's risk would arise because of the borrower's perception of the uncertainties involved in investment due to the lack of perfect information and perfect foresight. The lender's risk may arise from moral hazard or a possible margin of uncertainty (Keynes, 1936, p. 144). Such margins are related to the lack of creditworthiness of a small, new and unknown investor, and/or a new line of investment, and the

difference between the perception of the lender and the borrower regarding the profitability of the investment over time.

For a large existing enterprise in a developed country, internal financing provides a significant source of investment, eliminating the differences between the borrower's and lender's risks. In a developing country, such a possibility is non-existent for a new firm, or is limited for an existing firm, where the firm's size is usually small.

Hence, a small firm wishing to invest is at a double disadvantage when trying to obtain finance: "not only are there information imperfections in general" but also these "imperfections are likely to be more important within LDCs [developing countries] …, but more importantly the institutional framework for dealing with these capital market imperfections are probably less effective ..." (Stiglitz, 1989, p. 200). Such institutional imperfections lead to financial dualism which is not caused by policy-induced distortions. They manifest themselves in the wide gap in the rate of interest in the organized and unorganized capital markets, the gap between the interest rates available to existing large firms and new, and particularly small firms, wishing to initiate new activities. This group is faced with higher interest rates than large firms because of differences in its transaction and information costs and in its differential risks (Myint, 1985).

On the demand side an important source of market imperfection is the borrower's risk. Such a risk is once again higher for a developing country firm than a developed. The underdevelopment of the infrastructures, institutions and necessary inputs makes obtaining the necessary inputs on a regular basis more risky in a developing country. One example is the availability, or regular availability of transport facilities and such utilities as electrical power and water supply. More importantly, a firm's lack of knowledge and certainty to sell its products in the future because of the lack of perfect information on marketing channels, the lack of perfect future markets for all goods, and the lack of perfect foresight, and consequently lack of knowledge of future profits increases the risk of an investment. This may be the case to the extent that subjective (estimated) risk may exceed the objective one (Scitovsky 1954). Further instability in international markets and the resultant shock to the economy, the likelihood of intensification of protectionism in importing countries, all add to such a risk. Within a country, it is higher for a new and small firm, particularly if it wishes to initiate a new activity. Not only the small firms suffer from higher risk, but their capacity to take risk is also smaller than large ones. So they are reluctant to invest, particularly in new activities, unless they are compensated through government policies (Shafaeddin, 1998).

Policy bias

SMEs have also suffered from policy bias. Under import substitution regimes, policy makers in developing countries often did not consider small producers as progressive, and gave priority to large-scale plants for mass production (Helmsing, 1993, pp. 27-28). Similarly, whatever institutional and infrastructural support mechanisms were developed were geared mainly to large-scale production. This applied also, for example, to mechanisms for the allocation of credits and foreign exchange, import licensing, the development of transport systems, and distribution channels and

training facilities. In the case of Mali, small firms did not have access to State-controlled transport and marketing channels (Steel, 1993, p. 42). Moreover, the structure of demand has often favoured products of large firms with high import intensity rather than those of small firms. This is because the combination of low food prices and higher wages favoured urban consumers who have a higher propensity to consume "standardized products of large-scale industries" (Steel, 1993, p. 41). Moreover, government procurement often favoured the products of large firms.

F. Enterprise development and SAPs

In order to analyse the impacts of SAPs and SPs on enterprise development one may examine what they do, and what they do not do to resolve the obstacles to operation and development of enterprises, particularly SMEs. Generally speaking, implementation of these programmes increases exposure of firms to international and domestic competition. It changes the incentive structure in favour of exports, but it does not deal with other factors necessary for enterprise development in various groups of developing countries. It does not, for example, deal sufficiently with the questions of investment in capacity-building, productivity improvement, technological development and the provision of institutional and infrastructural support services, and it does not change the bias against SMEs.

(a) International competition in a globalizing world economy

Trade liberalization increases the exposure of domestic firms to competition in the international and domestic markets. The international market is characterized by the dominance of large established firms which influence the market through their strategies in the process of globalization, and/or flexible specialization and dynamic competition.[ii]

The characteristics of firms active in international trade, and the structure of the international market, are totally different from those assumed in the theoretical foundations of SAPs and SPs. International trade is dominated and shaped by the activities of about 35,000 large TNCs and global firms. In recent years, the size of large TNCs has increased due to intensification in mergers and acquisition. They do not base costs, products, prices and profits on their past experience. They are not certain of their future volume of sale, etc., because of imperfect information and so they run some risks. They do not often produce divisible, standardized and homogeneous goods. Their activities are not free of transaction costs. Moreover, they are not passive. They have the capacity to influence prices, technology and the quality of the goods they produce. They also target their markets and generally influence the environment, and the market structure, within which they operate. In other words, they take strategic actions which shape the market.

The economies of scale of large established firms are important, not only because they are sources of cost advantage (Krugman, 1984, Das., 1982), but more importantly, because they are sources of "dynamic" competition and "strategically active" behaviour leading to progressive and cumulative changes over time (Young, 1928). Such a dynamic competitive process implies that the ability to export would depend on "comparative strategic advantage" rather than comparative cost advantage alone (Best, 1990).

One may distinguish three types of established firms, domestic, TNCs and global. A domestic firm produces at home for the home or foreign markets. As an established firm it may enjoy home-based advantages resulting from factor endowment and other local conditions, economies of scale and learning and experience. A multinational firm usually also undertakes production and sales abroad in particular foreign markets. Thus in addition to home-based advantages, it enjoys host country advantages related to locating activities outside the home country and closeness to markets. A global firm, like a TNC, produces and sells in different markets. More importantly, it also collaborates with other firms to share R & D, production facilities, marketing, distribution, input procurement, product development, and design at the global level, without necessarily investing abroad directly for these activities (Best, 1990, 259-62 and Porter, 1990, 54). Hence, global firms enjoy advantages from networking, inter-firm cooperation and other new forms of business organization, some of which do not involve going through the market (Porter, 1990, 60-62 and Best, 1990). Networking allows the obtaining of cheaper sources of inputs, technology, intermediate products, distribution channels etc., through international consortia, cross licensing agreements, joint ventures and other forms of inter-firm cooperation (Best, 1990, p. 260). It also allows expanding the scope of the market to provide economies of scale. Further, networking can allow economies of scope and agglomeration. A network of firms could cooperate through sourcing, (i.e. purchase of intermediate inputs from other firms, or through inter-firm transactions, subcontracting, technology alliances and supply contracts for the provisions of inputs and intermediate goods), but compete in the market for final products. Such methods of collaborative competition provide global firms with additional advantages vis-à-vis TNCs.

The globalization of the business structure has been facilitated in recent decades, in particular, by reduction in transaction costs, including transport costs. Between 1950 and 1990 freight and cargo transport costs have declined by 15 per cent and 58 per cent, respectively. Similarly, a sharp decline in communication costs and the evolution of information technology have contributed to the reduction in the cost of, and the time necessary for, transactions. For example, the average cost of a 3-minute telephone call between New York and London declined from US$ 53.20 in 1950 to US$ 31.50 in 1970 and to US$ 3.22 in 1990. With the liberalization of telecommunication such costs are falling even further. Information technology has contributed not only to a reduction in production costs, but more importantly, it has brought about other gains in the form of better product quality, greater flexibility, customer service and the speed and reduced life cycle of production (Cane, 1992 and Meng, 1992).

Flexible specialization is another form of new business organization. While mass production is emphasized in the case of globalization, in flexible specialization the emphasis is on innovation and rapid adaptation to changes in the market. It requires multi-use equipment and skilled manpower. Hence, small and medium sized firms exploit their advantages in strategic thinking rather than strategic planning, which is common in global firms. Nevertheless, to internalize various externalities, a group of firms consult and cooperate with each other through industrial districts, regional conglomerations, federated enterprises and technological alliances. Such firms basically compete on differentiated goods (Best, 1990, chaps. 1, 8).

Globalization basically emphasizes cost reduction through networking and economies of scale and mass production; flexible specialization stresses product-led competition, speedy production and delivery, and cost reduction through capacity utilization. Integration into the world economy through globalization requires, inter alia, mainly sophisticated technology and capital; flexible specialization requires sophisticated technology and highly skilled manpower. None is easily available to new developing country firms particularly at the early stages of their development.

Globalization, and other new methods of organization have changed the nature of competition in the international market in three main ways. First, it has enhanced the "strategic competitive advantage" of large established firms. Second, it has intensified the process of Schumpeterian "Dynamic competition" and "creative distraction". In such a process, firms are continuously active in innovation, product development, quality improvement, shortening of delivery time, etc. As a result, the role of "non-price attributes" of products in competitive advantages has increased. Finally, the growing size and strategic behaviour of established firms limits the prospects for entry into the market of new independent firms. At the same time, the process of globalization has improved the possibilities and opportunities for developing countries to enter the international market through global firms which have relocated plants in some developing countries. This process, however, has also increased the risks - and vulnerability of these countries, to decisions of global firms to relocate these plants from one country to another.

(b) Changes in the structure of the domestic market

Liberalization, deregulation and privatization have led to increased competition not only between domestic and foreign firms but also among domestic firms. As a result, many firms, mostly SMEs, have not survived. Moreover, the degree of market concentration has increased in some countries.

For example, in the 1980s around 7,000 firms closed down in Chile and 20,000 in Argentina (Benavente *et al.*, 1996). In Latin America, generally speaking:

> "… the degree of economic concentration has increased significantly over the last decade as a small group of domestic conglomerates and local subsidiaries of large multinational corporations have managed to adapt themselves better to the new policy and regulatory environment. Small and medium sized enterprises as well as public firms have rapidly lost market shares, both as a result of deliberate privatization, but also as a consequence of market imperfection and of lack of information concerning precisely what is needed to become competitive in the new incentive regime" (*ibid.*, pp. 3-4).

In the case of industrial countries, economies of scale are regarded as sources of comparative advantage. In the case of developing countries, the relationships between export performance and the size of the firm (market concentration) is not clear (Jebuni *et al.*, 1988). Nonetheless, even if market concentration is beneficial for exports, SMEs may be useful for other economic and social reasons. Hence, if liberalization leads to more concentration, competition of SMEs with large firms will

become more difficult. Yet, SAPs and SPs do not contain elements which could enhance the capacity of firms, particularly small ones, to grow and compete.

(c) Investment

As mentioned earlier, investment in productive capacity, training and institutions and infrastructural development, is the main concern of the first group of developing countries, although it is also important for other groups. As far as investment is concerned, one should distinguish macro, industry and firm levels as all industries and firms may not react the same way. At the macro-level, none of the reform programmes concerned, directly or indirectly, led to the expansion of investment, or stimulated it. In fact, they have contributed to weakening incentives to invest by the private sector, particularly by small firms, for three main reasons. First, the immediate effect of contractionary macro-economic policies and exposure to import competition is a reduction in domestic demand for domestically produced goods. It is true that devaluation increases the cost of imported inputs contributing to changes in the demand structure in favour of domestically produced goods and could stimulate exports from SMEs. Nevertheless, imports are important inputs to the production process and investment goods are mostly imported in most developing countries. Hence, the increased costs of inputs and investment caused by devaluation could contribute to the slowing down of investment, if its negative impacts on the cost of production is greater than the beneficial impact of trade liberalization. Second, often design and/or implementation of reform programmes lack credibility and sustainability. In such circumstances, the resulting uncertainty would increase the perceived risks of investment. In fact, when inflationary pressure persists, despite the implementation of the reform programmes which are supposed to tackle them (this is usually the case in the early stages of implementation), entrepreneurs may prefer engagement in rent seeking activities rather than investing in productive capacities (Steel, 1993, p. 44). Third, the increased cost of fixed and variable capital, caused by devaluation and increased interest rates, could hamper investment, particularly if import compression prevails due to shortage of foreign exchange. Moreover, SAPs have led to a decline in public investment due to cuts in government expenditure.

In fact, at country level there is a strong evidence that SAPs have not had a positive impact on investment, particularly in sub-Saharan Africa. A study of 22 developing countries indicates that "SAPs are not as conducive to increased investment as they may appear to be at first sight" even though "there is no evidence that SAPs are associated with a downward shift in the investment function" (Bleany and Fielding, 1995). There is some evidence that in fact SAPs have had adverse effects on investment in sub-Saharan Africa (Mosley, 1989, Mosley *et al.*,1991 and Mosley, 1993, and Mosley and Weeks, 1995, Mosley *et al*., 1995). Even the World Bank data provided for the 1980s indicated that 14 out of 18 sub-Saharan countries which implemented SAPs in the 1980s, suffered from a decline in investment (World Bank, 1992). In the case of Nigeria, the rapid depreciation of the local currency has made long-term investment planning difficult (Adegbile, 1997). What is interesting is that countries which designed their own adjustment programmes performed better in terms of investment than those which accepted the SAPs (Mosley and Weeks, 1993, Table 5). In the case of Ghana, which is regarded as a successful reformer through SAP, the private sector as a whole did not respond to the provision of incentives for investment, mainly because of

uncertainty about government policies. Apart from inadequate policy framework, lack of institutional support and infrastructure, and lack of knowledge of markets for exports have been among the contributory factors to expansion of investment by the private sector (Aryectey, 1994). SAPs do not tackle these constraints.

In developing countries, particularly at early stages of development, public investment plays a crucial role in growth. In fact, evidence indicates that there is a strong correlation between capital expenditure by the State and the growth rate (Mosley *et al.*, 1995, p. 1467 based on Mosley and Weeks, 1993, Table 8). In over 18, out of 28, adjusting countries public investment declined in sub-Sahara during the 1980s (Mosley and Weeks, 1993, Table 6).

Structural adjustment has had also negative impact on foreign investment in the manufacturing sector of Africa. For example, a study on British manufacturing investment in 14 anglophone African countries for the period 1989-1994, indicates that their equity involvement declined over 30 per cent. This was so "despite concrete attempts by African Governments to improve the overall investment climate for both national and foreign investors" (Bernell, 1995, p. 1 and Table 2).

In the case of Ghana, the country has hardly managed to attract foreign direct investment. The average annual proposed investment in projects approved by the Ghana Investment Centre declined from about US$ 240 million in 1986-1987 to US$ 76 million in 1991-1992 (Tribe, 1996, Table 2).[iii]

While so far, reference is made in this section to sub-Sahara, Latin American countries have shown similar tendencies. For example, in Nicaragua SAPs and SPs did not lead to the expansion of investment during the period 1988-1993. Apart from political instability, lack of demand and lack of financing were two contributing factors to the lack of growth in investment (Dijkstra, 1998).

Data on investment at the industry level are scarce. Nevertheless, the scanty available evidence indicates a common feature of both domestic and foreign direct investment in the case of the first and second groups of developing countries. There was a tendency towards expansion of investment in natural resource-based products rather than high value-added activities, and labour intensive products were often neglected by investors. This would imply that the pattern of investment has shifted towards activities with static comparative advantage - mainly raw materials and resource based activities. (Benavente *et al.*, 1996, Lall, 1995, Osei Bach-Ocansey, 1995). In other words, while there has been a contraction in the overall rate of investment in many Latin American countries, the role of investment in such industries as raw material processing has been high. The impact of SAPs on investment was not uniform in the case of Latin America either (Benavente, *ibid.*).

As far as foreign investment is concerned, it should be mentioned that the available evidence confirms this pattern. For example, in the case of Ghana, FDI was concentrated on wood-processing, metals, and particularly non-metallic mineral products (Tribe, 1996, pp. 11-14). In the case of anglophone-African countries, mentioned earlier, the incidences of withdrawal of foreign investors from the countries concerned was more pronounced in the intermediate and capital goods sectors,

reinforcing "the already dominant pattern of UK equity involvement in the production of relatively low value-added wage goods, bulky intermediate goods ... Most of these activities use relatively simple and increasingly out-dated technologies" (*ibid.*, pp. 203-4).

Data on investment at the firm level are also scarce. Whether or not investment is stimulated at the firm level depends, *inter alia*, on the industry in which a firm operates. Moreover, it appears that the size of the firm is also important. Using the available evidence on investment, and on factors which constrained operation and development of enterprises during the implementation of reform programmes, one can make some inferences. For example, in the case of Mali only 43 per cent of a sample of firms surveyed invested in new equipment. The investment was mainly made by larger firms; the larger the size the larger the proportion of firms which invested in new equipment (Kessous and Gills, 1993, pp. 132-133). A survey of 112 large and medium enterprises in Ghana for the period 1983-1992 indicates that inadequate financial capital and scarcity and high costs of inputs were two main constraints on firms (Tribe, 1996). A high rate of inflation was also a contributory factor to low investment because it translated itself into high nominal rates of interest (Boch-Ocansey, 1995). Nevertheless, all firms did not perform uniformly and, while some new firms entered into business, SMEs suffered more.

(d) Productivity

Do SAPs lead to productivity growth? Before shedding some light on this question the concept of productivity should be clarified. In the theory of comparative cost advantage, according to which all goods are homogeneous, productivity refers to output per unit of input regardless of its quality.[iv] In the Schumpetrian world where competition does not depend only on cost and price factors, productivity takes a different meaning. For a given cost/price the ability to compete also depends on the quality and features of products produced, delivery time, services provided, etc. In fact, for a given cost of production these features determine the ability of the firms to command higher price premiums in international markets (Porter, 1990, p. 6). Unfortunately, however, this aspect of productivity is not quantifiable so here reference is made to the traditional concept of productivity.

In the short-run, productivity could increase as a result of capacity utilization. In the medium- and long-term, it could increase due to better allocation of resources to various activities (allocation efficiency), or better combination of inputs within an activity/firm (technical efficiency).

There is no general agreement on the impact of SAPs and SPs on productivity (see Havrylyshyn, 1990, for a review). One view is that liberalization, mainly liberalization of foreign trade and capital, will lead to total factor productivity (TFP) growth both at the firm and market levels. At the firm level, expansion of exports would allow the achievement of better capacity utilization and economies of scale, since it is assumed that liberalization leads to export expansion. Further, productivity will increase due to competitive pressure, absorption of foreign technology and knowledge through participation in foreign markets, and greater learning-by-doing as a result of higher output. At the market level, better allocation of resources, learning effects of trade and "spill

over effects" of inter-industry transactions and specialization, are among contributing factors (see Kawai, 1994 and for a summary).

A totally different view is that there is neither a theoretical ground, nor convincing empirical evidence that trade liberalization increases productivity (Rodrik, 1992 and Waverman and Murphy, 1992 and Kirkpatrick and Maharaj, 1992).[v] It is further argued that in fact import substitution also could improve productivity because it shelters the domestic market allowing the exploitation of economies of scale. Further, it involves "learning by doing" rather than learning through trade. On the other hand, the lack of competitive pressure under import-substitution could contribute negatively to productivity growth.

Evidence on the impact of liberalization on productivity is not illuminating. For example, since 1980 the labour productivity of Latin American industries has continued to increase slowly, following more or less, its trend in the 1970s. Nevertheless, while its gap with labour productivity in the United States narrowed in 1970, it has widened since 1980. The ratio of Latin American labour productivity to the that of United States labour productivity increased from 0.27 in 1970 to 0.34 and decreased sharply to around 0.25 in 1995 (Benavente and Katz, 1996). A part of the narrowed gap in the 1970s was due to the slowdown in labour productivity in the United States. Similarly, a part of the widening gap in the United States since the 1980s is due to its acceleration in the United States. Nevertheless, there is no evidence that the trend in labour productivity in Latin America as a whole has changed since the implementation of SAPs and liberalization in the early 1980s.

Within Latin America, different activities performed differently according to Table 2. Except for the automotive industry, labour productivity increased in all sectors in the 1970s. By contrast, since 1980 it has declined in all sectors except for resource-based industries (groups 3 and 4). Moreover, it is evident that the pace of increase in productivity in these sectors has slowed down since 1980.

Unfortunately, disaggregated figures for various countries are not readily available, but it is very likely that different countries performed differently considering that their output and investment performances have been different. For example, in the case of Mexico, TFP and labour productivity in the manufacturing sector fell during 1980-1985, but increased during the second half of the 1980s. Here again, resource-based industries were the main beneficiary of productivity growth. Nevertheless, the automobile industry also showed a jump in labour productivity growth of 1.2 per cent over 1980-1985, and to 6.7 per cent over 1985-1990. The improvement in productivity is attributed to a greater degree of "intra-industry (and intra-firm) specialization in foreign trade" (Ros, 1992, and Tables 2, 3 and p. 6). Another attributing factor is the growth rate of output (and demand) for the industry. In other words, there is an interrelation between productivity growth and output growth (*ibid.*, and Brown and Dominguez, 1994).

At the activity level, except for the automobile industry all industries which enjoyed productivity growth in Mexico were resource based. Moreover, a large number of industries, including labour intensive ones suffered from negative productivity growth over the

period 1984-1990 (*ibid.*, Table III). There is lack of sufficient evidence at firm level. Moreover, the available evidence at the country and activity levels suffers from two main confusions. First, in the discussion of protection and liberalization, no distinction is made between countries at different levels of development and industrialization. It is very likely that at their early stage of industrial development, infant industries and firms benefit from protection in the form of sheltered markets which allow them to exploit their domestic markets and better utilize their production capacity. At this stage, learning and experience also contribute to productivity growth. This is so provided support measures are not excessive and are not prolonged. Accordingly, while some liberalization is necessary to allow for access to imported inputs and for some competitive pressure, if across the board and rapid liberalization is undertaken before the stage of maturity is reached, it risks declines in productivity because of the impact of excessive pressure from imports. Only if the country has "static" comparative advantage in the industry concerned, (e.g. raw materials and resource-base industries), can the industry survive. When trade and liberalization measures are accompanied with contractionary macroeconomic policies and import compression, productivity will be affected negatively (see Section F).

On the other hand, if supportive measures are excessive and/or prolonged, productivity growth could be affected negatively particularly if the domestic market is saturated. At this stage a process of liberalization of foreign trade, if undertaken gradually and selectively, could contribute to productivity growth. It is possible that at early stages of liberalization productivity may decline temporarily because of the impact of competitive pressure from imports and the lack of market experience abroad. As penetration into the international market proceeds, productivity could increase. The case of the automobile industry in Mexico is an example of such a development. In this case, the improvement in productivity was attained partly with the help of TNCs.

In fact, there is some empirical evidence that the impact of trade policy on productivity "differs from country to country in accordance with its stage of development". For example, a cross-country study on Asia indicates that "at that stage [early stage of development] import substitution policies may contribute towards improving productivity. This means that infant industry protection as typified by import substitution is effective at early stages of economic development as it spurs productivity increases, but its efficacy is lost as the economy develops further". In some cases, the continuation of import substitution policies can have negative effects (Kawai, 1994, p. 394). Moreover, the evidence provided by the same study indicates that "trade liberalization generally leads to productivity growth with a possible exception in the case of low income countries". Import substitution resulted in the reduction of TFP growth only for countries where the income level exceeds US$ 2,000 (Urata, 1994, p. 370).

In the case of Brazil, labour productivity increased sharply at the early stages of import substitution (1949-1959), declined between 1959-1979, and sharply declined over the period 1975-1980. Following implementation of SAP in 1980, it first started declining (1980-1983) and then improved over the period 1985-1992 as Brazil gained more experience in exporting (Bonelli, 1994). There is also confusion over whether productivity increases or declines as a result of liberalization, would depend, *inter alia* on the reaction of firms.

(e) Reform programmes and biases against SMEs and other obstacles to their development

SAPs and SPs do not target SMEs directly. But can they remove market and policy biases against them? With respect to the market bias, the answer is clear: where market failure is concerned, SAPs do not attempt to remedy it. Nevertheless, a question may arise whether "market distortion" or biases caused by policy biases, could be remedied through SAPs, SPs etc., and whether obstacles to the development of SMEs were tackled.

On the one hand SAPs remedy some of the policy bias against SMEs by improving their access to such inputs as foreign exchange, imports, finance, etc. Moreover, SMEs are usually less dependent on imports than large firms. Hence, for a given rate of devaluation, the impact of devaluation on their production costs would be smaller than its impact on the cost of production of large firms. On the other hand, the cost of inputs increases in absolute terms increasing SMEs credit needs (Osci, *et al.*, 1993). At the same time, any increase in the interest rate, often advocated by SAPs and SPs, will increase the cost of borrowing for SMEs. Since SMEs rely less than large firms on internal sources of finance they will be affected more seriously than large firms by an increase in interest rates. It is true that interest rates in the formal financial markets increases equally for both large firms and SMEs. Nevertheless, SMEs may suffer from higher transaction costs of borrowing. For example, in the case of Kenya, for years commercial banks have financed more SMEs (firms with less than 50 employees); the percentage of SMEs borrowing from these banks increased from 25 per cent in 1970 to 58.4 per cent in 1991. Even if such change cannot be attributed entirely to SAPs and SPs, they must have played a role. Nevertheless, the increase in the real interest rate charged by the banks led to a decline in the volume of credit - in absolute terms - obtained by SMEs.[vi] SMEs remained in an unfavourable position, vis-à-vis large firms, in terms of transaction costs of borrowing, for which large firms enjoyed economies of scale. By 1990 the transaction cost of borrowing for SMEs was almost equal to the interest cost; so it acted as a deterrent to SME borrowers.[vii] Lack of financial standards and collateral were other problems faced by SMEs when borrowing (Kariuki, 1995). In the case of Indonesia, over the period 1981-1988, the net effect of financial liberalization on enterprises was positive for all firms but the SMEs (firms with less than 20 employees) which suffered more than large firms from the increased cost of borrowing. Large firms increased their access to foreign sources of finance, which was cheaper than domestic sources (Harris, *et al*., 1994).

The study on Kenya (Kariuki, 1995) also indicates that the lack of demand, and competition from imported products, (e.g. second-hand clothes in the textile industry), remained among the obstacles to the development of SMEs. As far as demand is concerned contractionary macroeconomic policies, fiscal, monetary and exchange rate policies contained in the SAPs, do definitely not favour demand for products produced by SMEs, particularly if these policies affect the lower income strata of society with a high propensity to consume products of SMEs. Similarly, liberalizing food prices contributes to reduction of real wages in urban areas. On the other hand, it increases the purchasing power of the rural population engaged in agriculture with a compensatory

effect on demand for products of SMEs. The higher the share of domestic production in food supply the greater the compensatory effect.

Hence, *a priori*, it is difficult to gauge the net effects of reform programmes on the relative position of SMEs vis-à-vis large firms. In fact, the relative performance of large firms and SMEs may vary from one country to another. Moreover, it also varies among SMEs depending *inter alia*, on the stage of development of the firm and, whether or not the Government has complementary policies to develop SMEs .

According to a sample survey in Mali, after liberalization there was a positive association between size and increased competition by imported products. Large enterprises were affected in particular; 55 per cent of the sample of large firms surveyed felt threatened by competition from imports (Kessous & Lessard, p. 136). As far as competition from imports is concerned a similar situation was noticed in the case of Ghana (Steel and Webster, 1992).

In the case of Nigerian petrochemical SMEs, absence of finance, lack of investment in equipment, lack of access to inputs and the lack of infrastructure were, in order of importance, among the constraining factors to the growth and performance of SMEs during structural adjustment. These issues are not tackled by SAPs and SPs (Mambala, 1996). Moreover, neither the Government nor the enterprises themselves took any significant measures for the development of SMEs.

In the case of Cameroon also, micro-firms and SMEs performed better during the implementation of SAPs over the period 1987-1992 both in terms of sales and profits. While total sales of a sample of firms surveyed declined by 17 per cent, sales of SMEs and micro-enterprises in fact increased (Table 3 and its source). Similarly, while large and medium size firms showed losses, SMEs and micro-enterprises made profits. According to the same table there is a negative association between size and indicators of performance except for labour productivity. The higher labour productivity shown by larger firms must be mainly due to greater use of capital.

One reason for such different patterns of performance is that large firms had benefited from protection under import substitution. By contrast, most SMEs did not benefit from such protection as they were mostly engaged in producing traditional home-products.

An interesting result of the survey of the Cameroon SMEs was that “non-privileged firms” performed better than “privileged” [viii] ones (*ibid*, pp. 46-47). Their difference in performance seems to have been due to the fact that non “privileged” firms had been under more competitive pressure, so they took some measures to improve their performance in order to survive.

It should be noted that in the case of Latin America, large firms survived and performed better as a result of the implementation of SAPs and SPs. This difference in performance between the two regions could well be due to the fact that large firms in Latin America were more mature than those in Africa as a result of their longer industrial experience. By contrast, most large firms in Africa were still at stages of infancy. A similar pattern is seen within Africa, for example, in the case of Ghana.

Although SMEs suffered from production losses more than large firms, as a whole firms managed to adapt to the new situation better than in Tanzania. The fact that Ghana's experience in industrialization is longer than that of Tanzania must have been a contributing factor.[ix]

G. Trade liberalization

Import liberalization efforts encompass a variety of measures, including the conversion of quotas and other quantitative measures into tariffs, lowering of tariff levels, reducing the disposition of tariffs, the removal of red-tape and the facilitation of trade procedures. Hence, quantification of import liberalization is not easy.[x] Moreover, as far as its impacts on various countries, activities and firms are concerned, two issues are worth mentioning. First, one cannot separate easily the impact of liberalization measures from other internal and external factors. Second, the way trade policy measures are implemented is also important. For example, liberalization may take place as a big bang or gradually, it may be across the board or discriminatory, it may be pre-announced providing clarity and stability or it may take place on an *ad hoc* basis.

(a) Country level

Country level factors are important for the impact of trade liberalization on different activities and firms. Countries are different in terms of level of development and industrialization as well as the macro-environment in which firms operate. A range of other factors, however, can also influence the "national environment". According to M. Porter (1990) four factors determine national environment: factor conditions (natural resources, unskilled and skilled labour, knowledge and infrastructure), the quantity and quality of home demand, related and supporting industries, and the nature of domestic competition, (i.e. market structure). These determinants together with their interactions constitute a "system" of national advantage referred to as a "diamond".

In broad terms there are two extreme viewpoints on trade policy: those who believe in universal trade policy and those who argue that trade policy is country and time specific. In other words, the policy which a specific country follows at each point in time should be related to its level of development and industrialization as well as the degree of distortion in the international market, (i.e. trade policies pursued by other countries). Over time, such policies may change depending on changes in the internal and external environment of the country.

A major difference between the two viewpoints is in their theoretical foundation. The theory of universal trade policy is based on the static version of the doctrine of comparative advantage. Accordingly, factor endowment is the only factor rendering a country different from another, determining its production and trade potential, so there is no need for intervention in trade. Others believe that comparative advantage is created and evolved, not given, so there is a need for government intervention at least temporarily in the case of an infant industry.[xi]

It should be emphasized that historical experience indicates that, with the exception of Hong Kong ARC (a city state), no country has achieved industrialization without infant industry support.

Nevertheless, history also indicates that beyond a point, liberalization is important in order to put pressure on industry or firms to improve efficiency.

(b) Implications of the infant industry argument for trade liberalization

One implication of the argument is that one cannot have a "universal" trade policy for all countries and activities, and liberalization cannot take the same form in all cases. Accordingly, one may classify developing countries into three groups as outlined in Section D.

An important characteristic of many countries of the first and second groups is that in most cases their domestic industries were developed as a result of duties imposed on imports for balance of payments purposes, and trade measures were not necessarily related to trade and industrial policies. As a result, import duties were often unplanned, excessive and protracted due to the emergence of vested interests. By contrast, in the case of the third group, trade policy was often a means to industrialization. The majority of countries in the first and second groups have undertaken "trade liberalization" in recent years. However, in the case of the third group, changes in trade policy have been made by Governments in the form of "trade policy reform", which has been selective, targeted and dynamic.

Generally speaking, the impact of trade "liberalization" on different groups is different, because they do not follow the same pattern. Trade liberalization could change the incentive structure in favour of exports, compared to production for domestic market. Nevertheless, it also makes domestic production subject to fierce competition from imports. In the case of the first group, where the countries lack export and production capabilities, although some liberalization is necessary, across the board liberalization is expected to lead to de-industrialization, and only simple processed products with high local raw material contents would survive, and their exports may increase. Similarly, products which have natural comparative advantage due to high transportation costs may survive. These are products which enjoy static comparative advantage.

Whether or not investment in expansion of production capacity for these products would take place would depend largely on "other factors" influencing domestic and foreign investment. Since SAPs often neglect investment, the expansion of production capacity through domestic investment could be limited. Moreover, foreign investment might not be forthcoming significantly because of the lack of infrastructure, institutions and human capital in general. These constraints place these countries in an adverse competitive position in attracting foreign direct investment (Shafaeddin, 1996).

It is not surprising that trade liberalization and other adjustment measures helped expansion of some exports of processed manufactured goods of adjusting sub-Saharan countries, but it did not help growth in their MVA (Lall, *et al.*, 1996, Chap.1). A similar conclusion was reached in the case of a sample of least developed countries which undertook trade liberalization. The differences in their performance was explained mainly by three factors: investment, availability of imports and the type of trade liberalization pursued.

Some of these countries had been protecting their industries blindly and excessively, without having a clear trade and industrial policy for targeting specific industries. Different activities require different degrees of liberalization at each point in time, as will be explained shortly.

Turning to the second group of countries which possess considerable industrial capacity and need penetration into international markets, trade liberalization can have a mixed impact on various industries and firms. The impact would depend on the type, experience (i.e. their maturity of activities) and the size of the firm and the policies which it pursues. The case of the third group is different since these countries have mostly followed targeted liberalization with their "policy reform" schemes designed by the Government. They did not liberalize all activities across the board.

(c) Impact of trade liberalization on different activities and firms

Different industrial activities are at different stages of development and have different characteristics and respond to incentives differently. Moreover, their contribution to general industrialization and development is different. If this is the case, one view is that an across-the-board liberalization would not necessarily be conducive to all industries and overall development. The incentive structure, including trade policies, should take into account the needs of individual industries.

Different activities have different learning curves. Some require longer periods of experience involving higher learning costs than others before they become mature. The more sophisticated an industry, in terms of technological development, the longer the period required to acquire the necessary skill and knowledge to become efficient (Lall, 1996). At each point in time also, different industries are at different levels of maturity. For industries which have the potential to become efficient because they are near the maturity stage, or they have enjoyed excessive and unnecessary long periods of protection, trade liberalization, provided it is introduced gradually, is essential because it puts pressure on the related firms to attain efficiency. However, for industries which are at early stages of their development, across the board liberalization could lead to their destruction. This is why in the 1970s and 1980s most East Asian countries, while reducing the degree of protection of some industries, mostly light consumer goods, in fact increased their protection of capital goods and some consumer durables. Obviously, if across-the-board support has been given to all industries, support to those which have no potential could cease.

Similarly, different activities may involve different degrees of market failure and risks, so they would require different degrees of incentives, to compensate for these risks. Usually, activities which require high levels of investment involve higher risk to the investors. If the investor is not sufficiently compensated for these risks, there will be a lower level of investment. As a result, across-the-board liberalization would put industries involving more risk in a relatively unfavourable position.

If different industries made the same contribution to industrialization and development, this would not matter. However, this is not the case. Different industries provide different dynamic

external economies. One example is dynamic external economies of learning and experience. The high cost of learning in industry A at present, will reduce not only the current cost of production in industry B, but also its costs in the future. Benefits of learning in industry A may not be entirely appropriated by the industry itself. Hence, it would be beneficial to the economy as a whole if it were given more incentives than other industries.

(d) Import intensity and trade liberalization

One argument in favour of uniform trade liberalization of all industrial activities is that it provides equal incentives to different activities and to export and production for the domestic market. Since, under import substitution regimes, protection policies were biased against export, uniform liberalization would in essence change the incentive structure in favour of exports. While there is some truth in this argument, one should note that the incentive which each activity receives from trade policy, depends on the effective rate of protection, rather than on the nominal rate of protection. Assuming that tariffs are the only means of protection, unless nominal tariff rates are absolutely equal for all imports, which has hardly been the case, for a given nominal tariff rate different industries may receive different effective rates of protection. The effective rate of protection of an industry (j) depends on three factors. The nominal tariff rate on the output of j, the nominal tariff rate on inputs used in the production process of j, and the import intensity of j.[xii] Other things being equal (i.e. given nominal tariff rates on outputs and inputs), the higher the import coefficient of an industry, the higher will be the effective rate of protection of the output of an industry. This is because as the import coefficient increases, domestic value added declines in proportion to total output and in absolute terms. As a result, a given nominal tariff on output has a greater proportionate effect on value added. In practice, usually various tariff bands are used: (e.g. one for the final output and one for imported inputs; the latter being usually zero or less than the rate for the output). Assume for simplicity that the normal tariff rates on inputs are zero. Accordingly, for a given level of output, as the import coefficient increases, value added declines in absolute terms and a given nominal rate has a greater proportionate effect on value added (Corden, 1974).

One implication of the above-mentioned case is that trade liberalization would be biased in favour of more import-intensive activities and more import-intensive firms. As can be seen from Table 7, the import intensity of different industrial activities vary significantly in all Latin American countries at each point in time. Moreover, it is clear that import intensity increased significantly as a result of liberalization. In the case of Argentina it increased by over four times between 1990 and 1994. Exports are usually more import intensive than other products (see Section F). Hence, it is not surprising if, in many countries in the second and third groups of developing countries mentioned above, which have some export capabilities, exports have increased, and at the same time the import intensity of exports must have also increased, leading to higher imports of intermediate products, thus a higher import bill and in some cases a larger debt burden. In the case of the first group, which have little export capacity in modern industrial products, exports of products which use domestic inputs (raw materials), again with little value added (for different reasons) have increased. In this case possibilities for the export of import-intensive products did not exist. Nevertheless, import bills often

increase basically because of imports of consumer goods. Accordingly, in both cases the sustainability of economic activities are in question when the current account deficits increase.

Within a given activity import liberalization provides more incentive for more import-intensive firms. Evidence of import intensity of enterprises is scarce. *A priori* one could assume that there is a positive association between size and scale of production not only in various activities, but also within the same activity. For example, in the case of Mali where raw materials account for 92 per cent of the total cost of inputs, the share of imported items in total inputs varies from 53 per cent in the case of micro-enterprises (with staff of less than four persons), to 95 per cent in the case of medium and large enterprises (with staff of over 30 persons) (Kessons and Lessard, 1993, p. 125).

In Latin American countries, which are in the second group, the import contents of production of many firms increased after liberalization to the extent that they substituted local parts and components with imported ones (Benavente, *et al.*, p.5).

One impact of this phenomena on SMEs was that many of them lost their markets, since SMEs were important suppliers of components for large firms. So it is not surprising that many SMEs ceased operation in Africa and Latin America in the 1980s and 1990s (Benavente, *ibid*. and Lall 1996).

To summarize, across the board and universal trade liberalization, do not distinguish among countries and activities in terms of their level of development, experience in industrialization and the contribution of an activity to learning, industrialization and general economic development. Nor do they take into account specific problems of SMEs. Hence, it is not surprising that the experience of developing countries in trade liberalization is mixed in terms of its impact on industrialization and enterprise development. Some have failed, others have succeeded better. Most often, trade liberalization, together with devaluation, have led in the case of the first and second group of developing countries, to increased investment, thus in exports in the short-run, but failed to increase investment, thus production capacity. Moreover, the nature of liberalization applied, has encouraged import-intensive activities and firms and resource-based industries, rather than those industries which could contribute to general development and industrialization. For countries in early stages of development, universal and across-the-board liberalization could lead to de-industrialization and the closure of firms. For this group, selective and targeted liberalization is required. Nevertheless, excess and prolonged protection should be strictly avoided. For the second group, gradual and targeted liberalization is important to enhance the competitiveness of their firms.

H. Impact of devaluation

The impact of devaluation on production and export capabilities of various firms in a developing country depends on the country and industry in which the firm is located, and specific characteristics of the firm particularly its size.

(a) Country level

The impact of devaluation of a nominal exchange rate on the production and exports of various countries depends on:

1. the extent to which devaluation of a nominal exchange rate can be translated into a real exchange rate, which depends in turn, *inter alia*, on the inflationary impact of the devaluation;
2. the exchange rate policies of competitors, (i.e. exogenous changes in these countries exchange rate, and the direction of trade of the country, i.e. on the "real effective exchange

3. the supply response, in terms of both exports and output, to changes in the real effective rate, through capacity utilization in the short-run, and the expansion of productive capacity or productivity in the long-run.

The inflationary impact of devaluation

The inflationary impact of devaluation is important because it affects the cost structure of economic activities. Moreover, it may affect the incentive to invest in production capacity negatively because the general inflationary tendencies created in an economy may cause instability and uncertainty. Further, if attempts are made to check inflation through reducing the absorption capacity of the economy, or if devaluation involves contractionary influences on effective demand through its consequential reduction in real wages and employment (even when measures are not taken to reduce absorption capacity), it may lead to under-utilization of production capacity. This is so unless the reduction in domestic demand is compensated for by export expansion.

The inflationary impact of devaluation, depends, *inter alia*, to a large extent on the import intensity of production of a country, since devaluation inflates the price of imports. The import intensity of production, however, varies substantially among developing countries. According to Table 5, in the early 1890s when reform programmes began in many developing countries, the import GDP ratio varied from 92 in the case of Hong Kong ARC to 5 in the case of Ghana. On average, the import ratio was highest in the highest income group. The lowest income group takes the second position. There are different reasons for the high import dependence of these two groups. Dependence on imports in the case of the higher income category is, to a large extent, due to the larger size of the modern manufacturing sector which is highly import intensive, (i.e. it depends on imported intermediate inputs). Import dependence of the lower income group is to a large extent due to their low capacity for the production of manufactured goods in general, including both finished products and intermediate inputs. Nevertheless, it is more likely that the countries in the lower income group are more subject to the inflationary impact of devaluation than the highest income group because of the rigidity in their supply structure. Thus, devaluation leads mainly to inflation, rather than to the expansion of production. In fact, it has been shown that in a sample of 58 developing countries over the period 1980-1987 a nominal devaluation of 10 per cent has led to a real devaluation of between 5.9 and 3 per cent over a course of three years. Moreover, there was a

negative association between the level of per capita income and the inflationary impact of devaluation in relation to the total rate of inflation (Shafaeddin, 1993). In other words, at a lower level of development, devaluation was found to have been responsible for a higher proportion of domestic inflation. Moreover, it was also shown that within both the highest and lowest income groups, there was an inverse relationship between the availability of imports and the inflationary impact of devaluation. Since most low income countries have suffered more than other developing countries in terms of shortage of foreign exchange, the result is not surprising. Many countries in this group have suffered from stagnant or slow export growth and debt strangulation.

Competitive devaluation

When a developing country devalues it can improve the competitiveness of its exports assuming that there is no change in exchange rates and productivity in other countries. Nevertheless, where a number of developing countries have devalued their currencies repeatedly, the real effective exchange rate of a devaluing developing country may change, due to changes in the exchange rate and prices in other countries. As a result, the change in the effective exchange[xiii] rate of any country depends not only on changes in its exchange rate but also on the changes in the exchange rates of the importing countries and competing exporting countries. Since the direction of trade varies from one country to another, a given rate of devaluation by a number of importing and competing countries affect each country differently.

(b) Activities/industries

Within each country also, the inflationary impact of devaluation varies among various activities and industries mainly because of their different import intensities. The scanty data available on input-output tables of a few developing countries are summarized in Tables 6 and 7. First of all, manufacturing products, particularly when produced for exports, are more import intensive than other products. Secondly, in the demand structure, investment goods are more import intensive than consumer goods, and exports show the highest import intensity. Moreover, within the manufacturing sector, import intensity of various industries is not the same. For example, in the mid-1970s in the case of Thailand, the import coefficient for industrial machinery and textile products was 0.33 and 0.06 respectively, while the average for the manufacturing sector was 0.21.[xiv]

As the directions of trade change among various countries, it also varies among various activities within a country. Hence, both the level and volatility of an effective exchange rate varies from one industry to another, depending not only on the extent and frequency of devaluation by the importing and/or competing countries, but also on the direction of trade for the related industry. In other words, the industry-specific effective exchange rates are different from the overall effective exchange rate of the country concerned (Brodsky and Sampson, 1993). For example, even in the 1970s, when devaluation was less common in developing countries than in the 1980s and 1990s, the industry-specific effective exchange rate of Tunisia varied from 85 in the case of clothing to 207 in the case of crude fertilizer (*ibid.*, 360). Similarly, the instability index varied from 2.09 in the case of cereals, to 2.79 for traded goods and 7.91 for imports of sugar (*ibid.*, 363-64).

Manufactured goods vis-à-vis agricultural products

Devaluation has different impacts on the prices of manufactured goods and primary commodities. At least over a short period of time, devaluation by a single small producer increases the domestic price of commodities leaving their international prices unaffected. Conversely, the immediate effect of devaluation on manufactured products is to leave their domestic prices unchanged but to reduce their prices in terms of foreign currency (i.e. in the international market). This is because in the short-run, international prices of primary commodities are demand-determined, and are not influenced by devaluation by any single country unless it is a large exporter; but their domestic prices are influenced largely by the exchange rate. In contrast to this, domestic prices of manufactured goods are (in the short-run) predominantly cost-determined, and only their prices in terms of foreign currency are influenced by changes in the exchange rate.[xv] Obviously, if a number of exporters of a commodity attempt to devalue their currencies, their export prices in the international market will fall, leading to a subsequent fall in domestic prices, unless the currency is devalued again and again. Such a fallacy of composition and repeated devaluation, led in fact to a fall in the international prices of a number of commodities in the late 1980s, while their domestic prices increased, leading to over supply (See Bhaskar, 1989, Gilbert, 1988; Maizels, 1988, Wattleworth, 1988).

The change in relative prices in favour of agriculture may have a welcome positive effect. It should be added, however, that the impact of devaluation on various agricultural products is not the same. It appears that cash crops benefited more than food production in many developing countries which devalued their currencies and applied other SAP measures (Stewart *et al*., 1992). The reason may be the fact that cash crops are more traded than foods in general, although in many developing countries some important food items are heavily imported.

It should also be noted, that when devaluation is accompanied with such other measures as the removal of price fixing for domestic staple food items, they could contribute positively to their prices at the farm level.

To the extent that devaluation has a contractionary effect on demand, particularly when it is accompanied by budget cuts, reduction in subsidies on consumer items, etc., it will affect aggregate demand adversely. Once again, the demand for various products will not be affected in the same way. Much will depend on the type of income and expenditure which is reduced and the group affected. Since devaluation reduces real wages and expenditure cuts usually affect the low and medium income groups, it is very likely that the demand for wage goods, particularly manufactured products, declines in relation to luxury manufactured items consumed by the well-to-do in the urban areas.

(c) Supply response and the situation of SMEs

The supply response to a devaluation of the effective exchange rate is a firm-level phenomenon. Nevertheless, it depends on the national environment in which it operates, (i.e. the level of development and industrial base of the country, types of activity and the size and experience of the firm). Here again, one should distinguish short-term effects from long-term ones.

The empirical literature on supply response to devaluation is inconclusive, basically because most often distinction is not made between the level of development of the country, heterogeneity of goods and the size of the firm.

Generally speaking, the supply response to devaluation of the effective exchange rate depends on two factors: the response to price signals and changes in the structure of productivity and profitability. Changes in the effective exchange rate represent changes in the relative price of export products in international markets. Nevertheless, the decision to expand output depends also on the changes in profitability of production in general.

Devaluation, at least when accompanied by other measures, may reduce productivity and profitability in the short-run because of its impact both on the supply and demand sides. On the supply side, when devaluation is accompanied with import shortages, input compression, contractionary macroeconomic management and premature removal, or reduction of infant industry protection, it may lead to lower labour productivity. Shortages of imports have been aggravated in many developing countries by import compression, necessitated, among other things, by obligations for debt repayments. Even when availability of foreign exchange was enhanced through SAPs, import compression became often necessary later on at the time of repayment of loans. Many low income countries were in this category. Import compression makes the production of manufactured goods difficult and more costly as a result of their dependence on imported input through its "volume" and price effects. Devaluation in its turn increases the cost of imported inputs, thus the unit

On the demand side, the “contractionary impact” of devaluation, together with “demand management”, tends to reduce aggregate demand in general as mentioned earlier. Removal of tariffs may lower the cost of production, through its impact on the price of imported inputs. Nevertheless, the final output of industries becomes subject to greater competition with imported goods. Such competition may result in a further decline in domestic demand from domestic industries, when the local industry is not mature enough to compete with imports. The resulting decline in demand may, in turn, contribute to the development of or increase in, excess capacity and lower productivity, including labour productivity, particularly where labour cannot be made redundant easily. Low income countries whose infant industries rely more on domestic demand are more seriously affected by such a decline in productivity and resultant increased unit production cost. As a result of such changes in productivity, the devaluation of an exchange rate can be self-defeating.

One may argue that the increase in exports resulting from devaluation may compensate for a reduction in domestic demand. This has in fact been the case in some developing countries which possessed developed industrial bases and a sufficient supply of imports. The immediate effect of devaluation of effective exchange rate (EER) was to increase exports. Nevertheless, in the case of low income countries with small industrial bases the expansion of exports has been limited to a few items mainly precious metals, and simple processed materials with high local contents. Otherwise, the lack of export supply capacity in manufactured goods in low-income countries has prevented export expansion beyond a limit (Lall, 1996). In the case of Latin America also, the available evidence indicates that "exports of more highly developed industrially diversified countries respond more strongly and immediately to exchange-policy" (Maguillansky, 1993, p. 107).

The combination of higher import costs and productivity losses tends to increase the unit costs (both marginal and average) of production. If such cost increases were passed on into prices, they would contribute to offsetting the impact of devaluation on prices, in terms of foreign currency, hindering competition in the international market. If they were not, they would reduce profitability.

Relative prices, and thus relative profitability of manufacturing, may decline yet for another reason. This reason is related to the different impact of devaluation on prices of manufactured goods and primary commodities. As mentioned earlier, at least over a short period of time, devaluation by a single country (small producer) increases the domestic price of commodities leaving their international prices unaffected. By contrast, the immediate effect of devaluation on manufactured products is to leave their domestic prices unchanged but to reduce their prices in terms of foreign currency, (i.e. in the international market).

Within an industry, devaluation of a country's exchange rate may have different inflationary impacts on various firms depending *inter alia* on their size. On the one hand, it can be argued that since SMEs are less import intensive than large ones (Parker *et al*., 1996, p. 19) they would feel the inflationary impact of devaluation less than large ones. SMEs usually are more labour intensive and use local material inputs, whereas large firms are capital intensive and use more imported intermediate inputs. Moreover, when devaluation is accompanied with the removal of restrictions on foreign exchange transactions, it would improve SMEs access to foreign exchange. Furthermore, since SMEs are more flexible than large firms they can adopt their product lines in response to changes in incentives and input costs. Hence, an "exchange rate devaluation hurts large enterprises that depend on imported inputs and should shift production towards small enterprises..." (Parker and *et al*., 1995 p. 19).

On the other hand, SMEs are usually more oriented towards the production of wage goods, whose demand may decline due to the contractionary impact of devaluation, as mentioned earlier. Hence, they may be affected by such a contractionary effect more than large firms. Moreover, one may argue that the assumption of higher flexibility of SMEs is not necessarily realistic. In fact, large firms may possess a higher capacity to adjust and respond to changes in incentives, particularly because of their easier access to financial and foreign exchange resources. For example, even though

SMEs may be less import intensive, they may be more vulnerable to increases in import costs, particularly if they cannot enjoy the advantage of better access to foreign exchange because of other requirements. For example, in Zimbabwe many SMEs were unable to take such an advantage because of their lack of a commercial bank account (Helmsing and Kolstree (1993)). In Senegal, the short-term effect of devaluation on investment by SMEs was negative, as they feared an increase in the cost of their imported inputs. In the long-run also their position vis-à-vis large firms is likely to weaken (Greevey *et al*.). The combination of a rise in imported inputs and a contraction of the internal market, caused to a large extent by devaluation, also had a similar impact on the sales performance of SMEs in Burkina Faso (Camilleri, 1997).

The inferior technological and other capabilities of SMEs may leave them in a disadvantageous position vis-à-vis large firms as far as their response to incentives are concerned. For example, for a given real exchange rate devaluation, supply elasticities, particularly for export products, may be smaller than large firms. Often SMEs lack not only production capabilities but also experience in marketing and selling abroad. The combination of a contractionary impact of devaluation, with lower supply elasticity for export expansion, may affect the productivity and profitability of SMEs adversely in relation to those of large firms, thus reducing their competitive position.

In short, devaluation is supposed to improve the incentive structure in favour of traded goods and to affect various activities/firms uniformly. Nevertheless, it does not affect various countries/activities/firms in the same way. Devaluation of nominal exchange rates cannot be translated easily into real exchange rate changes. In other words, the inflationary impact of devaluation on different countries/activities/firms is not the same. The higher the import intensity of a country/activity/firm, the greater the inflationary impact of devaluation on the cost of production of that country/activity/firm. There is also an inverse association between the level of *per capita* income (development) of a country in which a firm operates, and the inflationary impact of devaluation. Furthermore, within a country, or activity, the impact of devaluation on the effective exchange rate would depend on the direction of trade and the degree of devaluation by competitors and importers. Devaluation often changes the relative profitability of commodities and agricultural products vis-à-vis manufactured goods, but mostly favours cash crops rather than food production. Devaluation, when accompanied by the removal of restrictions on foreign exchange improves the access of SMEs to foreign exchange. Moreover, to the extent that they are less dependent on imports than large firms, it may be to their benefit. Nevertheless, their ability to respond to incentives may be less than that of large firms. The contractionary impact of devaluation, together with demand management may reduce domestic demand for products produced by SMEs. Most often, particularly in low income countries, the export capabilities of SMEs, are limited due to their lack of experience and the lack of supporting services. Hence, export expansion will not necessarily compensate for a reduction in their domestic demand. Most SMEs produce for the domestic market. The net effects of devaluation on the relative position of SMEs, vis-à-vis large firms is undetermined *a priori* requiring field research.

I. The need for changes at the firm level

In the new international contexts of competition and liberalization, firms cannot remain passive. Whatever the impact of macroeconomic reform programmes, there is a need for adaptation to new changes at the firm level. In fact, in many countries, the relative performance of firms depends on the reaction of firms towards liberalization and other reform programmes. For example, in the case of Ghana within SMEs, two broad groups could be distinguished: a minority of "dynamic successful adapters, and [a majority of] stagnant producers which had not adapted" (Steel and Webster, p. 423). The adapters suffered from a lack of finance for working capital and investment. Access to bank loans was more difficult for SMEs than large firms. Yet, to exploit new opportunities in the market, dynamic adapters tried to change their product lines, product mixes and marketing strategies (*ibid*., pp. 431-33).

Some successful firms attempted to react to the new competitive situation by employing new industrial organization techniques adapted to the local situation. For example, a Zimbabwean firm producing agricultural carts introduced changes in factory layout, just in time production and total quality control. The outcome was not only a 35 per cent cost reduction, but also higher quality and more reliable delivery. This is shown in Table 4. These changes in turn made the firm more competitive in international and internal markets.

This introduction of Japanese management techniques into a Brazilian auto component producer resulted in a reduction of the magnitude of 95 per cent for lead time, 77 per cent for distance travelled, and 75 per cent in set-up time. (For more details see Kaplinsky, 1995, Table 5).

Unfortunately, however, such experience is rare in developing countries. In fact, in some countries, even when the government's policy towards the use of these techniques changed, private enterprises did not change their attitudes, to a large extent because they were not aware of the need for a change in the internal strategy of the firms. This is the case, for example, in the Dominican Republic. As a result, the Government attempted, with the help of UNDP, to train managers of enterprises through a pilot project to enhance their awareness of these methods and to teach them their application. The results were satisfactory (Bossat and Kaplinsky, 1995).[xvi]

Another form of organizational change which has been tried with some success is the expansion of inter-firm cooperation through the clustering[xvii] of SMEs. The success of Sinas Valley in Brazil, which consists of a cluster of firms in the leather shoe industry is an example (Schmitz, 1995).[xviii] The case of an industrial district producing medical instruments (in Sialkot in Pakistan) is another example (Nadvi, 1997). Clustering contributes to competitiveness through "passive external economies" and "active joint actions by

SMEs also cooperate through networking and supply contracts. Such cooperation has been constrained however, by "low levels of human resource development, the weakness of the supplier, physical infrastructure and management and industrial relations" (Kaplinsky, 1995, pp. 26-31).

It is suggested that government intervention could facilitate clustering and other forms of inter-firm cooperation effectively through industrial policy by following a "triple C" approach, (i.e. "customer-oriented, collective and cumulative"). Accordingly, this policy should be: "driven by the need to meet the demands of the customer(s)" - including foreign ones; directed at groups of enterprises because it involves lower transaction costs and helps cooperation among SMEs and enhances their mutual learning; and aimed at the development of competitive capacities "cumulatively" over time so that public support gradually becomes unnecessary (Humphrey and Schmitz, 1996).

Drawing lessons from other successful cases of the reorganization of firms, one could also add the need for the training of the managers of firms, to raise their awareness of new forms of competition, the need for the internal reorganization of firms and the application of new methods of production.

Through reorganization and the application of new methods of production, some SMEs have shown the ability to exploit new opportunities provided by globalization and liberalization, while facing their challenges. However, there is not enough evidence. More research is needed on the conditions of success of firms in reacting to globalization and liberalization and the role of the government.

J. Summary

The immediate purpose of this study is to provide an analytical framework of the short and long-term impacts of macroeconomic reform and liberalization (mainly SAPs and SPs) on enterprise development, particularly SMEs, in a globalizing world economy. While aiming to lay a foundation for empirical field studies at the firm level, it also surveys the main research findings on the subject.

It is argued that there is a need for changes in the design of reform programmes. Moreover, to succeed, there is also a need for these reforms to be complemented with reforms at the micro-level for the development of the private sector. It is argued that macro reform programmes affect different countries and activities differently, depending on the environment within which a firm operates. Developing countries differ in terms of degree of general development, experience in industrialization, and knowledge of the functioning of the market and its supporting institutions and infrastructure.

To analyse the impact of macroeconomic reforms on enterprise development it is necessary to refer to conditions for and obstacles to enterprise development, particularly SMEs. It is argued that firms are cultural units for whom growth and development rely on internal factors and on their inter-action with external factors/agents and the environment in which they operate. These factors/agents include markets, the government, other firms, and consumers. Moreover, the environment in which they operate depends, *inter alia*, on structural and institutional factors, which are influenced in turn, by the level of development and industrialization of the country concerned. In this context, while firms may suffer from some common policy-related and structural obstacles to their development in all developing countries, including bias against SMEs, firms and governments in each country may need also to concentrate on country specific issues in their operation and development.

Globalization and liberalization schemes increase the exposure of domestic firms to fierce competition in the internal and international markets. In the new globalizing world economy competition is not confined to cost and prices. The growing size of global firms and their new methods of organization imply that dynamic Schumpeterian competition is becoming increasingly important. In such a process, non-price attributes and the strategic behaviour of firms play an increasing role. Reform programmes have not included elements to enhance the capabilities of firms and countries in this respect, to enable them to face new challenges. Moreover, they have rarely encouraged increasing the production capacity and productivity of firms. In fact, they have had negative influence on investment, and their impact on productivity is questionable, both on theoretical and empirical grounds.

The macro reform programmes implemented in developing countries have not yet targeted enterprises in general. While they have removed some policy biases against SMEs, they have also had negative impacts on SMEs, and their net effects are not *a priori* determined. It should be mentioned however, that a large number of SMEs have disappeared in countries which have been subject to liberalization. Generally, the experience of developing countries in trade liberalization is

mixed, in terms of its impact on industrialization and enterprise development. Some have failed, others have succeeded. Most often, trade liberalization together with devaluation, have led to increased exports in the short-run, but failed to increase the production capacity of the manufacturing sector except for resource-based industries. For countries, or sectors during the early stages of their development, universal and across-the-board liberalization could lead to de-industrialization and the closure of infant firms operating in those countries/sectors. Nevertheless, some targeted liberalization is required in order to provide infant firms with access to imported inputs and to put pressure on more mature firms to improve their efficiency.

Devaluation is supposed to improve the incentive structure in favour of traded goods and to affect various activities/firms uniformly. In fact, it does not affect various countries/activities/firms in the same way. The higher the import intensity of a country/activity/firm, the greater the inflationary impact of devaluation on the cost of production of that country/activity/firm. Moreover, there is an inverse association between the level of *per capita* income of a country, in which a firm operates, and the inflationary impact of devaluation. Furthermore, within a country/activity/firm, the impact of devaluation on the effective exchange rate, would depend, other things being equal, on the direction of trade, and the degree of devaluation of currencies by their competitors and importers. Devaluation often changes the relative profitability of commodities and agricultural products *vis-à-vis* manufactured goods, but mostly favours cash crops rather than food production. Devaluation, when accompanied by the removal of restrictions on foreign exchange improves the access of SMEs to foreign exchange. To the extent that they are less dependent on imports than large firms, it may be to their benefit. Nevertheless, the net effect of devaluation on SMEs is undetermined. Their ability to respond to incentives is less than that of large firms. The contractionary impact of devaluation, together with demand management, may reduce domestic demand for products produced by SMEs, as they are often more oriented toward production for the domestic market than large firms. Most often, particularly in low income countries, the export capabilities of SMEs, are limited, due to their lack of experience and the lack of supporting services. Hence, export expansion may not necessarily compensate for a reduction in the domestic demand for their products.

For macroeconomic reforms to be conducive to the development of enterprises, they should be designed to pay more attention not only to incentives and price signals, but also to non-price factors and attributes, including investment in physical capacity, human resources, and institutions. There is a need to distinguish among countries/sectors the levels of their experience in industrialization and their structural attributes. Within each country there may be a need for selective intervention/liberalization, depending on the stage of development of the industry, and its contribution to industrialization and development. Furthermore, at the firm level, there is a need for policy makers and managers to be aware of the need for the reform of enterprises to enhance their capabilities to participate in new forms of competition in the globalized and liberalized world economy. Complementarity of reforms at the macro- and micro-levels are essential.

Finally, as the net effect of reform programmes and liberalization on the relative position of SMEs is not clear *a priori*, field studies are required to examine the issue at the firm/sectoral levels.

Table 1

Distribution of developing countries according to various indicators
1986[a]

Per capita income		Manufacturing/ GDP		Man.export/total export		Population	
US$	**N°**	**%**	**N°**	**%**	**N°**	**Millions**	**N°**
Greater than 5 000	20	Greater than 25	7	Greater than 50	17	1 000 - 2 000	2
Of which oil exporters	(6)	20 - 25	16	40 - 50	7	100 - 200	4
3 000 - 5 000	11	15 - 20	20	30 - 40	7	50 - 100	6
Of which oil exporters	(3)	11 - 15	20	20 - 30	12	20 - 50	16
2 000 - 3 000	14	6 - 10	51	10 - 20	31	10 - 20	12
1 000 - 2 000	23	1 - 5	26	Less than 10 of which:	34	less than 10 of which:	104
500 - 1 000	25			1 - 5	(15)	5- 10	(27)
300 - 500	20					3 - 5	(12)
200 - 300	17					1 - 3	(22)
Less than 200	15					less than 0.5	(35)
Total	145		141		108		
Developed countries 5 000-1 800	20	21 - 40	20	84			

Source: Developing countries: UNCTAD secretariat; Developed countries: World Development Report, 1988, Appendix tables.

[a] Except for per capita income which is for 1985.

Table 2

Relative productivity gap[a] of Latin America vis-à-vis United States manufacturing activities, 1970, 1980 and 1994

Sector	1970	1980	% change (1980-70)	1994	% change (1994-1970)
Foodstuffs	0.23	0.25	8.7	0.18	-22.0
Traditional industries[b]	0.26	0.42	61.5	0.23	-11.5
Raw material processing industries	0.34	0.39	14.1	0.37	8.8
Metalworking sectors	0.23	0.29	26.1	0.25	8.7
Vehicle industry	0.26	0.23	-11.5	0.22	-15.4

Source: Benavente and Katz (1966), p. 31.

[a] Ratio of labour productivity in Latin America and the United States.

[b] Textiles, garments and leather goods.

Table 3

Profitability and productivity of various firms in Cameroon according to their size (1992)

	Micro (1 - 4)	Small (5 - 29)	Medium (30 - 99)	Large (100 +)
Profit /sale %	11.6	4.7	-1.6	-6.8
Productivity (Sales/labour)	4 350	4 932	15 991	16 810
Sale growth rate % (1987-1992)	16.2	8.4	0.7	-5.1

Source: Gauthier (1996).

Table 4

Results of changes introduced to method of production in a Zimbabwean firm

	Before changes	After changes
1. Labour input per unit	23 hours	13 hours
2. Distance travelled by work in progress	3.2 kms	100 metres
3. Time taken to pass through factory	8 days	80 minutes

Source: Kaplinsky (1994).

Table 5

Import GDP ratio for various groups of developing countries (1980-82)

Per capita Income Level US$	No. of Countries	Average	Maximum	Minimum
Greater than 1 500	15	41	92 Hong Kong, China	9 (Brazil)
1 500 - 800	17	35	69 (Congo)	15 (Colombia)
800 - 400	8	34	79 (Guyana)	5 (Ghana)
Less than 400	18	38	75 (Gambia)	10 (India)

Source: Based on UNCTAD Data Bank.

Table 6

Import coefficient of various activities (%)

Production		Exports		Demand	
Cyprus (1981)		**Sri Lanka (1981)**		**Republic of Korea (1985)**	
Manufacturing	51	Manufacturing[a]	60.5	Consumption	22
Agriculture	21	Garment	(66.5)	Investment	35
Mining	16	Primary products	11.8	Exports	36
Total output	20	Main items	(15.1)		
Exports	40	Total exports	46.5		

Sources: Alhukorala & Bandara (1989), Table 7; Demetriades *et al*. (1988), Table 3; Amsden (1988).

[a] Excluding petroleum products.

Table 7

Import coefficient of industrial sectors[a] for some Latin American countries (1974-1994) [b]

	Year	Sector	Year	Sector	Year	Sector
Country	**1974**		**1990**		**1994**	
Argentina:						
Total	7.2		4.1		16.6 [b]	
Maximum	26.7	IV	13.7	I	48.9	I
Minimum	2.7	V	0.2	III	2.8	III
Brazil:						
Total	13.1		6.7		11.5	
Maximum	27.3	IV	17	I	22.6	I
Minimum	2.3	III	2.8	V	5.2	V
Chile:						
Total	48.3		54.4		60.4	
Maximum	119.9	I	239.2	I	233.2	
Minimum	15.8	V	5.6	III	7 .4	III
Colombia:						
Total	20.9		23.9		35.9	
Maximum	59.9	I	97.9	I	113.4	I
Minimum	3.4	III	2.2	III	2.2	III
Peru:						
Total	15.8		10.3		19.9	
Maximum	93.3	I	95.9	I	216.1	I
Minimum	3.6	V	2.3	V	6.1	III

Source: Based on Benavente *et al*. (1996), Table 8.

[a] Sectors I: metal work; II: transport equipment; III: food, beverage, tobacco; IV: raw material processing; V: traditional industries.

[b] Includes capital goods.

Table A 1

GDP *per capita*, MVA/GD *per capita* and the share of exports of manufactured goods to total exports (1986)

Country/Group	GDP per capita (in US$)	MVA/GDP[a] (%)	Export of manufacturing/ Total exports(%)
GROUP I			
Africa			
Mozambique	149	0.2	
Malawi	170	12.8	5
Burkina Faso	174	14.0[a]	n.a.
Mali	185	6.0	n.a.
Republic of Tanzania	193	6.6	8
Uganda	220	4.0	5
Zambia	241	19.7	5
Madagascar	259	13.7	8
Rwanda	297	17.1	n.a
Kenya	333	12.3	12
Nigeria	389	3.2	2
Ghana	407	6.7	5
Congo	1 196	9.0	9
Asia			
Nepal	150	4.0	7
Bangladesh	153	9.3	66
Latin America and the Caribbean			
Haiti	330	17[b, c]	n.a.
GROUP II			
Africa			
Senegal	567	n.a.	10
Zimbabwe	588	27	23
Morocco	657	15.6	40
Botswana	840	6[c]	n.a.
Côte d'Ivoire	920	9.9	12
Tunisia	1 222	14.2	60
Cameroon	1 238	18.7	9
Mauritius	1 355	16.6	19
Asia			
India	284	18.7	57
Pakistan	309	16.4	66
Sri Lanka	389	18.1	44
Indonesia	442	14.0	18
Philippines	551	23.3	30
Thailand	799	20.3	44
Turkey	1 157	26.5	59

Table A 1 (continued)

Country/Group	GDP per capita (in US$)	MVA/GDP[a] (%)	Export of manufacturing/ Total exports (%)
Latin America and the Caribbean			
Bolivia	836	10.3	n.a
Ecuador	1 165	16.5	1
Jamaica	1 024	20.0	32
Colombia	1 176	22.4	15
Peru	1 254	19.3	15
Chile	1 381	20.7	18
Mexico	1 570	21.0	45
Brazil	2 023	25.9	46
Uruguay	2 166	24.0	35
Argentina	2 540	24.7	26
Venezuela	2 797	18.4	5
Trinidad and Tobago	4 280	12.5	25
GROUP III			
Malaysia			
Republic of Korea	1 733	22.0	16
Hong Kong, China	2 342	32.2	92
Singapore	6 127	18.9	53
Taiwan Province of China	6 773	24.8	59

Source: UNCTAD database.

[a] at constant 1980 prices.

[b] 1985.

[c] current prices.

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Notes

[i] Moral hazard implies that firms take excessive risks assuming that they will be bailed out if an unfavourable situation arises.

[ii] The following pages are based on Shafaeddin (1998).

[iii] The disbursed amount was less; for example, in 1992, it was US$ 40 million, as against the proposed amount of US$ 163 million.

[iv] Change in total factor productivity (TFP) is defined as changes in output not attributable to changes in inputs. Labour productivity is the value of output per unit of labour.

[v] It is interesting to note that a study undertaken by the World Bank also concluded that "stable, predictable correlation have not emerged" between productivity and trade (Tybout, 1991, p. 51)

[vi] It should be noted that the firms concerned operated on industrial premises of Kenya Industrial Estates, and were favoured by government authorities vis-à-vis other SMEs.

[vii] The smaller a firm the larger the transaction cost in relation to total loans. Moreover, the cost may vary depending on the source of finance. For example, in the case of the Philippines, they varied from 6.1 per cent of loans granted in the case of private banks to 37.1 and 47.1 per cent in the case of credit cooperatives and certain type of NGOs (McGuire and Conroy, 1997).

[viii] Privileged firms are those which benefited from governmental fiscal and investment schemes.

[ix] See Section G for more details.

[x] Some economists measure the degree of changes in domestic prices in relation to international prices as a measure of liberalization.

[xi] According to the infant industry argument, developed by F. List (1856), universal free trade is an end and infant industry protection is a means. The need for protection arises because countries are at different levels of industrialization. If all countries were at the same stage there would not be a need for infant industry support. Nevertheless, List regarded protection as a temporary policy. Protection should be applied only to the infant industries; as the industry matures over time protection should be gradually removed. While the proponents of the theory of universal free trade are interested in maximizing global welfare, he gave more weight to "national" interests (*ibid*., 9.74).

List provided a number of justifications for his argument. First, industrialization will not take place according "to natural cause of things", (i.e. through market forces) (*ibid.*, p. 378). Second, establishing a new industry involves greater risk, so new entrants should be given extra incentive, otherwise faced with external competition their industries would be ruined. Third, attaining experience, training, knowledge and relations among industries are gained through infant industry protection. In modern language externalities are important.

On modalities of trade, he argues that commercial policy is only one element of industrial policy and development policy. Moreover, since different industries require different knowledge, experience, linkages, and externalities, protection should be selective. Furthermore, protection should not be excessive and the protected industries should not be left in the hands of monopolists.

Domestic competition should be encouraged after an initial period. In determining the level of protection, social conditions should be taken into account but raw materials should be exempted from import duties (*ibid.*, p. 188). Progress and development ultimately leads to universal association. Nevertheless, when some nations are at lower levels of development than others, universal association is not achieved by free trade unless it is preceded by protection by countries which are at early stages of industrialization (*ibid.*, p. 71).

[xii] In mathematical terms: $EP = \dfrac{Ej - {}^{a}ij^{ti}}{1 - a_{ij}}$

Where: Ep = effective rate of protection
t_j = tariff rate on output of j
t_i = tariff rate on input
a_{ij} = import intensity (import coefficient) of output

[xiii] Effective exchange rate is defined as "average movement of any one currency in terms of a number of other currencies - generally the currencies of the major trading partners weighted according to their importance in the country's value of total trade (Bronsky and Sampson, 1993, p. 349).

[xiv] UNIDO (1985).

[xv] It should be mentioned, however, that when a country produces standard manufactured goods, e.g. ordinary textiles, the product may also behave the same way as a primary commodity.

[xvi] Such training was undertaken by a consultancy firm in Zimbabwe at a higher cost (*ibid*, p.140).

[xvii] Sectoral and geographical concentration of enterprises. Clusters consist mainly of SMEs; nevertheless large firms are also found in industrial districts.

[xviii] For a short survey see Humphrey and Schmitz (1996).

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